# Fiscal Note

**BILL #** SB 1721

**TITLE:** TPT; prime contracting classification

**SPONSOR:** Fann

**STATUS:** As Introduced

**PREPARED BY:** Hans Olofsson

**Description**

SB 1721, as introduced, would change the taxation of certain construction activities. Under current law, gross proceeds from activities that are limited to contracts for the "maintenance, repair, replacement or alteration" (MRRA) of existing property with the owners of real property are exempt from the prime contracting tax. Materials purchased to be incorporated into MRRA contracts are taxed under the retail classification of the Transaction Privilege Tax (TPT).

The bill would make the several changes to current statutes, including:

- Eliminating MRRA.
- Exempting residential construction projects of up to $100,000 from the prime contracting tax.
- Exempting non-residential construction projects of up to $1 million from the prime contracting tax.
- Exempting the construction of electricity generating facilities or renewable energy systems installed on commercial, residential, or governmental property from the prime contracting tax.
- Applying the proposed $100,000/$1 million exemption thresholds to contracts involving surface or subsurface work (commonly referred to as "heavy construction"). Under current law, surface/subsurface work is subject to the prime contracting tax regardless of the dollar value of the contract.

Materials used in contracts exempted from the prime contracting tax under the bill would be subject to retail TPT instead. The changes under the bill would apply to contracts entered into after June 30, 2021.

**Estimated Impact**

The bill is likely to result in a General Fund revenue loss. However, at the current time, there is insufficient information to determine the magnitude of such loss. We believe that there would be 3 types of revenue loss associated with the state retaining a smaller share of retail than prime contracting taxes:

1. For commercial (non-residential) projects, the exemption limit under the bill is raised from $750,000 to $1 million, which would result in some contracts (those between $750,000 and $1 million) being taxed under retail TPT that otherwise would have been taxed under prime contracting.
2. Utilities would pay retail TPT under the bill but prime contracting under current law regardless of the new exemption limits. (If a project meets the definition of MRRA under current law, the utility pays retail TPT.)
3. Surface/Subsurface projects would move from prime contracting to retail if the cost of such contract is $100,000 or less for residential projects and $1 million or less for non-residential projects.

For this analysis, we contacted the Department of Revenue, the League of Arizona Cities and Towns, and a representative of the Arizona Builders Alliance. However, they were not able to provide data that would help us to estimate the magnitude of the bill's fiscal impact.

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**Analysis**

Change to Residential Contracts
Under current law, activities are considered nontaxable MRRA if the contract amount for existing residential properties is 25% or less of the property's full cash value. Under such contracts, materials are taxed under retail TPT. Activities that exceed this threshold are considered taxable "modification" projects and they are subject to prime contracting TPT.

As noted above, the prime contracting exemption threshold would change to $100,000 for residential properties. As a result of this change under the bill, some activities that currently fall under MRRA would become "modification" projects or the other way around. Depending on the specifics of a contract, the bill could result in either a General Fund revenue gain or loss. To illustrate this point, we have constructed 2 hypothetical examples.

*Example 1 - $60,000 Kitchen and Bathroom Remodeling of Home*
In the first example, a home with a full cash value of $225,000 has both its kitchen and 2 bathrooms remodeled at a total cost of $60,000. We have further assumed that 40% of the contract cost is for materials [= $24,000] and the remaining 60% for labor [= $36,000].

Under current law, this remodeling project would be considered "modification" since the contract amount of $60,000 is 27% of the home's full cash value. For this reason, this amount would be subject to the prime contracting tax.

Current law provides a 35% deduction on the contract amount, which means that the tax base is reduced by $(21,000) to $39,000. At the state tax rate of 5%, this contract would generate prime contracting tax revenue of $1,950, of which $1,695 would be distributed to the General Fund.

Under the bill, this remodeling contract would be exempt from the prime contracting tax and instead the materials would be taxed under retail TPT. At the state tax rate of 5%, this would generate retail tax revenue of $1,200 [= $24,000 x 5%] of which $886 would be distributed to the General Fund. (Note that the General Fund retains 86.9% of state contracting TPT compared to 73.8% of state retail TPT.)

In this first example, the General Fund would incur a revenue loss of $(809) [=$886 - $1,695] under the bill.

*Example 2 - $120,000 Addition to Home*
In the second example, a home with a full cash value of $725,000 has a room and an additional garage added to its structure at a total cost of $120,000. As in the prior example, we have assumed that 40% of the contract cost is for materials [= $48,000] and the remaining 60% for labor [= $72,000].

Under current law, the project in this example would be considered MRRA since the contract amount of $120,000 is 17% of the home's full cash value. For this reason, only the materials used in this building project would be subject to tax under the retail classification of TPT. At the state tax rate of 5%, this would generate retail tax revenue of $2,400 [= $48,000 x 5%] of which $1,771 would be distributed to the General Fund.

Since the cost of the contract would exceed $100,000, this activity would be considered "modification" under the bill. For this reason, the $120,000 contract amount would be subject to the prime contracting tax. Taxable gross proceeds after the 35% deduction is $78,000 [= $120,000 - $42,000]. At the state tax rate of 5%, this contract would generate prime contracting tax revenue of $3,900, of which $3,389 would be distributed to the General Fund. In this second example, the General Fund would have a revenue gain of $1,618 [=$3,389 - $1,771] under the bill.

The 2 examples above demonstrate that the fiscal impact cannot be determined without examining each residential contract affected by the proposed legislation. However, at the current time, detailed contracting data is not available to the JLBC Staff.

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Change to Non-Residential Contracts
Under current law, activities are considered nontaxable MRRA if the contract amount for existing non-residential properties is $750,000 or less. Under such contracts, materials are taxed under retail TPT. Activities that exceed this threshold are considered taxable "modification" projects and they are subject to prime contracting TPT.

Under the bill, the prime contracting exemption for non-residential projects would increase from $750,000 to $1 million. As a result of this change, contracts between $750,000 and $1 million would be exempt from prime contracting under the bill whereas they would be subject to the contracting tax under current law. Since the General Fund retains a smaller share of retail TPT than prime contracting TPT, there would be some revenue loss for contracts in the $750,000 to $1 million range.

Construction of Electricity Generating Facilities and Installation of Renewable Energy Systems
Under the bill, a contract involving the "construction of any electricity generating facility or system, including renewable energy systems installed on commercial, residential, or governmental property, and including the maintenance, repair, replacement or alteration" of an existing facility or system would be exempt from the prime contracting tax. Materials used in such contracts would be subject to retail TPT.

The bill would apply to contracts entered into after June 30, 2021. Therefore, any construction of an electricity generating facility or installation of a renewable energy system on commercial, residential, or governmental property for which a contract was entered into after this date would be exempt from the prime contracting tax. Instead, regardless of the dollar value of the contract, retail TPT would be imposed on the materials used. As an example, this provision would apply to the construction of a new power plant as well as the installation of solar panels on commercial, residential or governmental buildings.

At the current time, the JLBC Staff does not have the required data to estimate the impact of this new, proposed prime contracting tax exemption. However, in general terms, the General Fund impact would depend on the extent to which the cost of such contract is attributable to labor as opposed to materials. As noted above, under current statute, the General Fund retains 86.9% of state TPT under the prime contracting tax compared to 73.8% under retail TPT. Moreover, the prime contracting tax is applied to 65% of the contract cost. This means that the "effective" General Fund distribution rate from the prime contracting tax is 56.5% [= 86.9% x 65%] of the contract. Therefore, as a general rule, under the bill, the General Fund will receive a smaller distribution of state sales tax revenue whenever materials make up less than 76.6% of the contract's value [ 73.8% x 76.6% = 56.5%].

According to data provided by the federal Energy Information Administration (EIA), the average construction cost for a power plant varies between a low of $687 per kilowatt (KW) to a high of $1,848 per KW depending on the type of energy (i.e., natural gas, wind, solar, or battery storage) used to generate electricity. The total construction cost depends on other factors, including the generating capacity or size of the power plant. In theory, to estimate the fiscal impact of this provision, we would need detailed data (such as the cost for labor and materials) on contracts entered into after June 30, 2021. However, since such data is not currently available, we are not able to produce such estimates.

Surface/Subsurface Contracts
Under current law, contracts that primarily involve surface or subsurface improvements to land ("heavy construction" such as paving a new road or adding a freeway lane) are subject to the prime contracting tax. Under the bill, surface/subsurface contracts below $100,000 for residential projects and $1 million for non-residential projects would be exempt from the prime contracting tax and instead the materials used in such contracts would be taxed under retail TPT.

At the current time, we do not have access to detailed surface/subsurface contract data. However, since most heavy construction projects tend to be large (often with construction costs in the millions of dollars), we believe that the impact of this exemption in the bill would be relatively limited.

**Local Government Impact**

For the same reason as outlined above, we cannot determine the local government impact of the bill.

2/26/21