



This Week in State Tax (TWIST)

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Arizona: State high court holds linen processing qualifies for TPT exemption

The Supreme Court of Arizona recently held that a taxpayer's machinery and equipment used in sanitizing healthcare textiles is exempt from Arizona use tax. The taxpayer rented reusable healthcare textiles to hospitals, outpatient facilities, and long-term care centers within Arizona. As part of its operations, the taxpayer collected, cleaned, and disinfected the textiles for reuse by its customers. From 2014 to 2018, the taxpayer purchased equipment to be used in the disinfecting process and remitted use tax to Arizona and the City of Phoenix on the purchases. The taxpayer later filed a refund claim on the grounds that such equipment qualified as machinery and equipment used directly in manufacturing or processing operations, and as such was exempt under state law. The Department of Revenue denied the refund claim; the Arizona Tax Court and the Court of Appeals affirmed the denial on appeal, and the taxpayer sought review by the state supreme court.

In its analysis, the supreme court focused on the meaning of "processing operations," which was not a defined term in the exemption statute. The court synthesized various dictionary definitions and Arizona case law into a single operative definition: a "processing operation" is a "series of integrated actions or methods that prepares a product for the market or converts a product into marketable form." In addition, only machinery or equipment that touches, manipulates, affects, or adds value to a product will qualify for the exemption. Applying this framework to the taxpayer's operations, the court found that the taxpayer's textile laundering and disinfecting process involved a series of actions that transformed the healthcare textiles into a marketable form. The textiles were not marketable for their intended use prior to the taxpayer's operations (*i.e.*, the cleaning and sanitizing), and the court disregarded whether the textiles acquired by the taxpayer could have been marketable for some other purpose prior to the taxpayer processing them to be used in the healthcare field. Therefore, the taxpayer's machinery and equipment that touched, affected, or added value to the textiles qualified for the exemption.

The court also addressed two other issues: (a) whether the taxpayer's "downstream transactions", *i.e.*, whether a taxpayer rents or sells a product were important to the analysis; and (b) whether the activities of the business as a whole must be viewed in determining eligibility for the exemption. The court held the determination of whether a taxpayer is eligible for the "processing operation" use tax exemption is based solely on "distinct operations within the entire business," such as the taxpayer's sanitization process, and does not require that taxpayers sell products instead of leasing them, only that they be made marketable. Please contact [Eric Gee](#) and [Brian Phillips](#) with questions about [9W Halo Opco LP v. Arizona Department of Revenue](#).

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