

**ARE CONSTRUCTION MANAGERS TAXABLE?
THE BOARD OF APPEALS SAYS NO,
BUT THE TAX COURT SAYS YES**

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The “True” Construction Manager Is Not Taxable As A Prime Contractor.

Arizona imposes a sales tax on “prime contractors, ” contractors that supervise, coordinate and control the construction of a project. But how are construction managers taxed? A construction manager that contracts directly with the owner to provide, for a fee, assistances with design, engineering, bid specifications and the selection of a prime contractor, and does not engage (contract with or pay) subcontractors to perform construction services, should not fall within the definition of “prime contractor” and should not be subject to the Arizona sales tax on his receipts.

However, if a construction manger steps “over the line” and begins to act as a “prime contractor” (by supervising, coordinating or controlling the construction project, or by contracting with or paying subcontractors), the Department may view the construction managers as taxable “prime contractors.” The following guidelines should be followed in establishing a construction manager situation:

1. The construction manager must not supervise, coordinate or control the construction work or deal with the subcontractors; the owner or the owner’s representative should have all contact with subcontractors--supervision, working out scheduling problems, dealing with faulty work, etc.;
2. The construction manager must not enter into the contracts with the subcontractors (the owner should be the contracting party); and
3. The construction manager must not pay the subcontractors (the owner should make those payments).

UNLESS, an agency relationship is created.

In some situations, the construction manager may also act as the “agent” of the owner (or “owner’s representative”) in dealing with the various subcontractors. This would include entering into contracts with the various subcontractors, but in an agency capacity for the owner, with the contracts being signed by the construction manager as the “owner’ representative” or “agent.” The construction manager, as the agent for the owner, may also pay the subcontractors from the funds received from the owner.

The construction manager, acting again as the agent of the owner, may also supervise and coordinate the actual construction work.

The Arizona Board of Tax Appeals, in a number of cases, has held that a person (corporation, partnership, etc.) that has acted as the “agent” of the owner in dealing with the various contractors performing the actual construction work for the owner’s project is not taxable as a “prime contractor,” even though the person may be supervising the “subcontractors” and coordinating the construction activity. These cases also cover situations where the person has entered into the contracts with the various contractors (Trade Contractors and specialty contractors), but has entered into those contracts and

signed them as the “agent” of the owner or the “owner’s representative.” In these agency situations, the Board has concluded that the various contractors are the taxable prime contractors, and not the agent. A summary of those cases follows:

(1) *Mackey Plumbing Co. v. Dep’t of Revenue*, Arizona Board of Tax Appeals No. 752-90-S (July 30, 1991). Frito-Lay, an owner-builder, hired Kaiser as its agent. Mackey Plumbing asserted that Kaiser was the prime contractor and, as such, was subject to taxation. The Board rejected Mackey Plumbing’s argument, holding that Kaiser was both formally and operationally an agent, and therefore not taxable.

First, Kaiser is merely an agent for Frito-Lay. The general conditions of the contract between appellant and Frito-Lay stipulate that Kaiser is a representative of Frito-Lay, i.e., an agent to a principal, and that appellant is considered a prime contractor for all purposes. Such was the relationship not only in form, but in substance as well. A name on a bank account or overseeing construction is not dispositive of the prime contractor issue. Kaiser’s conduct throughout the contract period was subject to Frito-Lay’s benefit, thereby making Kaiser an agent ... Indeed, Frito-Lay often dictated to Kaiser exactly how the project was to proceed as evidenced by field transmittal memoranda.

(2) *Jerry’s Plumbing v. Dep’t of Revenue*, Arizona Board of Tax Appeals, No. 473-86-S (June 20, 1989). This decision affirmed that agents of owner-builders are not taxable.

As pointed out by the Department at the hearing, this Board has previously ruled that an agent of an owner-builder is not taxable. *Mountain View Dev. Co. v. Dep’t of Revenue*, Arizona Board of Tax Appeals, No. 442-86-S, slip op. at 4 (Jan. 14, 1987). This ruling was based upon established law that an agent is not responsible for the tax liability of his principal. *State Tax Comm’n v. Martin*, 57 Ariz. 283, 293, 113 P.2d 640, 643 (1941).

(3) *Mountain View Dev. Co. v. Dep’t of Revenue*, Arizona Board of Tax Appeals, No. 442-86-S (Jan. 14, 1987) (“Appellant has demonstrated itself to be *an agent* of its general partners *with regard to Joint Venture No. 5*” and therefore “the assessment of tax made by the department is valid *with the exception of tax attributable to Joint Venture No. 5*”) (emphasis added).

(4) *Ormond Builders, Inc. v. Dep’t of Revenue*, Arizona Board of Tax Appeals, Docket No. 1883-02-S (May 15, 2003). Ormond Builders entered into Construction Manager Agreements with a governmental owner. The Construction Manager’s services were described as “review, advice, assistance, recommendation and administration.” The contract specifically identified the construction manager as owner’s agent. The trade contractors were responsible to the owner for completion of the contracts and payment was made by the Construction Manager “on behalf of the owner.”

The Board held that the Construction Manager was just another subcontractor who owed tax only on its portion of the contract, not the entire project cost.

In this type of situation, where the construction manager has also acted as the agent of the owner or the owner's representative in dealing with the various trade contractors involved in the construction of the owner's project, under the Board of Tax Appeals "agency" line of cases, the construction manager, even though it has supervised, coordinated or controlled the construction work and entered into contracts with the trade contractors, undertook those activities as the agent of the owner and would still meet the three guidelines listed above for being a nontaxable construction manager.

The *Ormond* case has now made its way through trial before the Arizona Tax Court and is on appeal to the Arizona Court of Appeals. The Tax Court found that even though Ormond was identified as the agent of the owner and the Trade Contractors were contractually obligated to pay the tax, Ormond was liable for the amounts of payments made to the Trade Contractors under both the state's prime contracting classification and the model city tax code. The Court held that all of the costs of work were gross receipts from prime contracting. The Court rejected all of the agency analyses set forth in the Board decisions cited above. This case is not yet completely through the Tax Court proceedings.

The Tax Court has also held that another construction manager is liable for tax on the total cost of construction under the Model City Tax Code, even where the construction manager never even served as a pass through for payment. The Court held that the construction manager "executed control over and monitored the development of the project." The Court relied on the Standard AIA Contract language that made the construction manager responsible for consultation, scheduling, budgeting, coordinating, planning, inspecting Trade Contractor work, etc. The Court included the entire cost of construction in the gross receipts because the form contract said the Owner would pay the construction manager for the cost of the work. In fact, all checks for payments to Trade Contractors were made by the owner, payable to the Trade Contractor. Nevertheless, the Court imputed the amount of those payments to the construction manager as income. This is an unpublished decision on appeal to the Arizona Court of Appeals.