

**DESIGN AND ENGINEERING
FEES AFTER SENATE BILL 1293:**

Welcome Legislative Relief From The Auditor

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A. *Legislation Clarifies that Architectural Fees are not Subject to the Arizona Transaction Privilege Tax Even When Undertaken by a Contractor*

On June 1, 2004, Senate Bill 1293 was signed into law, bringing resolution to a long-standing dispute between the Arizona Department of Revenue and industry groups regarding the scope of the contracting classification under the Arizona transaction privilege tax and the proper tax treatment of design-build contracts. Senate Bill 1293 clarifies that the portion of gross proceeds attributable to the direct costs of providing architectural or engineering services that are incorporated into a contract are not subject to the Arizona transaction privilege tax under the prime contracting classification. Copies of S.B. 1293 and the Senate Fact Sheet are attached hereto.

B. *Dispute Revolves Around Proper Tax Treatment Of Design-Build Contracts.*

A typical design-build project involves a single contract that is broken down into two constituent parts: one part for design services and another for general contracting services. The contract typically lists the design services and construction services separately and sets a price for each. The contract obligates the contractor to provide both services, but the contractor will often work with outside architects and engineers on the design phase. The design-build delivery system is a growing trend in the construction industry because it enables the owner to deal with only one party, keep a closer eye on overall costs, and streamline the billing process.

There is no dispute that design fees (architectural and engineering fees) are not taxable if an owner contracts directly with an architect or engineer. However, the Department of Revenue, in recent audits, has taken the position that contractors are subject to transaction privilege tax under the contracting classification for architectural and engineering service fees, even if these fees are separately invoiced. The Department considers the design services to be “incidental” to the contractor’s taxable business. The Department also considers the amount of design fees in a typical design-build contract to be “insignificant” compared to the overall contract amount.

Industry groups disagreed with this position, based on several early cases in which Arizona courts ruled that otherwise nontaxable revenue does not become taxable merely because the seller also engages in a taxable business activity.

C. *Early Arizona Cases Held That Design Fees Were Not Subject To Tax, Even If Included In A Single Contract With The Taxable Construction Services.*

In *Ebasco Services Inc. v. Arizona State Tax Comm’n*, 105 Ariz. 94, 98, 459 P.2d 719, 723 (1969), the Arizona Supreme Court addressed the issue of design revenue received by a contractor, and concluded that such revenue was not subject to tax under the contracting classification, saying “It is obvious that engineering and design does not fall within any of the statutory categories which would ordinarily identify one as a contractor or builder.” 105 Ariz. at 98, 459 P.2d at 723. In its opinion, the Court ruled that “We do not believe that this statute goes so far as to tax all activities of a corporation based on the fact that one of the activities engaged in is that of contracting.” *Id.*

In *State Tax Comm'n v. Holmes & Narver, Inc.*, 113 Ariz. 165, 548 P.2d 1162, (In Banc, 1976), the Arizona Supreme Court was again faced with this issue, though this time the parties had included the design services in the same contract as the contracting services. The Tax Commission (the Department of Revenue's predecessor) argued that *Ebasco* did not apply because *Holmes & Narver* involved a single contract that did not separately price the design and engineering services. 113 Ariz. at 168, 548 P.2d at 1165. The Commission further argued that the taxpayer's design and engineering services in *Holmes & Narver* "were so interwoven into the operation of the construction business that they are an essential part of that business and cannot appropriately be regarded as non-taxable on the ground that these particular services constitute a separate business." 113 Ariz. 167, 548 P.2d 1164.

The court concluded that, even under the facts present in *Holmes & Narver*, where the design services and construction services are wrapped into a single contract that does not separately price its constituent parts, the professional services will not merge for tax purposes into the taxable contracting activity if (1) it can be readily ascertained without substantial difficulty which portion of the business is for non-taxable professional services (design and engineering), (2) the amounts in relation to the company's total taxable Arizona business are not inconsequential, and (3) those services cannot be said to be incidental to the contracting business.

In its conclusion, the court reinforced its prior decision in *Ebasco*, stating "In *Ebasco* and here we merely conclude that design and engineering services are not contracting which is the business which is the subject of the tax." The court went on to note that "The Legislature has not said that all business is the subject of the transaction privilege tax, only those businesses specifically set forth in the statute." 113 Ariz. at 169, 548 P.2d at 1166.

Three years after *Holmes & Narver*, the Arizona Court of Appeals again rejected the Department's attempt to tax otherwise nontaxable revenue merely because it was earned by a taxpayer engaged in contracting activities. In *Dennis Development Co. v. Dep't of Revenue*, 122 Ariz. 465, 595 P.2d 1010 (App. 1979), the Department argued that proceeds from real property sold by a homebuilder were "gross receipts of a taxpayer" derived from the contracting business. In rejecting the Department's position, the court stated "we see nothing in the taxing statutes which would impose a tax on a seller of real property merely because the seller is also in the business of contracting." (This particular situation was subsequently addressed by the legislature in the form of a contracting tax deduction for the fair market value of land.)

D. *The Department's Audit Position, Based On Recent Court Of Appeals Decisions Interpreting Holmes & Narver, Runs Contrary To Ebasco.*

In several recent cases, the Department and local tax authorities have been successful in applying the *Holmes & Narver* three-prong test to other tax classifications. For example, in *Walden Books v. Dep't of Revenue*, 198 Ariz. 584, 12 P.3d 809 (App. 2000), the Arizona Court of Appeals accepted the Department's position that fees from a membership discount program were taxable under the retail sales classification because (1) the fees from the discount program could not be readily ascertained and would largely be speculative, (2) the total membership fees amounted to only about one percent of the company's total Arizona sales for the audit period, and (3) "the discount component of the Program was functionless standing alone." 198 Ariz. at 588, 12 P.3d at 813.

In *City of Phoenix v. Arizona Rent-a-Car*, 182 Ariz. 75, 893 P.2d 75 (App. 1995), the court applied the *Holmes & Narver* test and concluded that refueling charges received by a rental car company were taxable under the personal property rental classification “because every Budget car rental contract includes a refueling charge, the charge is an integral part of Budget’s car rental business” and the refueling charge amounted to a “minimal percentage” (2 percent) of Budget’s “audit-period gross income.” 182 Ariz. at 78-79, 893 P.2d at 78-79.

The Department relied on *Waldenbooks* and *Arizona Rent-a-Car* in taking the audit position that design fees are taxable when paid as part of a design-build contract. The problem with this position is that *Waldenbooks* and *Arizona Rent-A-Car* dealt with different tax classification and very different facts than the typical design-build project. More importantly, the Arizona Supreme Court already considered the issue of design fee revenue in *Ebasco* and *Holmes & Narver*, and in both cases rejected the Department’s attempt to expand the contracting classification to include design service fees.

E. *Senate Bill 1293 Was Introduced To Resolve The Dispute Regarding The Proper Tax Treatment Of Design-Build Contracts.*

The taxpayers that were audited by the Department challenged the Department’s attempt to tax design fees, and were poised to once again seek relief from Arizona’s high court, if necessary. At the same time, industry groups approached the Arizona legislature proposing legislation to clarify that design and engineering fees do not fall under the contracting classification, even if included in a single contract with construction services. Following a series of meetings involving legislators, industry groups, the affected taxpayers, and the Department of Revenue, and hearings before committees of the Arizona Senate and House of Representatives, S.B. 1293 was finalized and passed by both houses. A copy of the final House Engrossed Senate Bill, which was signed into law by the Governor, is included with this Tax Alert.

Senate Bill 1293 adds a new Section J to Section 42-5075 of the Arizona Revised Statutes (the contracting classification), which states:

The portion of gross proceeds of sales or gross income attributable to the actual direct costs of providing architectural or engineering services that are incorporated in a contract are not subject to tax under this section.

The statute defines “direct costs” as follows:

For the purposes of this subsection, "direct costs" means the portion of the actual costs that are directly expended in providing architectural or engineering services.

F. *Senate Bill 1293 Is Not Restricted To Contracts Labeled “Design-Build.” Only Direct Costs Are Excluded From The Tax.*

Although the legislation was introduced to resolve the dispute over the proper tax treatment of design-build contracts, the law is not limited to contracts that are labeled “design-build” (such as the AIA Standard Form of Agreement Between Owner and Design/Builder), but applies to any contract which incorporates architectural or engineering services. At the same

time, the exclusion only applies to the gross proceeds attributable to the actual direct costs of providing architectural or engineering services, “direct costs” being the costs directly expended in providing the architectural or engineering services. For example, if a contractor hires an outside architect to provide design services, the “direct costs” will be the actual amount of the architect’s invoices. If the contractor charges the owner a markup, that additional amount will be subject to the transaction privilege tax as part of the contractor’s taxable contracting receipts. On the other hand, if the contractor performs the design services using in-house architects and other professionals, then the direct costs (the nontaxable design costs) will be the direct labor costs involved in providing such services (compensation paid to the design professionals). The contractor may not make an allocation of overhead expenses or otherwise exclude indirect costs associated with providing the design services.

G. *Senate Bill 1293 Is Retroactive To The Date Of The Ebasco Decision; Refund Claims Are Limited.*

The statutory amendments made by Senate Bill 1293 are retroactive to October 17, 1969, the date of the Arizona Supreme Court’s decision in *Ebasco*. Accordingly, the Department could not treat the legislation as a change in law and attempt to impose taxes on design fee revenue received by taxpayers prior to the legislation’s enactment into law. At the same time, taxpayers who collected and paid taxes on the direct costs of providing design services are eligible for a refund of those taxes, subject to fairly stringent limitations imposed by S.B. 1293.

Any claim for refund based on the retroactive application of S.B. 1293 must be submitted to the Department of Revenue on or before December 31, 2004, pursuant to the requirements of Arizona statute (A.R.S. § 42-1118). A failure to file a claim on or before December 31, 2004 constitutes a waiver of the claim for refund under Section 42-5075. Additionally, any taxpayer claiming a refund has the burden to establish by competent evidence the amount of tax paid for all taxable periods and the amount, if any, attributable to gross proceeds of sales or gross income attributable to architectural or engineering services incorporated into the contract.

After December 31, 2004, the Department of Revenue is required to: (1) review all timely filed claims; (2) determine, on audit if necessary, the correct amount of each claim; (3) notify the taxpayer of the Department’s determination; and (4) if the aggregate amount of all refund claims based on S.B. 1293 exceed one hundred thousand dollars, reduce each claim proportionately so that the total refund amount equals one hundred thousand dollars. Interest shall not be allowed or compounded on any refundable amount if paid before July 1, 2005, but if the amount cannot be determined or paid until after June 30, 2005, interest will accrue thereafter.

Senate Bill 1293 provides that if a court finds any part of Section 2 of the bill--the retroactivity provision and refund restrictions--to be invalid, the entire section (the retroactivity provision as well as the refund restrictions) will be void. This provision discourages a taxpayer from challenging the refund restrictions in an attempt to get more than a pro rata share of the one hundred thousand dollar total refund amount. If that were to happen, and the taxpayer were successful in getting the refund restrictions declared invalid, the retroactivity provision would also go away, eliminating any entitlement to a refund based on Senate Bill 1293.

H. *Department's Proposed Rules Attempt to Define "Direct Costs"*

Following the passage of S.B. 1293, in August, 2004, the Department of Revenue issued a proposed ruling dealing with qualifying "direct costs" for purposes of identifying the portion of gross proceeds of sales or gross income excluded from the transaction privilege tax pursuant to A.R.S. § 42-5075(J) (added by S.B. 1293). A copy of the proposed ruling is attached.

We believe the Department's interpretation of "direct costs" in the proposed ruling is overly complicated and, in many cases, would result in a portion of the actual costs expended in providing architectural and engineering services being taxed under the contracting classification, contrary to the plain language and intent of the statute. We have advocated for a simpler approach that closely follows the statutory definition of "direct costs."

Below are several specific issues that we have identified with the approach taken in the Proposed Ruling:

1. In some cases, the formula utilized in the Proposed Ruling would limit the exclusion to less than the actual direct costs. Borrowing from Example 1, page 5, of the Proposed Ruling, if a taxpayer had \$55,000 of actual direct costs expended for architectural and engineering services, \$100,000 total actual costs expended for architectural and engineering services, and \$80,000 gross proceeds from architectural and engineering services, then, under the Department's formula, the taxpayer would only be able to exclude \$44,000 of revenue ($(55 / 100) * 80 = 44$), even though the taxpayer had \$55,000 actual direct costs.
2. In the Proposed Ruling, the Department limits the exclusion to actual costs that can be directly traced to and are directly associated with a single contract. This limitation does not comport with the plain language of the statute or the legislative history of S.B. 1293. There are situations where actual direct costs expended in providing architectural and engineering services may be incorporated into more than one contract. For example, an architect working in-house for a contracting firm may provide services for several projects during the same time period, and a portion of the architect's salary may be incorporated into each contract. The architect's salary (or a portion thereof) is a direct cost actually expended for architectural services incorporated into a contract. Under the Proposed Ruling, because of the "single contract" limitation, the architect's entire salary would be treated as an indirect cost.¹

¹ The Department's treatment of "direct costs" may or may not be consistent with generally accepted cost accounting principles. Regardless, accounting principles may not be used to circumvent the plain language and legislative intent of the statute. To the extent accounting principles and standards are utilized, we have urged the Department to look solely to those that are consistent with the plain language and intent of A.R.S. § 42-5075(J). As one example only, OMB Circular A-21, dealing with cost principles for government education contracts, provides for a direct cost allocation if a direct cost benefits two or more projects or activities.

3. The Department's formula does not provide for an allocation of indirect costs in cases where a taxpayer is working on more than one project during a particular tax period. In such cases, under the Proposed Ruling, 100% of indirect costs would be included in the denominator of the formula (the "total actual costs expended for architectural and engineering services") for each project, and would significantly and artificially reduce the percentage of gross receipts excluded from tax.

4. The formula used in the Proposed Ruling unnecessarily imposes timing issues and limitations contrary to the plain language and intent of the statute. This is illustrated by the Department's Example 2. Under this example, a taxpayer would be required to pay tax on \$20,000 of income in Tax Period 1, even though such revenue is clearly attributable to design and engineering services incorporated into the contract, simply because the taxpayer has received an advance payment. A payment attributable to direct architectural and engineering costs incorporated into a contract should not be treated as taxable revenue in the month received simply because the taxpayer has yet to incur the direct cost.