STRUCTURE OF ARIZONA'S SALES TAXATION OF CONTRACTING:

Why Can't The State Just Tax The Sale Of Building Materials?

By
Patrick Derdenger
Partner, Steptoe & Johnson LLP
201 E. Washington Street, 16th Floor
Phoenix, Arizona 85004-2382
(602) 257-5209
e-mail: pderdenger@steptoe.com

Prepared for
Second Annual Construction Industry Tax Issues Seminar
Thursday, May 19, 2005
Phoenix, Arizona

STEPTOE & JOHNSON LLP

Washington, D.C. *Phoenix* *Los Angeles* *London* *Brussels* *New York*

Copyright © 2005 by PATRICK DERDENGER

1. INTRODUCTION

The Arizona sales tax structure on contracting is quite a bit different from the structure found in other states. The norm in other states is to impose a sales tax on a contractor's purchase of building materials, treating the contractor as the ultimate consumer of those materials. In Arizona, and in four other states, sales of building materials to contractors are exempt from the sales tax, with the tax being imposed upon a "prime contractor's" gross receipts from the contracting project.[1] Subcontractors that work for a taxable prime contractor that is liable for the sales tax are exempt. The prime contractor is allowed a flat 35% deduction for labor costs so the result is a tax on the cost of the building materials plus the contractor's overhead and profit. The focus of any analysis in this area is on determining who the taxable "prime contractor" is and who are the exempt subcontractors.

1.1 Structure of the Contracting Tax--The "Prime Contractor" Is Taxable.

The sales tax under the contracting classification is imposed upon a "prime contractor's" gross receipts from his contracting activities. A.R.S. § 42 5075(B). The person liable for the sales tax under this classification is the "prime contractor."

Determining who is taxable as the prime contractor is not always easy because of the variety of construction arrangements that can take place. In addition to the "normal" situation where an owner contracts with a general contractor, who in turn contracts with subcontractors to construct an improvement, other situations commonly arise involving speculative builders, owner-builders, and construction managers, all of which have their own special rules regarding the imposition of the contracting tax. Interwoven throughout these various situations is the general rule that subcontractors are not liable for the sales tax if they can demonstrate the job was within the control of a prime contractor. A.R.S. § 42 5075(D). The starting point in this analysis is the definition of a "contractor," followed by the definition of a "prime contractor".

1.2 Definition of "Contractor."

A.R.S. § 42-5075(K)(2) defines "contractor" as being "synonymous with the term 'builder' and means any person, firm, partnership, corporation, association or other organization, or a combination of any of them, that undertakes to or offers to undertake to, or purports to have the capacity to undertake to, or submits a bid to, or does personally or by or through others, construct, alter, repair, add to, subtract from, improve, move, wreck or demolish any building, highway,

---

[1] The other four states are Hawaii, New Mexico, Washington and West Virginia. A.R.S. § 42-5075 *et seq*. (Arizona); H.R.S. § 237-13 *et seq*. (Hawaii); N.M.S.A. § 7-9-51 *et seq*. (New Mexico); W.R.C. § 82-04-050 *et seq*. (Washington); W.V.C. § 11-15-89 *et seq*. (West Virginia).

Copyright © 2005 by Patrick Derdenger

road, railroad, excavation, manufactured building or other structure, project, development or improvement, or to do any part of such a project, including the erection of scaffolding or other structure or works in connection with such a project, and includes subcontractors and specialty contractors." This section also provides that the definition will govern "without regard to whether or not the contractor is acting in fulfillment of a contract."

Examples of contracting[2] include:

- Land Clearing
- Other Site Preparation
- Well Drilling
- Structure Work
- Wiring
- Roofing
- Floor Covering
- Painting
- Wallpaper Hanging
- Air Conditioning and Heating
- Insulation Application
- Installation of New Appliances
- Erection of Signs

1.3 Definition of "Prime Contractor."

A.R.S. § 42-5075(K)(6) defines "prime contractor" to mean "a contractor who supervises, performs or coordinates the construction, alteration, repair, addition, subtraction, improvement, movement, wreckage or demolition of any building, highway, road, railroad, excavation, manufactured building or other structure, project, development or improvement including the contracting, if any, with any subcontractors or specialty contractors and who is responsible for the completion of the contract."

The following cases are helpful in determining when a contractor will be a taxable "prime contractor."

***(1) Trans-Zona Constr., Inc. v. Dep't of Revenue*, Arizona Board of Tax Appeals, No. 507-87-S (Feb. 10, 1988).** A construction Company was held to be the prime contractor because it fit the definition of "Prime Contractor." It obtained the building permit, contracted with the subcontractors, and, did the billing for the project.

---

[2] *Sales Tips Given for Contracting*, Ariz. Tax News, Oct. 1985, at 2.

Copyright © 2005 by Patrick Derdenger

(2) ***Bianco Constr. v. Dep't of Revenue,*** Arizona Board of Tax Appeals, No. 661-89-S (Dec. 19, 1989). The Board held that a prime contractor who built an apartment complex on land that it owned and then sold that apartment complex is liable for the sales tax under the contracting classification on that portion of the purchase price allocated to a warranty guarantee and a service contract. Purchase price amounts allocated to a consulting agreement and covenant not to compete do not constitute contracting income.

(3) ***Granite Constr. Co. v. Dep't of Revenue,*** 168 Ariz. 93, 811 P.2d 345 (Ct. App. 1990). The court of appeals held that a taxpayer performing federally required land reclamation work for a coal mining company in a Navajo-Hopi joint use area was taxable as a prime contractor because the reclamation work constituted contracting. In addition, the Navajo and Hopi Settlement Act of 1974, 25 U.S.C. § 640(d) et seq., did not preempt Arizona's taxation of the taxpayer's receipts from the coal mining company for its reclamation services.

(4) ***Ariz. Public Serv. Co. v. Dep't of Revenue,*** Arizona Board of Tax Appeals, No. 692-89-S (Oct. 3, 1990). The Board held that a taxpayer which provided "phone drop" services to telephone companies and cable television companies by laying the wires of those companies with its own equipment in trenches that it excavated for its own underground wires was taxable as a prime contractor.

(5) ***John M. Koza/John M. Kay Dev. & Constr. v. Dep't of Revenue,*** Arizona Board of Tax Appeals, No. 729-90-S (Feb. 28, 1991). The Board held that the taxpayer, a partner in a partnership that hired a general contractor for the construction project, was acting as a prime contractor for the project and thus was liable for the sales tax. The taxpayer argued that he was merely an agent of the partnership owner-builder and as such should not be taxed at all. The Board found no evidence of that agency relationship and rejected the argument. The taxpayer also argued that he did not have access to the money that was being taxed and could not be taxed on it; those funds had been borrowed by the partnership, the owner of the project, and were used to directly pay the subcontractors. The Board concluded that because the taxpayer's name was on the checks used to pay those subcontractors, such was evidence enough that the taxpayer had control over the money and should be taxed on it.

(6) ***Canyon State Excavating & Underground, Inc. v. Dep't of Revenue,*** Arizona Board of Tax Appeals, No. 586-88-S (Jan. 26, 1989), decision amended and reh'g denied (Apr. 25, 1989). The Board concluded that an excavation contractor was not liable for the sales tax under a contract it had with a sanitary district to dig trenches and install lateral sewer taps from the district's existing sewer main to new homes. The Board reasoned that the sanitary district was the prime contractor for the installation of the lateral taps to the new homes because it had responsibility for supervising the installation of the laterals and the home owners paid the district fees greater than the amounts paid by the district to the excavating contractor.

Copyright © 2005 by Patrick Derdenger

1.4 Persons Acting as "Agents" of the Owner Are Not Taxable as "Prime Contractors."

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 (subcontractors 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 control and was for 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).

Copyright © 2005 by Patrick Derdenger

*(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).

1.5 Subcontractors Are Not Taxable if There Is a Taxable "Prime Contractor" on the Job.

(1) The Statute. A.R.S. § 42-5075(D) provides that a subcontractor is not liable for the sales tax if "the job was within the control of a prime contractor . . . [and] the prime contractor . . . is liable for the tax on the gross income . . . attributable to the job and from which the subcontractors . . . were paid."

(2) The Regulation. The applicable regulation of the Arizona Admin-istrative Code (A.A.C.), R15-5-602(C), provides that:

> [E]very person engaging in a contracting activity is considered to be a prime contractor unless it can be demonstrated to the satisfaction of the Department that he is not a prime contractor as determined by the definitions contained herein.
>
> 1. Subcontractors are exempt provided that such persons are not acting in the capacity of prime contractors. A subcontractor is considered to be a prime contractor, and therefore liable for the tax, if:
>
> a. Work is performed for and payments are received from an owner-builder.
>
> b. Work is performed for and payments are received from an owner or lessee of real property.

(3) Subcontractor Exemption Certificate. Under Arizona's statutory sales tax structure, "prime contractors" are liable for sales tax on their gross contracting receipts minus the standard 35% labor deduction. Subcontractors, if they can establish that they were working for a taxable prime contractor, will be exempt from the sales tax. However, when a subcontractor works directly for and receives payment from an owner, lessee, or "owner-builder," that subcontractor will be deemed a prime contractor and will be liable for the sales tax. A.A.C. R15-5-602(C). A subcontractor may be working, one day, for a general contractor that has a contract with an owner to build a project and under those circumstances will be totally exempt from the sales tax. However, on the following day, that same subcontractor could be dealing with that same general contractor but this time the general contractor is building a

Copyright © 2005 by Patrick Derdenger

project on land that it owns. In that circumstance, the subcontractor could be dealing with that same general contractor but in this circumstance, the subcontractor may be the taxable entity if owner/general contractor is acting as an "owner-builder" (someone that builds on its land with the intent to hold). On the other hand, if the subcontractor is dealing with that owner/general contractor who is characterized as a speculative builder (someone that builds on its land with the intent to sell), then the subcontractor will not be the taxable entity but the speculative builder will be taxed on the sale of the completed structure.

There has been confusion on the part of the subcontractors when it comes to determining when they are dealing with a taxable prime contractor, taxable speculative builder, or an "owner-builder." To provide subcontractors with a semblance of certainty as to their nontaxable status, the legislature, in Senate Bill 1116, enacted a certificate mechanism. In short, a subcontractor that obtains a certificate from the person who hired the subcontractor, stating that "the person providing the certificate is a prime contractor and is liable for the tax," will not be taxed on the income it receives from the certificate giver. A.R.S. § 42-5075(E). The only catch is that if the subcontractor has reason to believe that the information contained on the certificate is erroneous or incomplete, the Department may disregard that certificate. Moreover, even if the person who provided the certificate is not technically liable for the taxes as a prime contractor, that person will nevertheless be deemed the prime contractor in lieu of the subcontractor to whom the certificate was provided. All subcontractors should obtain, as a matter of course, such a certificate from the person hiring them. If that person is not willing to give the certificate, then the subcontractor is put on notice that it may, in fact, be the taxable contractor on the job, and in that circumstance, the subcontractor should include in its bid, sales tax.

1.6 Computation of Tax

The starting point is "gross proceeds" or "receipts" from the taxpayer's contracting activities. From that, (1) subtract the value of the underlying land, when and to the extent that a contractor owns the land and sells the land and the completed structure (the "land deduction"); (2) multiply the gross proceeds or receipts, net of land, by 65% to arrive at the tax base; and (3) deduct state and local sales taxes. The result is the computational base against which the sales tax rate is applied. These deductions are discussed below.

(1) Land Deduction. Normally, a contractor will be engaged by an owner to build a structure on the owner's property. In this situation, the land deduction does not come into play. However, many times a speculative builder will build homes on land he owns and then will sell the completed structure with the underlying land at a later date. This is when the land deduction comes into play. In this regard, the sales price of the land, which is not to exceed its fair market value, is the amount allowed as the deduction. A.R.S. § 42 5075(B)(1). The Department has an informal audit "rule of thumb" or "safe harbor" in this regard. The Department will normally allow a land deduction if it does not exceed 20% of the sales price of the land and the completed structure. If

Copyright © 2005 by Patrick Derdenger

the land value is greater than 20%, the Department will require substantiation of that greater value, such as an appraisal report. *See e.g., Estes Homes v. Dep't of Revenue, Arizona Board of Tax Appeals*, No. 934-92-S/U(3) (Aug. 17, 1993) WL 662628 (Aug. 17, 1993) ("[t]he only limitation on the land deduction is that it cannot exceed fair market value"); *Acacia/Autumn & Masters Limited Partnership and Acacia/Country Limited Partnership v. Arizona Dep't of Rev.*, No. 1042-93-S, 1994 WL 662628 (Ariz.Bd.Tax.App. 1994) (where the sales price of land is not separately stated in the sales contract, the deduction is based on fair market value); see also *Arizona Joint Venture v. Arizona Dep't of Revenue*, 66P3d 771 (Ariz. Ct-App. 2003)(taxpayer must substantiate land value deductions).

(2) 35% Labor Deduction or 65% Inclusion. A.R.S. § 42-5075(B) provides that the tax base for the prime contracting classification is 65% of the gross proceeds of sales or gross income derived from the business. Prior to the Sales Tax recodification, effective July 1, 1989, old A.R.S. § 42-1308(B)(2) provided an "in lieu of labor" deduction of a flat 35% of the contractor's gross income or gross proceeds of sales. The new law, A.R.S. § 42-5075(B), recognizes the prior 35% labor deduction but in a reverse fashion—rather than giving a 35% *deduction*, it *includes* only 65% of the contracting income in the taxable base.

In computing the old 35% labor deduction, the land deduction must first be subtracted from the gross contracting proceeds. The 35% is applied against the net figure. A.R.S. § 42 1308(B)(2) (repealed 1989); *see also Knoell Bros. Constr., Inc. v. Dep't of Revenue*, 132 Ariz. 169, 644 P.2d 905 (Ct. App. 1982). Thus, if the sales price of a home and the underlying land is $100,000 and assuming that the fair market value of the land is $20,000, the 35% would be applied against the net figure of $80,000 with a resulting labor deduction of $28,000, for a net figure of $52,000.[3] If a contractor sells exempt materials separately to the owner, the labor deduction is computed on the contractor's receipts *net* of the materials receipts. *Kitchell Contractors, Inc. v. City of Phoenix*, 151 Ariz. 139, 726 P.2d 236 (Ct. App. 1986). These same rules would apply to the computation of the 65% tax base (65% x $80,000 = $52,000 tax base).

(3) Contractor's Deduction for State and Municipal Sales Taxes-Factoring. The state sales tax, as well as any applicable municipal sales tax, is not included in gross proceeds. A.R.S. § 42 5002(A)(1). Factoring is a method of utilizing a predetermined algebraic expression to computing taxes to be excluded from gross proceeds and to be paid to the assessing entity. It is most frequently used where contractors wish to charge the purchaser a flat amount and then compute the tax later using a factor. The Department previously issued a ruling for sales tax factoring, Arizona Sales Tax Ruling No. 3-0-84 (Mar. 1984)

[3] Under prior law, if actual labor constituted more than 35% of the net figure, the deduction was still limited to the 35% amount. This is suggested by the statute itself, which stated that the deduction is "in lieu of *any* labor." A.R.S. § 42-1308 (B)(2) (repealed 1989) (emphasis added); *see also Kitchell Contractors, Inc. v. City of Phoenix*, 151 Ariz. 139, 726 P.2d 236 (Ct. App. 1986).

Copyright © 2005 by Patrick Derdenger

(taking into account the Maricopa County Transportation Excise Tax), which has been superseded by Transaction Privilege Tax Procedures 00-1 and 00-2. Transaction Privilege Tax Procedure ("TPP") 00-1 deals with factoring for the retail classification and other non-prime contractors. TPP 00-2 deals with factoring for prime contractors. The procedures indicate that a contractor can determine the amount of sales tax collected (both state and municipal), which is not to be included in gross proceeds, by the use of a factor. Procedure 00-2 provides specific examples of how factors can be computed. The Department also publishes tables with pre-determined factors combining state and municipal sales taxes for ease of use.

In accord with *Kitchell*, the labor deduction must first be taken before the factored sales tax deduction is computed. 151 Ariz. 139, 726 P.2d 236 (Ct. App. 1986). This method allows a contractor to absorb the tax and removes the requirement to separately state the sales tax on the taxpayer's records and invoices in order to take a deduction for such amounts.

1.7 No Tax on Purchase of Materials.

Since the prime contractor is liable for the sales tax on his contracting activities, there is no sales tax on the purchase by either subcontractors or prime contractors of building materials which are incorporated into the construction project. A.R.S. § 42 5061(A)(27). Specifically, an exemption is provided for:

> "Tangible personal property sold to a person that is subject to tax under this article by reason of being engaged in business classified under the prime contracting classification under § 42-5075, or to a subcontractor working under the control of a prime contractor that is subject to tax under article 1 of this chapter, if the property so sold is any of the following:
>
> (a) Incorporated or fabricated by the person into any real property, structure, project, development or improvement as part of the business.
>
> (b) Used in environmental response or remediation activities under § 42-5075, subsection B, paragraph 6.
>
> (c) Incorporated or fabricated by the person into any lake facility development in a commercial enhancement reuse district under conditions prescribed for the deduction allowed by § 42-5075, subsection B, paragraph 8.

1.8 Exemptions.

In addition to the land, labor and tax deductions discussed above, the prime contracting classification in A.R.S. § 42-5075(B) provides for the following exemptions:

Copyright © 2005 by Patrick Derdenger

*(1) **Groundwater Measuring Devices***. Sales and installation of groundwater measuring devices required under A.R.S. § 45-604 and groundwater monitoring wells required by law, including monitoring wells installed for acquiring information for a permit required by law. A.R.S. § 42-5075(B)(2).

*(2) **Furniture and Fixtures in Manufactured Building.*** The sales price of furniture, furnishings, fixtures, appliances, and attachments that are not incorporated as component parts of or attached to a manufactured building or the setup site. The sale of such items may be subject to the sales tax under the retail classification. A.R.S. § 42-5075(B)(3).

*(3) **Military Reuse Zone (Williams Air Force Base).*** The gross proceeds of sales or gross income received from a contract entered into for the construction, alteration, repair, addition, subtraction, improvement, movement, wrecking or demolition of any building, highway, road, railroad, excavation, manufactured building or other structure, project, development or improvement located in a military reuse zone for providing aviation or aerospace services or for a manufacturer, assembler or fabricator of aviation or aerospace products within 5 years after the zone is initially established under A.R.S. § 41-1531. To qualify for this deduction, before beginning work under the contract the prime contractor must obtain a letter of qualification from the Department. A.R.S. § 42-5075(B)(4).

*(4) **Qualified Environmental Technology Manufacturing Facility.*** The gross proceeds of sales or gross income derived from a contract to construct a qualified environmental technology manufacturing, producing or processing facility, as described in A.R.S. § 41-1514.02, and from subsequent construction and installation contracts that begin within ten years after the start of initial construction. To qualify for this deduction, before beginning work under the contract the prime contractor must obtain a letter of qualification from the Department. The deduction applies for ten full, consecutive calendar or fiscal years after the start of initial construction. A.R.S. § 42-5075(B)(5).

*(5) **Remediation Work.*** The gross proceeds of sales or gross income from a contract to provide one or more of the following actions in response to a release or suspected release of a hazardous substance, pollutant or contaminant from a facility to the environment is exempt under the prime contracting classification, unless the release was authorized by a permit issued by a governmental authority:

(a) Actions to monitor, assess and evaluate such a release or a suspected release.

(b) Excavation, removal and transportation of contaminated soil and its treatment or disposal.

(c) Treatment of contaminated soil by vapor extraction, chemical or physical stabilization, soil washing or biological

Copyright © 2005 by Patrick Derdenger

treatment to reduce the concentration, toxicity or mobility of a contaminant.

(d) Pumping and treatment or *in situ* treatment of contaminated groundwater or surface water to reduce the concentration or toxicity of a contaminant.

(e) The installation of structures, such as cutoff walls or caps, to contain contaminants present in groundwater or soil and prevent them from reaching a location where they could threaten human health or welfare or the environment. This deduction does not include asbestos removal or the construction or use of pollution control equipment, facilities or other control items required or to be used by a person to prevent or control contamination before it reaches the environment. A.R.S. § 42-5075(B)(6). When nontaxable activities and taxable activities are undertaken together, the gross proceeds of nontaxable activities are only exempt if the proceeds attributable to this work are separately itemized within the contract or are separately identifiable. TPR 01-3.

(6) Labor For Installation of Exempt Machinery and Equipment. The gross proceeds of sales or gross income that is derived from a contract entered into for the installation, assembly, repair or maintenance of machinery, equipment or other tangible personal property that is deducted from the tax base of the retail classification pursuant to § 42-5061, subsection B, or that is exempt from use tax pursuant to § 42-5159, subsection B, and that does not become a permanent attachment to a building, highway, road, railroad, excavation or manufactured building or other structure, project, development or improvement. If the ownership of the realty is separate from the ownership of the machinery, equipment or tangible personal property, the determination as to permanent attachment shall be made as if the ownership were the same. The deduction provided in this paragraph does not include gross proceeds of sales or gross income from that portion of any contracting activity which consists of the development of, or modification to, real property in order to facilitate the installation, assembly, repair, maintenance or removal of machinery, equipment or other tangible personal property that is deducted from the tax base of the retail classification pursuant to § 42-5061, subsection B or that is exempt from use tax pursuant to § 42-5159. subsection B. For purposes of this paragraph, "permanent attachment" means at least one of the following:

(a) To be incorporated into real property.

(b) To become so affixed to real property that it becomes a part of the real property.

(c) To be so attached to real property that removal would cause substantial damage to the real property from which it is removed. A.R.S. § 42-5075(B)7.

Copyright © 2005 by Patrick Derdenger

A detailed discussion of the installation labor exemption is contained below**.**

(7) Lake Facility Development (Tempe Rio Salado Project). The gross proceeds of sales or gross income received from a contract for constructing any lake facility development in a commercial enhancement reuse district that is designated pursuant to A.R.S. § 9-499.08 if the prime contractor maintains the following records in a form satisfactory to the department and to the city or town in which the property is located:

(a) The certificate of qualification of the lake facility development issued by the city or town pursuant to A.R.S. § 9-499.08(D).

(b) All state and local transaction privilege tax returns for the period of time during which the prime contractor received gross proceeds of sales or gross income from a contract to construct a lake facility in a designated commercial enhancement reuse district, showing the amount exempted from state and local taxation.

(c) Any other information that the department considers to be necessary. A.R.S. § 42-5075(B)(8).

(8) Exempt Machinery and Equipment—No Purchase Agency Required. The gross proceeds of sales or gross income attributable to the purchase of machinery, equipment or other tangible personal property that is exempt from or deductible from transaction privilege and use tax under:

(a) Section 42-5061, subsection A, paragraph 25 (hospitals and health care organizations) or 29 (non-profit organizations for job training and placement).

(b) Section 42-5061, subsection B (the machinery and equipment exemption).[4]

(c) Section 42-5159, subsection A, paragraph 13, subdivision (a), (b), (c), (d), (e), (f), (i), or (j) (the use tax exemption for certain health care organizations).

(d) Section 42-5159, subsection B (the use tax exemption for machinery and equipment). A.R.S. § 42-5075-(B)(9).

---

[4] A.R.S. § 42-5061.B, and its various subsections, contain the machinery and equipment exemption. The machinery and equipment exemption is quite broad and encompasses machinery and equipment used directly in manufacturing, processing, job printing, refining or metallurgical operations, mining, certain telecommunication equipment, and more.

Copyright © 2005 by Patrick Derdenger

This exemption repealed the prior purchase agency agreement requirement for contractors to obtain these deductions. A detailed historical explanation of the purchase agency requirement and its repeal is contained below.

(9) Environmentally Controlled Poultry and Egg Production Facility. Income received from a contract for the construction of an environmentally controlled facility for the raising of poultry for the production of eggs and the sorting, cooling and packaging of eggs may be deducted from the gross proceeds of sales or gross income before computing the tax base. A.R.S. § 42-5075(B)(10).

(10) Project, Development or Improvement Used to Prevent, Monitor, Control or Reduce Water or Land Pollution. Income that is derived from a contract entered into with a person who is engaged in the commercial production of livestock, livestock products or agriculture, horticulture, viticulture or floriculture crops or products in this state for the construction, alteration, repair, improvement, movement, wrecking or demolition or addition to or subtraction from any building, highway, road, excavation, manufactured building or other structure, project, development or improvement used directly and primarily to prevent monitor, control or reduce air, water or land pollution may be deducted from the gross proceeds of sales or gross income before computing the tax base. A.R.S. § 42-5075(B)(11).

(11) Clean Rooms Deductible under § 42-5061(B)(17). Income that is derived from the installation, assembly, repair or maintenance of clean rooms that are deducted from the tax based of the retail classification pursuant to § 42-5061(B)(17) may be deducted from the gross proceeds of sales or gross income before computing the tax base. A.R.S. § 42-5075(B)(12).

(12) Low Income Residential Apartment Housing for the Seniors. For the taxable periods beginning from and after June 30, 2001, income derived from a contract entered into for the construction of a residential apartment housing facility that qualifies for a federal housing subsidy for low income persons over sixty-two years of age and that is owned by a nonprofit charitable organization that has qualified under § 501(c)(3) of the Internal Revenue Code may be deducted from the gross proceeds of sales or gross income before computing the tax base. A.R.S. § 42-5075(B)(13).

(13) Solar Energy Devices Supplied and Installed Pursuant to Contracts. For the taxable periods beginning from and after December 31, 1996 and ending before January 1, 2011, the contractor's retail cost of solar energy devices that the contractor supplied and installs pursuant to contracts may be deducted from the gross proceeds of sales or gross income before computing the tax base. The deduction may not exceed five thousand dollars for each solar energy device. Before deducting any amount under this subsection, the contractor must register with the Department as a solar energy contractor, which acts as an acknowledgment by the contractor that it will make its books and records relating to the sale of these devices available to the Department. A.R.S. § 42-5075(B)(14).

Copyright © 2005 by Patrick Derdenger

(14) Launch Sites. Income derived from a contract entered into for the construction of a launch site, as defined in 14 C.F.R. § 401.5, may be deducted from the gross proceeds of sales or gross income before computing the tax base. A.R.S. § 42-5075(B)(15).

(15) Domestic Violence Shelters. Income derived from a contract entered into for the construction of a domestic violence shelter that is owned and operated by a nonprofit charitable organization that has qualified under § 501(c)(3) of the Internal Revenue Code may be deducted from the gross proceeds of sales or gross income before computing the tax base. A.R.S. § 42-5075(B)(16).

(16) Post-Construction Pest Control. Income derived from contracts to perform post-construction treatment of real property for termite and general pest control, including wood-destroying organisms, may be deducted from the gross proceeds of sales or gross income before computing the tax base. A.R.S. § 42-5075(B)(17).

(17) State University Research Infrastructure Project. The gross proceeds of sales or gross income received from contracts entered into before July 1, 2006 for constructing a state university research infrastructure project if the project has been reviewed by the joint committee on capital review before the university enters into the construction contract for the project. For the purposes of this paragraph, "research infrastructure" has the same meaning prescribed in § 15-1670. A.R.S. § 42-5075(B)(18).

(18) Forest Product Processing. The gross proceeds of sales or gross income received from a contract for the construction of any building, or other structure, project, development or improvement owned by a qualified business for harvesting, transporting or the initial processing of forest products, including biomass, as provided in § 41-1516 if actual construction begins before January 1, 2010. To qualify for this deduction, the prime contractor must obtain a letter of qualification from the department of commerce before beginning work under the contract. A.R.S. § 42-5075(B)(19).

2. FOUR VARIANTS OF THE CONTRACTING CLASSIFICATION TAXING SCHEME

There are four variants of the contracting taxing scheme, each involving factual nuances that affect the calculation and incidence of the tax. The four variants are:

1. **The normal prime contractor,** involving a prime contractor doing work for an owner of real property.

2. **The speculative builder,** involving a builder that owns land and acts as his own prime contractor in

Copyright © 2005 by Patrick Derdenger

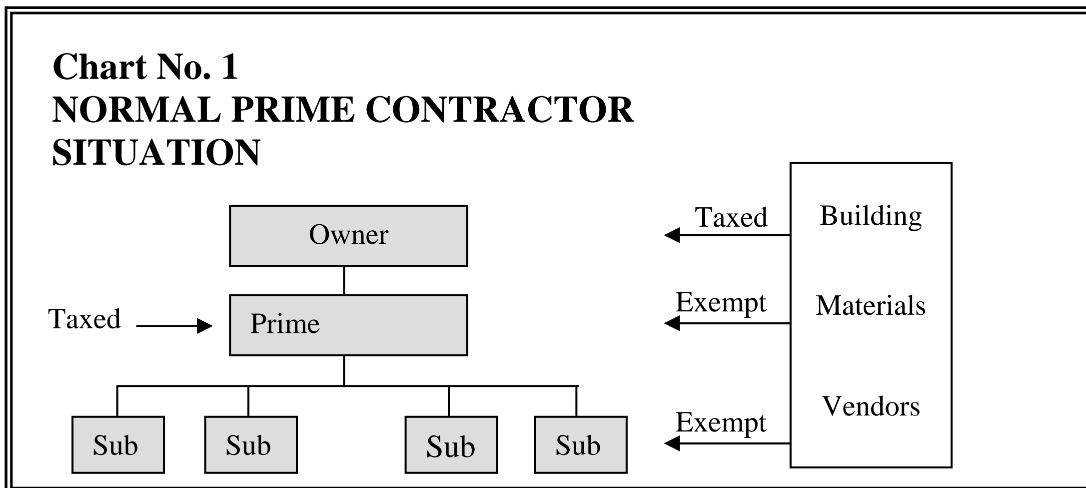
improving that land, with the intent to sell the improvements when completed.

3. **The owner-builder,** involving a builder that owns land and either acts as his own general contractor in improving that land or hires a prime contractor to do it, with the intent to hold the improvements after completion.

4. **The construction manager,** involving a person that contracts directly with the owner to provide, for a fee, assistance with design, engineering, bid specifications and selection of a prime contractor and does not engage subcontractors to perform construction services.

A discussion of the tax treatment of each of these variants follows.

3. NORMAL "PRIME CONTRACTOR" SITUATION



3.1 Prime Contractor Is Taxed.

In the usual situation, the property owner contracts with a general contractor for the construction of the improvement. The general contractor will enter into agreements with various subcontractors and will supervise or coordinate the construction (*see* Chart No. 1). The property owner will pay the general contractor pursuant to their contract and the general contractor will pay the subcontractors pursuant to their agreements. The taxable entity is the general or prime contractor. The subcontractors are not taxable because they can show that the job was within the control of a prime contractor, who is liable for the tax.

Copyright © 2005 by Patrick Derdenger

3.2 Tax Computation.

The tax computation for the normal prime contractor situation is fairly straightforward:

Chart No. 1A
Tax Computation

Construction Contract - $1 Million

$1,000,000	Gross income from contracting
– 350,000	35% Labor Deduction
$ 650,000	Taxable Amount (65% Tax Base)
$ 606,909	Factored Tax Deduction ($650,000 ÷ 1.071)
× 7.1%	Tax Rate (State, County & City)
$43,090	Tax

4. SPECULATIVE BUILDER.

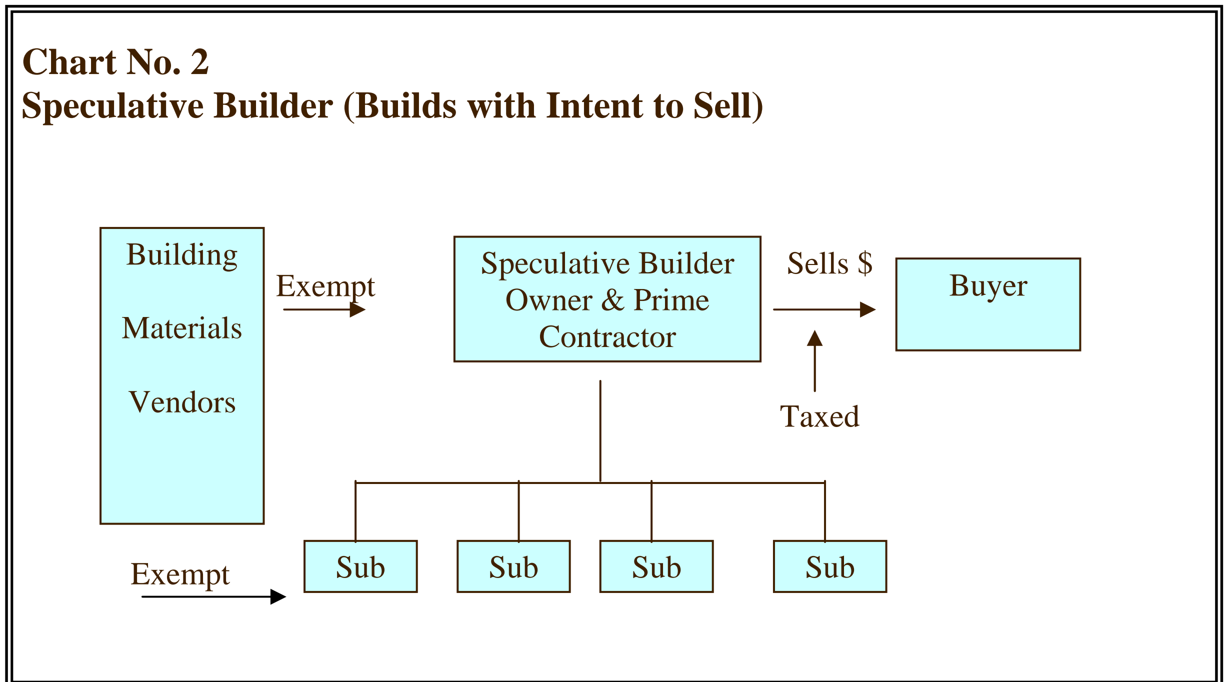


Chart No. 2A
Department of Revenue's Unwritten Audit Position

Speculative Builder Constructs House Without Contract in place before completion

DOR's position is that state statute does not have a speculative builder classification as does Model City Tax Code

Ignore definition of contractor: "without regard to whether or not the contractor is acting in fulfillment of a contract

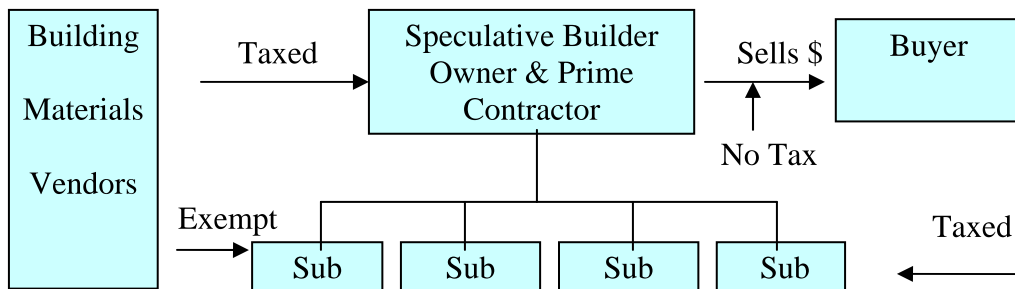
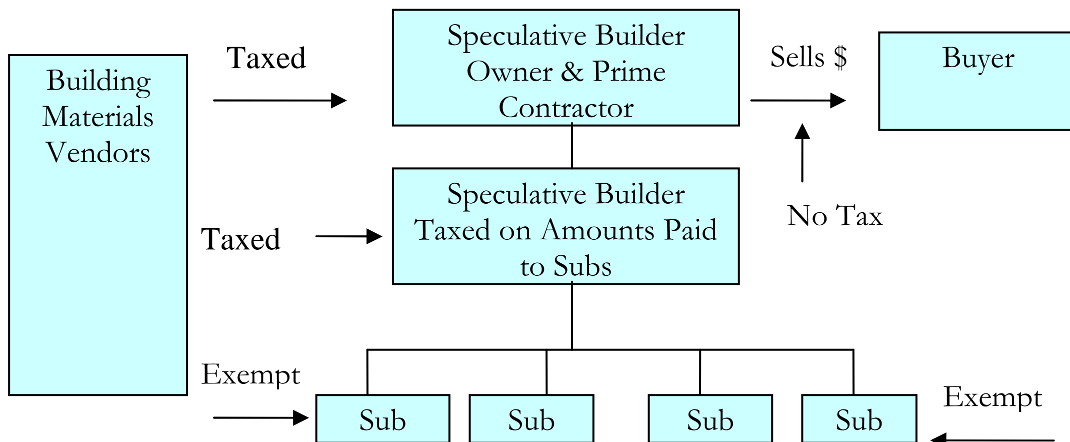


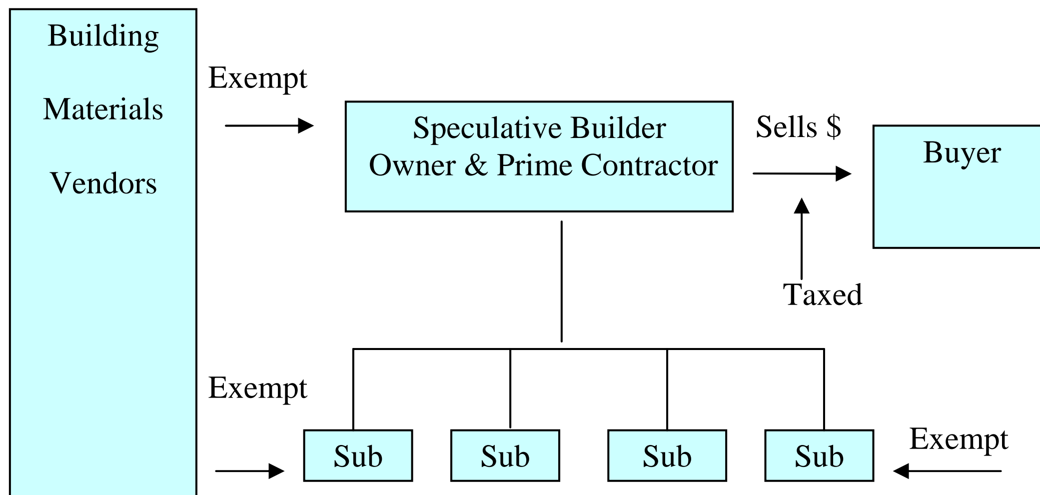
Chart No. 2B
Department of Revenue's Unwritten Audit Position
Speculative Builder Constructs House Without Contract in place before completion
Gives Forms 5005 to subcontractors



Copyright © 2005 by Patrick Derdenger

Chart No. 2C
Department of Revenue's Unwritten Audit Position

Speculative Builder Constructs House With Contract to Sell in Place Before Completion



4.1 Speculative Builder Is Taxed when Project Sold.

A taxpayer who acts as his own general contractor and builds on land that he owns with the intent at the time of construction to sell the completed improvement and underlying land is a speculative builder. A speculative builder will enter into agreements with subcontractors and will supervise or coordinate the construction. When the improvement is sold, the speculative builder will be taxed as a prime contractor on his sale proceeds. The subcontractors will not be taxed because they can show that the job was within the control of a prime contractor who is liable for the tax (*see* Chart No. 2). The term speculative builder is not defined or specifically mentioned in the sales tax statutes. However, the authority to treat a speculative builder as a taxable prime contractor is found in the last sentence of the definition of contractor found in A.R.S. § 42-5075(K)(2):

> For all purposes of taxation or deduction, this definition shall govern without regard to whether or not such contractor is acting in fulfillment of a contract.

This portion of the "contractor" definition is a result of *State Tax Comm'n v. Staggs Realty Corp*. 85 Ariz. 294, 337 P.2d 281 (1959). *Staggs Realty* held that a speculative homebuilder, who had homes built by an affiliated corporation on a speculative basis for subsequent sale to homebuyers, could not be taxed on the sale of the homes because Staggs did not first *contract* with others to

Copyright © 2005 by Patrick Derdenger

do construction work. The court concluded that the sales tax on contracting applies only to the person who first contracts with others to do construction work for them. Since Staggs did not contract first with the homebuyer to build the house, but built it on "speculation" only, it didn't satisfy the "contract" requirement and thus wasn't taxable. The quoted language was meant to take care of the *Staggs Realty* "loophole."

4.2 Department of Revenue's Unwritten Audit Position With Respect to Speculative Builders.

The Department of Revenue has developed an unwritten audit position regarding the taxation of speculative builders at the state level. The Department treats a speculative builder differently depending upon whether the speculative builder has a contract in place with a purchaser to buy the home prior to the completion of construction or not. If there is such a contract in place prior to the completion of construction, then the Department's position is that the speculative builder will be taxed as an ordinary prime contractor and taxed on the sales price of the home. See Chart 2C, above. In this case, the various subcontractors will be treated as exempt subcontractors.

However, if the speculative builder finishes construction of the house without a contract in place to sell the house, with such a contract being entered into after substantial completion of the house, the Department's position is that the speculative builder will not be taxed as a prime contractor. Rather, each of the subcontractors will be treated as the taxable prime contractors. See Chart 2A, above. The Department's position is that the state prime contracting statute does not have a speculative builder classification as does the Model C Tax Code and thus, if a homebuilder builds a house on speculation without a contract in place to sell it before its completes, that homebuilder will not be taxed at all. The Department's position, however, ignores the last part of the definition of contractor which provides that "this definition [contractor] shall govern without regard to whether or not such contractor is acting in fulfillment of a contract." See A.R.S. § 42-5075(H)(2). As discussed in Section 4.1 above, this provision in the definition of contractor is a result of the Staggs Realty case and was meant to overturn that case (where the court held that a speculative builder that built a house without a contract in place was not a taxable prime contractor).

The Department's unwritten audit position with respect to the state taxation of speculative builders is not based on the prime contractor classification statute (A.R.S. § 42-5075) and more importantly, puts a difficult burden on subcontractors to determine whether they are going to be the taxable prime contractor when doing work for a speculative builder. How does a subcontractor know whether the speculative builder had a contract in place to sell the house before the completion of construction or not. Subcontractors generally are not going to be privy to that type of information. If the speculative builder did not have a sale contract in place prior to completion of construction, then the burden of the tax under the Department's position falls on the subcontractors. As an editorial comment, the Department needs to change their unwritten audit position

Copyright © 2005 by Patrick Derdenger

and conform to the definition of contractor which applies regardless of whether there is a contract in place.

A speculative builder, in order to protect its subcontractors, could give the subcontractors Arizona Form 5005 (Prime Contractor Exemption Certificate). By doing this, the subcontractors would not be taxable but the speculative builder, whether not it had a contract in place to sell the house before completion of construction, would be treated as the taxable prime contractor, since as a part of issuing the Form 5005, the issuer (speculative builder) assumes all tax liability with respect to the project. See Chart 2B, above.

4.3 Tax Computation.

The tax computation (if the speculative builder is to be taxed on the sale of the house) begins with the speculative builder's "gross sales proceeds"; the remainder of the calculation is the same as for the normal prime contractor:

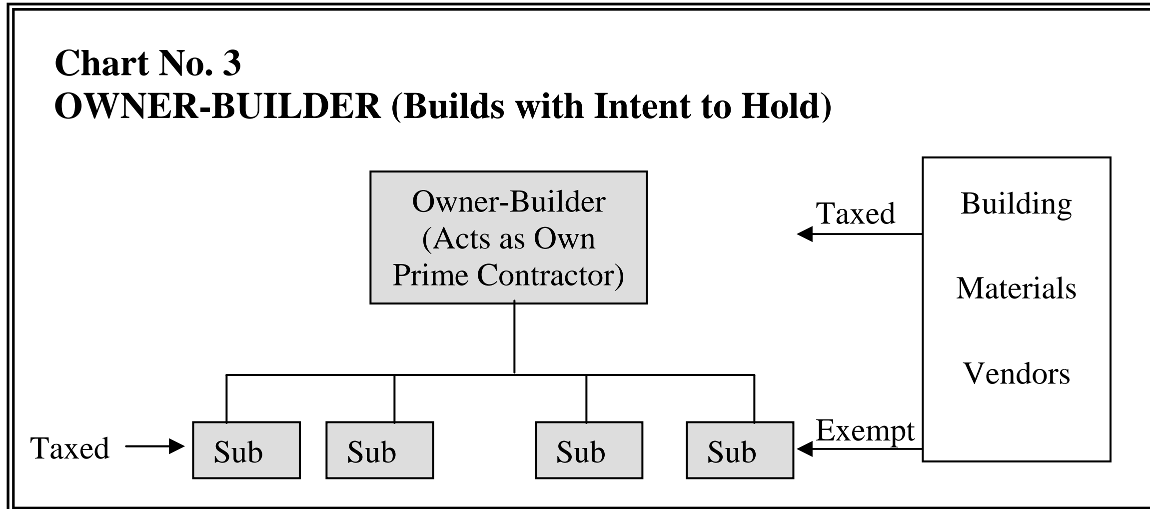
Chart No. 2A
Tax Computation

Land Value - $400,000
Construction Cost - $1 Million (paid to subs)

$2,000,000	Gross Sales Proceeds
- 400,000	Land Value
$1,600,000	
- 560,000	35% Labor Deduction
$1,040,000	Taxable Amount (65% Tax Base)
971,055	Factored Tax Deduction ($1,040,000 ÷1.071)
X 7.1%	Tax Rate (State, County & City*)
$ 68,944	Tax

(Compare to $43,090 for a Prime Contractor) *Assume City has land deduction

5. OWNER-BUILDER.



5.1 The "Owner-Builder" Classification of A.R.S. § 42-5076.

The owner-builder sales classification, is comprised of persons who sell real property as improved at any time on or before the expiration of 24 months after the improvement is substantially completed, meaning suitable for the use or occupancy intended. Such owner- builders and such persons are subject to tax under the owner-builder classification for the purpose of taxing the sale of those improvements incorporated within that 24-month period. *See* A.R.S. § 42-5076(A).

The prior statute defined an "owner-builder" as a person "who owns or leases real property within the state and who acts as a contractor, either himself or through others, in constructing any improvement upon the real property, which real property as improved is held by that person for his use or for rental purposes." *See* A.R.S. § 42 1301.12 (repealed 1989). This definition is omitted from the current owner-builder statute.

The purchase of tangible personal property for incorporation into any realty improvement, building, highway, road, railroad excavation, or other structure, project, development or improvement is subject to the tax computed on the sales price thereof, except for the purchase of tangible personal property which sale has already been subjected to the tax imposed under A.R.S. § 42-5061. A.R.S. § 42-5076(B).

5.2 Intent—"To Hold."

Intent is what separates an owner-builder from a speculative builder. A speculative builder builds with the intent to sell while an owner-builder builds with the intent to hold. *See e.g., Baywood Equities Corp. v. Dep't of Revenue*, Arizona Board of Tax Appeals, No. 491 86 S (Apr. 25, 1989). In *Baywood*, the Department emphasized the portion of the owner-builder definition requiring the improved real property to be held by the owner-builder "for his own use or for

Copyright © 2005 by Patrick Derdenger

rental purposes." The property owner contracted with a general contractor to build homes for sale to the public. The Board determined that the owner was not an owner-builder because the owner did not use or rent the homes it built. The Department argued that the owner's sale of the property for a profit constituted a "use," but the Board concluded that even though the sale was a use of the property, it was not "the type of use contemplated by the statute which requires "holding" the property."

An owner-builder builds with the intent to hold and use for himself what he built, acting as his own general contractor. Thus, the owner-builder will be subject to sales tax on his purchases of building materials. A.R.S. § 42-5076(B).

5.3 Subcontractors Will Be Treated as "Prime Contractors" when They Deal with Owner-Builders.

In the "normal" general contractor/subcontractor and speculative builder situations, the subcontractors should not have any tax liability because of the existence of a prime contractor on the job that is liable for the tax. However, subcontractors will be liable for the tax when work is performed for an owner-builder.

A.A.C. R15-5-602(C)(1) provides that subcontractors are exempt from sales tax provided that such persons are not acting in the capacity of prime contractors. A subcontractor is considered to be a prime contractor, and therefore liable for the tax, if:

(a) Work is performed for and payments are received from an "owner-builder."

(b) Work is performed for and payments are received from an owner or lessee of real property.

To illustrate, assume that a property owner wants to improve his property for his own use but wants to act as his own general contractor to avoid any middleman expense. The owner contracts directly with the subcontractors and pays them for their work. The subcontractors will be liable for the tax because work was performed for and payments were received from an owner-builder. A.A.C. R15-5-602(C)(1)(a). There appears to be some tension between A.A.C. R15-5-602(C)(1)(b) and the speculative builder analysis discussed above. Typically, a speculative builder owns property and contracts directly with subcontractors who perform the construction. The improved property is then sold. The Department will want to impose the tax on the speculative builder's sales receipts because that will yield a larger tax than the tax received from the subcontractors on their receipts from the speculative builder. Nevertheless, the regulation clearly states that a subcontractor is considered to be a prime contractor and liable for the tax if "work is performed for and payments are received from an owner of property," and a speculative builder is an owner. So, why isn't the subcontractor liable for the tax in a speculative builder situation?

Copyright © 2005 by Patrick Derdenger

The Arizona Board of Tax Appeals, in *Etter Constr. v. Dep't of Revenue*, No. 506 87 S (Feb. 10, 1988), held that a subcontractor who was dealing with a general contractor, and who also owned the land on which the project was being constructed, was to be treated as a "prime contractor," along with all the other subcontractors on the job. The general contractor's work, since he was also the owner of the land, was not taxable because he did not have any receipts that could be taxed. Moreover, the owner was not treated as a taxable owner-builder because he did not sell the project within 24 months of substantial completion. The Board in its conclusion relied on A.A.C. R15-5-602(C)(1)(b), which provides that a subcontractor will be taxed when work is performed for and payments received from the owner. [Note: This case was decided under the former owner-building statute, effective through August 3, 1984; see the next section.]

5.4 Tax Consequences when an Owner-Builder Sells the Improved Property.

(1) Former Statute. Prior to the amendment in 1984, A.R.S. § 42-1307(A)(9) (repealed 1989), the "owner-builder" statute, provided that "[a]n owner-builder who sells such real property as improved at any time on or before the expiration of 24 months after the improvement is substantially completed, meaning suitable for the use or occupancy intended, shall be treated as a prime contractor."

(2) Department's Position. The Department took the position under the former statute that if an owner-builder sold his improved real estate within 24 months after the original structure or project was completed (whether or not he had used a general contractor), he would be treated as a prime contractor and be subject to sales tax on the sales price (with a statutory credit being given for any sales tax paid by the owner-builder on the purchase of building materials). The Department also gave credit for any sales taxes paid by a "prime contractor" on the job if the Department received a waiver from the prime contractor that it would not seek a refund of those same taxes. This was the unwritten administrative policy of the Department only, and was not mandated by statute or regulation.

(3) SDC Mgmt. Inc. v. State ex rel., Dep't of Revenue, 167 Ariz. 491, 808 P.2d 1243 (Ct. App. 1991), cert. denied, (May 7, 1991). The court of appeals rejected the Department's position and held that to be an owner-builder one must also be the general contractor on the job, overseeing the subcontractors, etc. In *SDC*, the owner of the project was a developer that hired a general contractor to build improvements on its property. The improvements were sold within 24 months of substantial completion of construction and the Department took the position that the owner was liable for the sales tax on the sales price (less the deduction for the underlying value of the land). The owner argued that it could be taxed under the owner-builder provisions only if it were a builder, acting as the general contractor on the job. In this case, the owner hired a general contractor to undertake all construction. The general contractor employed by SDC paid the sales tax on its receipts. The court concluded that the tax on owner-

Copyright © 2005 by Patrick Derdenger

builders who sell within 24 months of construction applies only to those who do not hire a general contractor, but act as such themselves, thereby potentially escaping liability for payment of the tax.

(4) ***Current Statute.*** Senate Bill 1006, Laws 1984, ch. 152, amended the owner-builder statute as follows (the new language is in caps): "An owner-builder who sells such real property as improved at any time on or before the expiration of twenty-four months after the improvement is substantially completed, meaning suitable FOR THE USE OR OCCUPANCY INTENDED, SHALL BE TREATED AS A PRIME CONTRACTOR FOR THE PURPOSE of taxing the sale of those improvements incorporated within that twenty-four month period."

Senate Bill 1006 modified the wording of the owner-builder statute to tax the owner-builder only on the improvements made after the completion of the original structure within the 24-month period. The current owner-builder statute, A.R.S. § 42-5076(A), incorporates and uses the same language as Senate Bill 1006. This legislation completely changed the tax consequences to an owner-builder when the improved real property was sold within 24 months of substantial completion. Under the old statute, such a sale would cause the owner-builder to be treated as a prime contractor and subject to tax on the sales price. Under the new statute, the sale within 24 months causes the owner-builder to be taxed on the sale but only with respect to the improvements made after substantial completion of the structure and before sale, meaning that the owner-builder has little or no tax exposure. That being the case, the tax liability naturally shifts to the subcontractors because they cannot now show that the job was within the control of a taxable prime contractor.

5.5 "Substantial Completion."

The Department takes the position that the issuance of a certificate of occupancy is the equivalent of "substantial completion." However, the Arizona Board of Tax Appeals held that the issuance of such a certificate is not necessary to start the two-year period running as long as the project is otherwise complete and the certificate will be issued in due course. *Riviera Capital Corp. v. Dep't of Revenue*, Arizona Board of Tax Appeals, No. 402 85 S (Aug. 20, 1986).

Copyright © 2005 by Patrick Derdenger

5.6 Tax Computation.

The tax computation for the owner-builder situation is, unfortunately, fairly complicated and, at times, confusing.

Chart No. 3A
Tax Computation

Land Value = $400,000
Construction Cost - $1 Million (paid to subs)

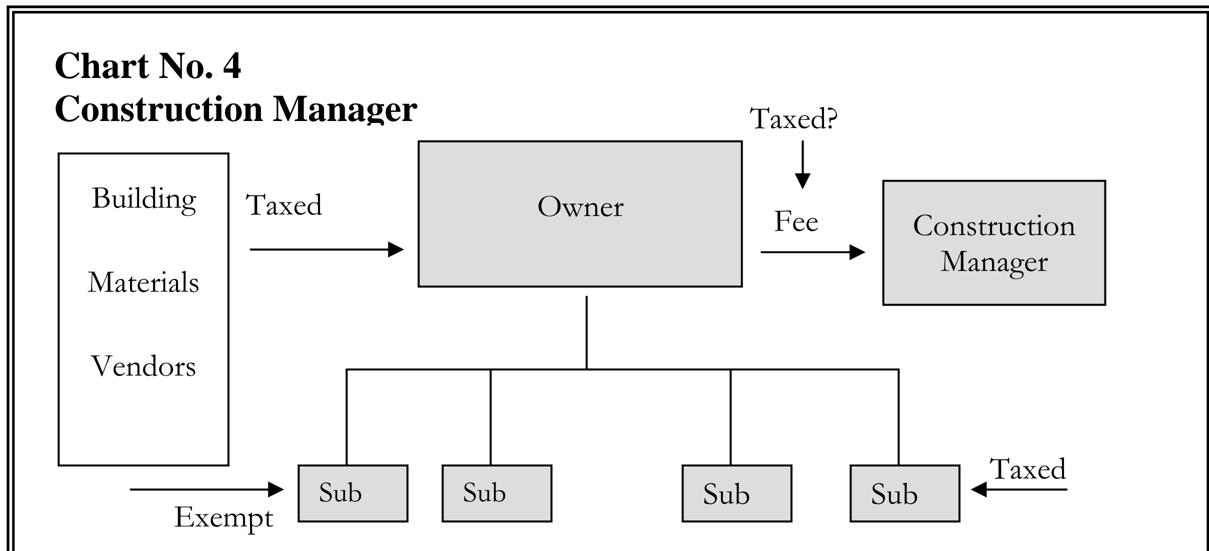
Subs are taxed on $1 Million

$1,000,000	
– 350,000	Labor Deduction
$ 650,000	Taxable Amount (65% tax base)
606,909	Factored Tax deduction ($650,000 ÷1.071)
× 7.1%	Tax Rate (State, County & City)
$ 43,090	Tax

Compare to $43,090 for Prime Contractor

Note: If Owner-Builder uses a prime contractor that pays the tax on initial construction, Owner-Builder is liable for tax on value of improvements made after substantial completion, if sold within 24 months of substantial completion.

6. CONSTRUCTION MANAGERS



6.1 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, assistance 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 manager 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 will likely view the construction managers as a 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).

6.2 Construction Manager Also Acting as Agent of Owner.

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's 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 has held that a person acting as the "agent" of the owner, who performs these types of activities, will not be the "prime contractor." Rather, the various subcontractors will be treated as the taxable prime contractors. *See Mackey Plumbing Co. v. Dep't of Revenue*, Arizona Board of Tax Appeals, No. 752-90-S (July 30, 1991); *Jerry's Plumbing v. Dep't of Revenue*, Arizona Board of Tax Appeals, No. 473-86-S (June 20, 1989); *Mountain*

Copyright © 2005 by Patrick Derdenger

View Dev. Co. v. Dep't of Revenue, Arizona Board of Tax Appeals, No. 442-86-S (Jan. 14, 1987).

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 subcontractors 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 subcontractors, 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 following chart diagrams the situation where the construction manager is also acting as the agent of the owner.

Chart No. 4B
Construction Manager

Building

Materials

Vendors

Taxed

Taxed

Exempt

Owner

"Owner's Rep"/Agent and Construction Manager

Sub

Sub

Sub

Sub

Taxed

Copyright © 2005 by Patrick Derdenger

6.3 Tax Calculation.

If the construction manager structures its relationship with the owner correctly, it will not be taxed, but the subcontractors will:

Chart No. 4C
Tax Computation
Construction Cost – $900,000
Construction Manager Fee – $100,000

Subs are taxed.

Amount	Description
$900,000	
– 315,000	35% Labor Deduction
$585,000	Taxable Amount (65% tax base)
546,218	Factored tax deduction ($585,000 ÷1.071)
× 7.1%	Tax Rate (State, County & City)
$ 38,781	Tax

Savings from normal prime contractor situation (compare Chart No. 1)

–$ 4,309 ($43,090 – $38,781)

7. MISCELLANEOUS

7.1 Federal Contractors.

There is no general exemption for contracting work done for the federal government. The incidence of the sales tax falls on the contractor, and becomes the contractor's liability, not the federal government's. A.A.C. R15-5-604; *see also Dep't of Revenue v. Hane Constr. Co., Inc.*, 115 Ariz. 243, 564 P.2d 932 (1977); *Tucson Mechanical Contracting, Inc. v. Dep't of Revenue*, 175 Ariz. 176, 854 P.2d 1162 (Ct. App. 1992) (prime contractor is not exempt on work done for federal government; Arizona-based contractors not discriminated against).

7.2 Design, Engineering and Procurement Services.

Engineering and procurement services are not subject to the sales tax under the contracting classification if those services are separate and apart from the contractor's contracting activity (they must be separately accounted for, billed, etc.).[5]

Copyright © 2005 by Patrick Derdenger

7.3 Legislation Clarifies that Design and Architectural Fees are Not Subject to the Arizona Transaction Privilege Tax 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. The Department of Revenue had taken the audit position that design and architectural services undertaken by a contractor (for example as a part of a "Design Build" contract) are taxable even if separately stated if such services are an integral part of the contractor's contracting activities or if they are insubstantial in relation to the contractor's contracting revenue. This legislation provides that design and architectural fees are not taxable.

(1) 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.

(2) 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, 459 P.2d 719 (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." 122 Ariz. at 469, 595 P.2d at 1014. (This particular situation was subsequently addressed by the

Copyright © 2005 by Patrick Derdenger

legislature in the form of a contracting tax deduction for the fair market value of land.)

(3) 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. at 588, 12 P.3d at 813, 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.

(4) 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.

Copyright © 2005 by Patrick Derdenger

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.

(5) 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.

(6) 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

Copyright © 2005 by Patrick Derdenger

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 to all taxpayers 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.

(7) Senate Bill 1293 as a Win-Win for the Department and Taxpayers, Bringing Final Resolution to a 35-Year Old Dispute Over The Taxation Of Design-Build Contracts. In *Ebasco* and *Holmes & Narver*, the Arizona Supreme Court concluded that "design and engineering services are not contracting," which is the business activity subject to tax under the contracting classification. In *Holmes & Narver,* 113 Ariz. at 169, 548 P.2d at 1166, the court added: "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." Senate Bill 1293 provides legislative affirmation that design services are not part of the contracting classification, even if those services are included in a single contract with taxable contracting services. At the same time, by limiting the exclusion to direct costs, S.B. 1293 provides a bright line of what is and is not taxable, aiding both taxpayers and the Department.

7.4 Forfeited Earnest Money Deposits

Forfeited earnest money deposits retained by a prime contractor (a homebuilder), constitute gross income on gross proceeds of sales from the business of prime contracting and are properly included in the measure of the transaction privilege tax. *Homes by Dave Brown v. Dep't of Revenue*, Arizona Board of Tax Appeals, No. 320 84 S (Sept. 12, 1984). In *Dave Brown*, a deposit was retained

Copyright © 2005 by Patrick Derdenger

when a buyer cancelled the purchase agreement for a home following the approval of the mortgage loan application and the contractor kept the deposit. The taxpayer contended unsuccessfully that rather than constituting income from contracting, these forfeited earnest money deposits represented liquidated damages that covered the expenses suffered as a result of the buyer's cancellation.

7.5 Exploratory Drilling.

The regulations provide that exploratory drilling, such as core drilling for purposes of testing, is not considered to be a contracting activity. A.A.C. R15-5-628.

7.6 Basis of Reporting.

The regulations require contractors to report on a progressive billing basis (accrual) or a cash receipt basis. Unused portions of allowable deductions may be carried forward. Homebuilders, speculative or otherwise, are to report as income the total selling price at the time of closing of escrow or transfer of title. A.A.C. R15 5 617.

7.7 Written Receipt.

A.R.S. § 42-5075(F) provides for the mandatory issuance of a written receipt by a contractor liable for the sales tax on the transaction (as well as a dealer of manufactured housing) to the purchaser, stating the amount of the contractor's gross receipts and the sales tax for which the contractor is liable.

QUERY: What is the purpose of this requirement—to provide a homebuyer with documentation of the sales tax paid with respect to the construction of his house for purposes of the federal income tax deduction? *But see Beimfohr v. Comm'r*, 51 T.C.M. (CCH) 430 (1986). In *Beimfohr*, the purchasers of a new, custom-built home were not entitled to deduct as general sales taxes the Arizona and Mesa city transaction privilege taxes imposed on the contractor's gross profits. The court rejected the taxpayer's alternative arguments that the transaction privilege taxes should be deductible as compensating for use taxes or real property taxes, noting that even if the transaction privilege taxes were properly classified as such, the taxpayers would not be entitled to a deduction. Taxes are deductible only by the person on whom they are imposed, *and under Arizona law, the transaction privilege tax was the personal liability of the contractor*.

NOTE: This issue became moot by the Tax Reform Act of 1986, which repealed the sales tax deduction for federal income tax purposes. However, with respect to state income tax purposes, a deduction should be allowed for taxes paid by the owner of a new, custom-built home (as long as the taxes are separately stated) because the applicable state statute allows a deduction for taxes *paid* during the taxable year. A.R.S. § 43-1043(A).

Copyright © 2005 by Patrick Derdenger

7.8 Distinction Between Contracting, Retail and Service Activities

A.A.C. R15-5-614 provides the following examples to distinguish between contracting, retail and service activities:

(1) ***Contracting.*** Examples include the installation of a central air conditioning system, the replacement of an air conditioning unit, water heater, electrical wiring, roof, plumbing, landscaping; the installation of a soft water system, remodeling of a kitchen, and the installation of new appliances, wallpaper and other fixtures.

(2) ***Retail.*** Retail activities consist of repairs in which the materials furnished are not incorporated into the structure. Examples: recharging refrigeration units with freon, replacement of washers in plumbing, etc.

(3) ***Services.*** Nontaxable services include carpet cleaning, waxing and polishing, duct cleaning, lawn mowing and garden maintenance.

Tax Ruling No. 4-15-81 deals with the question of whether repair and replacement activities are contracting or a retail sale of the repair/replacement part. The ruling indicates that "the best and simplest solution to the separation of the activities seems to lie in the direction of once contracting always contracting." Accordingly, if the original installation of the item was taxable as contracting or intended to be attached permanently, then all subsequent repair replacement of that item is contracting activity. However as enlightening as it may have been, the Department rescinded this ruling in August 1982, as being in conflict with A.A.C. R15-5-614.

The ruling presumes the following activities and any similar activities to be contracting:

1. Sign erection and maintenance.

2. Replacement or repair of a water heater.

3. Replacement or repair of a central air conditioning compressor, fan motors, blades, relays, and thermostats.

4. Repair or replacement of electrical circuit breakers, switches, and receptacles.

5. Repair or replacement of faucets.

6. Repair or replacement of toilet seats, valves, and controls.

7. Repair or replacement of portions of sprinkler systems.

8. Repair or replacement of doors, windows, cabinets, and counters in structures.

Copyright © 2005 by Patrick Derdenger

9. Charging air conditioning systems with freon or other substances.

Examples of the retail sale of tangible personal property with repair or installation labor in conjunction with realty would include the replacement of a light bulb, a fuse, or plug-in appliances that are not built-in.

(4) Lawn Maintenance Services vs. Landscaping. Transaction Privilege Tax Ruling 01-1 provides guidance in distinguishing between lawn, garden and tree maintenance business activities and landscaping activities for purposes of the transaction privilege tax.

Lawn maintenance businesses are defined by the Department as "those that provide the service of law mowing and edging, tree and bush trimming/pruning, weeding, leaf raking and removal, and other activities that maintain the general upkeep of outdoor areas." Even fertilizing, spraying of insecticides or herbicides and replacement of broken or damages watering system parts due to lawn maintenance activities, so long as they are no separate charges or they are "an inconsequential element of the service, are considered service activities. These types of activities are considered nontaxable services. An "inconsequential element," in order to qualify as such, must not exceed 15% of the total charge for services. A.A.C. R15-5-104. Prime contracting landscaping activities include the installation of trees or other plants (regardless of size); the removal of trees or other embedded plants; the installation or repair of sprinkler/watering systems; the building or modification of irrigation berms; and other actions that alter property.

The Arizona Legislature adopted this formulation of the rule into statute by amending A.R.S. §§ 42-5075(H) and (I) to include this specific language, but it also expanded the list of activities that qualify for exemption as lawn maintenance services. Laws 2002, ch. 307, § 1. This amendment is effective August 31, 2002. The Department has proposed a ruling to supersede and rescind TPR 01-1 that recognizes these differences. According to the newly amended statute and the propose rule, lawn maintenance activities would include lawn mowing and edging, weeding, repairing sprinkler heads or drip irrigation heads, seasonal replacement of flowers, refreshing gravel, lawn de-thatching, seeding winter lawns, leaf and debris collection and removal, tree or shrub pruning and clipping, garden and gravel raking and applying pesticides and fertilizer materials. The same sources define landscaping activities to include installing lawns, grading or leveling ground, installing gravel or boulders, planting trees and other plants, felling trees, removing and mulching tree stumps, removing other embedded plants, building or modifying irrigation berms, repairing sprinkler or watering systems, installing railroad ties and installing underground sprinkler or watering systems. TRP 02- (draft) (2002).

Copyright © 2005 by Patrick Derdenger

7.9 Cabinetmakers.

The current version of A.A.C. R15-5-616 addresses four possible areas of taxation for cabinetmakers. First, a cabinetmaker, who constructs and installs cabinets, is taxable on his gross income under the prime-contracting category. Second, a cabinetmaker who acts as a subcontractor is not taxable. Third, a cabinetmaker who constructs and delivers cabinets to a contractor without installing such cabinets is deemed to be making a sale for resale that is not taxable. Fourth, a cabinetmaker who constructs and sells cabinets to a final consumer without installing the cabinets is taxable as a retailer under A.R.S. § 42-5061.

The Department considers that the key to the taxation of cabinetmaking as a contracting activity lies in the installation of the cabinets. The cabinets must be fixed and incorporated into the structure or project by the cabinetmaker. When there is no installation, some activity other than contracting has usually occurred. The exception to the installation requirement is subcontracting. A cabinetmaker who acts as a subcontractor is not liable for the tax if the subcontractor can demonstrate that the job was controlled by a prime contractor who was liable for the tax.

The current regulation does address this issue. The cabinetmaker, as a subcontractor, is able to construct and install the cabinets without being held liable for the tax. A.A.C. R15-5-616 does not discuss any distinction between prime contracting and subcontracting. A proposed amendment to A.A.C. R15-5-616 provides that distinction by listing a fourth category. Specifically, proposed A.A.C. R15-5-616(B) provides that "when a cabinetmaker acts as a subcontractor under A.R.S. § 42-5075 (where there is a prime contractor on the job) the activity is nontaxable."

7.10 Carpet Installation.

The regulations provide that the sale and installation of floor covering that is affixed to real property is subject to tax under the contracting activity. However, the sale and installation of floor covering attached to tangible personal property, such as motor homes, boats and travel trailers, is taxable as a retail transaction. A.A.C. R15-5-613.

7.11 Contracts with Government Agencies.

Construction projects performed for the United States Government, state, cities, counties or any agencies thereof, are taxable. A.A.C. R15-5-604; *see also Debcon, Inc. v. Dep't of Revenue*, Arizona Board of Tax Appeals, No. 1782-98-S (July 26, 1999) (prime contractor was subject to tax on contract with U.S. Department of Commerce to build a weather station on federal reserve land in Arizona).

Copyright © 2005 by Patrick Derdenger

7.12 Contracts with Schools, Churches and Other Nonprofit Organizations.

Construction projects performed for a school, church or other nonprofit organization are taxable. A.A.C. R15-5-605.

7.13 Land Clearing and Well Drilling.

Original land clearing, leveling, ditching, well drilling and installation of pumps in wells for others are taxable as contracting. Agricultural tillage of improved farmlands, such as plowing, is not taxable. A.A.C. R15-5-606.

7.14 Public Address Communication Systems.

Public address, communication, intercommunication and security alarm systems installed in a structure by a contractor are taxable. A.A.C. R15-5-615.

7.15 Is the Rental of Contracting Equipment Taxed as Contracting or as a Rental?

Determining whether receipts from the rental of contracting equipment (tractors, graders, etc.) by a contractor are taxed under the contracting or rental classification is important because of the 35% labor deduction. If the activity is contracting, the 35% labor deduction applies. If it is a rental activity, the 35% labor deduction does not apply.

As a general rule, if the equipment is rented with an operator and possession of the equipment is not surrendered, the activity is contracting. If not, the activity is the rental of personal property. *City of Phoenix v. Bentley Dillie Gradall Rentals, Inc.*, 136 Ariz. 289, 665 P.2d 1011 (Ct. App. 1983). In *Bentley-Dillie*, the taxpayer was engaged in the business of providing contracting services rather than "renting" excavating equipment because the taxpayer did not relinquish possession and control of the equipment to its customers. The taxpayer's customers were billed at an hourly rate for work performed by the Gradall equipment and no formal written contracts were executed. However, the transactions were contracting services rather than rentals because the taxpayer sent its own employees to examine the job site and job specifications, to operate the equipment, and to determine which size Gradall equipment to use, and was responsible for correcting any mistakes of its operators.

The Department's regulation appears to be inconsistent with the case. A.A.C. R15-5-612 provides:

> A. Shovel, and backhoe operations, when provided with an operator are taxable as contracting activities. Persons engaged in such activities are subject to tax as subcontractors as specified in R15-5-602. When such

Copyright © 2005 by Patrick Derdenger

equipment is provided without an operator, the transaction is taxed as rental of personal property (see Article 15).

B. Income from crane and concrete pumping activities, provided with or without operators, is taxable as rental of personal property (see Article 15).

NOTE: Apparently, the Department just does not view crane and concrete pumping activities as contracting activities.

7.16 Road Materials.

Road materials, such as dirt, rock, gravel or asphalt, that are sold to the consumer and the materials are not incorporated into any real property (i.e., only dumped in mass at the site) by the vendor are subject to the transaction privilege tax under the retail classification. When materials are sold and either the vendor or a third party incorporates the materials into real property (i.e., the vendor or third party spreads or otherwise puts the road materials in place), it is a contracting activity that is subject to the transaction privilege tax under the prime contracting classification. The sale of materials is exempt if the materials are to be incorporated into a contracting job. The contractor actually incorporating the materials is considered the taxable prime contractor unless the contractor can demonstrate that another party is the prime contractor on the job. TPR 93-2.

7.17 Judicial Claims Awards.

Where disputes between prime contractors and customers force the parties into judicial settlement of payment amounts, payments received as judicial claim awards for disputed claims remain gross income derived from engaging in a business that is subject to the transaction privilege tax. TPR 93-27; *see also Tucson Elec. Power v. Dep't of Revenue*, 170 Ariz. 145, 822 P.2d 498 (Ct. App. 1991).

7.18 Out-of-State Contractors.

Liability for transaction privilege tax arises automatically when a taxpayer engages in a taxable business activity in Arizona. The taxable event takes place at the site where the actual contracting activity is conducted. Both in-state and out-of-state prime contractors who perform work within the geographic boundaries of the state are subject to the transaction privilege tax on 65% of the gross proceeds or gross income derived from the project. TPR 93-40. Out-of-state contractors should also be aware that they are subject to the bonding requirement imposed by A.R.S. § 42-1102 and A.A.C. R15-5-601. *See infra* § 1.6.18.

7.19 Small Business Administration Contracts

Due to the structure of Small Business Administration ("SBA") contracts, there is some confusion as to liability for the transaction privilege tax in this area. Generally, all contractors are considered to be prime contractors and subject to the transaction privilege tax. In order for contractors performing work for

Copyright © 2005 by Patrick Derdenger

the SBA to nontaxable subcontractors, the SBA must be subject to tax as a prime contractor. Because the SBA merely administers the federal government's small business development programs, it does not receive, nor does it distribute, gross proceeds for contracting, it is not responsible for the completion of projects, and it is not paid by the federal government for the performance of contracting activities. Accordingly, contractors performing work for federal agencies through contracts entered into with the SBA are taxable prime contractors and subject to the transaction privilege tax. TPR 93-42.

7.20 Model Home Furniture

Transaction privilege tax is imposed on the sale, or use tax is imposed on the purchase, of furniture used in a model home. The transaction privilege tax and use tax exemptions for sales of tangible personal property to be incorporated or fabricated into real property by prime contractors *do not apply* to the sale or purchase of furniture for use in a model home. Thus, if a prime contractor purchases model home furniture using a departmental certificate which states that such furniture is tax exempt, then the prime contractor will be liable for the amount of the tax, penalty and interest that would otherwise have been the liability of the vendor. TPR 95-12.

7.21 Permit Fees.

The cost of acquiring permits is a normal cost incurred by a person doing business under the prime contracting classification. As such, any amount received as reimbursement for acquiring permits is part of gross receipts from being in business; and, therefore, is fully taxable as gross income under the prime contracting classification. TPR 95-15.

8. OFF-SITE IMPROVEMENTS.

8.1 Former Regulations.

The regulations previously provided that a person who improves his own land to the extent of paving streets, adding curbs and installing utility lines, but who does not construct buildings on the improved lots, is not subject to the tax. A.A.C. R15 5 618 (repealed). The Department's position was that the contractors performing work for such a person would be subject to the sales tax on their receipts. The Department withdrew the regulation but still maintains that contractors making offsite improvements are subject to tax. In *Sahuaro Supply Co. v. Dep't of Revenue*, Arizona Board of Tax Appeals, No. 643-89-S (Nov. 7, 1989). the Board held that Sahuaro Supply Company, which constructed offsite improvements (roads, curbs, etc.) in residential subdivisions for developers of residential real estate, was a nontaxable subcontractor to the developer. The Department had argued that Sahuaro Supply Company was a taxable prime contractor because it did work for the owner of the land. The Board concluded that to establish the subcontractor exemption, a contractor must prove: (1) the job is within the control of a prime contractor; and (2) the prime contractor is liable for

Copyright © 2005 by Patrick Derdenger

the tax on its gross income from the job. In the *Sahuaro Supply* case, the evidence showed that the developer oversaw the construction work of the offsite improvements, which satisfied the first prong of the subcontractor exemption. The Board held that the second prong was satisfied because the developer did not qualify for an exemption from the sales tax but impliedly would be liable for the sales tax on the sale of improved lots to home builders. The Department unsuccessfully appealed this decision to the tax court.

Query. When the owner of lots on which the offsite improvements are made is a speculative builder, should not the off-site contractor be treated as a nontaxable subcontractor? What is the difference between a person who performs offsite improvements for a speculative builder and any other nontaxable subcontractor who performs electrical, plumbing, roofing, etc., work for a speculative builder?

8.2 Penalty and Interest Relief for "Off-Site" Contractors.

The legislature, in S.B. 1116, forgave the interest and penalties on the unpaid sales tax liabilities of contractors making "off-site improvements." Laws 1991, ch. 290, § 3.

As background, there has been considerable controversy over the last few years as to whether "off-site" contractors that have a contract with a developer, whether it be of a residential subdivision or an industrial park, are liable for sales taxes on their receipts as the taxable "prime contractor" for the off-site improvements. Some off-site contractors paid the sales tax on their receipts while the vast majority took the position that they were exempt subcontractors.

This legislation is an outgrowth of an appeal to the legislature to forgive the sales tax liability of those off-site contractors that did not pay the tax. Most of those contractors were small to medium-sized businesses faced with sales tax assessments in the six digits and if the assessments "stuck", most of those contractors would be forced out of business. The legislature balked at forgiving the tax liability, mainly because of the lobbying efforts of those contractors that had paid the tax, but did legislatively forgive interest and penalties on the unpaid sales taxes if, by January 1, 1992, the contractor reports the tax liability to the Department in the manner prescribed by the Department and satisfies the tax liability in a manner which is acceptable to the Department (if not full payment, then perhaps a payment plan).

Only those contractors making "off-site improvements" qualify for the certificate. "Off-Site improvements" include "paving and grading streets, constructing curbs, gutters, sidewalks, alleys, drainage or flood control facilities or piping, installing traffic control devices or water, utility or sewer lines or initial grading, including leveling and fill that occurs in conjunction with any of these activities in a platted subdivision, and within a public right of way or areas designated in a plat to be a public right of way or in areas otherwise owned by or dedicated to the public or a public service corporation, or in areas designated as

Copyright © 2005 by Patrick Derdenger

common areas to be owned by owners' associations or similar entities for the benefit of their members." Laws 1991, ch. 290, § 3(C)(2).

While not forgiving the past tax liability, the legislation at least provides the forgiveness of penalty and interest, which can amount to a substantial sum. However, in order to take advantage of the penalty and interest abatement provisions, the off-site contractor must have reported its past tax liability and have made satisfactory provision for payment to the Department by January 1, 1992.

9. CONTRACTING ON INDIAN RESERVATIONS

9.1 The Starting Point—The *Ramah* Case.

Contracting receipts for work performed on an Indian Reservation for the Indian tribe or nation are exempt from the sales tax under the federal "preemption" doctrine, *Ramah Navajo Sch. Bd., Inc. v. Bureau of Revenue*, 458 U.S. 832 (1982). A.A.C. R15 5 620 (repealed 1987). which indicates that income from contracting by non-Indians on an Indian reservation is taxable, has been voided by the *Ramah* decision. Even though a contractor performing work on an Indian reservation is not subject to the Arizona sales tax, the contractor may be subject to a sales tax on his contracting receipts imposed by the Indian tribe or nation. When the *Ramah* decision was issued, a number of Arizona Indian nations, including the Navajo Nation, stepped in to impose their own sales tax on contracting. A discussion of the sales tax code of the various Indian tribes and nations is beyond the scope of this guide. If the taxpayer is conducting business on an Indian reservation, the advice of competent tax counsel should be obtained.

9.2 Refund of Sales Taxes Paid by Contractors Prior to the *Ramah* Decision.

Before the *Ramah* decision was issued, some contractors were paying sales tax on their income from contracting activities on Indian reservations. After the *Ramah* decision, several of those contractors filed claims for refund. The Department's position has been to deny those claims for refund because the sales taxes in question were not initially "paid under protest." The Board of Tax Appeals upheld the Department's position. *Sun Eagle Corp. v. Dep't of Revenue*, Arizona Board of Tax Appeals, No. 329 84 S (Mar. 13, 1985); *Neumann Caribbean Int'l Ltd. v. Dep't of Revenue*, 156 Ariz. 581, 754 P.2d 308 (Ct. App. 1987), review granted, June 7, 1988. The Board in both cases held that the Department had a "semblance of authority" to impose the tax and the contractor had voluntarily paid it. The statutory procedure for recovery of sales taxes requires that the state's "semblance of authority" to collect the tax must be challenged by paying the tax "under protest." However, in the *Sun Eagle* case, the Board held that the contractor was entitled to a refund of the sales taxes paid after the *Ramah* decision even though the taxes were not paid under protest because, after the *Ramah* decision, the Department no longer had a "semblance of authority" to collect the taxes.

Copyright © 2005 by Patrick Derdenger

The Arizona Supreme Court accepted review of the *Neuman Caribbean* case, reversed the court of appeals and held that there was no statutory requirement for "payment, under protest" in the *Neuman Caribbean* situation. *Pittsburgh & Midway Coal Mining Co. & Neuman Caribbean Int'l, Ltd. v. Dep't of Revenue*, 161 Ariz. 135, 776 P.2d 1061 (1989).

9.3 Contracts with School Districts—The Greenberg Case.

In *Dep't of Revenue v. M. Greenberg Constr,* 182 Ariz. 397, 897 P.2d 699 (Ct. App. 1995), the court held that construction contracts with Arizona school districts where the work was on the reservation were taxable and that *Ramah* did not apply. Greenberg Construction did construction work on the Navajo Indian Reservation. It had contracts with the Ganado School District and the Chinle School District. The Department of Revenue assessed sales taxes under the contracting classification on Greenberg's from those school district projects. Greenberg argued that the state was preempted by federal law from imposing sales tax on its construction because it was doing work on the Indian reservation. Greenberg relied upon the United State Supreme Court's *Ramah* decision, which struck down the New Mexico sales tax on a contractor's from construction work done for the Ramah Navajo School Board.

The Department's position is that *Ramah* did not apply because the contracts in the Greenberg case were with the Ganado and Chinle school districts, which are political subdivisions of the state of Arizona and are not part of the Navajo tribal government. The Department was making a fine distinction but the court of appeals agreed and upheld the sales tax.

According to *Greenberg*, construction work will be subject to the Arizona sales tax unless the contract is with the Indian tribe or nation or an agency of the tribe. If it is with an Arizona school district, even though the work is done on the Indian reservation, the *Greenberg* decision concludes that such work is taxable.

Greenberg Construction filed a petition for review on February 17, 1995. The Arizona Supreme Court denied the petition for review on June 29, 1995. Greenberg did not file a petition for certiorari with the United States Supreme Court.

The holding of *Greenburg* was reaffirmed and expanded in *Flintco Inc. v. Dep't of Revenue,* Arizona Board of Tax Appeals, No. 1801-99-S (Oct. 19, 1999). In *Flintco*, the Board held that construction contracts entered into by a Cherokee Nation prime contractor (considered the non-member Indian) with the Tuba City Unified School District, a political subdivision of Arizona located on the Navajo Nation, were not exempt from taxation under the preemption doctrine even though, unlike *Greenburg*, the contractor was an Indian owned contractor. The board found the two circumstances indistinguishable for purposes of taxation as a prime contractor.

9.4 Contracts with the Bureau of Indian Affairs—The *Blaze* Case.

Copyright © 2005 by Patrick Derdenger

(1) ***The New Mexico Case.*** The Department's position is that construction contracts with the Bureau of Indian Affairs (BIA) for construction work on an Indian reservation, even though the work is for the benefit of the Indian tribe, are taxable. The Department's position is supported by a New Mexico Supreme Court case on the same subject. *Blaze Constr. Co. v. New Mexico Taxation & Revenue Dep't*, 118 N.M. 647, 884 P.2d 803 (1994), cert. denied, 514 U.S. 1016 (1995). Blaze Construction entered into contracts with the BIA for construction work on Indian reservations located in New Mexico. The New Mexico Department of Revenue took the position that those contracts, since they were with the BIA and not directly with an Indian tribe or an agency thereof, were taxable, not falling under the preemption doctrine of the *Ramah* case. The New Mexico Court of Appeals held that the BIA contracts were not taxable but the New Mexico Supreme Court reversed, concluding that they were taxable. The United States Supreme Court denied certiorari, meaning that the New Mexico Supreme Court decision stands as the law, at least in New Mexico.

(2) ***The Arizona Case—Board of Tax Appeals and Tax Court.*** To add confusion to this subject, Blaze Construction was involved in a similar case in Arizona. The Department of Revenue took the position that the BIA contracts for road building work on Indian reservations in Arizona were taxable. Blaze Construction appealed and received a favorable decision from the Arizona Board of Tax Appeals in *Blaze Constr. Co. v. Dep't of Revenue,* Arizona Board of Tax Appeals, No. 950-92-S (July 18, 1994). Issued in July 1994, the Arizona *Blaze* decision was issued after the New Mexico appeals court decision, but before the New Mexico Supreme Court decision, which was released on October 18, 1994. The Arizona Department of Revenue appealed the Board of Tax Appeals decision to the Arizona Tax Court. The Tax Court overturned the Board's decision and held for the Department.

(3) **The *Blaze* Court of Appeals Case.** Blaze appealed the tax court's decision to the Arizona Court of Appeals. The court of appeals reversed the tax court and held that Blaze's construction projects on an Indian reservation, where the contract was with BIA, were not subject to the Arizona sales tax. *Dep't of Revenue v. Blaze Constr. Co.*, 190 Ariz. 262, 947 P.2d 836 (Ct. App. 1997). The principles of Indian law preemption analysis apply even though Blaze's contracts for on-reservation road improvements were with the BIA rather than with the affected tribes and that those preemption principles required the court to conclude that the imposition of Arizona's contract and privilege tax on Blaze was impliedly preempted by federal law and therefore had no legal effect.

(4) ***The United States Supreme Court Decision—Taxable.*** In *Dep't of Revenue v. Blaze Constr. Co.,* 526 U.S. 32 (1999). the Supreme Court reversed the Arizona Court of Appeals decision, holding that construction contracts with the BIA for construction on an Indian reservation are subject to the Arizona transaction privilege tax under the prime contracting classification. The Supreme Court reversed the Arizona Court of Appeals relying upon the rule in *United States v. New Mexico*, 455 U.S. 720 (1982). which generally permits state taxation of federal contractors, in the absence of express action by Congress to

Copyright © 2005 by Patrick Derdenger

exempt the transaction, even though the contractor's services are performed on an Indian reservation. The United States Supreme Court concluded that governmental tax immunity is appropriate only when the levy falls on the United States itself, or on its agency or closely connected instrumentality. This immunity can be expanded only if Congress especially provides for an exemption. The Arizona transaction privilege tax under the prime contracting classification fell on Blaze Construction, and not on the BIA (a federal agency). Since Blaze was not an agency or instrumentality of the federal government and since Congress has not exempted these contracts from taxation, the United States Supreme Court held that Blaze's construction contracts with the BIA were taxable.

The Court also noted that it would confuse such a clear rule to impose an interest-balancing test, which Blaze had asked for, in such situations. Normally, an interest balancing test is applied when the tax affects an Indian tribe, with the interest of the state in asserting the tax being balanced against the interests of the Indian tribe and its sovereignty. The Court did not view this as a preemption analysis because the contract was not imposed upon the United States government or an agency or instrumentality of the federal government and, under *United States v. New Mexico*, the rule of taxation in such circumstances is clear.

9.5 Department of Revenue Rulings Covering Construction Contracts on Indian Reservations.

Transaction Privilege Tax Ruling 95-11(C) details the Department's position on the taxability of construction work performed on an Indian reservation. It provides:

> The gross proceeds derived from contracting activities performed on a reservation by the Indian tribe, a tribal entity or an affiliated Indian are not subject to Arizona's transaction privilege tax.
>
> The gross proceeds derived from construction projects performed on Indian reservations by non-affiliated Indian or non-Indian prime contractors are not subject to the imposition of Arizona transaction privilege tax under the following conditions:
>
> 1. The activity is performed for the tribe or a tribal entity for which the reservation was established; or
>
> 2. The activity is performed for an individual Indian who is a member of the tribe for which the reservation was established.

The gross proceeds derived from construction projects performed on Indian reservations by non-affiliated Indian and non-Indian prime contractors for all other persons, including the federal government, are subject to the imposition of Arizona transaction privilege tax.

Copyright © 2005 by Patrick Derdenger

9.6 Tax Consequences of Construction Work on Indian Reservations.

Contractor	Construction on Reservations: Contracting Party	Arizona Transaction Privilege Tax Result	Case
Non-Indian/Non-Affiliated Indian Prime Contractor	Indian Tribe, Tribal Entity, Affiliated Indian	Not Taxable	*Ramah*
Non-Indian/Non-Affiliated Indian Prime Contractor	Bureau of Indian Affairs	Taxable	*Blaze Construction* (U.S. Supreme) Court) TPR 95-11
Indian Tribe, Tribal Entity or Affiliated Indian Prime Contractor (Member)	Anybody	Not Taxable	*Ramah* and TPR 95-11
Non-Indian/Non-Affiliated Indian Prime Contractor	School District	Taxable	*Greenberg Construction* and *Flintco*

9.7 The *Luther Construction* Case - The Department was Estopped from Taxing BIA Contracts.

In *Valencia Energy Co. v. Arizona Dep't of Revenue*, 191 Ariz. 565, 576, 578-79, 959 P.2d 1256, 1267, 1269-70 (1998), the Arizona Supreme Court held that a taxing authority may be estopped (legally prevented) from assessing tax under the following four circumstances: (1) the taxing authority engaged in affirmative conduct inconsistent with a position it later adopted that is adverse to the taxpayer, (2) the taxpayer actually and reasonably relied on the taxing authority's prior conduct, (3) the taxing authority's repudiation of its prior conduct caused the taxpayer to suffer a substantial detriment because the taxpayer changed its position in a way not compelled by law, and (4) applying estoppel against the taxing authority would neither unduly damage the public interest nor substantially and adversely affect the exercise of governmental powers. 191 Ariz. at 576-78, 959 P.2d at 1267-69.

In *Luther Constr. Co., Inc., v. Arizona Dep't of Revenue*, ___ Ariz. ___, 406 Ariz. Adv. Rep. 56, 74 P.3d 276 (2003) (Exhibit D), the Arizona court of appeals considered whether Valencia applied to a taxpayer claiming equitable estoppel against the assessment of transaction privilege tax on payments by the

Copyright © 2005 by Patrick Derdenger

Bureau of Indian Affairs (BIA) to the taxpayer for construction projects on an Indian reservation.

Luther is a general construction company based in Albuquerque, New Mexico. As part of its business, Luther contracts with the BIA for construction projects on the Navajo reservation in Arizona. During a two-and-a-half year period in the mid-1980's, Luther paid Arizona transaction privilege tax under the prime contracting classification on gross proceeds from several BIA contracts. In January 1986, Luther sent a letter to ADOR requesting guidance concerning an exemption from tax for contractors and suppliers conducting business on the Navajo reservation. The administrator of ADOR's Tax Policy Section (Lee McFadden), responded to Luther's inquiry by letter the next month (the "McFadden letter"), and advised Luther that income from contracting activity on a reservation is exempt if the work is performed for, and payment is received from, among others, "the [BIA] for a hospital, school, road or other similar structure constructed for the use of Indians on the reservation." McFadden explained that "[t]he intent behind this exemption is not to tax an activity within a reservation if it is performed for the benefit of the Indians or the tribe."

In August 1986, Luther filed amended returns and requests for refunds for transaction privilege tax paid for periods in 1983 through 1986 on proceeds from BIA contracts for construction projects on the Navajo reservation. The amended returns specified that the deductions were for "non-taxable Indian work on reservations." ADOR responded by conducting an audit for the time periods listed in the amended returns. Subsequently, in October 1987, ADOR's Refund Supervisor, Jerry Lewis, sent Luther a copy of the completed audit and a refund check in the full amount requested by Luther. The audit report was signed by an auditor and his supervisor and reflected that Luther's BIA contracts were "Exempt Indian Contracting." Simultaneously, a member of ADOR's Audit Services Unit, Cleva M. Totress, sent Luther a refund check, including interest. An accompanying letter stated that the refund was "made as the result of: Contracting on Indian reservations for the benefit of Indians."

After the 1987 audit, Luther treated as exempt gross proceeds from both BIA-funded and state school-district-funded contracts to construct reservation schools. In August 1993, ADOR assessed delinquent taxes against Luther on gross proceeds from four school-district-funded contracts earned from July 1989 through December 1992. Significantly, the written assessment sent to Luther reflected that proceeds from a BIA-funded contract to construct a school during that period were exempt from tax.

In October 1993, Luther submitted its bid to the BIA to perform construction on another project on the Navajo reservation. Luther did not include the Arizona transaction privilege tax in the bid. The BIA awarded the contract to Luther in 1994. In April 1995, ADOR issued transaction privilege tax ruling ("TPR") 95-11, declaring, in relevant part, that the gross proceeds derived from on- reservation construction projects funded entirely by the federal government are not exempt from the state's transaction privilege tax. Thereafter, Luther

Copyright © 2005 by Patrick Derdenger

resumed its earlier practice of accounting for transaction privilege tax in its BIA contract bids.

In 1997, ADOR assessed Luther for delinquent transaction privilege tax on gross proceeds from the 1994 BIA Contract. The assessment amount totaled over $200,000 in tax liability, penalties, and interest.

In appealing the case to the Arizona Court of Appeals, Luther did not challenge the tax court's ruling that the proceeds from the 1994 BIA Contract were subject to transaction privilege tax. Rather, Luther argued the lower court erred by ruling as a matter of law that ADOR was not estopped from assessing this tax.

Luther argued that ADOR engaged in affirmative conduct inconsistent with its position adopted in the 1997 assessment by sending to Luther (1) the McFadden letter, (2) the results of the 1987 audit with accompanying letters and refund, and (3) the 1993 assessment. The Department conceded that the McFadden letter constituted an inconsistent act under Valencia, but argued that the letter was "stale" and could not be relied upon. The Department further argued that the 1987 and 1993 acts did not constitute formal affirmative conduct for purposes of estoppel.

The Arizona Court of Appeals held that the position of the Department taken in a prior audit may be considered an inconsistent "act" that "bear[s] some considerable degree of formalism" for estoppel purposes under Valencia. 74 P.3d at 279-280. The court further held that Luther did not need to prove that it would have successfully passed the tax to the BIA; rather, Luther could satisfy its burden by demonstrating that it may have passed the tax to the BIA and suffered a substantial detriment by not doing so.

9.8 The *Gosnell* Case —Contractors Must Be Treated Alike.

The Arizona Court of Appeals "struck a blow" for equal treatment of taxpayers in *Gosnell Dev. Corp. v. Dep't of Revenue,* 154 Ariz. 539, 744 P.2d 451 (Ct. App. 1987). In computing its Arizona sales tax liability under the "contracting classification," Gosnell computed its "labor deduction" in the manner sanctioned by the Department. However, Gosnell discovered later that the Department had established an administrative position that upon audit, it would not make an audit adjustment for those contractors that computed the "labor deduction" contrary to the Department's position for periods prior to March 1984 (the date on which the court of appeals rendered a decision in another case upholding the Department's position on the computation of the "labor deduction"). Through its administrative position, the Department applied the court of appeals' decision prospectively only. Upon learning this, Gosnell filed a claim for refund for the extra sales taxes paid prior to March 1984 as a result of computing its "labor deduction" using the Department's sanctioned position. The Department disallowed Gosnell's claim and Gosnell filed suit claiming that it was not being treated equally with other similarly situated taxpayers, since those that had not paid the extra tax before

Copyright © 2005 by Patrick Derdenger

March 1984 would not be required to do so, but Gosnell who had paid would not be given a refund. The court of appeals held that such differing treatment violated Gosnell's equal protection rights and ordered a refund of the sales taxes in question.

10. MARKETING ARM–CONTRACTING ARM

10.1 Overview of Marketing Arm–Contracting Arm Structure.

A number of residential developers, with the intent of minimizing the state sales tax liability on the construction and sale of homes, have established a dual structure for their contracting and marketing activities. Rather than have just one entity build and sell the homes, the builder will establish a separate marketing arm in addition to the contracting arm.

There are two possibilities with this structure.

First, the contracting arm can build the houses on land that it owns and then sell the completed homes and underlying land to the marketing arm. The marketing arm will then market those homes to prospective homebuyers. The completed homes and underlying land will generally be sold to the marketing arm at the contracting arm's cost plus a reasonable profit. See Chart A below.

Second, the contracting arm can contract with the marketing arm to build on land owned by the marketing arm. The amount of the construction contract is to be the contractor's cost plus normal mark-up. The marketing arm then will sell the completed homes to potential homebuyers. See Chart B below.

10.2 State Sales Tax Consequences.

In both instances, the Arizona sales tax will apply to the contracting arm's receipts from either selling the house to the marketing arm or from its receipts from building the house for the marketing arm. The marketing arm can then resell the homes with the normal mark-up. The marketing arm's receipts from the sale of those homes will not be subject to state sales tax, even though the homes were sold within two years from the date of substantial completion.

The Department of Revenue has issued several private rulings to this effect. Those rulings are based upon Sales Tax Ruling No. 2-15-84 which indicates that an owner-builder who uses a general contractor to make all improvements (when the general contractor pays sales tax on his receipts) will not be subject to the Sales tax under the contracting classification even if the owner-builder sells the completed project within two years from the date of substantial completion. The private rulings issued by the Department require a reasonable profit factor over and above the cost of construction. The profit factor must be reasonable under the facts and circumstances, and economic conditions. The Department has indicated that, if the profit percentage is not a fair, or arms-length profit percentage, they will impute a fair profit percentage. The worse case scenario, though, is if the profit percentage is too low, the Department, rather than

Copyright © 2005 by Patrick Derdenger

imputing a fair profit margin, would collapse the marketing arm-contracting arm structure, thereby taxing the end sale of the house to the homebuyer.

The use of this methodology minimizes the overall state sales tax by restricting it to the contracting arm's receipts (cost plus a reasonable profit) rather than applying the sales tax to the sales price of the house (as sold to the ultimate homebuyers).

There are very few cases dealing with the marketing arm-contracting arm structure. In *Acacia/Autumn & Masters Ltd. Partnership & Acacia/Country Limited Partnership v. Dep't of Revenue*, Arizona Board of Tax Appeals, No. 1042-93-S (Oct. 14, 1994). the taxpayer was a homebuilder that had established the contracting arm-marketing arm structure. The Department audited the taxpayer for both state and Town of Oro Valley sales tax purposes. The Department disallowed the marketing arm-contracting arm structure at the city level, on the basis that the model city tax code does not permit such an arrangement. The Board upheld the structure for state sales tax purposes but not for city tax purposes.

10.3 City Sales Tax Consequences.

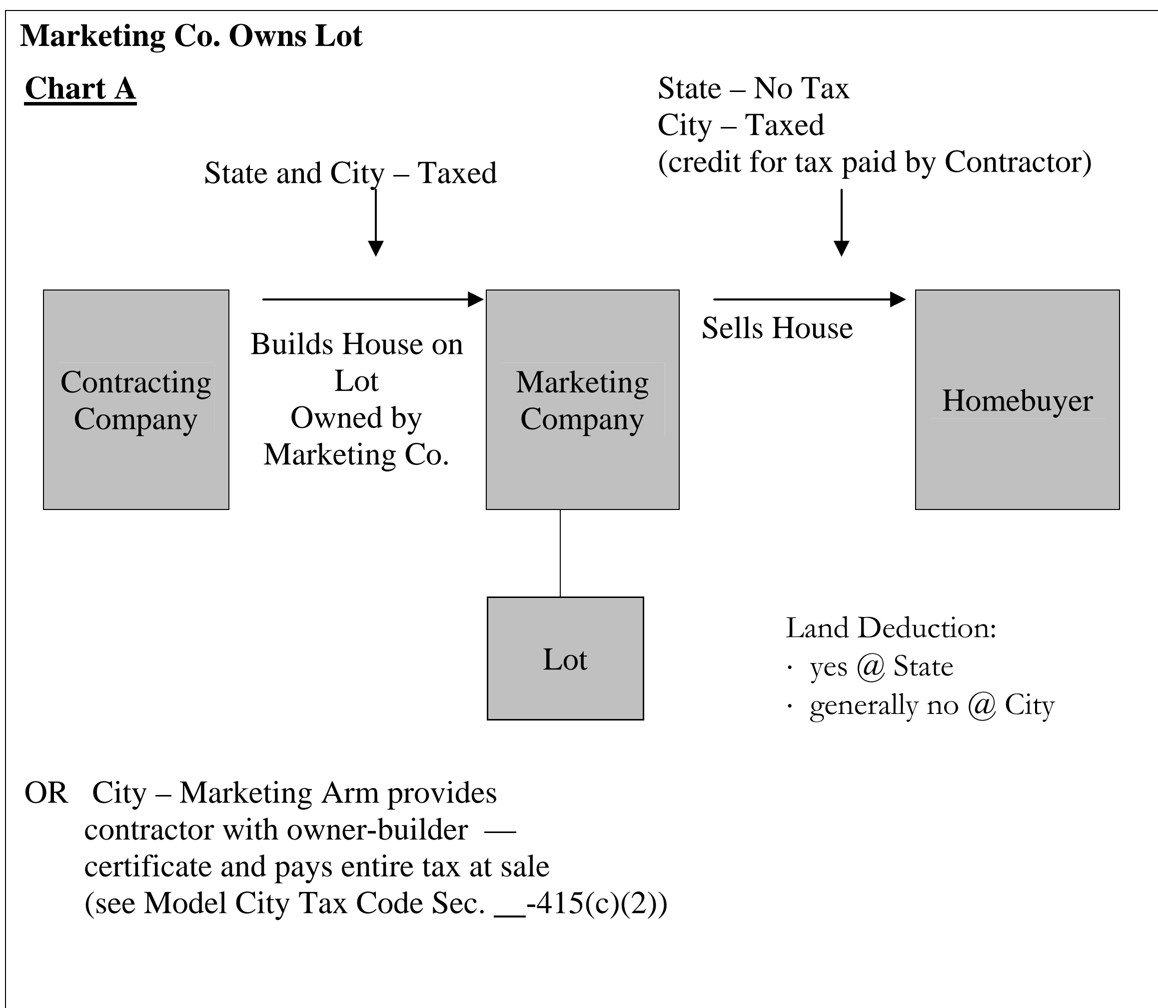
As pointed out in the *Acacia/Autumn* case, the marketing arm-contracting arm structure works for state sales tax purposes but *not* for city sales tax purposes. That is because the Model City Sales Tax Code is structured quite differently from the state statutes dealing with the taxation of contracting. The Model City Tax Code contains the "speculative builder" classification, which the state statute does not. It is the presence of the speculative builder tax at the city level that negates the marketing arm-contracting arm tax savings opportunity for city taxes. The city sales tax ramifications will be as follows:

(1) Marketing Company Owns Land. Under the Model City Tax Code, the contracting company will be liable for the city sales tax on its receipts from the marketing company for the construction of the house. There will be no land deduction, because the contracting company does not own the land. The contracting company, though, will be entitled to the normal 35% labor deduction. The marketing company, when it sells a house to the homebuyer, will be subject to city sales tax on its total sales receipts. It will be entitled to the normal 35% labor deduction. However, most cities do not provide for a land deduction. The marketing company, though, will receive credit against its city sales tax liability for the sales taxes paid by the contracting company. To delay the city tax until the sale of the house to the homebuyer, the marketing company could give a speculative builder certificate to the contracting company, indicating that the marketing company is a speculative builder that is improving the property for sale. *See* Model City Tax Code Section, Art. IV, § 416(c)(2). The result is that the contracting company will not be liable for City sales tax on its construction revenue but the marketing company will be liable for the speculative builder tax on the sale of the residence with no credit for sales taxes paid by the contracting company.

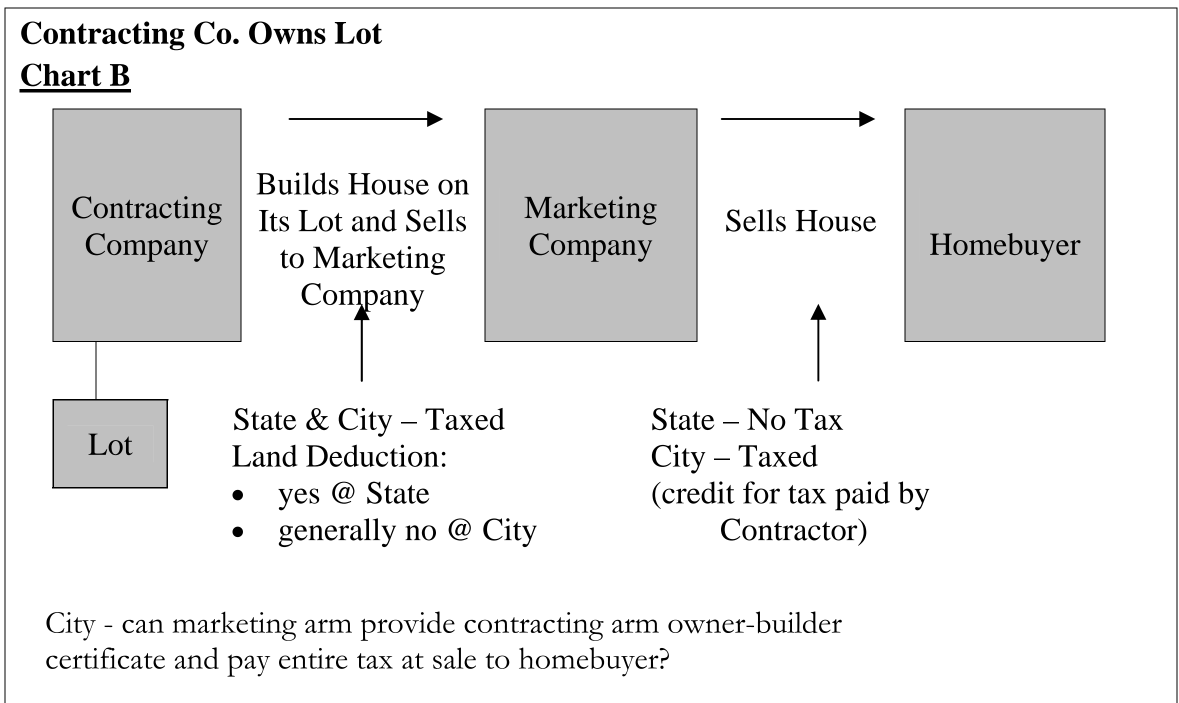
Copyright © 2005 by Patrick Derdenger

(2) Contracting Company Owns Land. The contracting company will be subject to city sales tax on its sale of the completed house and lot to the marketing company. The contracting company will be entitled to the normal 35% labor deduction but will not receive a land deduction because most cities do not provide for a land deduction. The marketing company will be subject to city sales tax on its sale of the house and lot to the homebuyer. It will receive the normal 35% labor deduction but will not receive the land deduction, again because most cities do not provide for such a land deduction. The marketing company will also receive credit against its city sales tax liability for the city sales taxes paid by the contracting company.

10.4 Charts A & B (See below and next page.)



Copyright © 2005 by Patrick Derdenger



11. SALES TAX ON DEALERSHIP OF MANUFACTURED BUILDINGS

11.1 Dealership of Manufacturing Buildings Is Prime Contracting.

The "prime contracting" classification of A.R.S. § 42-5075(A) also includes the "dealership of manufactured buildings." "Manufactured buildings" commonly include mobile homes, house trailers, prefabricated structures, etc. A.R.S. § 42-5075 (H)(4). A dealer who sells such "manufactured buildings" will be treated the same as a "prime contractor" for sales tax purposes, and will be entitled to the 35% labor deduction.

11.2 65% Inclusion.

Only 65% of the sales price of the manufactured building is included in the tax base. A.R.S. § 42 5075(B).

11.3 Deductions.

A dealer who sells manufactured buildings will be entitled to the following deductions:

(1) Furniture, furnishings, fixtures, appliances and attachments not incorporated as component parts of manufactured buildings at the time of purchase by the dealership for resale are exempt. Those items are subject to the sales tax under the retail classification. A.R.S. § 42-5075(B)(3).

Copyright © 2005 by Patrick Derdenger

(2) The sale of a used manufactured building by a dealership or others is not subject to the sales tax under this classification. A.R.S. § 42-5075(A).

11.4 Department's Position on Taxation of Mobile Homes, Manufactured Buildings and Recreational Vehicles (RVs).

The Department's position with respect to mobile homes, manufactured buildings, and RVs is found in Sales Tax Ruling No. 5-15-79 (Jan. 1988) (as amended). The following is a synopsis of the Department's ruling:

(1) New Mobile Homes. The sale of a new mobile home is taxed as prime contracting if the dealership meets the definition of "dealership of manufactured buildings" found in A.R.S. § 42-5075(H)(3). "Dealership of manufactured buildings" means a dealer licensed pursuant to title 41, chapter 16, A.R.S. § 41- 2141 *et seq.* who sells at retail manufactured homes, mobile homes or factory-built buildings, as such terms are defined in A.R.S. § 41-2142, and who supervises, performs or coordinates the excavation and completion of site improvements, setup or moving of a manufactured home or factory-built building including the contracting, if any, with any subcontractor or specialty contractor for the completion of the contract.

If the purchaser or his agent takes possession of the mobile home and transports it from the dealer's location, the sale is taxable in full as a retail sale.

(2) Used Mobile Homes. The sale of a used mobile home is excluded from the contracting tax. However, its sale will be subject to the retail sales tax if the dealer does not perform any of the activities described in A.R.S. § 42-5075(H)(3).

(3) Taxed as Retail Sale. If none of these events transpire (for new or used), then the sale is taxable in full as a retail sale.

(4) Trade-Ins. If the sale of the mobile home comes within the prime contracting classification, the trade-in will not be allowed for purposes of reducing the tax liability accruing under the contracting classification. If the sale of the mobile home comes within the retail sale provisions of A.R.S. § 42-5061, the trade-in will be allowed for purposes of reducing the tax liability accruing under the retail classification.

(5) Travel Trailers. The sale of travel trailers or motor homes is taxed as a retail sale.

(6) Difference Between Manufactured Homes and RVs. The Department construes "manufactured" homes to be those units which conform to the 1976 HUD standards and which bear the HUD label. The Department construes "recreational vehicles" to be those units which conform to the ANSI standards and which bear the state label. Any sale of these units will be taxed as follows:

Copyright © 2005 by Patrick Derdenger

(a) Those units built to HUD specifications and bearing the HUD label when the unit leaves the factory will be subject to tax under the prime contracting classification if the Arizona dealer is a "Dealership of Manufactured Buildings" as defined in A.R.S. § 42-5075(H)(3). If the dealer does not fit that definition on a particular sale, then the dealer is subject to tax under the retail classification.

(b) Those units built to ANSI specifications and bearing the state label when the unit leaves the factory will be subject to tax under the retail classification.

11.5 Surety Bonds for Out-of-State Contractors.

Effective July 1, 1989, A.R.S. § 42-1102, formerly A.R.S. § 42-1102. was amended to provide that a taxpayer who does not have a principal place of business in Arizona and who enters into a prime construction contract to be performed in Arizona must furnish the Director of the Department of Revenue a surety bond in an amount equal to the gross receipts to be paid under the contract multiplied by the sum of the applicable sales or use tax rates. The bond is not required where the total gross receipts to be paid under the construction contract, including any changes, are less than $50,000. "Principal place of business in Arizona" is defined as the continuous operation of a facility by the licensee with at least one full-time employee in Arizona for 12 consecutive months preceding the determination. A building or other construction permit shall not be issued to any person subject to the bond requirements unless that person demonstrates compliance with those requirements by furnishing a certificate from the Director of the Department of Revenue. A.A.C. R15-5-601 sets out the specifics for such surety bonds:

1. For the purpose of this rule:

   a. The principal place of business shall be Arizona if the licensee has continuously operated a facility with at least one full-time employee in Arizona for 12 consecutive months preceding the determination.

   b. A surety bond shall include a bond issued by a company authorized to execute and write bonds in Arizona as a surety or composed of securities or cash which are deposited with the Department of Revenue.

   c. The businesses subject to these bonds are grouped in accordance with the standard industry classifications by average business activity. The business classes and bond amounts are as follows:

   d. Two thousand dollars for:

1. General contractors of residential buildings other than single family;

2. Operative builders;

3. Plumbing, air conditioning, and heating, except electric;

4. Painting, paper hanging;

5. Decorating;

6. Electrical work;

7. Masonry stonework and other stonework;

8. Plastering, drywall, acoustical and insulation work;

9. Terrazzo, tile, marble and mosaic work;

10. Carpentry;

11. Floor laying and other floor work;

12. Roofing and sheet metal work;

13. Concrete work.

14. Water well drilling;

15. Structural steel erection;

16. Glass and glazing work;

17. Excavating and foundation work;

18. Wrecking and demolition work;

19. Installation and erection of building equipment;

20. Special trade contractors; and

21. Manufacturers of mobile homes.

2. Seven thousand dollars for:

a. General contractors of single family housing.

b. Water, sewer, pipeline, communication and power-line construction.

Copyright © 2005 by Patrick Derdenger

3. Seventeen thousand dollars for:

a. General contractors of industrial buildings and warehouses;

b. General contractors nonresidential buildings other than single family;

c. Highways and street construction except elevated highways.

4. Twenty-two thousand dollars for heavy construction.

5. One-hundred two thousand dollars for bridge, tunnel and elevated highway construction.

a. Except as provided in Subsection D. of this rule, any applicant whose principal place of business is outside Arizona or who has conducted business in Arizona for less than one year shall post a bond before the transaction privilege tax license shall be issued.

b. Any taxpayer subject to bonding requirements may submit a written request to the Director of the Department of Revenue for an exemption from the bond. The exemption request shall provide at least one of the following:

c. Any taxpayer who has been actively engaged in business for at least two years immediately preceding the exemption request may submit statements from an authorized state employee from each state in which the business has been licensed in the last two years verifying that the taxpayer has, for at least two years immediately preceding the date of the statement, made timely payment of all sales taxes and other transaction privilege taxes incurred;

6. Two-year reporting history as described above in paragraph (1) and an explanation of good cause for late or insufficient payment of the tax;

a. Documentation which verifies that no potential for Arizona tax liability exists;

b. Bond for a previously issued Arizona transaction privilege license that adequately covers the licensee's expected transaction privilege tax liability for Arizona for both the previously issued license and for this license.

Copyright © 2005 by Patrick Derdenger

7. The bond shall not expire prior to two years after the transaction privilege license is issued. Upon lapse or forfeiture of any bond by any licensee, the licensee shall deposit with the Department another bond within five business days of the licensee's receipt of written notification by the Department.

8. Any licensee, who has had a bond posted for at least two years and fulfills any exception listed in Subsection (D), or whose principal place of business becomes Arizona, may request a written waiver and that the bond be returned.

12. CITY SALES TAXATION OF CONTRACTING.

City sales taxation of contractors, speculative builders and owner-builders differs from the state sales tax laws.

12.1 Construction Contractors.

The Model Code uses the terminology "construction contractor," as opposed to "prime contractor" as used in the state statute. This term is defined in § 100 of the Model Code and is similar to the state's definition of "contractor."

> "Construction Contractor" means a person who undertakes to or offers to undertake to, or purports to have the capacity to undertake to, or submits a bid to, or does himself or by or through others, construct, alter, repair, add to, subtract from, improve, move, wreck, or demolish any building, highway, road, railroad, excavation, or other structure, project, development, or improvement to real property, or to do any part thereof. "Construction contractor" includes subcontractors, specialty contractors, prime contractors, and any person receiving consideration for the general supervision and/or coordination of such a construction project. This definition shall govern without regard to whether or not the construction contractor is acting in fulfillment of a contract.

Construction contractors are taxed under § 415 of the Model Code on the gross income from the contracting activity less a 35% standard deduction. Model Code § 415(b)(2). This is similar to the state sales tax on prime contractors. As at the state, subcontractors are exempt from taxation, but only if the subcontractor has obtained a written declaration from a construction contractor or a speculative builder or if the subcontractor is performing work for another subcontractor who has received such a written declaration. Model Code § 415(c).

Copyright © 2005 by Patrick Derdenger

12.2 Subcontractor Written Declarations.

The Model Code exempts subcontractors from the tax imposed on construction contractors, *only* if the subcontractor has obtained a written declaration in one of the following situations:

1. Where a construction contractor has provided the subcontractor with a written declaration that the construction contractor is liable for the tax on the project and the construction contractor has provided the subcontractor both its Arizona transaction privilege license number and its city privilege license number;

2. Where an owner-builder has provided the subcontractor with a written declaration that the owner-builder is improving the property for sale; the owner-builder is liable for the tax for such construction contracting activity; and the owner-builder has provided the subcontractor its city privilege license number; or

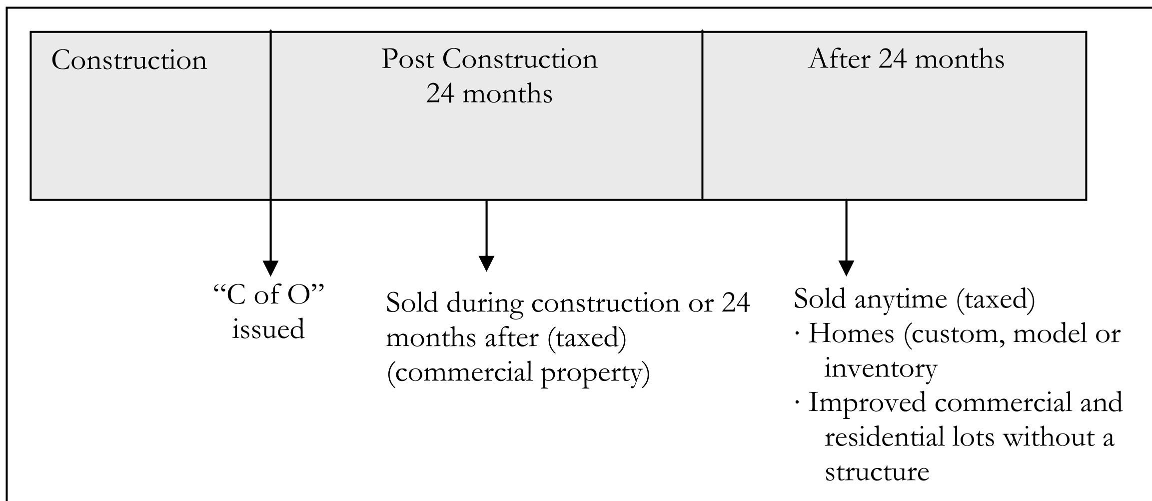
3. Where the subcontractor is performing work for a construction contractor who has received a written subcontractor declaration in either of the two situations above.

PLANNING TIP: Contractor's or specialty contractors who are contracting with either a prime contractor or an owner-builder/speculative builder should obtain the written declaration from the prime contractor or owner-builder/speculative builder before performing any subcontracting services. If the subcontractor does not have such a written declaration, the city will treat that entity as a taxable construction contractor. The cities have not issued forms for such written declarations and taxpayers need to prepare their own forms based upon the Model City Code language (see above). It is unclear whether the cities would accept the state "Prime Contractor's Exemption Certificate," Form 5005.

Copyright © 2005 by Patrick Derdenger

13. THE CITY SPECULATIVE BUILDER TAX

The speculative builder tax is imposed on the sale of "improved real property" if the improved real property is sold prior to completion or before the expiration of 24 months after the improvements are substantially complete. If custom, model or inventory homes or improved residential or commercial lots without a structure are involved, then the tax is imposed when sold, without any time limitation. *See* Model City Tax Code Section -416 and definition of "Speculative Builder" contained in Model City Tax Code Section -100.



13.1 The Structure of the Speculative Builder Tax.

(1) The Tax Imposition Section. Section -416(a) of the Model City Tax Code imposes a city privilege license tax under the "speculative builder" classification as follows:

> The tax shall be equal to ____ percent (___%) of the gross income from the business activity upon every person engaging or continuing in business as a *speculative builder* within the City. (Emphasis added).

(2) The Taxable Gross Income of a Speculative Builder. "The gross income of a speculative builder considered taxable shall include the total selling price from the sale of improved real property at the time of closing of escrow or transfer of tile." *See* Model City Tax Code Section –416(a)(1).

Copyright © 2005 by Patrick Derdenger

(3) Definition of a "Speculative Builder." Speculative builder is defined by the Model City Tax Code Section -100 as follows:

> *"Speculative Builder"* means either:
>
> (1) an *owner-builder* who sells or contracts to sell at anytime, improved real property (as provided in Section -416) consisting of:
>
> a. custom, model, or inventory homes, regardless of the stage of completion of such homes; or
>
> b. improved residential or commercial lots without a structure; or
>
> (2) an *owner-builder* who sells or contracts to sell improved real property other than improved real property specified in subsection (1) above:
>
> a. prior to completion; or
>
> b. before the expiration of twenty-four (2) months after the improvements of the real property sold are *substantially complete*. (Emphasis added).

(4) Definition of "Owner-Builder." An "owner-builder" is defined to mean "an owner or lessor of real property who, by himself or by or through others, constructs or has constructed or reconstructs or has reconstructed any improvement to real property." Model City Tax Code Section -100.

(5) When is the Project "Substantially Complete." *Id.* For speculative builders other than residential homebuilders, the 24 month period is measured from the date that the improvements were "substantially complete." That term is defined as follows:

> *"Substantially Complete"* means the construction contracting or reconstruction contracting:
>
> a. has passed final inspection or its equivalent; or
>
> b. certificate of occupancy or its equivalent has been issued; or
>
> c. is ready for immediate occupancy or use.

***(6)* The Trigger for the Imposition of Speculative Tax is the "Sale of Improved Real Property."** *See* Model City Tax Code Section -416(a)(3). The term "sale" has been broadly defined by the Model City Tax Code as follows:

> *"Sale of Improved Real Property"* includes any form of transaction, whether characterized as a lease or otherwise,

Copyright © 2005 by Patrick Derdenger

which in substance is a transfer of title of, or equitable ownership in, improved real property and includes any lease of the property for a term of thirty (30) years or more (with all options for renewal being included as a part of the term). In the case of multiple unit projects, "sale" refers to the sale of the entire project or to the sale of any individual parcel or unit.

(7) Definition of "Improved Real Property." *See* Model City Tax Code Section -416(a)(2). The trigger for the imposition of the tax is the "sale" of improved real property. Improved real property is defined by the Code as follows:

"Improved Real Property" means any real property:

a. upon which a structure has been constructed; *or*

b. where improvements have been made to land containing no structure (such as paving or landscaping); *or*

c. which has been reconstructed as provided by Regulation; *or*

d. where water, power, and streets have been constructed to the property line.

13.2 Exclusions and Deductions.

The following exclusions and deductions are allowed in computing the speculative builder tax:

(1) Standard 35% Deduction. The total selling price from the sale of improved real property, which is the tax base for the speculative builder classification, is reduced by a flat statutory deduction amount of 35%. See Model City Tax Code Section -416(c)(2).

(2) Land Deduction. Most cities do not allow a deduction for either the cost or the fair market value of the underlying land. That is the case with the major cities in the Phoenix area. The Model City Tax Code provides local options which may be adopted by a city, for a deduction for the cost of the land, which is local option M, and a deduction for the fair market value of the underlying land, which is local option N. The Master Version of the Model City Tax Code should be consulted as to which cities offer the land deduction. A good number of the smaller, outlying cities and towns allow a deduction for the fair market value of the land. The Master Version of the Model City Tax Code should be as to which cities offer the land decision (local option N). They include the following:

Copyright © 2005 by Patrick Derdenger

Deduction for fair market value of land.

Bullhead City	Pima
Camp Verde	Pinetop-Lakeside
Colorado City	Prescott
Douglas	Prescott Valley
Eloy	Quartsite
Flagstaff	Safford
Kingman	Sahuarita
Lake Havasu City	Sedona
Mammoth	Show Low
Parker	Thatcher
	Wilcox

A limited number of cities provide a deduction for the cost of the land (local option M).

They include:

Deduction for cost of land.

Duncan
Nogales
Patagonia
Tucson
Winslow
Youngtown

(3) ***Reconstruction Contracting***. Cases involving "reconstruction contracting," the speculative builder may exclude from its gross income the prior value allowed for reconstruction contracting in determining the speculative builder's gross income. Model City Tax Code Sec. __ - 416(b)(1). Reconstruction of real property is defined by Model City Tax Code Regulations to mean "the subdividing of real property and, in addition, all construction contracting activities performed upon said real property; provided, however, that each of the following conditions are met:

1. A structure existed on said real property prior to the reconstruction activities; and

2. The "prior value" of said structure exceeds fifteen percent (15%) of the "prior value" of the integrated property (land, improvement and structure); and

3. The total cost of all construction contracting activities performed on said real property and the twenty-four (24) month period prior to the sale of any part of the real property exceeds fifteen percent (15%) of the "prior value" of the real property; and

Copyright © 2005 by Patrick Derdenger

4. The structure which exists on the real property prior to the reconstruction activity still exists in some form upon the property, and is included, in whole or in part, in the property sold." Model City Tax Code Reg. -416.2(a).

An example of reconstruction contracting would be the conversion of apartments into condominiums with the sale of the individual condominium units.

"Prior value" is defined by the regulations to mean "the value of the total integrated property, with improvements, as existing immediately prior to any reconstruction activity. A property's full cash value for secondary tax purposes is to be used as the property's "prior value." Additionally, a taxpayer may use the "alternative prior value" in lieu of the full cash value of the property for secondary property tax purposes. The "alternative prior value" is the "actual cost of the reconstruction property prior to reconstruction, provided that evidence of such cost is presented to the tax collector and is determined by the tax collector, in his sole discretion, to be satisfactory." Such evidence may consist of an arms length acquisition price accompanied by a full appraisal of all property involved which appraisal shall have been performed by the real estate broker or MAI appraiser. *See* Model City Tax Code Reg. -416.2(b) and (c).

(4) Labor for Installation of Income–Producing Capital Equipment. There is a deduction for the gross proceeds of sales or gross income derived from the installation, assembly, repair or maintenance of income-producing capital equipment as defined in Section -110 of the Model City Tax Code, as long as that equipment does not become permanently attached to a building or other structure. The installation labor deduction does not include any income from contracting activity which consists of the development of or modification to real property in order to facilitate the installation, assembly, repair, maintenance or removal of the income-producing capital equipment. Additionally, permanent attachment is defined by the Code to mean at least one of the following:

a. to be incorporated into real property.

b. to become so affixed to real property that becomes a part of the real property.

c. to be so attached to real property that removal would cause substantial damage to the real property from which it is

d. removed. *See* Model City Tax Code Section -416(c)(2)(B).

13.3 Exemptions.

The Model City Tax Code also provides a number of exemptions from the speculative builder classification. They are:

Copyright © 2005 by Patrick Derdenger

(1) Purchase of Income-producing capital equipment and tangible personal property sold to "qualifying hospitals." An exemption is provided for the gross proceeds of sales or gross income attributable to the purchase by a speculative builder of machinery, equipment or other tangible personal property that is exempt from or deductible from the privilege or use tax under:

a. Section -465(g) (the income-producing capital equipment exemption) and (p) (the sales tax exemption for sales of tangible personal property to "qualifying hospitals").

b. Section -660(g) (the use tax exemption for income producing capital equipment) and (p) (the use tax exemption for sales of tangible personal property to "qualifying hospitals").

(2) Construction of Egg Production Facility. Gross income from the construction of an environmentally controlled facility for the raising of poultry for the production of eggs and the sorting, or cooling and packaging of eggs is exempt.

(3) Clean Rooms. Revenue derived from the installation, assembly, repair or maintenance of clean rooms is exempt where the clean room equipment qualifies for deduction under Section -465(g) relating to income producing capital equipment. Both the cost of the clean room equipment and its installation is exempt.

(4) Agricultural Pollution Control Equipment. Revenue derived from a contract entered into with a person engaged in the commercial production of livestock, livestock products or agricultural, horticultural, viticultural or floricultural crops or products in Arizona for the construction, alteration, repair, improvement, etc. of any building or other structure, or project used directly and primarily to prevent, monitor, control or reduce air, water or land pollution is exempt.

13.4 Tax Credits.

After the speculative builder tax liability has been determined, a speculative builder is allowed the following tax credits against its tax liability:

(1) Tax credit for purchase of building materials. A tax credit is allowed in an amount equal to the city privilege or use tax, or the equivalent excise tax, paid directly to a taxing jurisdiction or as a separately itemized charge paid directly to the vendor with respect to the tangible personal property incorporated into the structure or improvement to real property which is the subject of the speculative builder tax.

(2) Tax credit for taxes paid by prime contractor. A tax credit is allowed in an amount equal to the privilege taxes paid to the particular city, or

Copyright © 2005 by Patrick Derdenger

charged separately to the speculative builder, by a construction contractor, on the gross income derived by that contractor from the construction of any improvements to the real property, which are subject to the speculative builder tax.

These credits, though, cannot be claimed by the speculative builder until such time that the gross income against which those credits apply is reported. This means that the speculative builder must first report its speculative builder revenue to the city (or be assessed in an audit situation) first before it is entitled to the credits. *See* Model City Tax Code Section -416(c)(3).

The common credit which is given is the credit for the sales taxes paid by the prime contractor on the job. This prevents a double taxing of the actual cost of the construction. With this prime contracting credit, the speculative builder tax is essentially imposed on the land value and overhead and profit of the developer.

13.5 Exclusion For The Sale Of Partially Improved Residential Real Property To Another Speculative Builder.

A speculative builder is not taxable on the sale of "partially improved residential real property" to another speculative builder if, and *only* if, the following conditions are met.

(1) The speculative builder purchasing the partially improved residential real property has a valid city privilege license for construction contracting as a speculative builder; *and*

(2) *At the time of the transaction*, the purchaser provides the seller with a properly completed written declaration that the purchaser assumes liability for and will pay all privilege taxes which would otherwise be due the city at the time of sale of the partially improved residential real property; *and*

(3) **The seller also:**

a. maintains proper records of such transactions in a manner similar to the requirements relating to sales for resale; and

b. retains a copy of the written declaration provided by the buyer for the transaction; *and*

c. is properly licensed with the city as a speculative builder and provides the city with the written declaration attached to the city privilege tax return where the speculative builder claims the exclusion. *See* Model City Tax Code Section -416(b)(4).

(4) Definition of "*partially improved residential real property*." This term is defined to mean:

Copyright © 2005 by Patrick Derdenger

> Any improved real property, as defined in subsection (a)(2) . . . , being developed for sale to individual homeowners, where the construction of the residence upon such property is *not* substantially complete at the time of the sale. (Emphasis added). *See* Model City Tax Code Section -416(a)(4).

13.6 Homeowner's Bonafide Non-Business Sale of a Family Residence.

An *individual* will not be subject to the speculative builder tax if the individual builds the home and sells it within 24 months from substantial completion if the following requirements are met:

1. The property was actually used as the principal place of a family residence or vacation residence by the immediate family of the seller for the 6 months next prior to the offer for sale; and

2. The seller has not sold more than two such family or vacation residences within the thirty-six months immediately prior to the offer for sale; and

3. The seller has not licensed, leased, or rented the sold premises for any period within 24 months prior to the offer for sale.

(1) Construction Contractors Taxable on Work Done for Homeowner. If a homeowner of a family residence contracts with a licensed construction contractor for improvements to the residence, the construction contracting on a family residence is presumed to be for the owner's bonafide non-business purpose and all construction contractors are required to report and pay the tax imposed on the construction of those improvements (under the construction contracting classification).

(2) Homeowner's Purchase of Tangible Personal Property. A homeowner's purchase of tangible personal property for inclusion in any construction, alteration or repair of his or her residence is subject to tax under the retail sale classification (the homeowner is treated as the ultimate consumer).

(3) Homeowner Must Be An Individual. The homeowner must be an *individual* and no other entity, association or representative may qualify for the homeowner's bonafide non-business sale of a family residence. The only exceptions are that an administrator, executor, personal representative, or guardian in guardianship or probate proceedings, for the estate of a deceased or incompetent person or a minor, may claim the "homeowner" status for that person if that person would have otherwise qualified with respect to the residence involved.

Copyright © 2005 by Patrick Derdenger

13.7 Opportunities?

(1) Contract to sell the improved real property but do not transfer title until after the 24-month period? Does It Work? No. See definition of "Speculative Builder" (an owner-builder who sells or "contracts to sell").

(2) A long term lease rather than a sale? Will not work if the lease is for a term of 30 years or more (with options for renewal being included as a part of the term). See Model City Tax Code Section –416(a)(3), definition of "Sale of Improved Real Property."

(3) Short term lease with option to purchase? Rather than selling the property, it would be leased for a short term to get past the 24-month period with the lease providing a purchase option that could only be exercised after the expiration of the 24-month period. Would this work? Probably not. See the definition of "Sale of Improved Real Property," which is defined to include "any form of transaction, whether characterized as a lease or otherwise, which in substance is a transfer of title of, or equitable ownership in, improved real property … ." See also the definition of "Speculative Builder" which includes the reference "or contracts to sell." Could that language cover a lease with a purchase option? What if the lease were only a short term lease with no purchase option, with there being no contractual obligation to sell or to purchase the property. That may work.

(4) Transfer Property to L.L.C. and Sell Membership Interests. Put the property in a limited liability company (or corporation) and sell the membership interests in the LLC or stock in the corporation. Is this situation covered by the "Definition of Improved Real Property" which includes "any form of transaction … which in substance is a transfer of title of, or equitable ownership in, improved real property … ."

(5) Allocation of Purchase Price. The speculative builder tax classification applies only to the "sale of improved real property." What if the sale transaction includes both real property and personal property, such as equipment or intangibles? Many times, an apartment complex or office building will be sold within the 24-month trigger period but by that time it is fully leased up, or close to being fully leased up. Those in-place leases certainly have a value and they are assigned by the seller to the purchaser of the building. Should the value of the assigned leases, which is an intangible, be subject to the speculative builder tax? See City of Phoenix CAP No. 1394. (March 2, 1999) (value of assigned leases not subject to speculative builder tax).

To the extent that assets other than a building and land are transferred, as a planning technique it is recommend that the purchase price be allocated among land, building, personal property (such as equipment, etc.) and intangibles (such as the value of any assigned leases). To the extent that any income producing capital equipment is involved, there is a specific deduction for that equipment and there should be a purchase price allocation to it.

Copyright © 2005 by Patrick Derdenger

13.8 The *Estancia* Case.

In *Estancia Development Associates LLC v. City of Scottsdale*,[6] the court held that the speculative builder provision of the Model City Tax Code does not apply to sale of real property that is unimproved at the time of sale, even though the sales contract requires subsequent improvements to be made by the seller. Estancia owned real property in Scottsdale and entered into contracts to sell the individual lots into which the property had been subdivided. Under the contract, the purchaser agreed to buy the property and Estancia agreed to set up an escrow for the transaction. Estancia's contracts also obligated it to make improvements to the property. Those improvements were to be paved roads, sewers, water, telephone, cable television, natural gas and electric service. As of the close of escrow, no structure had been erected on any parcel that Estancia sold. It was also not disputed that Estancia later completed the off-site improvements contemplated by the purchase contractor.

The speculative builder tax of the Model City Tax Code taxes the sale of "improved real property" within 24 months from the date of substantial completion of the improvements. Improved real property is further defined to include land "where water, power and streets have been constructed to the property line." The Court of Appeals held that since there had been no improvements made to the property at the time of the close of escrow, which was the time of sale, the speculative builder tax did not apply, although it was contemplated and Estancia was obligated to make off-site improvements after the sale. The court relied upon the plain language of the Model City Tax Code which makes it clear that the speculative builder tax only applies if improvements "have been made" or "constructed" at the time of sale.

13.9 Cities Response to Estancia Case.[7]

The following is a proposal from the cities to amend the model city tax code to reserve the Estancia decision.

> Proposed Model City Tax Code Changes and Underlying Rationale:
>
> Regarding our effort to close the loophole in MCTC Section 416 exposed in the Estancia decision, as well as to clarify the potential limitations of the current subsection (a)(2)(D), we propose following language to modify the definition of "Improved Real Property" in Section 416:

Sec. __-416. Construction contracting: speculative builders.

(a) (2) "Improved Real Property" means any real property:

(A) Upon which a structure has been constructed; or

---

[6] 291 Ariz. Adv. Rptr. 45 (3/23/99).

[7] Proposal to Amend Model City Tax Code Sections 100 & 416 (03/20/03).

Copyright © 2005 by Patrick Derdenger

(B) Where improvements have been made to land containing no structure (such as paving or landscaping); or

(C) Which has been reconstructed as provided by Regulation; or

(D) Where water, power, and streets OR ANY UTILITY SERVICE(S) have been constructed to the property line.; OR

(E) WHERE THE SELLER HAS COMMITTED BY CONTRACT, TERMS OF SALE, OR OTHERWISE, TO MAKE OR HAVE MADE ANY OF THE ABOVE LISTED IMPROVEMENTS, REGARDLESS OF THE STAGE OF COMPLETION AT THE CLOSE OF ESCROW OR TRANSFER OF TITLE.

Discussion pertaining to changes in Section 416(a)(2)(D):

(D) Where water, power, and streets OR ANY UTILITY SERVICE(S) have been constructed to the property line.; OR

The change from “and” to “or” in subsection (D) addresses a grammatical oversight in the code intended to eliminate a potential argument that completion of all three stated improvements are required to qualify as improved real property. Both the ongoing actual treatment of property sales subject to this clause and the original intent of this subsection, was to treat a sale following the completion of any improvement as a taxable event, not only the instance of a sale following completion of all three of the specifically named elements: water, power, and streets.

The change from only mentioning “water” and “power” to "any utility service(s)" allows consideration of natural gas or other common utility lines, again in keeping with the original intent of taxing any improvement.

The practice and intent of subsection (a)(2)(D) has been and remains to hold transactions taxable if any of the listed improvements have been made to real property.

Note that we originally drafted this change to say, "Where streets or utilities have been constructed...." This version was changed to reference "any utility service(s)" rather than merely "utilities" to address a concern voiced by several cities that merely referring to "utilities" may have produced a potential argument that the extension of stubbed out lines to the property line are not technically "utilities" until they are actually attached and/or operating. We mention this here to make it clear that the intent has been and remains to impose tax on the

Copyright © 2005 by Patrick Derdenger

sale of any property where any utility line has been constructed to the property being sold, without requiring determination of actual attachment to and/or operability on the property being sold.

Discussion pertaining to the addition of new subsection (E):

> (E) WHERE THE SELLER HAS COMMITTED BY CONTRACT, TERMS OF SALE, OR OTHERWISE, TO MAKE OR HAVE MADE ANY OF THE ABOVE LISTED IMPROVEMENTS, REGARDLESS OF THE STAGE OF COMPLETION AT THE CLOSE OF ESCROW OR TRANSFER OF TITLE.

Regarding the addition of subsection (E), we refer to the Arizona Court of Appeals decision in Estancia Development Associates, L.L.C. v. City of Scottsdale, (196 Ariz. 87, 993 P.2d 1051).

In the Estancia case, the taxpayer sold vacant properties with a contractual promise to complete certain infrastructure improvements ("...paved roads, sewers, water, telephone, cable television, natural gas and electric service to the property by the date set forth in Public Report"). Although the selling price clearly reflected the added value associated with these future improvements, the completion of the improvements did not occur until after close of escrow and transfer of title.

The Taxpayer argued that since the improvements were not completed at the close of escrow, the property did not meet the definition of "Improved Real Property" and thus was not subject to the tax. The court found for the taxpayer, and explained their decision based on the current definition of "Improved Real Property" in the MCTC as follows:

> In each description of the improvements, the past perfect tense is used. No provision is made for taxation of vacant land on which improvements are yet to be constructed. Thus, the S.R.C. (Scottsdale Revenue Code) does not tax the price of vacant land on which improvements were promised to be made but as of the time of sale have not been made. The taxpayer conceded at oral argument, however, that if any improvements had been made, the entire price of all improvements, including uncompleted ones, could be subject to tax.

We are aware that Estancia is unable to point to a policy reason for allowing transactions in which the improvements are deferred to escape the tax otherwise imposed. Nor are we able to discern one. However, it is enough that the S.R.C.'s plain language does not extend the tax to such transactions. Our duty is to apply the S.R.C. as written, not to judge whether the drafters' decision was wise.

Copyright © 2005 by Patrick Derdenger

We cannot determine an equitable rationale for favoring sales structured in this manner with an exemption that is not available on comparable sales where title passes after construction. Furthermore, we can neither think of, nor have we been offered a reasonable cause for structuring a sale in the manner described above, other than as a means of avoiding the tax.

We created the proposed subsection (E) to directly address the court's plain indication that, while the drafter's intent likely would have been to tax this type of transaction had they been able to foresee it, the code as written is not properly worded to anticipate a sale arranged in this way. Per discussions with the members of the UAC, including those involved in drafting the original version of the Model City Tax Code, the intent was clearly to capture and hold taxable all sales of improved real property as described. The original language was drafted based on "completed improvements" only with the intention of excluding sales of vacant land, failing to anticipate vacant land sales that included the value of future improvements in the selling price.

The drafter's did not contemplate the sale of a home, building, or other improvement where the selling price was based upon a promise to complete such improvements after the close of escrow or title transfer. If they had any comprehension that real property sales might be structured in this manner, the original drafters have indicated they would have included a passage similar to the proposed language in the original text.

13.10 Discussion pertaining to changes in the definition of "Owner-Builder" in Section 100:

"Owner-Builder" means an owner or lessor of real property who, by himself or by or through others, constructs or has constructed or reconstructs or has reconstructed any improvement to real property, INCLUDING AN OWNER OR LESSOR THAT HAS COMMITTED BY CONTRACT, TERMS OF SALE, OR OTHERWISE, TO MAKE OR HAVE MADE ANY IMPROVEMENT TO THE REAL PROPERTY, REGARDLESS OF THE STAGE OF COMPLETION AT THE CLOSE OF ESCROW OR TRANSFER OF TITLE.

This change is being made to address a concern that the current definition of Owner-Builder is also based on language in the past perfect tense, with no provision for considering the possibility that an owner might enter into an arrangement for the sale of land that is vacant at the time that title transfers or escrow closes, but where the selling price is predicated on a improvements to be constructed after the transfer of title or close of escrow.

Again, this change simply levels the municipal tax playing field for like properties of comparable values, sold for comparable amounts, regardless of when the improvements that lead to those values and selling prices occur.

Copyright © 2005 by Patrick Derdenger

13.11 Taxation of Owner-Builders not Speculative Builders.

The tax liability for an owner-builder who is not a speculative builder is imposed at the expiration of twenty-four months (24) after the improvement to the property is substantially complete. That tax is imposed on:

(1) The gross income from the activity of construction contracting upon the real property in question which realized by those construction contractors to whom the owner-builder provided written declaration that they were not responsible for the taxes as prescribed in subsection -415(c)(2); and

(2) The purchase of tangible personal property for incorporation into any improvement to real property, computed on the sales price. Model City Tax Code Section -417.

Exemptions. An owner-builder is generally provided with the same exemptions, deductions and tax credits as a speculative builder. See Model City Tax Code Section -417(b).

Example. If an owner provides subcontractors with the written owner-builder's declaration that the subcontractor is exempt, and the owner does not sell the property within twenty-four months of substantial completion (and the property involved is commercial property), then upon the expiration of that twenty-four month period, the owner will be considered to be a taxable owner-builder and subject to tax on the amount paid the various subcontractors as well as on the purchase price of building materials that the owner-builder purchased directly. The owner-builder provision would not apply to an owner that builds a residence because such a person would be considered to be a speculative builder and will be taxed on the sale of the residence no matter when it sold (during construction, within twenty-four months of completion of construction or anytime thereafter).

14. HISTORICAL BACKGROUND ON PURCHASE AGENCY AND INSTALLATION LABOR EXEMPTION

14.1 History of Labor Deduction for Installation of Exempt Machinery and Equipment That Does Not Become Permanently Attached.

(1) ***Senate Bill 1280.*** Senate Bill 1280[8] provides a deduction for:

> The gross proceeds of sales or gross income that is derived from a contract entered into for the installation, assembly, repair or maintenance of machinery, equipment or other tangible personal property that is deducted from the tax base

[8] Laws 1996, ch. 319, enacted as new A.R.S. § 42-1310.16(B)(7) and renumbered as § 42-5075(B)(7) by Laws 1997, ch. 150,

Copyright © 2005 by Patrick Derdenger

> of the retail classification pursuant to § 42-5061, subsection B, that does not become a permanent attachment to a building, highway, road, railroad, excavation or manufactured building or other structure, project, development or improvement. If the ownership of the realty is separate from the ownership of the machinery, equipment or tangible personal property, the determination as to a permanent attachment shall be made as if the ownership were the same. The deduction provided in this paragraph does not include gross proceeds of sales or gross income from that portion of any contracting activity which consists of the development of, or modification to, real property in order to facilitate the installation, assembly, repair, maintenance or removal of machinery, equipment or other tangible personal property that is deducted from the tax base of the retail classification pursuant to § 42-5061, subsection B.

A.R.S. § 42-5075(B)(7) has since been amended to add the following phrase after both references to § 42-5061, Subsection B: "or ["and," for the second reference] that is exempt from use tax pursuant to § 42-5159, Subsection B." "Permanently attached" is defined by subsection (B)(7) to mean at least one of the following:

> a. To be incorporated into real property.
>
> b. To become so affixed to real property that it becomes a part of the real property.
>
> c. To be so attached to real property that removal would cause substantial damage to the real property from which it is removed.

The cross-reference to § 42-5061(B) is to the machinery and equipment exemptions contained under the retail classification.

> A prime contractor may establish entitlement to the deduction by both:
>
> (a) Marking the invoice for the transaction to indicate that the gross proceeds of the sales or gross income derived from the transaction was deducted from the base; and
>
> (b) Obtaining a certificate executed by the purchaser indicating the name and address of the purchaser, the precise nature of the business of the purchaser, the purpose for which the purchase was made, the necessary facts to establish the deductibility of the property under § 42-5601, subsection B, and a certification that the person executing the certificate is authorized to do so on behalf of the purchaser. The certificate may be disregarded if the prime

Copyright © 2005 by Patrick Derdenger

contractor has reason to believe that the information contained in the certificate is not accurate or complete.[9]

A contractor that does not comply with those two requirements may still establish entitlement to the deduction by presenting facts necessary to support the entitlement, but the burden of proof is on that contractor. The legislation as enacted also authorizes the Department to prescribe a form for the certificate and to promulgate rules that describe the transactions with respect to which a person is not entitled to rely solely on the information contained in the purchaser's certificate.

Finally, the legislation provides that the Department may require the purchaser, which gave the certificate to the contractor, to establish the accuracy and completeness of the information required to be contained in the certificate that would entitle the prime contractor to the deduction. If the purchaser cannot establish the accuracy and completeness of the information, the purchaser is liable in an amount equal to any tax, penalty and interest, that the prime contractor would have been required to pay. Payment of such amount exempts the purchaser from any use tax on the items of machinery and equipment in question.

This legislation became effective on July 1, 1997. Moreover, this legislation is not intended to affect, and may not be cited or considered in, the construction or interpretation of A.R.S. § 42-5075 with regard to issues involving tax periods beginning before July 1, 1997.

(2) Department's Transaction Privilege Tax Ruling 97-3 Implementing Senate Bill 1280. On July 15, 1997, the Department issued Transaction Privilege Tax Ruling ("TPR") 97-3, implementing Senate Bill 1280. It was released just 15 days after the effective Senate Bill 1280. TPR 00-1 and 00-2 superseded this ruling, but provided similar guidance. TPR 97-3 is recapped here.

> **The Deduction under A.R.S. § 42-5075(B)(7) (formerly § 42-1310.16(B)(7)) for Labor Involved in Installation of Machinery and Equipment That Does Not Become Permanently Attached. The statute defines "permanently attached" to mean at least one of the following:**
>
> 1. The tangible personal property is incorporated into real property;
>
> 2. The tangible personal property is so affixed to real property that it becomes a part of the real property; or
>
> 3. The tangible personal property is so attached to real property that removal would cause substantial damage to the real property from which it is removed.

---

[9] A.R.S. § 42-5075(C)(1).

Copyright © 2005 by Patrick Derdenger

The Department's ruling indicates that the existence of any one of the three factors means that the tangible personal property is permanently attached and the income from the installation contract is subject to tax under the prime contracting classification. Further, the ruling provides that if the machinery and equipment exemption applies, and the machinery and equipment is not permanently attached under the above tests, the deduction is only for the income derived from the installation, assembly, repair or maintenance of the machinery or equipment, and does not also apply to the machinery and equipment itself. As indicated below, the Department's position is that an agency agreement is still required for the contractor to secure an exemption for the cost of the exempt machinery and equipment itself.

Machinery and Equipment That Qualifies for the Installation Labor Deduction. This part of the Department's rulings lists all of the various items of machinery and equipment that qualify for the exemption. They are set forth in A.R.S. § 42-5061(B), and include machinery and equipment used in manufacturing, processing, fabricating, job printing, refining or metallurgical operations; mining machinery or equipment; certain tangible personal property used by telecommunications companies; machinery or equipment or transmission lines used in producing or transmitting electrical power; pipes or valves 4 inches in diameter or larger; etc.

The Department's ruling indicates that deductions added in the future under A.R.S. § 42-5061(B) for new categories of exempt machinery and equipment will also qualify for the deduction under A.R.S. § 42-5075 (B)(7) for installation labor.

Agency Agreements. It is the Department's position that, even under Senate Bill 1280, and even if machinery and equipment is not permanently attached, the contractor, in order to secure the exemption for the machinery and equipment, must have a purchase agency agreement with the owner. Without the purchase agency agreement in place, it is the Department's position that the contractor is not entitled to the exemption for the machinery and equipment that was installed, although the installation labor will not be subject to sales tax.

Two Separate Lines of Businesses. The Department recognizes that it is possible for a person to be engaged in two lines of business. *State Tax Comm'n v. Holmes & Narver, Inc.*, 113 Ariz. 165, 548 P.2d 1162 (1976).

The Department, however, makes a distinction between business activities that are incidental to the principal business and interwoven in the operation, to the extent that they are, in effect, an essential part of the major business, and businesses that are not incidental to the primary business, such as contracting. If the business activity is incidental to the principal business and an integral part of the operation of the principal business, then it will not be taxed as a separate business. The Department's primary reliance for this conclusion is *City of Phoenix v. Arizona Rent-A-Car Systems, Inc.*, 182 Ariz. 75, 893 P.2d 75 (Ct. App.

Copyright © 2005 by Patrick Derdenger

1995) (gasoline refueling charges, were held to be a integral part of the rental car business).

Retailer/Prime Contractor Separate Lines of Businesses. The Department's ruling ultimately focuses on the critical issue as it relates to Senate Bill 1280: the situation where a person engages in two separate lines of business, one line of business as a retailer and the other line of business as a prime contractor. The Department concludes that if the retail business is not an integral part of the contracting business, the person may make sales of the exempt machinery and equipment at retail without an agency agreement and be entitled to the exemption. The determination of whether a person engages in two separate lines of business depends on the facts and circumstances surrounding the business. The Department is very likely take a close look at a contractor that also purports to be a retailer of exempt machinery and equipment. As a practical matter, and to avoid this problem, such a contractor should consider having two separate legal entities (for example, two separate corporations or two separate limited liability companies) to avoid this problem. One corporation would be the contracting business and the other corporation, with its separate sales tax license number, would be the retailer of the exempt machinery and equipment.

Exemption Certificate to Support Labor Exemption. The Department indicates that the normal transaction privilege tax exemption certificate should be used to document the deduction for the exempt installation labor. The purchaser (the one with the project) should provide the exemption certificate to the contractor, check the box marked "19 Other" and indicate A.R.S. § 42-5075(B)(7) as the statutory authority for the exemption. The purchaser should also provide a detailed description of the type of property purchased and the use of that property.

The ruling also suggests that if the contractor has entered into a valid, written purchase agency agreement with the owner, the contractor or owner should provide the vendor of the exempt machinery and equipment with a tax exemption certificate, indicating that the machinery and equipment is exempt machinery and equipment.

Ruling. The Department concludes that a prime contractor may deduct from its tax base the gross income derived from a contract to install, assemble, repair or maintain machinery, equipment or other tangible personal property that does not become permanently attached to the project and the machinery and equipment are tangible personal property qualifies to be deducted from the retail tax base by the seller under A.R.S. § 42-5061(B).

However, the contractor is entitled to deduct the cost of the exempt machinery and equipment only to the extent that the contractor has entered a valid purchase agency agreement with the owner. Or, the contractor may be entitled to the exemption if the contractor engages in a completely separate, independent line of business as a retailer that sells such exempt machinery and equipment. In that case, a purchase agency agreement is not needed.

Copyright © 2005 by Patrick Derdenger

➔ **CAUTION:** The Department will look at the facts and circumstances of each case to see if the contractor has a separate, independent line of business as a retailer. In order to avoid this problem, as indicated above, it is recommended that two separate legal entities be established to carry on the two separate lines of business.

If the contractor does not have a purchase agency agreement, and even though the machinery and equipment is not permanently attached, the Department has ruled that the contractor will not be entitled to the machinery and equipment exemption for the cost of otherwise exempt machinery and equipment.

Examples. The ruling provides a number of examples. They are summarized below:

(1) *Permanent Attachment with a Valid, Written Purchase Agency Agreement.* In this case, the contractor will not be entitled to a deduction for the installation labor of the exempt machinery and equipment, but will be entitled to the machinery and equipment exemption for the cost of that machinery and equipment.

(2) *Permanent Attachment without a Valid, Written Purchase Agency Agreement.* In this case, the contractor is essentially out of luck. It will not be entitled to the deduction for installation labor and will not be entitled to the exemption for the cost of the exempt machinery and equipment.

(3) *No Permanent Attachment with a Valid, Written Purchase Agency Agreement.* This is the best case scenario. The contractor will be entitled to the installation labor deduction and will also be entitled to the exemption for the cost of the exempt machinery and equipment.

(4) *No Permanent Attachment and No Valid, Written Purchase Agency Agreement.* The contractor will be entitled to the installation labor deduction but will *not* be entitled to the machinery and equipment exemption.

(5) *No Permanent Attachment with a Valid, Written Purchase Agency Agreement when the Qualifying Machinery and Equipment Was Purchased by the Prime Contractor Prior to July 1, 1997. The Installation of the Machinery and Equipment Will Take Place Both Before and After July 1, 1997.* The contractor will be entitled to the installation labor deduction for installation that took place after July 1, 1997. It will not be entitled to the installation labor deduction for installation that took place prior to July 1, 1997. The contractor will be entitled to the machinery and equipment exemption because of the existence of the purchase agency agreement.

Copyright © 2005 by Patrick Derdenger

(6) *Retail Sale of Qualifying Machinery and Equipment with Installation.* The example the Department gives is that a retailer sells a copier to a job printer. The retailer delivers the copier to the job printer's premises and sets it up. The Department concludes that the sale of the copier to the job printer qualifies for the machinery and equipment exemption (with no need for a purchase agency agreement) and the installation labor is deductible as services under A.R.S. § 42-1310.01(A)(2). This situation deals with a retailer and not a contractor. Thus, the installation labor deduction and purchase agency concepts do not come into play at all.

(3) Department's Transaction Privilege Tax Rulings 00-1 and 00-2 Implementing Senate Bill 1280. On August 28, 2000, the Department issued TPR 00-1 and TPR 00-2, which supersede and rescind TPR 97-3, but also serves to implement Senate Bill 1280. TPR 00-1 is applicable for the tax periods through December 31, 1998. TPR 00-2 has a similar purpose, but is applicable for the tax periods beginning January 1, 1999. The differences between TPR 00-1, TPR 00-2, and TPR 97-3 will be highlighted below in order to emphasize the changes in the Department's ongoing approach to the transaction privilege tax for the prime contracting classification.

(4) Transaction Privilege Tax Ruling 00-1 (Tax Period of July 1, 1997 through December 31, 1998).

Deduction under A.R.S. § 42-5075(B)(7). The ruling utilizes the identical statutory definition for "permanently attached" as did TPR 97-3, A.R.S. § 42-5075(B)(7), and the existence of any one of the three factors constituting permanent attachment of tangible personal property subjects the income derived from the installation contract to taxation under the prime contractor classification. If the qualifying machinery, equipment or other tangible personal property is not permanently attached according to that statutory test, a deduction is permitted for the gross proceeds or gross income derived from the installation, assembly, repair, maintenance or removal of the machinery, equipment or tangible personal property. The deduction, however, excludes any portion of the overall contracting activity that consists of the development of, or modification to, real property in order to facilitate the installation, assembly, repair, maintenance or removal of machinery, equipment or other tangible personal property. This mirrors the approach of TPR 97-3.

Agency Agreements. The critical distinction between TPR 00-1 and TPR 97-3 is in the Department's treatment of agency agreements. Until TPR 97-3 was superseded by TPR 00-1, a contractor purchasing qualifying machinery or equipment under A.R.S. § 42-5061(B) would not be able to deduct the proceeds attributable to providing the qualified equipment from its tax base unless it purchased the equipment through an agency agreement. Under TPR 00-1, a prime contractor may deduct from its tax base the gross income derived from a contract to install, assemble, repair or maintain machinery, equipment or other tangible personal property that does not become permanently attached to the project and the

Copyright © 2005 by Patrick Derdenger

machinery and equipment qualifies to be deducted from the retail tax base by the seller under A.R.S. § 42-5075(B)(7) irrespective of whether an agency agreement is in place. The Department, however, has enumerated additional tax benefits if the contractor and the owner enter into a valid agency agreement. Consult TPR 95-21 for details on creating valid agency agreements.

A prime contractor may not deduct proceeds attributable to providing the machinery or equipment that is installed, assembled, repaired or maintained. As previously noted, the deduction also excludes any portion of the overall contracting activity that consists of the development of, or modification to, real property in order to facilitate the installation, assembly, repair, maintenance or removal of machinery, equipment or other tangible personal property. If, however, the contractor and owner enter into a valid, written purchase agency agreement, the proceeds attributable to providing qualified tangible personal property that the prime contractor will install, assemble, repair or maintain is not included in the prime contractor's tax base at all. Without a valid purchase agency agreement, the proceeds attributable to providing machinery and equipment is included in the contractor's tax base and only the gross income derived from the installation, assembly, repair or maintenance of the qualified machinery, equipment or other tangible personal property is deductible from the contractor's tax base. Thus, the execution of a valid agency agreement between the owner and contractor is no longer required to accrue certain tax benefits, but it may provide significant additional tax advantages.

Documentation to Substantiate Deductions. In order to ensure the benefit of the deductions provided under S.B. 1230 and TPR 00-1, proper documentation is required to substantiate any deduction. The Department has identified A.R.S. § 42-5075(C)(1) as the appropriate statutory source of the documentation requirement to take advantage of A.R.S. § 42-5075(B)(7) deductions, and pursuant to A.R.S. § 42-5075(C)(3), the Department has adopted the Arizona Department of Revenue Transaction Privilege Tax Exemption Certificate. In order to deduct from the tax base for the gross income derived from the enumerated contracting activities, the prime contractor should obtain this certificate from the owner and retain the certificate in its records. The purchaser should be sure to check the box marked "Other" and indicate A.R.S. § 42-5075(B)(7) as the specific statutory authority for the exemption. This certificate and a marked invoice will provide the requisite documentation to substantiate a deduction from the tax base.

With a valid, written purchase agency agreement in place with the owner, the prime contractor or the owner should provide the vender of the qualified machinery, equipment or other tangible personal property with a Certificate. The vendor should retain the tax exemption certificate, executed by the owner or the contractor as agent for the owner, in their records to substantiate the deduction from the tax base. Consult TPP 00-3 for additional information on the use of exemption certificates.

Copyright © 2005 by Patrick Derdenger

Examples. The ruling provides a number of examples. They are summarized below:

(1) *Equipment Exempt under A.R.S. § 42-5061(B) and Not Permanently Attached*. Under these circumstances, a contractor may deduct the labor portion of the contract from its gross income. Proceeds attributable to providing the equipment are still included in the gross income of the contractor.

(2) *Equipment Exempt under A.R.S. § 42-5061(B) and Permanently Attached*. Under these circumstances, a contractor may not deduct the labor portion of the contract from its gross income. Proceeds attributable to providing the equipment are also still included in the gross income of the contractor.

(3) *Equipment Exempt under A.R.S. § 42-5061(B) Pursuant to an Agency Agreement and Not Permanently Attached*. This is the best scenario. Under these circumstances, a contractor may deduct the labor portion of the contract from its gross income. Proceeds attributable to providing the equipment would not be included in the gross income of the contractor.

(4) *Equipment Exempt under A.R.S. § 42-5061(B) Pursuant to an Agency Agreement and Permanently Attached*. Under these circumstances, a contractor may not deduct the labor portion of the contract from its gross income. Proceeds attributable to providing the equipment would not be included in the gross income of the contractor.

TPR 00-1 is retroactive to July 1, 1997, the effective date of S.B. 1280 and TPR 97-3, and significantly alters the Department's prior approach to agency agreements, giving contractors the flexibility to coordinate the options that provide the greatest tax benefit and business flexibility to each individual contractor. This ruling is applicable for the tax period from July 1, 1997 to December 31, 1998.

(5) Transaction Privilege Tax Ruling 00-2 (Tax Period Beginning January 1, 1999).

TPR 00-2 is applicable for the tax periods beginning January 1, 1999. This ruling restates the Department's approach to deductions under A.R.S. § 42-5075(B)(7) as set forth in TPR 00-1, utilizing the three-factor test for "permanent attachment." However, the Department's ruling abandons any requirement that a contractor use an agency agreement in order to benefit from the deduction permitted under A.R.S. § 42-5075(B)(7) and (B)(9).

Agency Agreement Requirement Abandoned. Effective January 1, 1999, with or without a purchase agency agreement, the amount a prime contractor receives from a project owner as reimbursement for the purchase of

Copyright © 2005 by Patrick Derdenger

qualified machinery, equipment and other tangible personal property is excludable from the primer contractor's gross contracting revenue before computing the tax base for the project under subsections (B)(7) and (B)(9). *See infra* § 1.6.3.

Deductions under A.R.S. § 42-5075(B)(7). Under A.R.S. § 42-5075(B)(7), a prime contractor can deduct the gross proceeds of sales or gross income of a contract to install, assemble, repair or maintain qualified machinery and equipment and other tangible personal property that does not become a permanent attachment to real property when computing its tax base. However, the portion of any contracting activity that consists of the development of, or modification to, real property in order to facilitate the installation, assembly, repair, maintenance or removal of the machinery, equipment or other tangible personal property may not be deducted.

Deductions under A.R.S. § 42-5075(B)(9). The ruling also details the Department's approach to deductions under A.R.S. § 42-5075(B)(9). Under this subsection, the gross proceeds of sales or gross income derived from a contract to permanently install, assemble, repair or maintain qualified machinery, equipment or other tangible property is includable in a prime contractor's tax base under the prime contracting classification.

Examples. Assume that a contractor is performing actions that constitute an "improvement to real property."

(1) *Exempt Machinery Permanently Attached.* If the contractor purchased, with or without an agency agreement, exempt machinery under A.R.S. § 42-5061(B) that was not permanently attached, then A.R.S. § 42-5075(B)(7) permits the contractor to deduct the labor portion of the contract from the contractor's gross income except for any portion of any contracting activity which consists of the development of, or modification to, real property in order to facilitate the installation, assembly, repair, maintenance or removal of machinery, equipment or other qualifying tangible personal property. The equipment cost will not be included in the gross income of the contractor.

(2) *Exempt Machinery Not Permanently Attached.* If the contractor purchased, with or without an agency agreement, exempt machinery under A.R.S. § 42-5061(B) that was permanently attached, then A.R.S. § 42-5075(B)(9) does not permit the contractor to deduct the labor portion of the contract from the contractor's gross income. The equipment cost will not be included in the gross income of the contractor.

(6) Department's Proposed Ruling on Permanent Attachment Exemptions under A.R.S. § 42-5075(B)(7). The Department was poised to issue a new ruling in 2002 providing taxpayers with additional guidance on the issue of determining permanent attachment that tended to revive the *Brink* standard that was legislatively overruled by S.B. 1280. Due to a near unanimous view from

Copyright © 2005 by Patrick Derdenger

commentators and practitioners against the posture of the proposed ruling, the Department withdrew its proposed ruling and concluded that it would not issue any other ruling on permanent attachment. Instead, the Department concluded that such determinations would have to be made on a case-by-case basis due to the fact-intensive nature of the inquiry.

However, in the so ruling, the Department raised an additional issue that may be of serious concern to contractors. The Arizona Court of Appeals decision in *Dep't of Revenue v. Ariz. Outdoor Advertisers*, 41 P.3d 631 (Ct. App. 2002), held that the reasonable person test as previously applied in annexation questions was properly used in considering whether equipment is permanently attached. This standard is embodied by the following statement cited in *Outdoor Advertisers*: "'Would the ordinary reasonable person validly assume that the article in question belongs to and is a part of the real estate on which it is located.'" This, the court of appeals held, was the appropriate test to govern inquiries into permanent attachment. The Department indicated that this ruling would be applied in any future conflict related to permanent attachment.

Several commentators have noted flaws in this approach. First, A.R.S. § 42-5075(B)(7) already contains a workable three-factor test. Next, the reasonable person standard, which is conceptually simple, provides interpretive bodies (i.e., the Department and the courts) with wide latitude to determine what "reasonable" means. This degree of subjectivity may add considerable uncertainty to an area of state taxation already plagued by confusion. Contractors and commentators alike should be wary of the continuing import of *Outdoor Advertisers* and appropriately alter their activities to account for any potentially anomalous results under the reasonable person standard.

14.2 History of Exemption for Machinery and Equipment – Legislative Repeal of Purchase Agency Agreement Requirement for Contractors' Purchases of Exempt Materials.

(1) Exempt Equipment. A.R.S. § 42-5061(B) exempts "retail sales" of the following types of personal property from the sales tax:

(a) Machinery or equipment used directly in the manufacturing, processing, fabricating, job printing, refining or metallurgical operations.[10]

(b) Machinery or equipment used directly in mining.[11]

---

[10] A.R.S. § 42-5061(B)(1). The statute continues by stating that manufacturing, processing, fabricating, etc., "refer to and include those operations commonly understood in their ordinary meaning," a description which is not always free from debate. *Meredith Corp. v. State Tax Comm'n*, 23 Ariz. App. 152, 531 P.2d 197 (1975) (holding that "broadcasting" was not "processing" as that term is commonly understood); *see also* Ariz. Atty. Gen. Op. I86-114 (Nov. 7, 1986).

[11] A.R.S. § 42-5061(B)(2).

Copyright © 2005 by Patrick Derdenger

(c) Certain tangible personal property used by telephone and telegraph companies.[12]

(d) Personal property used in electric power production and transmission (but not distribution).[13]

(e) Pipes or valves four inches in diameter or larger used for transporting oil, natural gas, artificial gas, water or coal slurry.[14] NOTE: Pipe or values four inches in diameter or larger used to transport sewage, so called "dirty pipe," will not qualify for a deduction under this section.[15]

If a contractor has been engaged to build a structure which would also require the provision of the types of machinery or equipment or personal property listed above, the contractor should enter into a purchase agency agreement with the owner to purchase those materials as the owner's agent. *See* A.A.C. R15-5-608. If the contractor does not and groups those items in his construction contractor, the Department takes the position that the sales tax exemption for those items will be lost.

(2) DOR Ruling on Purchase Agency Agreements. The Department issued Transaction Privilege Ruling 95-21 on the subject of purchase agency agreements. In the ruling, the Department sets out the requirements for a valid purchase agency agreement. Prior to TPR 00-2, if such a valid purchase agency agreement is in place, then the Department would honor the various machinery and equipment exemptions for such items purchased by the contractor as the agent for the owner. Without the agency agreement in place, prior to TPR 00-2, the Department will disallow the machinery and equipment exemption.

The Department requires four elements for a valid agency agreement:

(1) **Intent to Create.** There must be a provision in the agreement that manifests the intent to create an agency relationship. The Department provides the following example:

> Contractor, and its subcontractors, shall act as Owner's agent for the purpose of making approved purchases of machinery, equipment, materials and other tangible personal property required under the terms of the contract to which this agreement is appended (or contract in which this agreement is incorporated). No other provision in the contract shall negate or modify the provisions of this agency agreement.

---

[12] A.R.S. § 42-5061(B)(3).

[13] A.R.S. § 42-5061(B)(4).

[14] A.R.S. § 42-5061(B)(6).

[15] TPR 02-2.

Copyright © 2005 by Patrick Derdenger

(2) **Authority to Act.** There must be a provision that vests in the agent the authority to make purchases on behalf of the principal and to bind the principal. The Department provides the following suggested language:

> All machinery, equipment, materials and other tangible personal property shall be purchased by the Contractor and its subcontractors on behalf of and for the account of Owner as its agent. Title to the subject property shall pass directly from the vendor to Owner. Neither the Contractor nor any of its subcontractors shall acquire any ownership interest in such property.
>
> In making such purchases, the Contractor and any of its subcontractors shall include the following language on the purchase orders:

Purchaser. The name and address of the purchaser on all order forms shall be:

"(Owner)" OR "(Contractor), as agent for (Owner)"

(Owner's address).

Signature. The signature on all purchase orders shall be:

"(Contractor), as agent for (Owner)"

To substantiate that the contractual provisions are not merely matters of form, the purchases should be made by one of the following methods:

(3) **Owner Pays for Purchases.** The purchases are made in the name of the principal; with the principal's funds or credit, either in the form of cash advances or checks drawn on a separate bank account maintained by the principal. Title to the items purchased passes to the principal at the time of purchase.

(4) **Agent Pays for Purchases.** The purchases are made in the name of the principal, with the agent's funds or credit. In this case, the transactions must be segregated. The agent must maintain separate, detailed accounting records for these purchases.

The Department recognizes that various approaches to drafting an execution of an agency agreement exist, such as that of an undisclosed principal. The Department notes that if the language of the agreement and the associated conduct of the parties is other than as set out in the examples contained in the ruling (Nos. 1 through 4 above), the agency agreement is subject to review by the Department as to the facts and circumstances surrounding its execution. The burden of proof as to the validity of the agreement lies with the taxpayer.

Copyright © 2005 by Patrick Derdenger

(3) A History of the Purchase Agency Agreement Litigation: The Ball, Ball & Brosamer Case—Purchase Agency Required or Not?

Board of Tax Appeals Decision—Required. In *Ball, Ball & Brosamer, Inc. v. Dep't of Revenue*,[16] the Board held that a prime contractor's transfer, pursuant to its construction contracts, of four-inch diameter pipes and valves used to transport water was not exempt from sales taxation. A.R.S. § 42-5061(B)(6) exempts from the sales tax under the retail classification the sale of pipes or valves four inches or larger in diameter used to transport oil, natural gas, artificial gas, water or cold slurry. The Board held that because this exemption is available only to those taxpayers taxable under the retail classification and not to those taxable under the prime contracting classification, the prime contractor was liable for the payment of the sales tax on the cost of those materials.

Tax Court Decision—Not Required. The tax court reversed the Board of Tax Appeal's decision in the *Ball, Ball & Brosamer* case. The tax court held that a purchase agency agreement was not required for the contractor, Ball, Ball and Brosamer, to claim the pipes and valves exemption. The tax court reasoned that such a purchase agency requirement in a contractor situation violated the equal protection clause because the Department did not require such a purchase agency agreement in a non-contractor situation.

Court of Appeals Reverses the Tax Court, Requires Purchase Agency Agreement. In a June 29, 1995 decision, the Arizona Court of Appeals, in *Brink Elec. Constr. Co. & Ball, Ball & Brosamer, Inc. v. Dep't of Revenue*,[17] overturned the tax court's decision and required a purchase agency agreement to take advantage of the machinery and equipment exemptions. The court of appeals concluded that the machinery and equipment exemptions were under the retail classification and thus were not available to contractors. The tax court had come to the same result, but held that it was denial of Ball and Brink's equal protection rights to require a purchase agency agreement. This equal protection violation was based on two grounds:

(1) The Department of Revenue in previous years had allowed contractors, such as Ball and Brink, to claim exemptions for machinery and equipment, along with four-inch pipes and valves, etc., without the need of a purchase agency agreement and, in fact, giving refunds to some. Not to allow Ball and Brink to claim the exemptions just because they did not have a purchase agency agreement, the taxpayers argued, violated their equal protection rights.

(2) Contractors that had purchase agency agreements in place received the benefit of the exemptions. Those that did not, did not. There is really no difference in the two situations, other than the piece of paper. Both contractors with and without purchase agency agreements acted and performed their construction and installation activities in the same manner. The denial of an

[16] Arizona Board of Tax Appeals, No. 710-89-S (Dec. 12, 1990).

[17] 184 Ariz. 354, 909 P.2d 421 (Ct. App. 1995) (consolidated).

Copyright © 2005 by Patrick Derdenger

exemption to those who did not have the purchase agency agreement, the taxpayers argued, was a denial of their equal protection rights.

The tax court based its equal protection decision on the second argument. The court of appeals rejected both equal protection arguments and overturned the tax court. The result, now, is that a purchase agency must be in place for a contractor to take advantage and claim the machinery and equipment exemptions. The Arizona Supreme Court denied the taxpayers' petition for review on the purchase agency issue and the *Brink* permanently attached issue.[18] However, Senate Bill 1323, Laws 1998, ch. 90, legislatively overruled this holding.[19]

(4) Hospital Projects. A.R.S. § 42-5061(A)(25) exempts from the sales tax all personal property purchased by a "qualifying hospital," which is defined in A.R.S. § 42-5001. Again, if a contractor is constructing a project for a qualifying hospital, the contractor should have a separate agreement in which the contractor agrees to purchase the building materials as the agent of the hospital in order to take advantage of the hospital exemption. If this is done, A.A.C. R15-5-629(B) provides that the cost of such property will not be deemed to be contracting income, although it is installed or incorporated into the hospital construction project.[20]

(5) United States Government Projects. A.R.S. § 42-5061(K)(1) provides that the sales tax shall not apply to sales made directly "[t]o the United States government, its departments or agencies by a manufacturer, modifier, assembler or repairer." A.R.S. § 42-5061(L) provides a 50% sales tax deduction "from upon any sale of tangible personal property made directly to the United States governments or its departments or agencies," which is not deducted under the provisions of A.R.S. § 42-5061(K). If a contractor is engaged to build a project for the United States government, the contractor should enter a purchase agency agreement with respect to the building materials. If that is done, the contractor's receipts for the sales of building materials directly to the U.S. government should be totally exempt under A.R.S. § 42-5061(K) if the contractor qualifies as a "manufacturer, modifier, assembler or repairer" or is otherwise 50% exempt under A.R.S. § 42-5061(L).

(6) Legislative Repeal of Purchase Agency Agreement Requirement Effective January 1, 1999. The Arizona legislature, in 1998, passed legislation eliminating the need for purchase agency agreements in prime-contracting situations.[21] Contractors will no longer be required to enter into a purchase agency agreement with property owners when selling and installing certain machinery and equipment that qualifies for a deduction under the retail classification and use tax statutes (the machinery and equipment deductions). In

[18] No. CV-95-0304-PR (Ariz. Jan. 17, 1996).

[19] *See infra* § 1.6.

[20] *See also Kitchell Contractors, Inc. v. City of Phoenix*, 151 Ariz. 139, 726 P.2d 236 (Ct. App. 1986).

[21] S.B. 1323, Laws 1998, ch. 90.

Copyright © 2005 by Patrick Derdenger

addition, prime contractors will no longer be required to enter purchase agency agreements when performing work for qualifying hospitals and health care centers.

The legislation accomplishes this by putting the machinery and equipment and qualifying hospital exemptions, which had been only retail classification deductions, also under the prime contracting classification. The new legislation became effective January 1, 1999.

The cities have also followed suit and amended the Model City Tax Code to repeal the purchase agency agreement requirement. The Model City Tax Code makes the same change by putting the machinery and equipment exemption and the hospital exemption under the contracting classification, so that a contractor will be entitled to deductions for the cost of those items of tangible personal property, without the need for a purchase agency agreement. The Model City Tax Code change also became effective January 1, 1999.

The purpose of the Bill was to legislatively overrule the *Brink* case, to the extent that it required purchase agency agreements. The legislation also stated that it was not intended to affect prior interpretations of the sections of the Arizona Revised Statutes being amended. In other words, it was not meant to be retroactive and not meant to affect the outcome of the *Brink* case, for any periods prior to its effective date of January 1, 1999.

14.3 Significant Case Law Related to the Taxation of Construction Activities.

1. *Duhame v. State Tax Commission*, 65 Ariz. 268, 179 P.2d 252 (1947).

Construction contracting income is distinct from retail sales, and taxation of contractors as a separate class is not discriminatory.

A licensed contractor challenged the former occupation tax imposed on his gross income on a variety of constitutional and statutory grounds. The Supreme Court, however, denied each objection. The statute imposing the occupation tax was specific enough to prevent a due process violation and an improper delegation of legislative power. The contractor was also not entitled to an exemption for sales to the federal government. The exemption only applied to sales of tangible personal property, and the construction materials, instead of being sold, became incorporated into real property. Finally, fact of deductions, exclusions, and exemptions available to other occupations but not to contracting posed no violation of equal protection, because treating one category of business activity differently from others easily satisfies rational basis review.

2. *Moore v. Smotkin*, 79 Ariz. 77, 283 P.2d 1029 (1955).

Landowners subdividing and developing tracts of land are not taxable contractors.

Copyright © 2005 by Patrick Derdenger

The former occupation tax on contractors applied to anyone "engaged in or continuing in the business of contracting." The taxpayer, against whom the Commission (the Department of Revenue's predecessor) had assessed tax on contracting, had purchased tracts of land, improved them by adding streets and utilities, divided the tracts into lots, and built homes that it sold with the lots. Interpreting the statute imposing the occupation tax strictly, the Supreme Court held that "contracting" applied only to persons who enter into contracts to perform services for another. This definition was widely accepted in such areas as mechanic's liens and worker's compensation. Moreover, those contracts the taxpayer entered into before the home in question was built only referred to the sale of a home and not to building one.

3. *Arizona State Tax Commission v. Staggs Realty Corp.*, 85 Ariz. 294, 337 P.2d 281 (1959).

Speculative builder was not engaged in taxable contracting.

Taxpayer contracted with an affiliated corporation that built homes for the taxpayer for its subsequent sales to homebuyers. The taxpayer could not be taxed on the sale of the homes because it did not first contract with others to perform construction contracting. At the time, the sales tax on contracting applied only to a person who first contracts with others to perform construction services. Since the taxpayer did not contract with the homebuyers before building homes, but built on "speculation" only, the "contract" requirement was not satisfied. Occasional sales contracts executed before construction were not taxable because they were contracts to *sell a* home rather than build one.

To abolish the "loophole" created by the *Staggs Realty* decision, the Legislature subsequently added the following language to the statute imposing tax on contracting,

> For all purposes of taxation or deduction, this definition shall govern without regard to whether or not such contractor is acting in fulfillment of a contract.

4. *Combustion Engineering, Inc. v. Arizona State Tax Commission*, 91 Ariz. 253, 371 P.2d 879 (1962).

Comparatively insignificant local supervision and labor required to install boiler for APS where boiler was constructed outside the state constitutes interstate commerce and thus not taxable in Arizona.

An out-of-state engineering company designed and manufactured large steam boilers outside Arizona. The manufacturer entered into contracts in New York with Arizona Public Service for the sale and delivery of two boilers, which were shipped to Arizona partially unassembled. APS's general contractor erected the boilers. Under separate labor contracts, the manufacturer supervised and assisted the general contractor, but the services rendered in Arizona represented less than ten percent of the manufacturer's total receipts. The manufacturer had no other physical presence in Arizona. The State Tax Commission assessed tax on the labor contracts as contracting and the sale of the boilers as furnishing

Copyright © 2005 by Patrick Derdenger

construction materials. On appeal, the sale of the boilers *and* the local supervision and labor were interstate transactions and, therefore, exempt from state tax. The amount of income generated in Arizona was comparatively insignificant. Because shipping the boilers fully assembled was impossible, and final assembly so complex that the manufacturer reasonably chose not to trust a local firm and risk APS rejecting the finished product, the Arizona activities merely completed manufacturing that had begun outside the state and were thus "relevant and appropriate" parts of interstate sales.

5. *State Tax Commission v. Parsons-Jurden Corp.*, 9 Ariz. App. 92, 449 P.2d 626 (1969).

Procurement, consulting, and design and engineering fees are not taxable under the contracting classification.

Taxpayer's contract required it to procure machinery, equipment, and construction materials on behalf of the owner and provide advice to the owner on the design and engineering of the project and other services necessary for construction activities. The taxpayer did not furnish materials, did not have discretion over purchases, used the owner's money, and did not carry insurance. Title in the materials passed directly from the vendor to the owner. The Tax Commission determined that a sizable portion of sums the Taxpayer spent on behalf of the owner were taxable sales of tangible property at retail. On appeal, The Supreme Court held that the taxpayer was merely a purchasing agent. Even though the contract referred to the taxpayer as an independent contractor, the contract relationship was one of principal and agent as to the purchase of materials. Engineering, procurement, accounting and other "home office services necessary" for the construction of facilities were not "sales" within the meaning of the statute imposing tax on the sale of tangible property at retail.

6. *Ebasco Services Inc. v. Arizona State Tax Commission*, 105 Ariz. 94, 459 P.2d 719 (1969).

Design and engineering fees received by a contractor and funds a contractor spends as a purchasing agent are not taxable contracting.

Soon after the Court of Appeals reasoned that design and engineering fees are not taxable sales, the Arizona Supreme Court addressed gross income attributable to design and engineering received by a contractor. Ebasco Services built power generation plants, and under separate contracts provided design and engineering fees. The State Tax Commission assessed tax on the design and engineering on the grounds that such activity was an integral part of Ebasco Services' construction business. *Ebasco* held that the contracting classification did not embrace such revenue, because engineering and design obviously were not covered by "any of the statutory categories which would ordinarily identify one as a contractor or builder." The former statute imposing tax on construction contracting did not permit taxing any activity a company engages in because "one of the activities engaged in is that of contracting."

Ebasco Services also acted as a purchasing agent on behalf of the utilities owner. Ebasco Services purchased $40 million in equipment on behalf of the owner, who

Copyright © 2005 by Patrick Derdenger

furnished the equipment for the construction Ebasco Services performed. The Commission assessed tax on the funds under several theories of constructive income. The Court rejected all of them, holding that the funds did not constitute consideration for the services Ebasco Services performed.

7. *State Tax Commission v. Howard P. Foley Co.*, 13 Ariz. App. 85, 474 P.2d 444 (1970).

Interstate commerce exemption did not apply to foreign corporation's' joint venture to perform one construction contract in the state using materials procured outside the state.

Two foreign corporations formed a joint venture to contract with Arizona public Service for the construction of electric transmission lines and transmission substations in Arizona. The taxpayers had no other contracts in Arizona, and practically all the construction materials were procured from outside the state. The taxpayers filed for refund of sales tax on the ground that they were engaged in interstate commerce. The Commission denied the claim, and the Superior Court rendered summary judgment for the taxpayers. On appeal, the taxpayers' Commerce Clause argument did not prevail. An exemption from state tax for interstate commerce did not apply because the entity was formed for the specific purpose of doing business in Arizona, and the contract was intrastate in character. Entering into only one contract in Arizona and obtaining the materials in interstate commerce failed to make the contracting an interstate activity.

8. *Lusk Corp. v. Arizona State Tax Commission*, 462 F.2d 187 (9th Cir. 1972).

Construction of "off-site" improvements to residential lots is taxable contracting.

A real estate developer purchased and subdivided large tracts of land for residential development. While a wholly owned subsidiary contracted with purchasers to build homes, the developer itself, prior to offering lots for sale, constructed streets, sidewalks, and sewer lines, and similar "off-site" improvement that were essential to residential use of the land. On appeal from the bankruptcy court's finding that the off-site improvements were not taxable contracting, but rather "real estate development, the Ninth Circuit disagreed. The construction was in fact subject to sales tax under the contracting classification. Former ARS § 42-1301 imposed tax not only on persons building structures but also on those who construct any "project, development or improvement," whether or not such persons are "acting in fulfillment of a contract."

9. *State Tax Commission v. Holmes & Narver, Inc.*, 113 Ariz. 165, 548 P.2d 1162 (1976).

As in Ebasco, design and engineering services are not taxable even where those services were not separately stated in the contract; a three part test was used to determine whether otherwise nontaxable services must be included in a construction contract.

Seven years after *Ebasco*, the Arizona Supreme Court again addressed the design and engineering fees issue. This time, though, the parties had included the

Copyright © 2005 by Patrick Derdenger

design services in the same contract as the contracting services. The Tax Commission argued that *Ebasco* did not apply to a single contract that did not separately state the price of the design and engineering services. The Commission further argued that the taxpayer's design and engineering services "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." The Court concluded that, 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 *provided* (1) the non-taxable portion of the contract can be readily ascertained without substantial difficulty, (2) the amount of otherwise non-taxable gross income, in relation to the company's total taxable Arizona business, is "not inconsequential," and (3) those services cannot be said to be incidental to the contracting business.

In 2004, the Legislature finally resolved the issue of whether design and engineering fees included in a construction contract. It amended the prime contracting classification to expressly exclude the portion of a contract attributable to "direct costs of providing architectural or engineering services" from taxable contracting, and defined "direct costs" as the "portion of the actual costs that are directly expended in providing architectural or engineering services."

10. *Department of Revenue v. Hane Construction Co.*, 115 Ariz. 243, 564 P.2d 932 (App. 1977).

    Out-of-state contractor was taxable under contracting classification on construction contract with BIA for work done on Indian reservation; contracting activity was not barred by federal exemption from state tax, federal preemption, or insufficient contacts with the state.

Out-of state taxpayer contracted with the Bureau of Indian Affairs to perform construction on the Colorado Indian Reservation in Arizona. State courts had jurisdiction over disputes between non-Indians arising out of the taxpayer's activities, and the taxpayer hired a substantial number of non-Indian personnel from outside the Reservation. Arizona could tax the gross income from the contracting. First, federal preemption did not apply because a) the tax was not imposed on Indian land, property, or income; b) taxing the contractor did not interfere with tribal government; c) minimal federal regulation covered the contracting activity, and d) no conflict existed between the imposition of the state tax and any applicable federal contracting law because the contractor could have increased its bid to obtain reimbursement for the state tax. Second, governmental exemption did not apply because the tax was imposed on the contractor, rather than on the federal government. Finally, contacts between the contractor and the state were sufficient to permit taxation.

In 1997, the Arizona Court of Appeals held that *Hane's* ruling on the federal preemption issue had been abrogated by intervening United States Supreme Court decisions requiring a balancing of federal, state, and tribal interests. Applying that

Copyright © 2005 by Patrick Derdenger

test, the Court of Appeals held that federal Indian policies and related tribal interests outweighed the state's interest in its activities on Indian reservations. The Arizona Supreme Court denied review, but the United States Supreme Court reversed the Court of Appeals in 1999, in *Arizona Department of Revenue v. Blaze Construction Co.*, 526 U.S. 32 (1999), discussed below.

11. *Dennis Development Co. v. Department of Revenue*, 122 Ariz. 465, 595 P.2d 1010 (App. 1979).

Gross income from the sale of land separately priced in a construction contract is not taxable contracting.

Three years after *Holmes & Narver*, the Arizona Court of Appeals rejected another attempt by the Department to tax otherwise nontaxable revenue merely because it was earned by a taxpayer engaged in contracting activities. The homebuilder in question sold lots improved by homes under contracts separately stating the price of land. The Department assessed additional tax on the sales price of the land. On appeal, the Department argued that proceeds from real property sold by homebuilders were "gross receipts of a taxpayer" derived from contracting activity. It argued that the Legislature intended this result because it was aware of a Department regulation so construing the statute imposing tax but chose not to address the issue when it subsequently amended the statute. The court disagreed, finding "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." It rejected the Department's analysis of legislative intent because, for twenty-three years during which the tax was reenacted three times, the Department construed the statutes as excluding sales of land from contractors' tax liability.

The Legislature subsequently enacted the result in *Dennis*, by amending the contracting classification to include a tax deduction for the fair market value of land.

12. *Knoell Brothers Construction, Inc. v. State, Department of Revenue*, 132 Ariz. 169, 644 P.2d 905 (App. 1982).

Standard 35% labor deduction computed after land value is deducted from gross income.

In computing the thirty-five percent labor deduction, the deduction for the fair market value of land must first be subtracted from the gross contracting proceeds. The thirty-five percent is applied against the net figure. Thus, if the sales price of a home and the underlying land is $100,000 and assuming that the fair market value of the land is $20,000, the thirty-five percent labor deduction would be applied against the net amount, $80,000, resulting in a labor deduction of $28,000, for a net taxable income of $52,000. The taxpayer's allegation that the Department previously allowed taxpayers to compute the labor deduction on the total gross receipts, without first netting out land, did not estop the Department from collecting tax based on a formula resulting in a smaller labor deduction.

13. *Kitchell Contractors, Inc. v. City of Phoenix*, 151 Ariz. 139, 726 P.2d 236 (App. 1986).

Copyright © 2005 by Patrick Derdenger

Exemption for retail sales to a charitable organization did not apply to a single agreement for materials and supplies and services as a construction manager, and the standard deduction is computed on income net of the deduction allowable for materials and supplies.

A contractor entered into two contracts to perform construction of hospital facilities. One contract covered the construction, and the other covered contractor's sale to the owner of materials and supplies that would be used by the contractor to build the project. Both contracts were subparts of an agreement for construction management services. The contractor computed the thirty-five percent standard deduction on its total gross income and deducted the sales of materials and supplies as exempt retail sales to a charitable organization. The City disallowed the exemption, and after summary judgment in favor of the contractor, objected to calculating the standard deduction before the exemption. On appeal, the exemption was upheld. The sales contract was not an artificial contrivance, because valid business reasons justified structuring it as a sale, especially in light of the fact that the exemption benefited the hospital, not the contractor. The fact that the sales contract was drafted in conjunction with the construction management agreement, by itself did not support disregarding actual transactions that occurred. Following *Ebasco* and *Knoell Brothers*, the standard deduction had to be computed on the net proceeds after deducting the exempt sales.

14. *Gosnell Development Corp.. v. Arizona Department of Revenue*, 154 Ariz. 539, 744 P.2d 451 (App. 1987).

Contractors in same class must be treated equally; prior court of appeals decision must be applied so as to treat taxpayers the same.--those that paid the tax must get refund and those that did not would not be assessed..

Gosnell Development computed its tax by computing the standard deduction after deducting the sale price of land from its gross income (the net method). The Department assessed additional tax against contractors that computed the standard deduction before deducting land (the gross method). The Department prevailed on this issue in *Knoell Brothers*, but on remand, the Tax Court applied the ruling prospectively. The Department decided not only to forego auditing taxpayers who used the gross method before *Knoell Brothers* was decided, but also to deny refunds for taxpayers who had used the net method. Gosnell sued for a refund of tax paid before the ruling, for the amount of tax it would have saved had it used the gross method, on equal protection grounds. On appeal, the court of appeals held that an equal protection violation had resulted because taxpayers in the same class were treated differently. The court ordered the Department to make the refund to Gosnell.

15. *Tucson Mechanical Contracting, Inc. v. Arizona Department of Revenue*, 175 Ariz. 176, 854 P.2d 1162 (App. 1992).

Prime contractor not exempt on work done for federal government; discrimination against Arizona-based contractors not shown.

Copyright © 2005 by Patrick Derdenger

The legal incidence of Arizona's tax on prime contracting falls on the contractor. Thus, the federal government's immunity from state taxation does not apply when the government engages a prime contractor in Arizona. The appellants in *Tucson Mechanical* were licensed Arizona contractors, against whom the Department had assessed sales tax on income from federal contracts. The Tax Court rejected the claim that the tax was unconstitutionally imposed on the federal government.

The Court of Appeals discussed recent U.S. Supreme Court cases holding that, while the states cannot tax the United States directly, they can tax private parties with whom the federal government does business, even if the financial burden ultimately falls on the federal government. These decisions established that intergovernmental tax immunity does not result "simply because the tax has an effect on the United States, or even because the federal government shoulders the entire economic burden of the levy." Rather, tax is directly imposed on the government only when the actual tax levy is on the United States or some agency or instrumentality so closely connected that the two cannot be viewed as separate entities. Based on this authority, the Court rejected the taxpayers' contention that sales tax on contractors engaged by the federal government violates the Intergovernmental Immunities Clause.

The Court of Appeal also rejected the taxpayers' contention that the Department had singled out Arizona-based contractors for tax enforcement. The Court found no evidence of i) a policy to ignore out-of-state contractors or ii) systematic and deliberate conduct discriminating against in-state contractors. The fact that the Department could not audit many contractors did not establish discrimination, and the Department is not obligated by statute to audit and enforce transaction privilege tax against *all* prospective taxpayers.

16. *RDB Thomas Road Partnership v. City of Phoenix*, 180 Ariz. 194, 883 P.2d 431 (App. 1994).

"Owner-builder" selling project within twenty-four months of substantial completion is subject to municipal sales tax.

The City assessed municipal sales tax on an owner of real property who had a prime contractor build an office building on the property, because the property owner sold the building within twenty-four months of completion of the construction. The City's Tax Code imposes tax on an "owner-builder" that sells improved real property at any time within twenty-four months from the date of substantial completion of the improvement. An "owner-builder" is defined by the Code to mean "an owner or lessor of real property who, by himself or by or through others, constructs or has constructed or reconstructs or has reconstructed any improvement to real property."

On appeal, the City argued that the taxpayer was an owner-builder because it constructed the office complex "by or through" its contractor. The taxpayer argued that an owner-builder engaging a contractor is only subject to tax if a principal-agent relationship exists between the owner and the builder, rather than contracting "through" an independent, third party that performs the construction. The taxpayer relied on *SDC Management, Inc. v. State ex rel. Arizona*

Copyright © 2005 by Patrick Derdenger

Department of Revenue, 167 Ariz. 491, 808 P.2d 1243 (Ct. App.1991), which construed the statute imposing state sales tax on prime contracting. The state definition of "owner-builder," however, covered a person "who *acts as a contractor,* either himself or through others." The Court disagreed with the taxpayer, finding that, while agency was required by the state definition, the city definition did not because it lacked the "acting *as a contractor*" element. Accordingly, the taxpayer fell within the City's definition of "owner-builder" and was subject to the sales tax on the sale of the office building.

The state definition reaches an owner-builder who acts as its own general contractor to build a project and contracts directly with the subcontractors to complete of the project. On the other hand, the City Code definition reaches an owner that hires a general contractor to build the project, who in turn subcontracts with subcontractors.

17. *Arizona Department of Revenue v. M. Greenberg Construction*, 182 Ariz. 397, 897 P.2d 699 (App. 1995).

Construction contracts with Arizona school districts for work performed on Indian reservations are taxable.

Greenberg Construction did construction work on the Navajo Indian Reservation. It had contracts with the Ganado School District and the Chinle School District. The Department of Revenue assessed sales taxes under the contracting classification on Greenberg's gross income from the school district projects. Greenberg argued that the state was preempted by federal law from imposing sales tax on its construction because it was doing work on the Indian reservation.

Greenberg relied upon the United States Supreme Court's *Ramah* decision, which struck down New Mexico sales tax on construction performed on the Navajo Indian Reservation for the Ramah Navajo School Board, a subdivision of the Navajo Nation. The Department countered that *Ramah* did not apply because Greenburg's contracts were with political subdivisions of the state of Arizona that were funded in large part by the state and served Indian and non-Indian children. The Court of Appeals sided with the Department, holding that gross income from contracts with Arizona school districts for contracting performed on Indian reservations is taxable. Unless the contract is with an Indian tribe or an agency of a tribe, construction contracting is subject to Arizona sales tax.

18.. *Irby Construction Company v. Arizona Department of Revenue*, 184 Ariz. 105, 907 P.2d 74 (App. 1995).

Arizona Department of Revenue collaterally estopped from imposing transaction privilege tax on a builder who constructed electrical power transmission lines.

In 1983, the Arizona Tax Court determined that Irby Construction was a tax exempt retailer, not a contractor, of power lines it had erected. In 1993, the Tax Court collaterally estopped the Department from challenging the 1983 ruling. After the Court of Appeals subsequently ruled in *Brink Electric* (discussed below) that an unrelated builder of electrical substations was subject to sales tax on construction contracting, the Department appealed from the Tax Court's

Copyright © 2005 by Patrick Derdenger

estoppel ruling for Irby Construction. The Department argued that, given the holding in *Brink Electric*, the Tax Court's application of collateral estoppel resulted in the unequal administration of justice among taxpayers engaged in the same business activities.

The Court of Appeals held that the doctrine of collateral estoppel required the tax court to rule that Irby Construction was a tax exempt retailer. The *Brink Electric* decision was not an intervening change in the law between the two tax court decisions and the Court declined to retroactively apply *Brink Electric* to a dispute already resolved. However, if the Department assessed tax under the contracting classification on Irby's power line construction activities *after* the *Brink Electric* decision, the doctrine of collateral estoppel would not bar taxing Irby Construction as a contractor in order to achieve equity of tax treatment between Irby Construction and the taxpayer in *Brink Electric*.

19. *Brink Electric Construction Co. v. Arizona Department of Revenue*, 184 Ariz. 354, 909 P.2d 421 (App. 1995).

Materials and supplies provided in performing construction do not qualify for retail sales tax exemptions; permitting such exemptions for contractors acting as purchase agents did not violate equal protection; and taxable contracting does not require permanent attachment to real property.

The taxpayers furnished and installed electrical substation equipment and pipes and values for transporting water. Exemptions from retail sales tax applied to both the electrical transmission equipment and the pipes and valves. The Department allowed the retail sales tax exemptions to contractors furnishing and installing such materials to customers under a purchasing agency agreement, but it denied the exemptions to the taxpayers. The taxpayers asserted on appeal that gross income attributable to furnishing materials were retail sales of exempt equipment. The Court of Appeals disagreed, holding that all gross income from contracting, including furnishing the materials, is taxable contracting, and retail sales tax exemptions only apply to retail sales. It reasoned that materials incorporated into the construction projects were not resold in their original condition, so no retail sale occurred. The exemption for materials and supplies that a contractor purchases to perform a construction contract is not a resale exemption. Rather, the exemption is intended to prevent double taxation because the contractor will owe tax on gross income from furnishing the materials. Therefore, a contractor may only claim exemptions included in the prime contracting classification.

Brink Electric also held that permitting exemptions to contractors who acted as purchase agents did not violate equal protection because the taxpayers were free to enter into their own purchase agency agreements and, therefore, were not treated differently. *Brink Electric*'s ruling on exemptions was subsequently superseded by the Legislature enacting exemptions for contracts to install, assemble, repair or maintain machinery or equipment qualifying for certain retail sales tax exemptions.

Copyright © 2005 by Patrick Derdenger

Brink Electric also rejected the assertion that the installation of the electrical substation equipment was not taxable contracting because the equipment was not permanently attached to real property. The equipment was merely bolted to concrete pads and steel supports to immobilize it, could be removed without damaging the pads and supports, and was periodically removed and moved to new locations as power needs changed. *Brink Electric* held that permanent attachment, while sufficient to establish taxable contracting, is not *required* for taxable construction services. Taxable contracting need only include building, repairing, changing, or demolishing a real property improvement. Whether a specific article is an improvement to real property depends on whether an annexation takes place; the article's adaptability to the realty's use and purpose; and, most importantly, the intention of the person making the annexation. Under these factors, overall, the installation improved the real property for the purpose of transmitting electricity.

20. *Centric-Jones Co. v. Town of Marana*, 188 Ariz. 464, 937 P.2d 654 (App. 1996).

Arizona town had authority to impose transaction privilege tax on a Colorado prime contractor working on a one-time construction project.

Centric-Jones was a Colorado-based contractor that had agreed to build pumping plants and switching yards for the Central Arizona Project, on a one-time basis. Other than the project at issue, Centric-Jones did no business in the town, nor did it hold itself out as engaging in the construction business in Arizona. The town assessed municipal sales tax on Centric-Jones's contracting income from the project.

On appeal, the tax was properly deemed a tax on the privilege of doing business as measured by the revenues Centric-Jones realized, and not merely a license tax paid in advance of any business being done. Second, the contractor's project could not be deemed a casual activity because the exemption applied to taxpayers who only sporadically engages in a certain type of business activity; it did not apply to Centric, which regularly engage in the contracting business but which engaged in this particular area of that business only once.

The Federal Due Process Clause did not require the town to notify Centric-Jones that its activities were taxable before imposing tax, nor did due process require perfect apportionment of gross receipts from the construction project between the town and other taxing jurisdictions. Lastly, the town's tax did not violate the Commerce Clause because: a) there was sufficient nexus, namely, physical presence for over three years, b) the tax was fairly apportioned because the project was conducted solely in the town, c) the tax did not discriminate against interstate activities because the tax applied equally to Arizona and out-of-state contractors, and d) the tax was fairly related to the traffic and safety services provided by the town.

Copyright © 2005 by Patrick Derdenger

21. *Estancia Development Associates LLC v. City of Scottsdale*, 196 Ariz. 87, 993 P.2d 1051 (1999).

The speculative builder provision of the Model City Tax Code does not apply to sale of real property that is unimproved at the time of sale, even though the sales contract requires subsequent improvements to be made by the seller.

Estancia owned real property in Scottsdale and entered into contracts to sell the individual lots into which the property had been subdivided. Estancia's contracts obligated it to make improvements to the property after the close of escrow. The speculative builder tax of the Model City Tax Code taxes the sale of "improved real property" within twenty-four months from the date of substantial completion of the improvements. The Court of Appeals held that since there had been no improvements made to the property at the time of the close of escrow, which was the time of sale, the speculative builder tax did not apply, although it was contemplated and Estancia was obligated to make off-site improvements after the sale.

22. *Arizona Department of Revenue v. Blaze Construction Co.*, 526 U.S. 32 (1999).

State may tax a contractor performing services for the federal government on Indian reservations for the benefit of an Indian tribe (see Hane Construction).

The Bureau of Indian Affairs contracted with the taxpayer construction company to build and maintain roads on Indian reservations in Arizona. The Department assessed transaction privilege tax on the gross income from the BIA contracts.

Blaze Construction declined to exempt state taxation in the absence of Congress and Arizona enacting legislation to do so. First, without Congress acting to extend the federal government's immunity from state taxation to its contractors, federal immunity did not apply. Second, the balancing test for inferring whether Congress intended to pre-empt state taxation, which applies to contracts with tribes or tribal members for services on Indian reservations, does not apply to contracts with the United States government. Rather, a bright-line standard for taxing federal contractors is necessary to avoid litigation and inefficient tax administration.

23. *Arizona Department of Revenue v. Arizona Outdoor Advertisers, Inc.*, 202 Ariz. 93, 41 P.3d 631 (App. 2002).

Reasonable person test governs determination of real versus personal property for tax purposes--does it apply to the contracting classification?

The Department assessed sales tax on the taxpayer's rentals of advertising billboards as commercial leases of real property. The billboards consisted of modular frameworks bolted to support poles driven several feet down into the ground. Customers' advertising panels were hung on the frameworks. The billboards were designed to be easily disassembled. They were erected on land leased from third parties, and the leases permitted their removal upon one

Copyright © 2005 by Patrick Derdenger

month's notice. Advertising locations were abandoned whenever they became unprofitable. To remove the billboard, the support poles were severed at the ground level, and the entire unit was hauled to its next location. The taxpayer protested the assessment as employing the wrong sales tax classification, because it rented personal property.

While the Tax Court employed a traditional fixtures analysis to determine whether the billboards were personal or real property, the Court of Appeals found a "reasonable person" test preferable for tax purposes. The test inquires whether a reasonable person, considering all the relevant circumstances, would assume the item in question was a part of the real estate where it was located. The right to remove the billboards, their design, and the fact that removal took place frequently outweighed the affixture of the support poles and warranted finding that the billboards were personal property.

The Department has indicated that it will use the Arizona Outdoor Advertisers case as test for determining permanent attachment for purposes of the installation labor exemption of A.R.S. § 42-5075.B.7.

24. *Arizona Joint Venture v. Arizona Department of Revenue*, 205 Ariz. 50, 66 P.3d 771 (App. 2003).

Department not estopped because the taxpayer could not show any detriment to its reliance on the Department's prior positions.

The Court rejected taxpayer's argument that three prior audits that failed to adjust land value deductions estopped the department from challenging the taxpayer's land deductions in a subsequent audit. The Court found that the taxpayer failed to identify specific conduct inconsistent with the current audit, should have been aware that the failure to adjust the land deduction resulted from the Department's mistake, and most importantly could not demonstrate legal detriment merely by failing to pay taxes it was obligated to pay. In addition, *Arizona Joint Venture* holds that the Department is not barred from challenging the land value deduction after issuing an audit notice, nor does its acceptance of the deduction before the notice is issued transfer the burden of proof to the Department.

25. *Luther Construction Co. v. Arizona Department of Revenue*, 205 Ariz. 602, 74 P.3d 276 (App. 2003).

A taxpayer claiming equitable estoppel against the Department may rely upon a written letter from the department, formal action taken on a refund claim, and an audit assessment.

An administrator's 1986 written guidance that contracting performed for the Bureau of Indian Affairs and for the benefit of Indian tribes was not subject to tax, a 1987 granting of a refund claim for tax collected on BIA contracts and a 1993 audit assessment not taxing BIA contracts where the work was for the benefit of the Indian tribe were inconsistent acts supporting estoppel against a subsequent state audit assessing tax on BIA contracts. The taxpayer relied upon the Department's prior positions that BIA contracts were not subject to the prime contracting classification tax to its detriment when it did not include the tax in its bid for the BIA job that was the subject of the subsequent audit and assessment.

Copyright © 2005 by Patrick Derdenger

In addition, the Court of Appeals remanded the case to the tax court to determine whether the taxpayer was aware that a 1993 audit assessment against the taxpayer, which declined to tax contracts with the BIA, was in conflict with assessments against other taxpayers that taxed such contracts (in other words, was the taxpayer's reliance reasonable). Additionally, rather than showing that it would have been able to pass the tax on in a winning bid for the contract, the taxpayer only needed to show that it could have collected tax on the contract and suffered substantial detriment by not doing so.

15. CONCLUDING NOTE

This section on the taxation of contracting represents merely an overview of a very complex area of Arizona taxation. If the information contained within this section does not appear to provide sufficient guidance for a particular issue of interest, be sure to consult A.R.S. § 42-5075, Title 15, Article 5 of the Arizona Administrative Code and the Department's published rulings and procedures. Citations to the proper sources have been included, where appropriate. With respect to city sales taxation of contracting, please refer to the Model City Tax Code and Regulations. For more detail or for specific guidance, be sure to consult with a tax professional.

Copyright © 2005 by Patrick Derdenger