

**DOR STRATEGIES IN AUDITING THE
MARKETING ARM--CONTRACTING ARM
STRUCTURE FOR HOMEBUILDERS**

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
STEPTOE & JOHNSON LLP
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

**USING A SEPARATE MARKETING ARM TO REDUCE
TAXES ON HOMEBUILDING ACTIVITIES**

By
Patrick Derdenger
Partner, Steptoe & Johnson LLP
201 E. Washington Street, 16th Floor
Phoenix, Arizona 85004-2382
(602) 452-0929
email: pderdenger@steptoe.com

Washington, D.C. Phoenix Los Angeles London Brussels New York
Copyright © 2006 by PATRICK DERDENGER

ATTACHMENTS:

Letter dated September 4, 1985 A
Letter dated November 25, 1985 B
Marketing/Construction Agenda..... C
Private Taxpayer Ruling LR05-007 (September, 2005).....D

MARKETING ARM–CONTRACTING ARM.

1.1 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.

1.2 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 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 is only one case 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 home builder 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.

1.3 Possible Advantages For Marketing Arm To Own The Land.

There are two possible advantages for the marketing company to own the land as opposed to the contracting company.

1. **Land Deduction.** With the marketing company owning the land, there will be no issue as to the land deduction. If the contracting arm owns the lot, then for state tax purposes (and for purposes of those cities that have a land deduction for the fair market value for the land), the contracting arm is entitled to a deduction for the fair market value of the land. As previously indicated in these materials, the Department has an unwritten audit "safe harbor" and allows a land deduction equivalent to 20% of the overall sales price of the house and the lot without requiring any backup documentation as to the fair market value of the land. If the land is worth more than 20% of the sales price of the house and the lot, the homebuilder is entitled to a deduction for the greater amount but must be able to

substantiate the fair market value of that land, typically by the way of an appraisal report. On the other hand, if the marketing arm owns the land, the land deduction does not come into play since the marketing arm is not taxable at the state level on the sale of the house and the lot to the homebuyer. With the marketing arm owning the land, the issue of the fair market value of the underlying lot is avoided.

2. **Development Costs and Fees.** The developer of a subdivision typically incurs various municipal fees, such as water and sewer hookup, etc. If the marketing company owns the land, it as the owner can pay those fees itself and they would not be subject to tax as a part of the prime contractor's revenue. On the other hand, if the contracting arm paid those fees and was then reimbursed by the marketing arm-owner, the Department of Revenue would undoubtedly take the position that those fees are subject to tax under the prime contracting classification. In this regard see Department of Revenue TPR at 95-15(04/17/95) in which the Department of Revenue held that construction permit fees paid by the prime contractor and reimbursed by the owner were subject to tax under the prime contracting classification.

1.4 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 which 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, § 415(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.

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.

1.4. Charts A & B. (See below)

