

ARIZONA SALES TAXATION OF CONTRACTING

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I. 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).² The person liable for the sales tax under this classification is the "prime contractor."

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).

² Effective January 1, 1999, the sales tax statutes (title 42) were renumbered.

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(H)(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, 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 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 THE SUBCONTRACTOR EXEMPTION.

(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 Administrative 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) Canyon State Excavating Case. In *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.

(4) 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 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.

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

1.4 DEFINITION OF “PRIME CONTRACTOR.”

A.R.S. § 42-5075(H)(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) *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.

1.5 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).

(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).

1.6 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 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) 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) (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.

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. See A.R.S. § 42-5061(A)(27), which provides an exemption for:

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).

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:

(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 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. A detailed discussion of this installation labor exemption is continued 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). 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).

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.

(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 Cod 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).

(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.

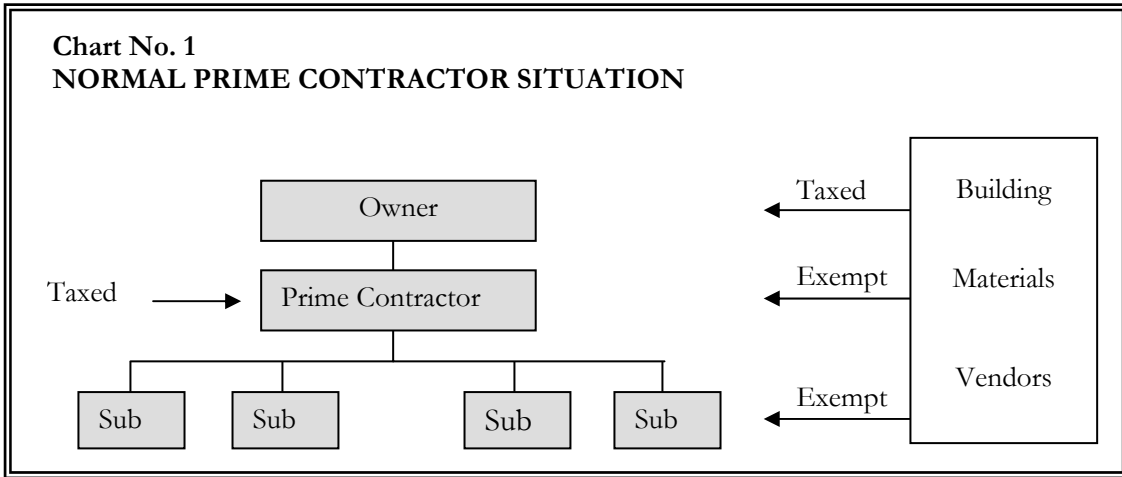
2. **FOUR VARIANTS OF THE CONTRACTING CLASSIFICATION TAXING SCHEME.**

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:

- a. **The normal prime contractor, involving a prime contractor doing work for an owner of real property.**
- b. **The speculative builder,** involving a builder that owns land and acts as his own prime contractor in improving that land, with the intent to sell the improvements when completed.
- c. **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.
- d. **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.



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.

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)
<u>\$43,090</u>	Tax

4. **SPECULATIVE BUILDER.**

Chart No. 2
Speculative Builder (Builds with Intent to Sell)

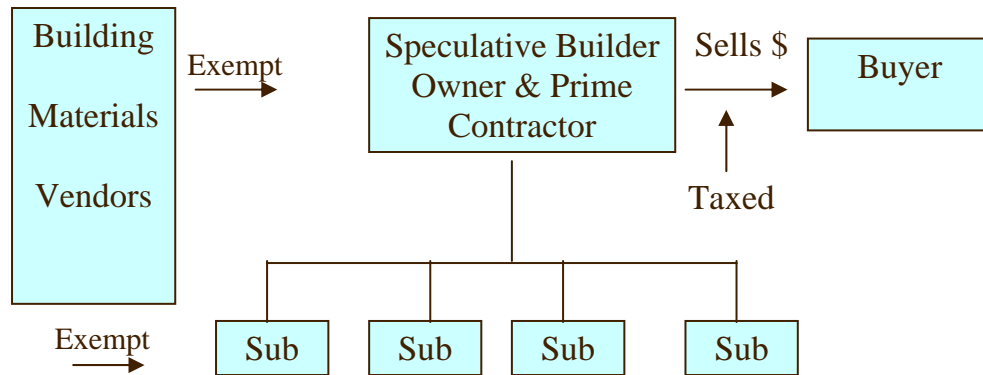
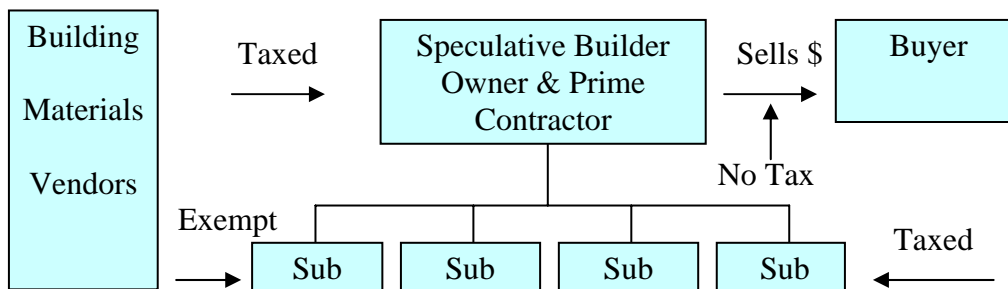


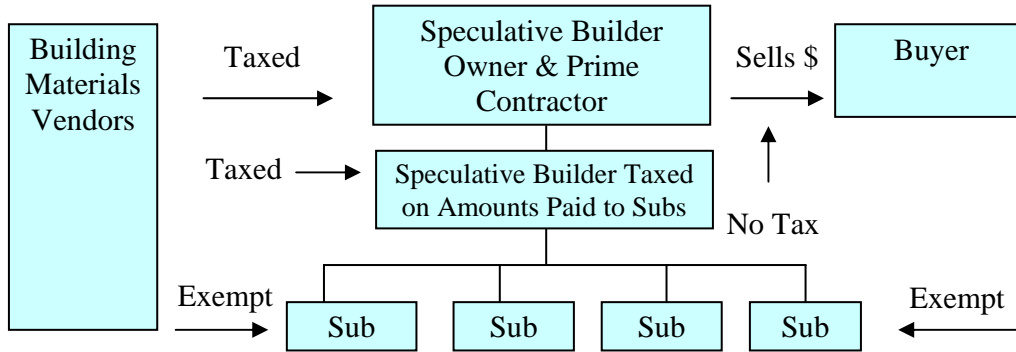
Chart No. 2A
Department of Revenue's Unwritten Audit Position



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"

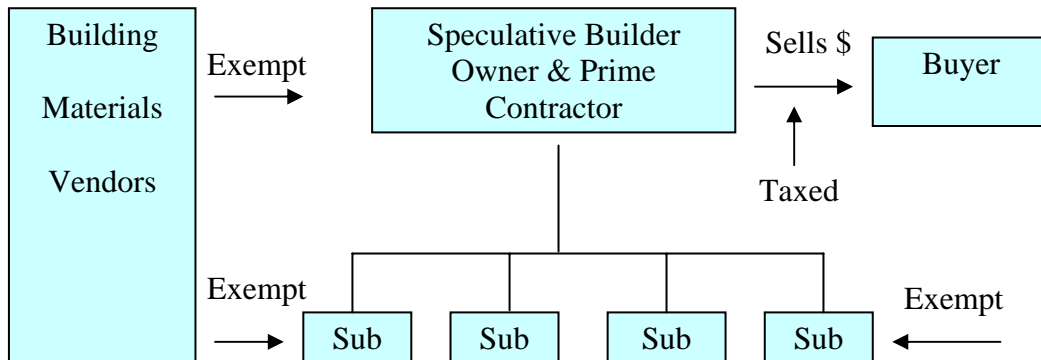
Chart No. 2B
 Department of Revenue's Unwritten Audit Position



Speculative Builder Constructs House Without Contract in place before completion

- Gives Forms 5005 to subcontractors

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(H)(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 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 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 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 almost 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 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)

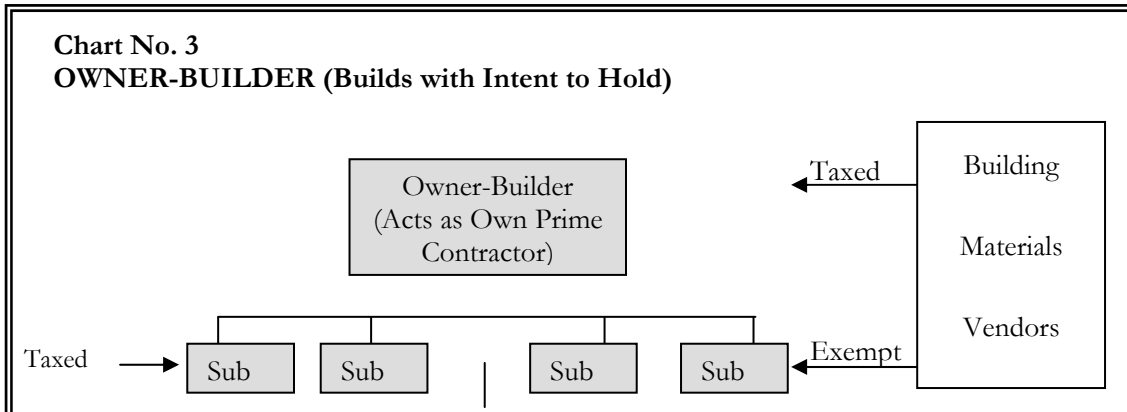
\$2,000,000	Gross Sales Proceeds
<u>- 400,000</u>	Land Value
\$1,600,000	
<u>- 560,000</u>	35% Labor Deduction
\$1,040,000	Taxable Amount (65% Tax Base)
971,055	Factored Tax Deduction (\$1,040,000 ÷ 1.071)
<u>X 7.1%</u>	Tax Rate (State, County & City*)
\$ 68,944	Tax

(Compare to \$43,090 for a Prime Contractor)

*Assume City has land deduction

5. OWNER-BUILDER

**Chart No. 3
OWNER-BUILDER (Builds with Intent to Hold)**



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 person 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 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?

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."

(a) *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.

(b) *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-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.

(2) *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.”

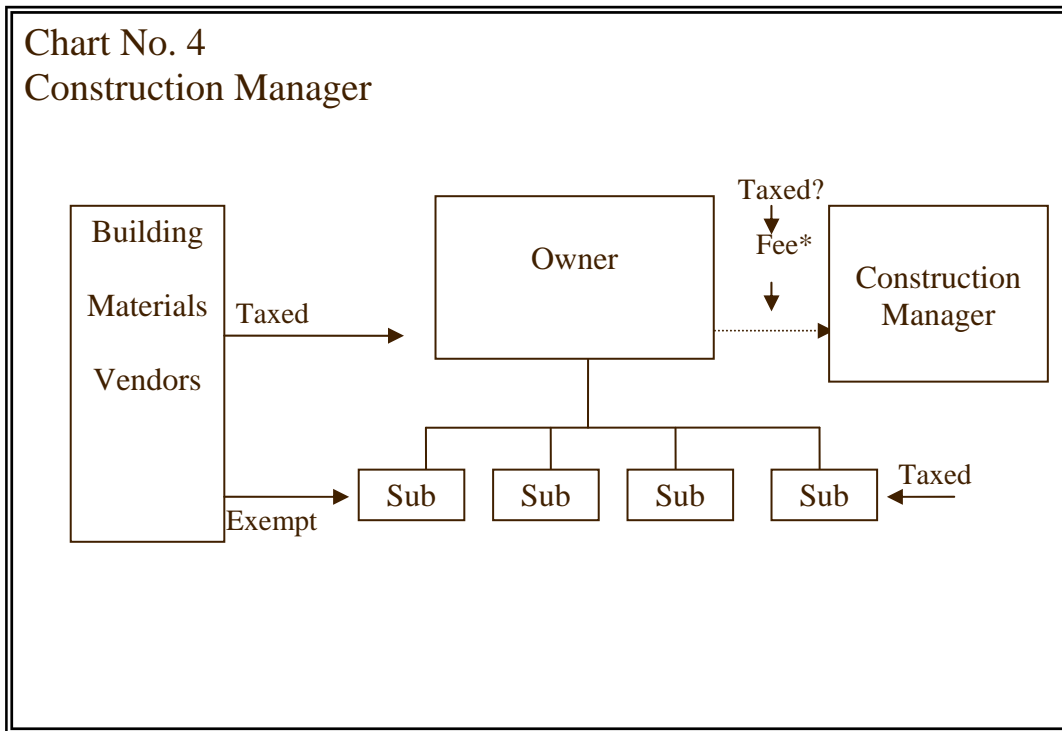
The Department takes the position that the issuance of a certificate of occupancy is the equivalent of “substantial completion.” However, the Arizona Board of Tax Appeals held that the issuance of such a certificate is not necessary to start the two-year period running as long as the project is otherwise 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).

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.

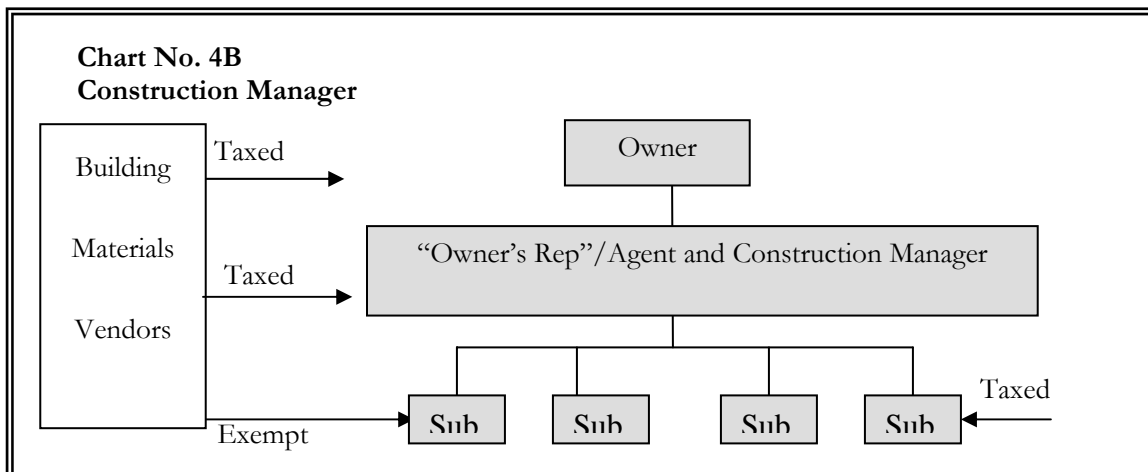
In some situations, the construction manager may also act as the “agent” of the owner (or “owner’s representative”) in dealing with the various subcontractors. This would include entering into contracts with the various subcontractors, but in an agency capacity for the owner, with the contracts being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



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.	
\$900,000	
– <u>315,000</u>	35% Labor Deduction
\$585,000	Taxable Amount (65% tax base)
546,218	Factored tax deduction (\$585,000 ÷ 1.071)
× <u>7.1%</u>	Tax Rate (State, County & City)
<u>\$ 38,781</u>	Tax
Savings from normal prime contractor situation (compare Chart No. 1)	
– \$ <u>4,309</u>	(\$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 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.

(a) *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.

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

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

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

period, and (3) “the discount component of the Program was functionless standing alone.” 198 Ariz. at 588, 12 P.3d at 813.

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

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

(d) Senate Bill 1293 Was Introduced To Resolve The Dispute Regarding The Proper Tax Treatment Of Design-Build Contracts.

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

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

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

The statute defines “direct costs” as follows:

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

(e) 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.

(f) Senate Bill 1293 Is Retroactive To The Date Of The Ebasco Decision; Refund Claims Are Limited.

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

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

After December 31, 2004, the Department of Revenue is required to: (1) review all timely filed claims; (2) determine, on audit if necessary, the correct amount of each claim; (3) notify the taxpayer of the Department's determination; and (4) if the aggregate amount of all refund claims based on S.B. 1293 exceed one hundred thousand dollars, reduce each claim proportionately so that the total refund amount 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.

(g) Senate Bill 1293 Is 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. *Holmes & Narver*, 113 Ariz. at 169, 548 P.2d at 1166. In *Holmes & Narver*, 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.

7.3 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 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.

7.4 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.

7.5 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.

7.6 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).

7.7 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:

A. 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.

B. 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.

C. 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.
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.

a. 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. TPR 02- __ (draft) (2002).

7.8 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.”

7.9 *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.

7.10 *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).

7.11 *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.

7.12 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.

7.13 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.

7.14 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 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.

7.15 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.

7.16 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).

7.17 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* § 1.8.18.

7.18 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 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.

7.19 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.

7.20 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 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 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.⁵

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

⁵ 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.

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.

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.*

A. *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.

B. *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.

C. *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.

D. *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 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 RULING COVERING CONSTRUCTION CONTRACTS ON INDIAN RESERVATIONS

Transaction Privilege Tax Ruling 95-11 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.

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	<i>Ramah</i>
Non-Indian/Non-Affiliated Indian Prime Contractor	Bureau of Indian Affairs	Taxable	<i>Blaze Construction</i> (U.S. Supreme Court) TPR 95-11
Indian Tribe, Tribal Entity or Affiliated Indian Prime Contractor (Member)	Anybody	Not Taxable	<i>Ramah</i> and TPR 95-11
Non-Indian/Non-Affiliated Indian Prime Contractor	School District	Taxable	<i>Greenberg Construction</i> and <i>Flintco</i>

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 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, Cleve 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 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.

10. 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 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.

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).

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 16,⁶ who sells at retail manufactured homes, mobile homes or factory-built buildings, as such terms are defined in § 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

⁶A.R.S. § 41- 2141 *et seq.*

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:
 - (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.

12. 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:

- A. For the purpose of this rule:
 1. 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.

2. 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.

B. 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:

1. Two thousand dollars for:
 - a. General contractors of residential buildings other than single family;
 - b. Operative builders;
 - c. Plumbing, air conditioning, and heating, except electric;
 - d. Painting, paper hanging;
 - e. Decorating;
 - f. Electrical work;
 - g. Masonry stonework and other stonework;
 - h. Plastering, drywall, acoustical and insulation work;
 - i. Terrazzo, tile, marble and mosaic work;
 - j. Carpentry;
 - k. Floor laying and other floor work;
 - l. Roofing and sheet metal work;
 - m. Concrete work.
 - n. Water well drilling;
 - o. Structural steel erection;
 - p. Glass and glazing work;

- q. Excavating and foundation work;
 - r. Wrecking and demolition work;
 - s. Installation and erection of building equipment;
 - t. Special trade contractors; and
 - u. 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.
 3. Seventeen thousand dollars for:
 - a. General contractors of industrial buildings and ware-houses;
 - 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.

C. 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.

D. 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:

1. 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;

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

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

4. 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.

E. 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.

F. 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.

13. CITY SALES TAXATION OF CONTRACTING.

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

13.1 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).

13.2 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.