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SIGNIFICANT ARIZONA CASE LAW RELATED TO THE SALES TAXATION OF CONSTRUCTION ACTIVITIES

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1. *Moore v. Pleasant Hasler Const. Co.*, 51 Ariz. 40, 76 P.2d 225 (1937).

The legislature's inclusion of a separate sales tax classification for contractors indicates it intended that the classification for selling tangible personal property not apply to contractors.

Arizona's original sales tax laws did not contain a separate classification for contractors. As a result, the Supreme Court of Arizona had previously held that when a contractor builds a structure, it sells all of the tangible materials incorporated into the building to the owner, and therefore must remit sales tax under the classification for selling tangible personal property. However, after the Supreme Court decided that case the legislature amended Arizona's sales tax laws and added a separate classification for contractors, with a different tax rate.

In this case, a construction company brought suit and asserted that it was not subject to Arizona sales tax under the classification for selling tangible personal property in light of a new amendment adding a classification for contractors. The Supreme Court agreed, and overturned its previous decision to the contrary. It held that by adding a separate section to the sales tax laws to cover contractors, the legislature intended that the classification for selling tangible personal property should not apply to construction contractors.

2. *Crane Co. v. Arizona State Tax Commission*, 63 Ariz. 426, 163 P.2d 656 (1945) (*Crane 1)*.

A merchant who sells tangible personal property to a contractor that uses the property to fulfill contracts with others is making a non-taxable sale for resale.

A merchant brought suit against the State Tax Commission to enjoin it from assessing a tax on the merchant's gross receipts from selling materials to contractors. At issue was whether or not a sale of materials to a contractor, who would incorporate the materials into a building or structure, constituted a sale for resale. Arizona's sales tax laws exempted from the retail classification any sales for resale.

The Supreme Court noted that contractors are not the ultimate consumers of the materials they use to incorporate into structures. Since they are not the final consumer, the Court held that "when a merchant sells tangible personal property to a

contractor for use of and used by the contractor in construction for others, such sale is a sale for resale and is not taxable." *Crane*, 63 Ariz. at 438, 163 P.2d at 661.

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

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

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

The holding in this case has the effect of overturning *Crane 1*, above, that a merchant's sales to a contractor are exempt sales for resale. Contractors are not taxed under the retail classification, and the materials they incorporate into a structure becomes real property and constitutes tangible personal property no more. As a result, contractors cannot qualify for the exemption under the retail classification for sales for resale.

4. *Johnson v. Crane Co.*, 75 Ariz. 156, 253 P.2d 341 (1953).

A merchant's sale to a contractor of materials incorporated into structures does not constitute a sale for resale because the materials have become real property and are no longer tangible personal property.

A plumbing contractor purchased plumbing equipment from a merchant. It used the vast majority of the equipment purchased to fulfill contracts or subcontracts. The seller attempted to charge the contractor sales tax, but the contractor refused, and the seller filed suit.

To resolve the case, the Supreme Court of Arizona confirmed that it had overturned *Crane 1*. At issue in the case was whether a merchant's sale to a contractor who uses the materials in performing its contracts constitutes a sale for resale. Following *Duhame*, it held that such a sale was not a sale for resale. It reasoned that "[w]hen a contractor fabricates his materials for the contractee, and the completed structure is erected on the owner's land, it is as much real property as the land itself. The constituent elements of tangible personal property have been destroyed by their incorporation into the completed structure. And such a contractor, therefore, is not making a sale of tangible personalty to his contractee." *Johnson*, 75 Ariz. at 157, 253

P.2d at 341. As a result, a merchant's sale to a contractor of materials incorporated into structures does not constitute a sale for resale. The court noted, however, that subsequent changes to the sales tax laws not in effect at the time of the sales here might create an independent exemption for contractors.

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

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

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

6. *State Tax Commission v. Wallapai Brick and Clay Products*, 85 Ariz. 23, 330 P.2d 988 (1958).

Brick manufacturers were exempt from remitting tax on sales of bricks to licensed contractors who incorporated the bricks into structures or improvements.

Brick manufacturers extracted clay from land they owned, refined the clay and used it to make bricks, which they then sold to contractors. The contractors used the bricks to fulfill contracts by incorporating the bricks into structures, projects, developments and improvements. At issue in the case was whether the brick manufacturers were subject to remitting tax on such sales under the retail or mining classification.

The Arizona Supreme Court noted that the minerals as extracted had no value and could not be sold until they were refined into bricks. Therefore the brick manufacturers were taxable on their first marketable product – the bricks – rather than the extraction of the clay itself (since they could not be taxable under both classifications as to the same receipts). Accordingly, the tax was imposed under the retailing classification on the sale of the bricks, rather than on the extraction of the clay from the ground under the mining classification. The retailing classification exempts sales of tangible personal property to licensed contractors who incorporate the tangible personal property into structures, projects, developments or improvements while fulfilling their contracts. As a result, the brick manufacturers were exempt from sales tax for such sales to licensed contractors.

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

Speculative builder was not engaged in taxable contracting.

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

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

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

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

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

An out-of-state engineering company designed and manufactured large steam boilers outside Arizona. The manufacturer entered into contracts in New York with Arizona Public Service for the sale and delivery of two boilers, which were shipped to Arizona partially unassembled. APS's general contractor erected the boilers. Under separate labor contracts, the manufacturer supervised and assisted the general contractor, but the services rendered in Arizona represented less than ten percent of the manufacturer's total receipts. The manufacturer had no other physical presence in Arizona. The State Tax Commission assessed tax on the labor contracts as contracting and the sale of the boilers as furnishing construction materials. On appeal, the sale of the boilers *and* the local supervision and labor were interstate transactions and, therefore, exempt from state tax. The amount of income generated in Arizona was comparatively insignificant. Because shipping the boilers fully assembled was impossible, and final assembly so complex that the manufacturer reasonably chose not to trust a local firm and risk APS rejecting the finished product, the Arizona activities merely completed manufacturing that had begun outside the state and were thus "relevant and appropriate" parts of interstate sales.

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

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

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

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

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

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

Ebasco Services also acted as a purchasing agent on behalf of the utilities owner. Ebasco Services purchased $40 million in equipment on behalf of the owner, who furnished the equipment for the construction Ebasco Services performed. The Commission assessed tax on the funds under several theories of constructive income. The Court rejected all of them, holding that the funds did not constitute consideration for the services Ebasco Services performed.

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

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

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

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

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

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

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

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

Seven years after *Ebasco*, the Arizona Supreme Court again addressed the design and engineering fees issue. This time, though, the parties had included the design services in the same contract as the contracting services. The Tax Commission

argued that *Ebasco* did not apply to a single contract that did not separately state the price of the design and engineering services. The Commission further argued that the taxpayer's design and engineering services "were so interwoven into the operation of the construction business that they are an essential part of that business and cannot appropriately be regarded as non-taxable on the ground that these particular services constitute a separate business." The Court concluded that, where the design services and construction services are wrapped into a single contract that does not separately price its constituent parts, the professional services will not merge for tax purposes into the taxable contracting activity *provided* (1) the non-taxable portion of the contract can be readily ascertained without substantial difficulty, (2) the amount of otherwise non-taxable gross income, in relation to the company's total taxable Arizona business, is "not inconsequential," and (3) those services cannot be said to be incidental to the contracting business.

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

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

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

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

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

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

15. *State Tax Commission v. Anderson Development Corp.*, 117 Ariz. 555, 574 P.2d 43 (Ct. App. 1977).

A contractor was exempt from use tax for out-of-state purchases of equipment used in mining even though the contractor itself was not subject to tax under the mining classification.

A company that operated a mine in Arizona hired a contractor, Anderson, to obtain scrapers and tractors, along with persons to operate the machinery, and use such equipment to remove waste rock, overburden and ore from the mine. Since Anderson purchased the scrapers and tractors from out of state, the State Tax Commission attempted to charge Anderson use tax.

The Court of Appeals held that Anderson was not subject to use tax, because of an exemption under that tax for machinery and equipment directly used in mining. It so held despite the fact that Anderson itself was not engaged in mining or taxable under the mining classification of sales tax. Rather, it provided a non-taxable service to a mining company. Despite this, the Court of Appeals found that Anderson's use of the equipment was used directly in mining activities. The exemption was tied to how the contractor used the property, not exactly the classification the contractor was taxable under.

The Court further held that a determination that a contractor was exempt from transaction privilege tax was not determinative as to its exemption under the use tax even though the two taxes complement each other.

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

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

Three years after *Holmes & Narver*, the Arizona Court of Appeals rejected another attempt by the Department to tax otherwise nontaxable revenue merely because it was earned by a taxpayer engaged in contracting activities. The homebuilder in question sold lots improved by homes under contracts separately stating the price of land. The Department assessed additional tax on the sales price of the land. On appeal, the Department argued that proceeds from real property sold by homebuilders were "gross receipts of a taxpayer" derived from contracting activity. It argued that the Legislature intended this result because it was aware of a Department regulation so construing the statute imposing tax but chose not to

address the issue when it subsequently amended the statute. The court disagreed, finding "nothing in the taxing statutes which would impose a tax on a seller of real property merely because the seller is also in the business of contracting." It rejected the Department's analysis of legislative intent because, for twenty-three years during which the tax was reenacted three times, the Department construed the statutes as excluding sales of land from contractors' tax liability.

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

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

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

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

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

Exemption for retail sales of tangible personal property to non-profit hospital applies to contractors retail sales of building materials to hospital; and the standard deduction is computed on income net of the deduction allowable for building materials.

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

conjunction with the construction management agreement, by itself did not support disregarding actual transactions that occurred. Following *Ebasco* and *Knoell Brothers*, the standard deduction had to be computed on the net proceeds after deducting the exempt sales.

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

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

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

20. *S.D.C. Management Co., Inc. v. State ex rel. Arizona Department of Revenue*, 167 Ariz. 491, 808 P.2d 1243 (App. 1991), *review denied*, May 7, 1991.

State Tax – Developer that hired general contractor was not taxable on sale of project.

The taxpayers who hired an independent general contractor to improve their real property, and who did not contract directly with subcontractors, are not contractors under A.R.S. § 42-1301 and are not subject to the transaction privilege tax imposed under A.R.S. § 42-1310(2)(i) as it existed pre-1979. Because the taxpayers did not act as contractors, the taxpayers are not owner-builders under A.R.S. § 42-1301(9) and are not subject to the transaction privilege tax imposed under A.R.S. § 42-1310(2)(j) as it exists post-January 1, 1979.

21. *Indigo Co. v. City of Tucson.* 166 Ariz. 596, 804 P. 2d 129 (App. 1991).

City Tax – Owner builder not subject to city tax on construction loan draws.

The taxpayer was the managing partner in development partnerships with third parties that held draws on the proceeds of construction loans for disbursement to contractors, subcontractors, laborers and material suppliers. As an owner performing

improvements to real property, the taxpayer was an owner-builder as opposed to a construction contractor. The loan draws did not constitute gross income to the taxpayer despite the taxpayer's failure to segregate the funds in its accounting procedures, because the taxpayer did not have an individual ownership interest in the loan proceeds, and had to use the proceeds for the sole benefit of each development partnership. Thus, the construction draws were not gross income to the taxpayer subject to the privilege tax under Tucson code § 19-417(a)(2).

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

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

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

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

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

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

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

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

On appeal, the City argued that the taxpayer was an owner-builder because it constructed the office complex "by or through" its contractor. The taxpayer argued that an owner-builder engaging a contractor is only subject to tax if a principal-agent relationship exists between the owner and the builder, rather than contracting "through" an independent, third party that performs the construction. The taxpayer relied on *SDC Management, Inc. v. State ex rel. Arizona Department of Revenue*, 167 Ariz. 491, 808 P.2d 1243 (Ct. App.1991), which construed the statute imposing state sales tax on prime contracting. The state definition of "owner-builder," however, covered a person "who *acts as a contractor*, either himself or through others." The Court disagreed with the taxpayer, finding that, while agency was required by the state definition, the city definition did not because it lacked the "acting *as a contractor*" element. Accordingly, the taxpayer fell within the City's definition of "owner-builder" and was subject to the sales tax on the sale of the office building.

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

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

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

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

Greenberg relied upon the United States Supreme Court's *Ramah* decision, which struck down New Mexico sales tax on construction performed on the Navajo Indian Reservation for the Ramah Navajo School Board, a subdivision of the Navajo Nation. The Department countered that *Ramah* did not apply because Greenburg's

contracts were with political subdivisions of the state of Arizona that were funded in large part by the state and served Indian and non-Indian children. The Court of Appeals sided with the Department, holding that gross income from contracts with Arizona school districts for contracting performed on Indian reservations is taxable. Unless the contract is with an Indian tribe or an agency of a tribe, construction contracting is subject to Arizona sales tax.

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

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

In 1983, the Arizona Tax Court determined that Irby Construction was a tax exempt retailer, not a contractor, of power lines it had erected. In 1993, the Tax Court collaterally estopped the Department from challenging the 1983 ruling. After the Court of Appeals subsequently ruled in *Brink Electric* (discussed below) that an unrelated builder of electrical substations was subject to sales tax on construction contracting, the Department appealed from the Tax Court's estoppel ruling for Irby Construction. The Department argued that, given the holding in *Brink Electric*, the Tax Court's application of collateral estoppel resulted in the unequal administration of justice among taxpayers engaged in the same business activities.

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

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

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

The taxpayers furnished and installed electrical substation equipment and pipes and values for transporting water. Exemptions from retail sales tax applied to both the electrical transmission equipment and the pipes and valves. The Department allowed the retail sales tax exemptions to contractors furnishing and installing such materials to customers under a purchasing agency agreement, but it denied the exemptions to the taxpayers. The taxpayers asserted on appeal that gross income attributable to

furnishing materials were retail sales of exempt equipment. The Court of Appeals disagreed, holding that all gross income from contracting, including furnishing the materials, is taxable contracting, and retail sales tax exemptions only apply to retail sales. It reasoned that materials incorporated into the construction projects were not resold in their original condition, so no retail sale occurred. The exemption for materials and supplies that a contractor purchases to perform a construction contract is not a resale exemption. Rather, the exemption is intended to prevent double taxation because the contractor will owe tax on gross income from furnishing the materials. Therefore, a contractor may only claim exemptions included in the prime contracting classification.

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

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

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

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

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

On appeal, the tax was properly deemed a tax on the privilege of doing business as measured by the revenues Centric-Jones realized, and not merely a license tax paid in advance of any business being done. Second, the contractor's project could not be

deemed a casual activity because the exemption applied to taxpayers who only sporadically engages in a certain type of business activity; it did not apply to Centric, which regularly engage in the contracting business but which engaged in this particular area of that business only once.

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

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

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

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

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

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

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

Blaze Construction declined to exempt state taxation in the absence of Congress and Arizona enacting legislation to do so. First, without Congress acting to extend the federal government's immunity from state taxation to its contractors, federal immunity did not apply. Second, the balancing test for inferring whether Congress

intended to pre-empt state taxation, which applies to contracts with tribes or tribal members for services on Indian reservations, does not apply to contracts with the United States government. Rather, a bright-line standard for taxing federal contractors is necessary to avoid litigation and inefficient tax administration.

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

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

The Department assessed sales tax on the taxpayer's rentals of advertising billboards as commercial leases of real property. The billboards consisted of modular frameworks bolted to support poles driven several feet down into the ground. Customers' advertising panels were hung on the frameworks. The billboards were designed to be easily disassembled. They were erected on land leased from third parties, and the leases permitted their removal upon one month's notice. Advertising locations were abandoned whenever they became unprofitable. To remove the billboard, the support poles were severed at the ground level, and the entire unit was hauled to its next location. The taxpayer protested the assessment as employing the wrong sales tax classification, because it rented personal property.

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

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

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

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

The Court rejected taxpayer's argument that three prior audits that failed to adjust land value deductions estopped the department from challenging the taxpayer's land deductions in a subsequent audit. The Court found that the taxpayer failed to identify specific conduct inconsistent with the current audit, should have been aware that the failure to adjust the land deduction resulted from the Department's mistake, and most importantly could not demonstrate legal detriment merely by failing to pay taxes it was obligated to pay. In addition, *Arizona Joint Venture* holds that the Department is

not barred from challenging the land value deduction after issuing an audit notice, nor does its acceptance of the deduction before the notice is issued transfer the burden of proof to the Department.

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

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

An administrator's 1986 written guidance that contracting performed for the Bureau of Indian Affairs and for the benefit of Indian tribes was not subject to tax, a 1987 granting of a refund claim for tax collected on BIA contracts and a 1993 audit assessment not taxing BIA contracts where the work was for the benefit of the Indian tribe were inconsistent acts supporting estoppel against a subsequent state audit assessing tax on BIA contracts. The taxpayer relied upon the Department's prior positions that BIA contracts were not subject to the prime contracting classification tax to its detriment when it did not include the tax in its bid for the BIA job that was the subject of the subsequent audit and assessment. In addition, the Court of Appeals remanded the case to the tax court to determine whether the taxpayer was aware that a 1993 audit assessment against the taxpayer, which declined to tax contracts with the BIA, was in conflict with assessments against other taxpayers that taxed such contracts (in other words, was the taxpayer's reliance reasonable). Additionally, rather than showing that it would have been able to pass the tax on in a winning bid for the contract, the taxpayer only needed to show that it could have collected tax on the contract and suffered substantial detriment by not doing so.

33. *Arizona Department of Revenue v. Ormond Builders, Inc.*, CA-TX 06-0005 (Sept. 13, 2007).

Construction managers are taxable as prime contractors as to their own fees, but are not taxable on amounts paid to trade contractors as an agent of the owner.

Ormond was an experienced construction contractor and was hired by two Arizona school districts to act as a construction manager for the construction of educational facilities. Ormond supervised and coordinated all construction activities. However, the school districts themselves directly entered into contracts with trade contractors to perform all actual construction work. While Ormond was not a party to any of the contracts with trade contractors, it did sign a few contracts as a representative of the school district.

In addition, Ormond oversaw payment of the trade contractors by receiving the amount due from the school district and then passing it along to the trade contractors. Since Ormond was not a party to the contracts with trade contractors, it was not obligated to pay the trade contractors unless it received money from the school

district. Ormond paid transaction privilege tax on its own fees, but not on the amounts it passed on to trade contractors. The Department of Revenue audited Ormond and assessed additional tax asserting that it was a taxable prime contractor, and must pay tax on the money it paid to trade contractors on behalf of the school districts.

The Arizona Court of Appeals held that, as a construction manager acting as the agent of the owner, Ormond was not liable for transaction privilege tax on amounts paid to trade contractors. However, Ormond was taxable as a prime contractor on amounts it received from the owners for acting as the construction manager.

34. *Arizona Dept. of Rev. v. Action Marine, Inc*., 281 Ariz. 141, 181 P.3d 188 (Ariz. 2008).

Officers and directors of a corporation may be held personally liable for transaction privilege tax collected from customers and not remitted to the Department of Revenue.

The Randall family owned Action Marine, Inc., a business that sold boats and related items at retail, and operated the business as officers and directors. They collected transaction privilege tax from customers through a separately stated charge, but failed to remit the amount collected to the Department of Revenue. The Department sued the Randalls individually to collect the amount of tax owed.

The Arizona Supreme Court held that the Department may hold officers and directors of a corporation personally liable for collected and unpaid transaction privilege tax if: 1) the corporation separately charges customers for transaction privilege tax; 2) the officer or director has a duty to remit the money collected; and 3) the officer or director fails to remit the money collected or engages in untruthful accounting of the additional charge.

It remains unclear if a separate line entry for transaction privilege tax in a schedule of values or similar contract document would amount to a separately stated charge to customers.

