

ARIZONA TAX: PRECONSTRUCTION SERVICES – ARE THEY TAXABLE UNDER THE PRIME CONTRACTING CLASSIFICATION OF THE ARIZONA TRANSACTION PRIVILEGE TAX OR NOT? (HOUSE BILL 2622 ANSWERS THE QUESTION)

By: Pat Derdenger, Partner
Step toe & Johnson LLP
201 East Washington Street, 16th Floor
Phoenix, Arizona 85004-2382

Arizona taxes persons engaged in the business of prime contracting. A.R.S. § 42-5075(A). To be taxable under this classification, a person must be a contractor who supervises, performs or coordinates the modification (construction, alteration, repair, addition, subtraction, improvement, movement, wreckage or demolition) of real property and who is responsible for completion of the contract.¹ A.R.S. § 42-5075(N)(8). For tax purposes, the term “contractor” is synonymous with “builder” and includes any person who performs, offers to perform, submits bids to or purports to have the capacity to modify real property, including subcontractors.

Construction managers at risk and, even on occasion general contractors, often enter into agreements separate and apart from their construction manager agreements or general contracts to provide property owners and developers pre-construction services, such as cost estimations, labor availability estimations, subcontractor selection as well as actual design assistance. The taxability of these services under the prime contracting classification has remained an open question due, in part to the nature of the services and in part to the Department’s aggressive interpretation of the prime contracting classification.

This presentation is intended as an introduction to the recent developments that bear on this issue and will outline and compare the Department’s position as outlined in a November 2007 memorandum prepared by the Tax Research Division with a pending exemption before the Arizona Legislature.

I. The Current Departmental Approach: Preconstruction Services Are Limited to Design Advice and Taxability Determined on a Case-by-Case Basis.

In November of 2007, the Department prepared a memorandum for the City of Tucson regarding the taxability of preconstruction services in several construction manager at risk contracts the City had executed with contractors for public improvement projects. A copy of this memorandum is attached as Appendix A. While the analysis was specific to the contracts at issue, this memorandum provides some insight into the Department’s perspective and position with respect to taxing preconstruction services under the prime contracting classification.

¹ A property owner who engages one or more contractors to modify real property and does not itself modify real property is not a taxable prime contractor. A.R.S. § 42-5075(N)(8).

STEPTOE & JOHNSON LLP

- A. *The Department's Underlying Assumptions: Preconstruction Services Relate Only to Design Preparation and Design Document Preparation and Taxability Is Determined on a Case-by-Case Basis.*

Relying on the definitions of “prime contractor” and “contractor” outlined above, the Department observed that many activities in preconstruction services contracts fall into a gray area with respect to taxation. The Department made several basic assumptions that serve as a backdrop to its analysis. First, it correctly stated the legal principle that taxation depends on the actual activity, not the name given to that activity by the parties. In other words, if the activity constitutes prime contracting, it will be taxable. Second, it assumed, as it is statutorily required to, that all gross income from a taxable business is presumed subject to tax unless the contrary is proved by the taxpayer. *See* A.R.S. § 42-5023.

Third, because the City of Tucson code defines “preconstruction services” as “advice during the design phase,” the Department narrowly construed “design phase” to the time period and activities involved in designing the project and preparing the design documents. Finally, as a necessary consequence, the Department takes the position that activities that go beyond providing design advice to the owner or the owner’s design professional do not constitute preconstruction services.

- B. *Because of the Case-by-Case Nature of Preconstruction Services, the Department's Analysis Focused on Identifying Non-Taxable Services Under Certain Safe Harbors.*

1. Safe Harbor Based on the Exemption for Design and Engineering Services.

Because of the existing exemption for actual and direct design and engineering costs located at A.R.S. § 42-5075(J), the Department posits that certain preconstruction services will be exempt under the penumbra of this exemption. According to the Department, these services include:

- a. Preconstruction services that wholly support the architect or engineer in drafting designs for the project, such as design review and recommendations for materials to be specified in the design.
- b. When the preconstruction services contract is between the construction manager/contractor and the architect, engineer or design professional and support that professional’s design work.

2. Safe Harbor Based on a Separate Line of Business.

The Department recognizes that taxpayers may engage in separate lines of business with one being taxable and the other non-taxable. Going back to the Arizona Supreme Court’s decision in *State Tax Comm’n v. Holmes & Narver, Inc.*, 113 Ariz. 165, 548 P.2d 1162 (Ariz. 1976), the Department will exempt receipts from preconstruction services if: (1) the

STEPTOE & JOHNSON LLP

activity is not taxable (such as work that directly supports design); (2) the amount of gross income from the exempt activity is substantial; and (3) the services are not incidental to the taxpayer's contracting business.

Based on a separate line of business analysis, the Department posits that another safe harbor exists. It will consider a taxpayer to be engaged in a separate line of business of providing design phase services if:

- a. The charge for preconstruction services that solely support the actual design of the project are separately billed and paid;
- b. Over the past year, the amounts the taxpayer received for these services comprises 15% or more of the taxpayer's total gross proceeds from contracting, *including income from its construction activities*; and
- c. The services are not incidental to the contracting business, such as determining bid prices or selecting subcontractors.

It should be noted, however, that the Department's position with regard to separate lines of business ignores the Supreme Court's decision in *Ebasco Servs., Inc. v. State tax Comm'n*, 105 Ariz. 94, 459 P.2d 719 (Ariz. 1969). In that case, the Court held that a contractor who executed separate design contracts and construction contracts could not be taxed as a contractor for receipts derived from the design contracts. It stated, "[w]e 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.* at 98, 459 P.2d at 723. In other words, for purposes of the design contract, the taxpayer engaged in no activities that met the definition of contracting, regardless of whether those activities were ancillary or incidental to its construction services.

A similar argument exists for preconstruction services for two reasons. First, while certain preconstruction services may bear on the taxpayer's construction phase activities, such as the initial scheduling, subcontractor selection and materials estimates, under a preconstruction services contract, the taxpayer is performing those services *for the benefit of the owner*, not for its own benefit. Second, those services, in and of themselves, do not meet the definition of contracting.

C. While Balking at Making Any Substantive Determinations, the Department's Memorandum Indicates that It Will Treat Most Preconstruction Services as Taxable.

While the Department did not make any official determinations in its memorandum to the City of Tucson, the narrow interpretation it assumed in construing "design phase," indicates that the Department will treat many preconstruction services as taxable. Indeed, it indicated under the A.R.S. § 42-5075(J) safe harbor and the separate line of business safe harbor that the

following preconstruction services would likely be taxable because they support future construction activities rather than current design activities:

- Determining the guaranteed maximum price;
- Determining bid prices;
- Selecting or contracting with suppliers or subcontractors;
- Developing a construction management plan;
- Developing construction schedules;
- Assessing the availability of labor and materials that may effect design if these services were performed for the owner rather than the design professional; and
- Assessing the availability of labor and materials to determine costs.

II. The Arizona Legislature Is Currently Considering a Bill to Exempt Most Preconstruction Services Considered Taxable by the Department.

The State legislature has crafted and is currently considering a bill, House Bill 2622, that provides an exemption for preconstruction services under the prime contracting classification. H.B. 2622, 48th Legislature, 2d Reg. Session. A copy of H.B. 2622 and the Senate Fact Sheet accompanying the bill are attached as Appendix B. The Bill, if passed and signed into law, will effectively vitiate the Department's position with respect to most of the preconstruction services bulleted above. The Senate passed HB 2622 on May 21, 2008 and has transmitted it to the House for consideration. The proposed bill will apply retroactively to tax periods beginning January 1, 2001, but no refund mechanism is authorized.

The original bill, as introduced in the House, piggybacked the definition of "preconstruction services" found in Arizona's Public Improvement statutes. Under that definition, "preconstruction services" means "advice during the design phase." A.R.S. § 34-101(22). The Senate, however, amended the Bill. While continuing to exempt "design phase services," the amended bill provides detailed lists of the types of services that constitute exempt design phase or taxable construction phase services.

H.B. 2622 exempts the gross proceeds or gross income attributable to a *separate, written design phase or professional services* contract that is *executed before modification* (construction) begins, regardless of whether the preconstruction services are provided sequential to or concurrent with taxable prime contracting activities. For purposes of the exemption, "professional services" includes architectural, assayer, engineering, geology, surveying or landscape architectural services that are not otherwise exempt under A.R.S. § 42-5075(J). However, *H.B. 2622 does not exempt any "construction phase" services.*

H.B. 2622 operates by providing litany of services that are exempt "design phase" activities and taxable "construction phase" activities. Generally "design phase" means "services

STEPTOE & JOHNSON LLP

for developing and completing a design for a project” that are not also “construction phase services”.

A. Exempt Design Phase Services.

Specifically, H.B. 2622 defines the following as “design phase” activities:

1. Evaluating surveys, reports, test results or other information regarding on-site conditions, including the physical characteristics of the land, legal limitations and utility locations for the site.
2. Evaluating any criteria or programming objectives for the project to ascertain project requirements, including physical characteristics affecting costs or the projected utilization of the project.
3. Preparing drawings and specifications for architectural program documents or other design documents that identify the scope of or materials for the project.
4. Preparing an initial schedule for the project, but not any updates to the master schedule after construction has begun.
5. Preparing any preliminary cost estimates prior to the final design of the project, which may include: (1) costs for labor, materials, equipment, tools, water and utilities regardless of whether they are temporary or permanent or whether they become incorporated into the finished project; (2) the cost of labor and materials to be furnished by the owner of the real property; (3) the cost of any equipment belonging to the owner of the real property that will be assigned to the prime contractor; (4) the cost of installing equipment specifically provided by the owner and required by any design document; (5) the fee paid to the prime contractor; (6) any bond and insurance premiums; (7) any applicable taxes; and (8) any contingency fees for the prime contractor that may be used before completion of the project.
6. Reviewing and evaluating any cost estimates or project documents and making recommendations for on-site use, the selection of materials and building systems, construction feasibility and the availability of labor.
7. Preparing the plan and procedures for qualifying and selecting subcontractors.

B. Taxable Construction Phase Services.

In contrast, “construction phase services” generally include any service required for the execution and completion of any modification of improved real property. Specifically, these services include:

STEPTOE & JOHNSON^{LLP}

1. The administration or supervision of any modification performed on the project, such as scheduling, cost controls, team management, safety programs, the close-out process or warranty period services.
2. The administration or supervision of any modification performed pursuant to a punch list or any change orders. The bill defines “change orders” as a written instrument executed after contract execution that provides for: (1) a scope of change in the work, (2) the amount of adjustment, if any, to the guaranteed maximum price and (3) the adjustment, if any, in completion time.
3. The administration or supervision of any modification performed pursuant to change directives, i.e. an order calling for a change before any agreement is reached regarding the adjustment to the guaranteed maximum price or completion time.
4. The inspection to determine the dates of substantial and final completion.
5. The preparation of any manuals, warranties, as-built drawings or other drawings that must be furnished by the prime contractor under the terms of the contract.
6. Preparation of any status reports after work has commenced, such as: (1) master schedule updates; (2) cash flow projection updates; (3) site reports; (4) reports on discrepancies between design documents that have to be resolved; (5) reports on any health or safety issues.
7. The preparation of any daily work or site logs.
8. The preparation of any submittals or shop drawings used by the prime contractor to illustrate details of the work performed.
9. The administration or supervision of any other activity for which the prime contractor receives a certificate of payment or final payment.