TAXPAYER INFORMATION RULING LR 20-016

Douglas A. Ducey
Governor

Carlton Woodruff
Director

December 10, 2020

Thank you for your letter dated July 10, 2019, requesting a taxpayer information ruling ("TIR") on behalf of your unnamed client ("Taxpayer"). Specifically, you requested a ruling on whether Taxpayer's gross income derived from a contract to complete offsite improvements after the sale of real property to another property developer is subject to Arizona's transaction privilege tax ("TPT"). Pursuant to Arizona Revised Statutes ("A.R.S.") § 42-2101, the Arizona Department of Revenue ("Department") may issue taxpayer information rulings to taxpayers and potential taxpayers on request.

ISSUE:

Whether Taxpayer, a property developer, is taxable under the prime contracting classification on the gross income received after the sale of improved property for contracting work, where the sales contract requires Taxpayer to complete unfinished improvements to the land. Specifically, Taxpayer requested guidance on this issue as it pertains to prime contracting and not the city's tax on speculative building.

RULING:

The Department rules as follows:

Income derived by Taxpayer from the sale of improved real property—where the sales contract requires Taxpayer to ensure completion of certain improvements to the property post-title transfer—is not taxable under the prime contracting classification when: (1) compensation for the improvements are included in the real property's sale price and are not specified; (2) the improvements are not formalized in a separate contract between Taxpayer and buyer; and (3) payments to Taxpayer post-title transfer are delayed disbursements from escrow for the improvements and not additional modification activities.

SUMMARY OF FACTS:

The following is a summary of the relevant facts based on your letter dated July 10, 2019, and received on July 24, 2019, together with subsequent correspondence with the Department received on January 24, 2020, June 17, 2020, September 15, 2020, and November 3, 2020:

Taxpayer develops land in Arizona but is not a construction company and does not have an Arizona contractor license through the Registrar of Contractors ("ROC"). Taxpayer, through two separate subsidiaries, sells parcels of land designated for residential development to home builders. The land parcels are generally sold to home builders after offsite improvements have been completed, although this is not always the case and, at times, Taxpayer is required to complete already agreed-to offsite improvements after title in the land has passed to the buyer.[1] In cases where improvements are required to be made to the property after the land is sold, the sales contract between Taxpayer and a home builder includes: (1) the sales price includes all improvements to be made (*i.e.,* the cost of improvements are not separately stated; and (2) the names and ROC numbers of all contractors involved in the improvements. As the charges for improvements were already negotiated and are part of the original contract with the prime contractor(s), there is no separate contract with the developers or separately stated amounts to complete those improvements. The owner is only required to complete improvements that were separately contracted for with the prime contractors before the sale with the developer was contemplated.

Taxpayer hires contractors to complete the offsite improvements in phases and not on a per lot basis. Accordingly, a contractor may work on land which has not been sold, or land which has been sold to several builders, or land which will be transferred in the future (*.e.g.,* municipality right of ways, homeowners associations, etc.). Land paved into streets is dedicated to the city as a right of way at the time of plat recordation, which occurs prior to transfer of title to lots from Taxpayer to the builders. After the offsite improvements are completed on the dedicated land, they are subsequently conveyed to the municipality; usually 12 to 15 months after plat recordation.

The offsite improvements on the lots sold to the builders primarily consist of grading, constructing new sewer and water stubs ("utilities stub") to the lot lines (these are within the property easements), and building new retaining and shared walls along the property lines. Grading performed on a lot is generally completed prior to the sale to the home builder and utilities stub outs are performed on the lots post-sale/title transfer.

All work performed and paid for prior to the sale of the property is paid for by Taxpayer, and the cost is built into the selling price of the property. Additionally, the cost of improvements to the lot after

[1] Offsite improvements may include access roads, sidewalks and curbs, sewers, and utility lines.

title transfer is also built into the selling price of the property. "Due to the complexity of the sales transaction and timing of financing, typically title will transfer on most lots prior to completion of all work."[2]

"The general contractors charge [Taxpayer] transaction privilege tax under the prime contractor classification for all work performed to all land in the phase (including finished lots where title has transferred, finished lots where title has not transferred, unfinished lots, and land appurtenant to the lots)."[3]

DISCUSSION AND LEGAL ANALYSIS:

Arizona's TPT differs from the sales tax imposed by most states. It is a tax on the privilege of conducting business in the State of Arizona. Differing from a true sales tax, the TPT is levied on income derived by the seller, who is legally allowed to pass the economic expense of the tax on to the purchaser. However, the seller is ultimately liable to Arizona for the tax. The Arizona TPT is imposed under sixteen separate business classifications. A.R.S. § 42-6102(A) provides that the state's TPT provisions shall govern the imposition of county excise taxes. Accordingly, all sales subject to TPT are also subject to applicable county excise taxes.

A.R.S. § 42-5075 imposes TPT on "the business of prime contracting." The tax base for the prime contracting classification is sixty-five percent of a prime contractor's gross receipts derived from the business. See A.R.S. § 42-5075(B). The tax base for TPT generally includes gross sales without any deductions for any business expense. Any deductions, exemptions, or exclusions from TPT must be specifically provided for in statute and they are unique to each classification, so they cannot simply be read into another tax classification for which they are not explicitly provided.

The term "contracting" means "engaging in business as a contractor." A.R.S. § 42-5075(R)(3) provides the following definition for the term "contractor":

> "Contractor" is synonymous with the term "builder" and means any person or organization 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, modify any building …

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[2] Letter from ***, to Arizona Department of Revenue, (Jul. 10, 2019) (on file with author).
[3] *Id.*

A.R.S. § 42-5075(R)(10) provides that the term "prime contractor" means:

> A contractor who supervises, performs or coordinates the modification of any building… including contracting, if any, with subcontractors or specialty contractors and who is responsible for completion of the project...

Under A.R.S. § 42-5075(R)(6) "modification" means construction, grading and leveling ground, wreckage or demolition. And under A.R.S. § 42-5075(R)(7), "modify" means to make a modification or cause a modification to be made.

Property Developer

TPT is imposed on the business activity of prime contracting and the tax base is sixty-five percent of the gross income derived from the job unless otherwise excluded or deducted.[4] Laws 2018, Chapter 341, (SB 1409) added qualifier language to A.R.S. § 42-5075(A), to read "[t]he prime contracting classification does not include any work or operation performed by a person that is not required to be licensed by the registrar of contractors *pursuant to section 32–1121* (emphasis added)." The Senate Fiscal Notes referred to this provision as the "handyman exemption."[5] However, A.R.S. § 32-1121 includes more than simply "handymen." Primarily at issue, is A.R.S. § 32-1121(A)(6) which provides that an owner of property is not required to be licensed by the Registrar of Contractors ("ROC") when they are acting as a property developer *and* hire ROC licensed general contractors or specialty contractors to complete appurtenances or structures on their property for the purpose of sale. However, this only applies if the licensed contractors' names and ROC license numbers are included in all sales documents. See A.R.S. § 32-1121(A)(6). A prime contractor is defined as any person or company who "supervises, performs or coordinates the modification of [real property]…*and* who is responsible for the completion of the contract."[6]

Generally, an owner of land who acts as a property developer and hires a general contractor to complete appurtenances or structures on their real property–prior to selling to a purchaser–is not

[4] A.R.S. § 42-5075(B) (2019).
[5] Hans Olofsson, Fiscal Note SB 1409 Arizona State Legislature (2018), https://www.azleg.gov/legtext/53leg/2R/fiscal/SB1409.DOCX.pdf (last visited Feb 26, 2020).
[6] A.R.S. § 42-5075(R)(10) (2019) (emphasis added).

subject to TPT under the prime contracting classification for the construction activities.[7] In such cases, the contractor(s) is responsible for the prime contracting TPT.

A.R.S. § 42-5075(Q) provides that, notwithstanding the definition of "prime contractor,"[8] a person who sells real property and is responsible to the new owner for modifications made to the property after title transfer, *and* who receives consideration for the modifications, is taxable under the prime contracting classification on the gross income received for the modifications made subsequent to the transfer of title. The methodology for determining and applying TPT under A.R.S. § 42-5075(Q) is as follows:

(1) The contract for the sale of the real property specifies the amounts to be paid to the property developer for modifications to be made after the transfer of title.
(2) The property developer enters into a contract with the buyer, separate from the contract for the sale of the real property, for the post-transfer modifications and amounts to be paid.
(3) When post-title transfer modifications are required, all payments after the sale, other than delayed disbursements from escrow, are presumed taxable until otherwise demonstrated by the property developer.
(4) The tax base for any taxable income to the seller is computed in the same manner as a prime contractor under A.R.S. § 42-5075.

Thus, a property developer is not taxable under A.R.S. § 42-5075(Q) when the property developer sells real property which requires certain modification activities to be completed post-title transfer, and the modification costs are not specified in the sale contract, or formalized in a separate contract (*i.e.,* the cost of the modifications is built into the sale price of the property), and payments made to the property developer post-title transfer are delayed disbursements from escrow as compensation for such improvement costs and not additional modification activities.[9]

City Tax

It is important to note, the imposition of city privilege taxes is separate and distinct from the state's TPT and accompanying county excise taxes. As with the state's TPT, city privilege taxes are imposed on the vendor for the privilege of engaging in business in the city. The Model City Tax Code ("MCTC")

[7] Although not under consideration with this ruling, there may be no TPT obligations on the sale of the property, but there may be speculative builder taxes imposed by the municipalities, unless otherwise exempt.
[8] As defined in A.R.S. § 42-5075(R)(10).
[9] A.R.S. § 42-5075(Q)(1) (2019).

was created in order to impose and administer city privilege taxes. Similar to Arizona's TPT, city privilege taxes are imposed "upon persons on account of their business activities." See MCTC § -400(a)(1). All Arizona cities follow the MCTC in the imposition of their privilege tax based upon their local ordinances. However, certain options exist, allowing each city to alter or qualify the imposition of its privilege tax.

A.R.S. § 42-6004 and MCTC § -415 collectively apply to construction contractors who are equivalent to prime contractors in activities and taxation. MCTC § -415(b)(1) allows an exemption for gross income derived by subcontractors. MCTC § -415(b)(2) provides a deduction of thirty-five percent (35%) on the contracting gross income subject to the tax.

MCTC § -100 defines "construction contractor" as 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 except for remediation contracting.

MCTC § -415(a)(5) provides that the MCTC construction contracting classification does not include gross income or operation performed by a person that is not required to be licensed by the ROC pursuant to A.R.S. § 32-1121.

Speculative Builder

MCTC § -416 imposes a city privilege tax on the gross proceeds derived from the sale of improved residential or commercial real property, is taxable to the property owner by the cities as a speculative builder, unless otherwise excluded or deducted. The state and counties do not impose a speculative builder tax.

A speculative builder is an owner-builder who sells or contracts to sell at any time residential homes (custom, model, or inventory), regardless of the stage of construction, or improved residential or commercial lots without a structure; or any other property (*e.g.*, commercial property with a

structure) before the expiration of 24 months from the time improvements are substantially completed.[10]

The speculative builder tax is due when the improved real property is sold (*i.e.* when a sales contract is entered into) and the tax base includes the total selling price at the time of close of escrow or transfer of title.[11] Improved real property means any real property upon which: (1) a new structure has been substantially completed; (2) improvements have been made to the land with no structure—*i.e.,* offsite improvements; (3) has been reconstructed; or (4) where water, power and streets have been constructed to the property line.[12] MCTC § 416(c) provides certain exemptions, deductions and credits to the tax.

Liability for the speculative builder tax may be passed to the purchaser of the improved real property when the purchaser is also a speculative builder who provides the seller with a completed Arizona Form 5022 Speculative Builder Resale Certificate.

Discussion

TPT is imposed on the gross income derived from the business of prime contracting. A contractor has been defined to mean a person undertakes the supervision or coordination of the modification activities and is responsible for the completion of the project. Modification activities include construction, grading, or leveling ground. However, the prime contracting classification does not include those persons who are not required to be licensed by the ROC pursuant to A.R.S. § 32-1121.

Generally, a property developer who owns property and is not acting in the capacity of a contractor is not taxable under the prime contracting classification for state, county, and city purposes.[13] Although, for state and county purposes, A.R.S. § 42-5075(Q) provides that an owner of property—who would not otherwise be taxable under the prime contracting classification—will be taxable when they sign a contract to sell real property and the contract provides that:

1. Modification activities are to occur after title in the real property transfers to the buyer;
2. The owner is contractually responsible for the completion of modification activities; and

[10] MCTC § -100 (2019).
[11] MCTC § -416(a)(1) (2019).
[12] MCTC § -416(a)(2) (2019).
[13] See A.R.S. § 42-5075(A) (2019); MCTC § -415(a)(5) (2019); and A.R.S. § 32-1121(A)(6) (2019).

3. The owner is to be specifically compensated by the buyer for the modification work completed post-title transfer (compensation not included as part of the sale price of the property) such that:
    a. The sales contract specifies amounts to be paid for modifications subsequent to the transfer of title
    b. There is a separate contract for modification which specifies amounts to be paid for modifications subsequent to the transfer of title, or
    c. Subsequent to the transfer of title the seller receives amounts other than delayed disbursements from escrow.

Here, the statutory provisions require that the property developer receive a consideration specifically for the modification work to be completed for the new owner. This is demonstrated when these new modifications are separately stated in the sales contract for the land or in a separate contract. Accordingly, if the sale of improved real property requires that already in progress improvements be completed by the seller for the new owner post-title transfer, but the consideration is only for the sale of the real property—*i.e.,* the work is included in the sale and payments post-sale are delayed escrow disbursements—then A.R.S. § 42-5075(Q) does not apply. In this case, Taxpayer contracted with third party contractors for off-sites to be completed prior to any sale of the land. When the sale to the property developer is negotiated, part of the agreement for sale is that Taxpayer complete the work already in progress and agreed to between Taxpayer and the third party contractor. There appears to be no specific improvements required or separately contracted for with the new owners. Accordingly, it appears that A.R.S. § 42-5075(Q) does not apply.

If compensation for the work completed post-title transfer is in addition to the sale price of the property (*i.e.,* separately stated or provided for in a separate contract) and done specifically for the new owner as opposed to completed work already contracted for with a third party, then A.R.S. § 42-5075(Q) would apply and the original owner would be deemed the prime contractor for purposes of this section and be taxable on the gross receipts received from the additional compensation. That does not appear to be the case here.

Moreover, payments received by Taxpayer post-title transfer, or post-sale, which are not delayed escrow disbursements, are presumed taxable to Taxpayer under the prime contracting classification, until otherwise proven by Taxpayer, through the books and records of the company, that such payments were not compensation for post-sale modifications.

Ultimately, A.R.S. § 42-5075(Q) operates to shift the burden of the prime contracting TPT from the prime contractor on the job to the original owner of the property where there is a sale of the property and subsequent to the sale specific amounts payable to the original owner are allocated for modification work for the new owner. It appears that unless A.R.S. § 42-5075(Q) is satisfied, the burden of the prime contracting TPT remains with the contractor on the job.

Additionally, and although Taxpayer has not specifically requested a ruling on the speculative builder tax, it appears appropriate to mention that Taxpayer's gross income derived from the sale of improved residential lots, is taxable by the cities as a speculative builder, unless otherwise excluded or deducted.[14] The state and counties do not impose a speculative builder tax.

Conclusion

Improvements made to real property after the transfer of title are not taxable under the prime contracting classification when: (1) compensation for the improvements is included in the sale price and the contract does not specify the amounts for the improvements; (2) the improvements are not formalized in a separate contract from the sales contract; and (3) payments to seller post-title transfer are a delayed disbursement from escrow as compensation for such improvements and not additional modification activities.

This response is a taxpayer information ruling (TIR) and the determination herein is based solely on the facts provided in your request. The determinations are subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the Department's making of an accurate determination, this taxpayer information ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law, or notification of a different Department position.

If the Department is provided with required taxpayer identifying information and taxpayer representative authorization before the proposed publication date (for a published TIR) or date specified by the Department (for an unpublished TIR), the TIR will be binding on the Department with respect to the taxpayer that requested the ruling. In addition, the ruling will apply only to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling. The ruling may not be relied upon, cited, or introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the taxpayer information ruling. If the

[14] MCTC § -416 (2019).

required information is not provided by the specified date, the taxpayer information ruling is non-binding for the purpose of abating interest, penalty or tax.