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Governor

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Director

TAXPAYER INFORMATION RULING LR17-002

January 3, 2017

Thank you for your letter dated August 19, 2016, requesting a taxpayer information ruling ("TIR") on behalf of your unnamed homebuilder client ("Company") and its *** subsidiaries ("***" or "****"). Specifically, Company *** doing business in Arizona and you requested a ruling regarding Company's proposed structure. 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.

DESCRIPTION OF PARTIES:

- Company is a home builder and the parent of an affiliated group of entities that *** build and sell new homes in *** through its subsidiaries.
- Company's subsidiaries are structured as *** that will own the underlying land and market sell the completed home and lot to the final customer. *** will also be responsible for the offsite improvements, lot development and vertical (new house) construction.

ISSUE:

Whether *** structured to own, market and sell real property and that utilize construction managers or other personnel to oversee the performance of construction work performed by third party construction trades are taxable as prime contractors?

RULING:

Because *** do not engage in any of the modification activity, they are not taxable as prime contractors if they are structured to own, market and sell real property and utilize construction managers or other personnel to oversee the construction work performed by third party trade contractors.¹

¹ For City tax purposes, such a structure would likely give rise to the speculative builder tax. City taxes are not addressed in this TIR.

Although construction managers and assistant construction managers hired by affiliate PM, would, under the *Ormond* rule² (discussed below), be considered prime contractors because of their work in supervising the completion of a project, such a conclusion is not reached in this specific structure because of an exemption in A.R.S. § 42-5075(R)(10).

A.R.S. § 42-5075(R)(10) was amended in 2007 to provide that a contractor normally taxable as prime contractor is exempt from the TPT where that person owns the land on which the modification activity is being conducted and does not perform any of that modification work himself, but instead hires this party contractors to do so. This is so even if there is a contract for the sale of the land while it is being improved.

To maintain an exemption under A.R.S. § 42-5075(R)(10), *** must be able to show that all modification activity was undertaken by unrelated third parties. *** is required to retain a detailed list of all contractors engaged to do construction work for each project together with copies of all invoices received from them detailing the work they performed.

Because all the income *** will be earning will be non-taxable for TPT purposes, *** do not have to report any income or obtain TPT licenses unless they plan on engaging in other taxable activities. In addition, *** may *not* use Form 5000, otherwise purchase construction materials tax exempt, or utilize any other TPT exemption because they are not conducting any taxable TPT activity.

This ruling does not affect the Department's marketing arm/construction arm policy.

SUMMARY OF FACTS:

The following facts are a summary based on your ruling request dated August 19, 2016 as well as additional information provided in your letter dated October 20, 2016:

Company *** doing business in ***. It will build and sell new homes in *** through one or more of its subsidiaries. Companies subsidiaries will be structured as *** and those *** will be based and operate *** in ***. The *** will own the underlying land of each new home development project throughout the entire construction process, it will market it and then sell the completed home and lot to the final customer.

Once title of the new home passes to the final customer, the *** are responsible to the customer to ensure that any necessary warranty work occurs. The *** will contract with third party contractors ("Trades") to perform such warranty work; however, the *** will not

²*Ariz. Dep't of Revenue v. Ormond Builders, Inc.*, 216 Ariz. 379, 166 P.3d 934 (App.2007).

receive any additional compensation for this warranty work. The Trades will be paid by the *** for any warranty work requested, unless they are responsible under their separate construction contracts for the work. Beyond this warranty work, the *** will not be responsible to its customers for additional construction after passage of title.

While *** will be responsible for the offsite construction, lot development and vertical (new house) construction, they will not physically perform any actual construction work. *** will contract directly with Trades to perform the vertical (new house) construction, lot development and offsite improvements. *** construction managers and assistant construction managers will oversee the work performed by the Trades. *** will hold Class B General Contractors licenses issued by the Arizona Registrar of Contractors.³

*** will not hire employees. Rather, Company has an affiliate payroll master company ("PM") that will lease employees to ***. PM will charge *** a service fee for their utilization of personnel. The construction managers and assistant construction managers will be paid directly by PM. In addition to construction managers and assistant construction managers, PM will also provide other personnel to ***. Those professionals include clerical office personnel, purchasing agents, sales agents, operational supervision personnel and a division president. PM pays the construction managers and assistant construction managers as well as other personnel utilized by ***.

The primary duties and responsibilities of construction managers include:

- Ensure delivery of homes in accordance with construction schedules and closing dates;
- Notify trade contractors and suppliers of schedule changes;
- Order material and ensure timely delivery to job sites in accordance with schedules;
- Manage trade contractors to ensure proper communication and prompt resolution of problems;
- Manage storage and installation of materials in accordance with company policy and procedures;
- Inspect materials to ensure accuracy and quality;
- Ensure home sites properly cleared and prepped for construction start;

³ Under A.R.S. § 32-1121(A)(6) contractors are not required to obtain a license from the Registrar of Contractors if they own property and are developers that build or improve structures or appurtenances to structures on their property for the purpose of sale or rent *provided* they contract for such a project with a general contractor or specialty contractor licensed by the Registrar of Contractors. To qualify for the exemption, the licensed contractors' names and license numbers must be included in all sales documents.

- Conduct quality control inspection on homes;
- Conduct on-site safety and construction meetings.

The primary duties and responsibilities of assistant construction managers include:

- Assist construction manager in his duties;
- Provide feedback and make recommendations to improve construction process and materials quality;
- Provide feedback about quality of trade contractors and suppliers;
- Ensure safety precautions taken in all construction stages;
- Ensure proper storage of equipment and materials;
- Identify and communicate problems and ensure proper resolution of same.

DISCUSSION & LEGAL ANALYSIS:

- 1. Without considering A.R.S. § 42-5075(R)(10), whether the construction managers and assistant construction managers used by *** to oversee the completion of the construction activity of contracted trades are prime contractors?**

A.R.S. § 42-5075(A) imposes TPT on “the business of prime contracting.” The term “contracting” means “engaging in business as a contractor.” See A.R.S. § 42-5075(R)(2). The tax base for the prime contracting classification is sixty-five percent of a prime contractor's gross receipts derived from the business⁴ and generally includes gross sales without any deductions for any business expense unless specifically provided for in statute.

A.R.S. § 42-5075(R)(3) provides a 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, structure or project. A.R.S. § 42-5075(R)(10) defines a prime contractor as a contractor who supervises, performs or coordinates the modification of any building and who is responsible for the completion of the contract.

To be clear, the term “prime contractor” is *not* synonymous with the term “general contractor” as used in the contracting industry. Rather, for TPT purposes, the prime contractor need only be responsible for the completion of its contract that requires it to supervise, perform, or coordinate a modification. Additionally, a prime contractor does not

⁴ See A.R.S. § 42-5075(B).

have to be responsible for the completion of an entire project, it only has to be responsible for the completion of its own contract. However, not every person who decides to build or supervise construction work is taxable as a prime contractor, the law was intended to tax only those who hold themselves out as doing contracting work for others.⁵

Being liable for the TPT as a prime contractor does not depend on whether a person is a “general contractor” as that term might be used in the contracting industry. A construction project may have more than one prime contractor and a contractor may be taxable as a prime contractor without being the general contractor on a project.⁶ What is important is that the contractor be responsible for the completion of its contract that requires it to supervise, perform, or coordinate a modification. Likewise, the *title* used in a specific situation to describe work done by a contractor is not critical, the *type* of work conducted by the contractor is.

The case of *Arizona Department of Revenue v. Ormond Builders, Inc.*, 216 Ariz. 379, 166 P.3d 934, (App. 2007) demonstrates this concept of looking at the work performed rather than the title very well. In that case, *Ormond* was contracted not as a general contractor but as a construction manager. Its responsibilities under the contract included work traditionally done by those recognized as prime contractors for TPT purposes. It included developing time schedules, preparing budgets, monitoring and inspecting the performance of the trade contractors. In addition, among other things, it was responsible for coordinating and providing general direction to trade contractors’ work, processing and reviewing change orders, assisting in obtaining all building permits, reviewing and processing applications by the trade contractors for progress and final payments and assisting the school districts in determining substantial completion of the work. The trade contractors were hired directly *Ormond’s* client but were paid by *Ormond* on their behalf.

Because *Ormond* was responsible for completing its own contracts to act as a construction manager, the court held that it acted as a prime contractor and was responsible for the TPT

⁵ Arizona courts have noted that the legislative history [of the prime contracting statute] reflects an intent to tax those only who we might traditionally consider to be “contractors,” that is, those who for a consideration undertake to build for others. See *SDC Management., Inc. v. State ex rel. Arizona Dep’t of Revenue*, 167 Ariz. 491, 497, 808 P.2d 1243, 1249 (Ct. App. 1991)

⁶ See *Ariz. Dep’t of Revenue v. Ormond Builders, Inc.*, 216 Ariz. 379, 385, 166 P.3d 934, 940 (App.2007).

on its gross receipts from the construction manager contract.⁷ See *Arizona Dep't of Revenue v. Ormond Builders, Inc.*, 216 Ariz. 379, 385, 166 P.3d 934, 940 (Ct. App. 2007).

In this case, *** will not perform any construction work but will utilize Trades. Its construction managers and assistant managers will oversee the construction work performed by the Trades.⁸ The managers and assistant managers will be hired and paid by PM directly and *** will pay a service fee to PM for their utilization. They are generally responsible for managing the homebuilding process and ensuring compliance with quality standards, including resolving any construction issues and ensuring that the projects are completed on time and within budget. In essence, they will be doing the work of those generally recognized as prime contractors for TPT purposes. Thus, under the *Ormond* analysis, *** construction managers and assistant construction managers would normally be considered prime contractors because of their work in supervising and coordinating the completion of the construction projects. Because those managers are working with *** as *de facto* employees, *** would normally be considered the prime contractor.

2. Whether the provisions of A.R.S. § 42-5075(R)(10) prevents the imposition of the TPT under prime contracting classification on * when it uses construction managers and assistant construction managers to oversee construction work but does not perform any modification activities itself?**

By 2007 legislative amendment, the definition of the term “prime contractor” was changed. A.R.S. § 42-5075(R)(10), as amended, provides:

"Prime contractor" means a contractor who supervises, performs or coordinates the modification 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. ***Except as provided in subsections E and Q of this section, a person who owns real property, who engages one or more***

⁷ Although the court held they were contractors, Ormond was not liable to pay any additional TPT on other grounds.

⁸ If a third party general contractor were hired to supervise the trades to ensure they complete the development in accordance with Company's plans and specifications, the general contractor would be considered the prime contractor under general prime contracting principles. See *SDC Mgmt., Inc. v. State ex rel. Arizona Dep't of Revenue*, 167 Ariz. 491, 499, 808 P.2d 1243, 1251 (Ct. App. 1991)(A general contractor who works for an owner-builder is itself taxed as a “prime contractor.”).

contractors to modify that real property and who does not itself modify that real property is not a prime contractor within the meaning of this paragraph regardless of the existence of a contract for sale or the subsequent sale of that real property. [Highlighted portion added in a 2007 amendment].⁹

The term “modification” and “to modify” were also added by the 2007 amendment. Under A.R.S. § 42-5075(Q)(5) as it then read, “modification” meant construction, alteration, repair, addition, subtraction, improvement, movement, wreckage or demolition; and under A.R.S. § 42-5075(Q)(6) the term “modify” as it then read, meant construct, alter, repair, add to, subtract from, improve, move, wreck or demolish.¹⁰ Thus, at the time of the amendment, “modify” and “modification” indicated physical construction work.

In addition, the fact sheet from the 2007 amendment notes:

It is common practice for a property owner to hire a prime contractor to construct a building or make other property improvements. In some cases, a property owner may agree to a contract to sell the property to another party... before the property’s title is transferred to the new owner...

Using this scenario, the original prime contractor may have already made some TPT payments during construction. By having to pay TPT on the gross proceeds of the sale, it could lead to the owner’s share of the gross proceeds related to new construction being double-counted along with the original prime contractor’s sales tax payments. State law does not provide a mechanism for the owner to receive a refund for taxes already paid ...¹¹

In explaining the amended provisions, it indicates that the statute:

1. Excludes property owners who hire contractors to make improvements on the property from the definition of prime contractor...

⁹ See Laws 2007, Chapter 188, Section 1.

¹⁰ The definition of the terms modification and modify were again changed by an amendment in 2015. See SB 1446, Laws 2015 Chapter 4, section 11.

¹¹ See Senate Fact Sheet to HB 2627, Forty-eighth Legislature, First Regular Session available on the Arizona Legislature’s website www.azleg.gov.

2. Allows the former property owner to be considered a prime contractor ... only on improvements not included in the sales contract ...¹²

Under A.R.S. § 42-5075(R)(10), the word “itself” and the term “does not *itself* modify” together with the then definition of the term “to modify” suggests it is the property owner ***itself*** that is prohibited from making the modifications or conducting the construction activity. Thus, a person or organization that would normally be considered a prime contractor under the terms of the statute qualifies for an exemption if that person owns property and retains contractors to do the actual construction work on that property but does not participate itself in any of the construction work. This is so even if there is a contract for the sale of the property and modification is ongoing. If the property owner builder does any modification work itself, the exception does not apply, making any amount it receives under a contract for the sale of the improved property taxable for TPT purposes.¹³

A.R.S. § 42-5075(R)(10) also contains an exception to this exception. A prime contractor will nevertheless be taxable under the prime contracting classification if that person issues a Form 5005 (pursuant to A.R.S. § 42-5075(E)) to the other contractors on the project indicating to them that it will be responsible for the TPT or it receives consideration for modifications it performs after title passes to the customer (pursuant to A.R.S. § 42-5075(Q)).¹⁴

From the facts provided, *** will be the property owner for each development project. It will hire Trades directly and will use construction managers and assistant managers who will, in essence, perform the functions of a prime contractor and oversee the work of the Trades. Although the work *** performs in supervising the trades would normally qualify as prime contracting under the *Ormond* analysis, as a result of A.R.S. § 42-5075(R)(10) it is not considered a prime contractor because it is *not* performing any of the modification work itself. Thus *** is free to own, market and sell real property and to utilize construction

¹² *Id.*

¹³ It is important to note that the Department considers leased or temporary employees (whether construction managers or other workers) paid directly by an affiliate of a taxpayer as much a part of the taxpayer as the taxpayer’s permanent employees. Hence, if any modification work is conducted by the *** through temporary, leased, contracted or permanent employees, or other workers hired by PM, the exemption would not apply.

¹⁴ A.R.S. § 42-5075(Q) imposes TPT under the prime contracting classification where a person who owns real property sells that property to a third party but still remains responsible to the new owner for modifications made to the property after title has passed and receives payment for the modifications. Only the income received after title passes is taxable under this section.

managers or other personnel to oversee the performance of construction work performed by third party construction trades on its property. *** structured in this manner would not be taxable as a prime contractor.

When *** hires the Trades directly to do the construction work, the Trades will receive compensation from ***. As a result of A.R.S. § 42-5075(R)(10), those Trades will be responsible for completing their contracts with *** and will be responsible for the prime contracting TPT on the income they receive.

To maintain the exemption under A.R.S. § 42-5075(R)(10), *** must be able to demonstrate that any modification activity was undertaken by unrelated third parties. Temporary, leased, contracted or permanent employees, or other workers hired by PM would be considered part of *** and those workers would not qualify as unrelated third parties. *** is also required to retain a detailed list of all Trades including their contact information, license number etc. showing Trades engaged to do construction work for each aspect of construction for the project. *** must also retain copies of all invoices received from those Trades with the details of the work performed by them. Those records must be kept for the normal limitation period for other TPT records.

Because all the income *** will be earning will be non-taxable for TPT purposes because they contract with Trades to do the contracting activity, *** does not have to report any income or obtain a TPT license unless it plans on engaging in other taxable activities. In addition, *** may *not* use Form 5000 or otherwise purchase construction materials tax exempt or utilize any other TPT exemption because it is not conducting any taxable TPT activity.

This ruling does not affect the Department's marketing arm/construction arm policy.

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 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.