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ARIZONA TRANSACTION PRIVILEGE TAX RULING TPR 06-2

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ISSUE:

What are qualifying “direct costs” for purposes of identifying that portion of gross proceeds of sales or gross income not subject to transaction privilege tax under the prime contracting classification, as provided by A.R.S. § 42-5075(J)?

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 42-5075 *Prime contracting classification*, levies the transaction privilege tax on the business of prime contracting. Arizona Laws 2004, 46th Leg., 2d Reg. Sess. ch. 309 (S.B. 1293), effective August 25, 2004, amends the prime contracting classification and provides for A.R.S. § 42-5075(J).

A.R.S. § 42-5075(J) provides a specific exemption from transaction privilege tax imposed under the prime contracting classification for the portion of gross proceeds of sales or gross income attributable to the actual direct costs of providing architectural or engineering services that are incorporated in a contract.

A.R.S. § 42-5023 provides that it is presumed that all gross proceeds of sales and gross income derived by a person from business activity classified under a taxable business classification comprise the tax base for the business until the contrary is established.

A.R.S. § 42-5075(J) defines “direct costs” as the portion of actual costs directly expended in providing architectural or engineering services.

A.R.S. § 42-5075(B) provides that the tax base for the prime contracting classification is 65% of the gross proceeds of sales or gross income derived from the business.

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Arizona Administrative Code (A.A.C.) R15-5-2211 states:

- A. The taxpayer, on the application for a transaction privilege tax or use tax license, shall elect to report and pay taxes based on either the “cash receipts” or the “accrual” method.
- B. Under the cash receipts method, a sale is reported in the month in which payment is received. Under the accrual method, the sale is reported in the month in which it occurs without regard to when payment is received. Allowable deductions and exemptions shall be reported in a manner consistent with the reporting of the tax.

DISCUSSION:

A.R.S. § 42-5075 levies the transaction privilege tax on the business of prime contracting. Prime contracting includes altering, repairing, improving, adding to, or subtracting from any building, structure, improvement, or other project. The tax base for the prime contracting classification is 65% of the gross proceeds of sales or gross income derived from the business.

The portion of gross proceeds or income attributable to the portion of actual costs directly expended in providing architectural or engineering services is deducted from gross proceeds or gross income before computing the tax base. A.R.S. § 42-5075(B), (J). Actual costs directly expended in providing architectural or engineering services are referred to as “qualified direct costs” in this ruling.

The portion of actual costs not directly expended for architectural or engineering services is not a qualified direct cost under A.R.S. § 42-5075(J). Therefore, gross proceeds or income attributable to expended indirect architectural costs, indirect engineering costs, or construction costs do not qualify for the exemption provided by A.R.S. § 42-5075(J).

The exemption under A.R.S. § 42-5075(J) is reported in a manner consistent with the reporting of the tax. A.A.C. R15-5-2211(B). Taxpayers claiming the exemption under A.R.S. § 42-5075(J) must retain adequate documentation to support the exemption from the tax base.

Direct Costs

A.R.S. § 42-5075(J) restricts qualified direct costs to that portion of the actual costs that are directly expended and, therefore, directly traceable to architectural and engineering services that are incorporated into a contract. Qualified direct costs for architectural and engineering services include actual direct labor costs, direct material costs, and third-party architectural or engineering costs. Even if a cost is essential to perform a contract's

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required scope of architectural or engineering services, the cost does not necessarily qualify as a direct cost under A.R.S. § 42-5075(J).

“Architectural and engineering services” means professional services solely of an architectural or engineering nature that are required to be performed or approved by a person registered, licensed, or certified by state law to provide such services, including the registered, licensed, or certified person’s employee or outside third-party consultant necessary for the performance of the contract’s architectural or engineering services.

Qualified architectural or engineering services do not include contracting activities provided in A.R.S. § 42-5075 or, for example, a third-party architect’s interior design or decorating services.

Qualified direct costs as required by A.R.S. § 42-5075(J) include:

1. Actual costs of labor directly expended in providing architectural or engineering services. Actual direct labor costs expended for architectural or engineering services include the costs of labor that are directly expensed for and that can be directly traced to a contract. These include hourly wages and salaries paid to employees for actual time spent exclusively and directly for the contract’s required architectural and engineering services. For example, clerical wages paid to persons entering data from an engineering survey, which is part of the contract’s scope of engineering services, may be appropriately considered actual direct labor costs. In-house architectural or engineering employees may provide services for several contracts during the same period. Nonetheless, the total cost for all contracts attributed to these services shall not exceed the employee’s actual hourly rate. Components of direct labor costs may include the employer’s portion of the following actual expenses: payroll taxes, basic compensation, efficiency bonus, workers’ compensation, pension benefits, health and life insurance, cost of living allowance, sick pay, holiday pay, vacation pay, and unemployment compensation insurance.
2. Actual costs of materials directly expended in providing architectural or engineering services. Actual direct material costs are directly expensed for architectural or engineering services, can be directly traced to a single contract, and become an integral part of property produced, including, for example, blueprints, plans, specifications, renderings, or models. Actual direct material costs also include directly expended costs of materials consumed in the contract for architectural or engineering services that are directly traceable to a contract.
3. Qualified direct costs include amounts paid to a third-party for qualified architectural or engineering services.

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Indirect Costs

Qualified direct costs under A.R.S. § 42-5075(J) exclude indirect costs. Indirect architectural or engineering costs are those costs that are not directly expended for and cannot be directly traced to a single contract's architectural or engineering services. Indirect architectural or engineering costs are costs that are incidental to or necessary for the performance of architectural or engineering services that cannot be directly traced to the contract. For example, the salary of the vice-president of engineering may be a direct cost associated with the entire engineering department. However, her salary is also a common or joint cost associated with multiple engineering divisions, teams, contracts, or projects. Therefore, her salary is an indirect cost of that contract unless her hourly salary rate is directly expended for and can be directly traced to the single contract's architectural or engineering services.

Indirect costs under A.R.S. § 42-5075(J) include:

1. Actual costs of labor indirectly expended, including the costs of labor that are not directly expended for and that cannot be directly traced to a single contract in providing architectural or engineering services. Indirect labor costs also include officers' compensation and other indirect labor costs necessary for the performance of architectural or engineering services not directly traced to the contract.
2. Actual costs of materials indirectly expended, including the costs of materials that are not directly expended for and that cannot be directly traced to a single contract in providing architectural or engineering services. Actual indirect material costs expended for architectural or engineering services do not become an integral part of property, are not directly consumed in the contract, and are not directly traced to the contract.
3. Examples of indirect costs include, but are not limited to, utilities, office supplies, copying costs, purchasing costs, handling costs, storage costs, depreciation and other cost recovery allowances, rent, lease, taxes, insurance, repairs, maintenance, research, experimental, bidding costs, administrative costs, legal costs, accounting costs, and interest. Indirect costs also include overhead.

Total actual costs expended must include all direct and indirect architectural or engineering costs properly incorporated into the contract.

RULING:

Qualified direct costs are actual costs directly expended for architectural or engineering services, including direct labor costs, direct material costs, and third-party architectural or engineering subcontracted costs.

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Gross proceeds attributable to qualified direct costs are deducted from the contractor's gross contracting proceeds or income before the 35% reduction of the tax base.

Subsection J provides for an exemption from income, not a deduction of costs. Therefore, to qualify for the exemption under A.R.S. § 42-5075(J), the contractor must have both gross proceeds and qualified direct costs from the same contract. The exemption cannot be greater than the lesser of the contract's qualified direct costs or the gross proceeds or income from the contract.

In calculating the exemption, the contractor may first attribute any income received from the contract to the contract's outstanding qualified direct costs that have not already been used to offset or exempt gross proceeds or income under subsection J. Income in later tax periods may be exempt if there are qualified direct costs not used in earlier periods to offset income for those periods.

A contractor's books and records must separately state and clearly establish that the contractor has qualified direct costs available to offset gross proceeds or income.

Note: Cities impose tax under the provisions of the Model City Tax Code. The application of city tax on the portion of gross proceeds or income attributable to actual direct costs of providing architectural or engineering services incorporated in a contract may differ from the state tax treatment. Please refer to the Model City Tax Code (or the appropriate city) to determine the proper city tax treatment for a particular location.

Gale Garriott, Director

Signed: December 19, 2006

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning application of the law. Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.