August 25, 2004

Attached please find an Adobe PDF version of a proposed Arizona Transaction Privilege Tax Ruling explaining what qualifying “direct costs” are for purposes of identifying the portion of gross proceeds of sales or gross income that is not subject to transaction privilege tax pursuant to Arizona Revised Statutes § 42-5075(J). In an ongoing effort to interact with and inform the public regarding issues relating to taxation, the Department would appreciate your written comments on this document.

To view the file, you will need to have Adobe Acrobat Reader version 5.0 or higher (the current version is available for download at http://www.adobe.com/products/acrobat/readstep2.html). Hard copies of the proposed ruling are available upon request.

Please be advised that the deadline for comments or a request for extension of time for review is Wednesday, September 8, 2004. This office will review all comments that are received through this date and make any appropriate revisions before the Department issues the final ruling.

Please address your comments to:

Christie Comanita, Manager
Tax Policy & Research Division
Arizona Department of Revenue
1600 W. Monroe
Phoenix, AZ 85007
Fax: (602) 716-6791
E-mail: comanitac@revenue.state.az.us

Thank you for your continuing efforts to establish an ongoing line of communication with the Department of Revenue.

Sincerely,

/s/ Christie Comanita
Manager
Tax Policy & Research Division

Attachment
ARIZONA TRANSACTION PRIVILEGE TAX RULING
TPR 04-___

This substantive policy statement is advisory only. A substantive policy statement does not include internal procedural documents that only affect the internal procedures of the agency and does not impose additional requirements or penalties on regulated parties or include confidential information or rules made in accordance with the Arizona administrative procedure act. If you believe that this substantive policy statement does impose additional requirements or penalties on regulated parties you may petition the agency under Arizona Revised Statutes § 41-1033 for a review of the statement.

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:


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

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

DISCUSSION:

Arizona Revised Statutes (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 percent of the gross proceeds of sales or gross income derived from the business.
Direct Costs

A.R.S. § 42-5075(J) defines direct costs as the portion of actual costs that are directly expended in providing architectural or engineering services that are incorporated in a contract. This definition of direct costs follows generally accepted cost accounting principles.

Qualified direct costs are actual costs directly expended solely for architectural or engineering services including direct labor costs, direct material costs, third-party architectural or engineering subcontractor costs and other directly expended costs in providing architectural or engineering services that can be directly traced to and are directly associated with a particular contract. Qualified architectural or engineering services are those architectural or engineering services which are incorporated into a specific contract and that are within the scope of architectural and engineering practice as provided in Arizona Revised Statutes, Title 32, Chapter 1.

Direct costs are allowable when incurred and directly expensed solely for the performance of a specific contract’s architectural or engineering services. Direct costs expended in providing architectural or engineering services that are incorporated into a single contract may not be shifted to another contract.

If a cost is essential to perform a contract’s required scope of architectural or engineering services, the cost does not necessarily qualify as a direct cost under A.R.S. § 42-5075(J). The cost must be an actual cost directly expended in providing architectural or engineering services that are incorporated into a single contract.

If an architectural or engineering service cost is directly expended for more than one contract, then for purposes of A.R.S. § 42-5075(J), that particular joint cost is not a qualified direct cost, unless the architectural or engineering service cost is directly and solely expensed for each contract, can be directly traced to each contract, solely benefits each contract and the cost is readily identified so that all of the architectural or engineering service cost is fairly and reasonably assigned to each contract. If not, the cost expended in providing architectural or engineering services for more than one contract is a common or indirect cost of the architectural or engineering function.

Qualified actual 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 single contract. These includes wages and salaries paid to employees, supervisors and managers for actual time spent exclusively for the contract’s required architectural, engineering, landscape architectural, land surveying, soil and geological 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.

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 and are directly traceable to and associated with a single
contract.

3. Direct costs include other directly expended costs in providing architectural or
engineering services that can be directly traced to a single contract, including
amounts paid to third-party architectural or engineering subcontractors. Examples
might include equipment rental, telephone and travel solely where the service or
consumption is directly connected to and expensed in providing architectural or
engineering services for a specific contract.

Indirect Costs

Qualified costs under A.R.S. § 42-5075(J) exclude indirect costs. Indirect job costs are all
costs other than qualified direct costs expended for the performance of the contract's
architectural or engineering services.

Indirect architectural or engineering costs are those costs, which are not directly expended,
cannot be directly traced to, and are not directly attributable to a single contract's
architectural or engineering services. 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 that is not
directly traceable to, directly associated with and directly expended for architectural or
engineering services of a single contract.

Actual direct and indirect costs which are expensed for non-architectural or non-
engineering services are unqualified direct costs under A.R.S. § 42-5075(J).

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 expensed for, and that cannot be directly traced to a single contract in
providing architectural or engineering services. These include but are not limited to
payroll taxes, retirement, insurance, service costs, strike expenses, sick leave,
holiday time, health care, unemployment, pension and fringe benefits. Indirect labor
costs also include officers’ compensation and indirect labor costs expensed for
management and administrative functions such as safety engineering, accounting, finance and marketing.

2. Actual costs of materials indirectly expended including the costs of materials that are not directly expensed 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 traceable or associated with a single contract.

3. Examples of indirect costs are utilities, office supplies, copying costs, purchasing costs, handling costs, storage costs, depreciation, section 179 costs, rent, lease, taxes, insurance, repairs, maintenance, research, experimental, bidding costs and interest. Indirect costs also include overhead.

A.R.S. § 42-5075(J) provides that this exemption from transaction privilege tax imposed under the prime contracting classification is limited to the portion of gross proceeds or gross income attributable to the actual direct costs expended for architectural or engineering services that are incorporated in a contract. Actual direct costs expended for architectural or engineering services limit the portion of gross proceeds or gross income exempt from transaction privilege tax under the prime contracting classification. Without actual direct costs expended for architectural or engineering services, a taxpayer cannot exempt gross receipts or gross income under A.R.S. § 42-5075(J).

When the contractor hires a third party to perform the architectural or engineering services, the exemption under A.R.S. § 42-5075 (J) is limited to the amount paid to the third party for the architectural or engineering services performed under the contract. Use of a formula for the calculation of the exemption is not required.

When the architectural or engineering services are performed by the contractor’s in-house staff or architectural or engineering functions, the computation of the portion of gross receipts or gross income attributable to the actual direct costs expended for architectural or engineering services is determined by the following formula:

\[
\text{Portion of exempt gross proceeds or gross income attributable to architectural and engineering services limited by actual expended direct costs. A.R.S. § 42-5075(J).} = \frac{\text{Actual direct costs expended for architectural and engineering services}}{\text{Total actual costs expended for architectural and engineering services}} \times \text{Gross proceeds and gross income from architectural and engineering services.}
\]

**EXAMPLE:** Computation of the portion of gross proceeds or gross income exempt from transaction privilege tax under A.R.S. § 42-5075(J).
Example 1

During the current tax period, taxpayer A a prime contractor with architectural and engineering staff enters into a $550,000 design-build contract. Taxpayer A expends $55,000 for architectural and engineering costs that are considered qualified actual direct costs.

### Gross receipts from architectural and engineering services

<table>
<thead>
<tr>
<th>Service</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross receipts from architectural design</td>
<td>$30,000</td>
</tr>
<tr>
<td>Gross receipts from architectural construction evaluation</td>
<td>$15,000</td>
</tr>
<tr>
<td>Gross receipts from architectural construction consultation</td>
<td>$10,000</td>
</tr>
<tr>
<td>Gross receipts from engineering design</td>
<td>$25,000</td>
</tr>
<tr>
<td>Total gross receipts from architectural and engineering services</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

### Direct costs from architectural and engineering services

<table>
<thead>
<tr>
<th>Function or Staff</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxpayer architectural function or in-house staff Architectural services</td>
<td>$30,000</td>
</tr>
<tr>
<td>Taxpayer engineering function or in-house staff Engineering services</td>
<td>$25,000</td>
</tr>
<tr>
<td>Total direct costs from architectural and engineering services</td>
<td>$55,000</td>
</tr>
</tbody>
</table>

### Indirect costs from architectural and engineering services

<table>
<thead>
<tr>
<th>Cost</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indirect labor including management and officer compensation</td>
<td>$10,000</td>
</tr>
<tr>
<td>Indirect materials and supplies</td>
<td>$2,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$4,000</td>
</tr>
<tr>
<td>Research and experimental</td>
<td>$1,000</td>
</tr>
<tr>
<td>Total indirect costs from architectural and engineering services</td>
<td>$17,000</td>
</tr>
</tbody>
</table>

Taxpayer A’s computation of the portion of gross proceeds or gross income attributable to actual direct costs for the current tax period is:

\[
\text{Portion exempt} = \frac{\text{Actual direct costs}}{\text{Total actual costs}} \times \text{Gross proceeds and gross income from architectural and engineering services}
\]

In this example, exempt gross proceeds or gross income attributable to architectural and engineering services is limited by actual expended direct costs of $55,000. The formula’s result of $61,111 is not allowed. A.R.S. § 42-5075(J).

The contract’s total amount of gross proceeds or gross income due to architectural and engineering services exempt from transaction privilege tax under A.R.S. § 42-5075(J) is limited to the qualified actual direct costs of $55,000 or 10% of the total contract. The portion of gross proceeds or gross income exempt from transaction privilege tax under
A.R.S. § 42-5075(J) cannot exceed actual direct costs expended for architectural or engineering services incorporated into the single contract to design and build.

If for reporting purposes, taxpayer A can identify the gross receipts or gross income as receipts or income from architectural and engineering services, then, to the extent of gross receipts from architectural and engineering services, these gross receipts or gross income would be reduced by the $55,000 qualified direct costs.

If for reporting purposes, taxpayer A cannot identify the gross receipts or gross income as receipts or income from architectural and engineering services, then to the extent of the contract’s gross receipts or gross income, the contract’s reported gross receipts or gross income would be reduced by 10% of the contract’s gross receipts or gross income for each reporting period until the full $55,000 is exempted.

Example 2

On its application for a transaction privilege tax or use tax license, taxpayer B elected to report and pay transaction privilege taxes on the cash receipts method. Taxpayer B enters into a single contract to design and build a structure. Taxpayer B’s employees provide the contract’s required architectural and engineering services. For each tax period, taxpayer B computes the following actual direct costs expended for architectural and engineering services incorporated into the contract.

<table>
<thead>
<tr>
<th>Tax Period</th>
<th>Payments of gross receipts or gross income from architectural and engineering services</th>
<th>Qualified Direct Costs</th>
<th>Reported exempt gross receipts or gross income from architectural and engineering services</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$20,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>2</td>
<td>$0</td>
<td>$20,000</td>
<td>$0</td>
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<tr>
<td>3</td>
<td>$40,000</td>
<td>$25,000</td>
<td>$40,000</td>
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<td>$50,000</td>
</tr>
<tr>
<td>6</td>
<td>$60,000</td>
<td>$41,000</td>
<td>$42,000</td>
</tr>
<tr>
<td>7</td>
<td>$15,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

For Tax Period 3, taxpayer B will first attribute gross proceeds or gross income due to qualified direct costs from Tax Period 2 and then gross receipts or gross income due to qualified direct costs from current Tax Period 3. For Tax Period 4, taxpayer B will attribute gross proceeds or gross income due to qualified direct costs remaining from Tax Period 3. Qualified direct costs cannot be utilized more than once in the calculation of exempt gross receipts or income under A.R.S. § 42-5075(J).
RULING:

Qualifying costs are actual costs directly expended for architectural or engineering services including direct labor costs, direct material costs, third-party architectural or engineering subcontracted costs and other directly expended costs in providing architectural or engineering services that can be directly traced to a single contract. Qualifying costs excludes indirect costs. Actual direct costs expended for architectural or engineering services limit the amount of architectural or engineering services gross proceeds or gross income exempt from transaction privilege tax under A.R.S. § 42-5075(J).