

# STATE OF ARIZONA

Department of Revenue



Janet Napolitano  
Governor

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Director

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:

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

9 **ISSUE:**

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

13 **APPLICABLE LAW:**

14 Arizona Revised Statutes (A.R.S.) § 42-5075 *Prime contracting classification*, levies the  
15 transaction privilege tax on the business of prime contracting. Arizona Laws 2004,  
16 46<sup>th</sup> Legislature, 2<sup>nd</sup> Regular Session, Chapter 309, (S.B. 1293), effective August 25, 2004,  
17 amends the prime contracting classification and provides for the addition and retroactive  
18 application of A.R.S. § 42-5075(J).

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

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

25 **DISCUSSION:**

26 Arizona Revised Statutes (A.R.S.) § 42-5075 levies the transaction privilege tax on the  
27 business of prime contracting. Prime contracting includes altering, repairing, improving,  
28 adding to or subtracting from any building, structure, improvement, or other project. The  
29 tax base for the prime contracting classification is 65 percent of the gross proceeds of sales  
30 or gross income derived from the business.

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## 31 **Direct Costs**

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

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

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

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

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

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

61 1. Actual costs of labor directly expended in providing architectural or engineering  
62 services. Actual direct labor costs expended for architectural or engineering  
63 services include the costs of labor that are directly expended for, and that can be  
64 directly traced to a single contract. These includes wages and salaries paid to  
65 employees, supervisors and managers for actual time spent exclusively for the  
66 contract's required architectural, engineering, landscape architectural, land  
67 surveying, soil and geological engineering services. For example, clerical wages  
68 paid to persons entering data from an engineering survey, which is part of the

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69 contract's scope of engineering services, may be appropriately considered actual  
70 direct labor costs.

71 2. Actual costs of materials directly expended in providing architectural or engineering  
72 services. Actual direct material costs are directly expended for architectural or  
73 engineering services can be directly traced to a single contract, and become an  
74 integral part of property produced including for example, blueprints, plans,  
75 specifications, renderings or models. Actual direct material costs also include  
76 directly expended costs of materials consumed in the contract for architectural or  
77 engineering services and are directly traceable to and associated with a single  
78 contract.

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

## 85 Indirect Costs

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

89 Indirect architectural or engineering costs are those costs, which are not directly expended,  
90 cannot be directly traced to, and are not directly attributable to a single contract's  
91 architectural or engineering services. For example, the salary of the vice-president of  
92 engineering may be a direct cost associated with the entire engineering department.  
93 However, her salary is also a common or joint cost associated with multiple engineering  
94 divisions, teams, contracts or projects. Therefore, her salary is an indirect cost that is not  
95 directly traceable to, directly associated with and directly expended for architectural or  
96 engineering services of a single contract.

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

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

100 1. Actual costs of labor indirectly expended including the costs of labor that are not  
101 directly expensed for, and that cannot be directly traced to a single contract in  
102 providing architectural or engineering services. These include but are not limited to  
103 payroll taxes, retirement, insurance, service costs, strike expenses, sick leave,  
104 holiday time, health care, unemployment, pension and fringe benefits. Indirect labor  
105 costs also include officers' compensation and indirect labor costs expensed for

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106 management and administrative functions such as safety engineering, accounting,  
107 finance and marketing.

108 2. Actual costs of materials indirectly expended including the costs of materials that  
109 are not directly expensed for, and that cannot be directly traced to a single contract  
110 in providing architectural or engineering services. Actual indirect material costs  
111 expensed for architectural or engineering services do not become an integral part of  
112 property, are not directly consumed in the contract and are not directly traceable or  
113 associated with a single contract.

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

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

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

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

Portion of exempt gross proceeds or gross income attributable to architectural and engineering services <u>limited</u> by actual expended direct costs. A.R.S. § 42-5075(J).	=	$\frac{\text{Actual direct costs expended for architectural and engineering services}}{\text{Total actual costs expended for architectural and engineering services}}$	x	Gross proceeds and gross income from architectural and engineering services
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134 **EXAMPLE:** Computation of the portion of gross proceeds or gross income exempt from  
135 transaction privilege tax under A.R.S. § 42-5075(J).

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136 Example 1

137 During the current tax period, taxpayer A a prime contractor with architectural and  
 138 engineering staff enters into a \$550,000 design-build contract. Taxpayer A expends  
 139 \$55,000 for architectural and engineering costs that are considered qualified actual direct  
 140 costs.

141	<u>Gross receipts from architectural and engineering services</u>	
142	Gross receipts from architectural design	\$30,000
143	Gross receipts from architectural construction evaluation	\$15,000
144	Gross receipts from architectural construction consultation	\$10,000
145	Gross receipts from engineering design	\$25,000
146	Total gross receipts from architectural and engineering services	<u>\$80,000</u>

147	<u>Direct costs from architectural and engineering services</u>	
148	Taxpayer architectural function or in-house staff	
149	architectural services	\$30,000
150	Taxpayer engineering function or in-house staff	
151	engineering services	\$25,000
152	Total direct costs from architectural and engineering services	<u>\$55,000</u>

153	<u>Indirect costs from architectural and engineering services</u>	
154	Indirect labor including management and officer compensation	\$10,000
155	Indirect materials and supplies	\$ 2,000
156	Depreciation	\$ 4,000
157	Research and experimental	\$ 1,000
158	Total indirect costs from architectural and engineering services	<u>\$17,000</u>

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

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).

$$\begin{array}{r}
 \$55,000 \text{ Actual direct costs} \\
 \text{expended for architectural} \\
 \text{and engineering services} \\
 \hline
 \$72,000 \text{ Total actual costs} \\
 \text{expended for architectural} \\
 \text{and engineering services}
 \end{array}
 \times
 \begin{array}{r}
 \$80,000 \text{ Gross proceeds and gross} \\
 \text{income from architectural and} \\
 \text{engineering services}
 \end{array}$$

161 The contract's total amount of gross proceeds or gross income due to architectural and  
 162 engineering services exempt from transaction privilege tax under A.R.S. § 42-5075(J) is  
 163 limited to the qualified actual direct costs of \$55,000 or 10% of the total contract. The  
 164 portion of gross proceeds or gross income exempt from transaction privilege tax under

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165 A.R.S. § 42-5075(J) cannot exceed actual direct costs expended for architectural or  
166 engineering services incorporated into the single contract to design and build.

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

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

176 Example 2

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

<b>Tax Period</b>	<b>Payments of gross receipts or gross income from architectural and engineering services</b>	<b>Qualified Direct Costs</b>	<b>Reported exempt gross receipts or gross income from architectural and engineering services</b>
1	\$20,000	\$0	\$0
2	\$0	\$20,000	\$0
3	\$40,000	\$25,000	\$40,000
4	\$40,000	\$0	\$5,000
5	\$50,000	\$51,000	\$50,000
6	\$60,000	\$41,000	\$42,000
7	\$15,000	\$10,000	\$10,000

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

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189 **RULING:**

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

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