ARIZONA TRANSACTION PRIVILEGE TAX RULING
TPR 06-___

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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 Legislature, 2nd Regular Session, Chapter 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.

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

32   A. The taxpayer, on the application for a transaction privilege tax or use tax
33   license, shall elect to report and pay taxes based on either the "cash
34   receipts" or the "accrual" method.

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36   B. Under the cash receipts method, a sale is reported in the month in which
37   payment is received. Under the accrual method, the sale is reported in
38   the month in which it occurs without regard to when payment is received.
39   Allowable deductions and exemptions shall be reported in a manner
40   consistent with the reporting of the tax.

41 **DISCUSSION:**

42 Arizona Revised Statutes § 42-5075 levies the transaction privilege tax on the business of
43 prime contracting. Prime contracting includes altering, repairing, improving, adding to or
44 subtracting from any building, structure, improvement, or other project. The tax base for
45 the prime contracting classification is 65 percent of the gross proceeds of sales or gross
46 income derived from the business.

47

48 The portion of gross proceeds or income attributable to the portion of actual costs directly
49 expended in providing architectural or engineering services is deducted from gross
50 proceeds or gross income before computing the tax base. A.R.S. § 42-5075(B); A.R.S.
51 § 42-5075(J). Actual costs directly expended in providing architectural or engineering
52 services are referred to as "qualified direct costs" in this ruling.

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

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

63

64 **Direct Costs**

65 A.R.S. § 42-5075(J) restricts qualified direct costs to that portion of the actual costs that are
66 directly expended, and therefore, directly traceable to architectural and engineering
67 services that are incorporated into a contract. Qualified direct costs for architectural and
68 engineering services include actual direct labor costs, direct material costs and third-party
69 architectural or engineering costs. Even if a cost is essential to perform a contract's
70 required scope of architectural or engineering services, the cost does not necessarily
71 qualify as a direct cost under A.R.S. § 42-5075(J).

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73 "Architectural and engineering services" means professional services solely of an
74 architectural or engineering nature which are required to be performed or approved by a
75 person registered, licensed or certified by state law to provide such services including the
76 registered, licensed or certified person's employee or outside third-party consultant
77 necessary for the performance of the contract's architectural or engineering services.
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79 Qualified architectural or engineering services do not include contracting activities provided
80 in A.R.S. § 42-5075, or for example, a third-party architect's interior design or decorating
81 services.
82
83 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.

Indirect Costs

109 Qualified direct costs under A.R.S. § 42-5075(J) exclude indirect costs. Indirect
110 architectural or engineering costs are those costs that are not directly expended for and
111 cannot be directly traced to a single contract's architectural or engineering services.
112 Indirect architectural or engineering costs are costs that are incidental to or necessary for

113 the performance of architectural or engineering services that cannot be directly traced to
114 the contract. For example, the salary of the vice-president of engineering may be a direct
115 cost associated with the entire engineering department. However, her salary is also a
116 common or joint cost associated with multiple engineering divisions, teams, contracts, or
117 projects. Therefore, her salary is an indirect cost of that contract unless her hourly salary
118 rate is directly expended for and can be directly traced to the single contract's architectural
119 or engineering services.

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

121   1. Actual costs of labor indirectly expended including the costs of labor that are not
122   directly expensed for, and that cannot be directly traced to a single contract in
123   providing architectural or engineering services. Indirect labor costs also include
124   officers' compensation and other indirect labor costs necessary for the performance
125   of architectural or engineering services not directly traced to the contract.

126   2. Actual costs of materials indirectly expended including the costs of materials that are
127   not directly expensed for, and that cannot be directly traced to a single contract in
128   providing architectural or engineering services. Actual indirect material costs
129   expensed for architectural or engineering services do not become an integral part of
130   property, are not directly consumed in the contract, and are not directly traceable or
131   associated with a single contract.

132   3. Examples of indirect costs include utilities, office supplies, copying costs, purchasing
133   costs, handling costs, storage costs, depreciation and other cost recovery
134   allowances, rent, lease, taxes, insurance, repairs, maintenance, research,
135   experimental, bidding costs, administrative costs, legal costs, accounting costs and
136   interest. Indirect costs also include overhead. This is not an exhaustive list of
137   indirect costs.

138 Total actual costs expended must include all direct and indirect architectural or engineering
139 costs properly incorporated into the contract.
140

141 **RULING:**

142 Qualified direct costs are actual costs directly expended for architectural or engineering
143 services including direct labor costs, direct material costs and third-party architectural or
144 engineering subcontracted costs.
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146 Gross proceeds attributable to qualified direct costs are deducted from the contractor's
147 gross contracting proceeds or income before the 35% reduction of the tax base.
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149 Subsection J provides for an exemption from income, and not a deduction of costs.
150 Therefore, to qualify for the exemption under A.R.S. § 42-5075(J) the contractor must have

151   both gross proceeds and qualified direct costs in the same tax period from the same
152   contract. The exemption cannot be greater than the lesser of the contract's qualified direct
153   costs or the gross proceeds or income from the contract.
154
155   In calculating the exemption, the contractor may first attribute any income received from the
156   contract to the contract's outstanding qualified direct costs that have not already been used
157   to offset or exempt gross proceeds or income under subsection J. Income in later tax
158   periods may be exempt if there are qualified direct costs not used in earlier periods to offset
159   income for those periods.
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161   A contractor's books and records must separately state and clearly establish that the
162   contractor has qualified direct costs available to offset gross proceeds or income.
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166   *Note: Cities impose tax under the provisions of the Model City Tax Code and the*
167   *application of city tax on the portion of gross proceeds or income attributable to actual*
168   *direct costs of providing architectural or engineering services incorporated in a contract*
169   *may differ from the state tax treatment. Please refer to the Model City Tax Code (or the*
170   *appropriate city) to determine the proper city tax treatment for your particular location.*
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