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ARIZONA TAX RESEARCH ASSOCIATION

February 24, 2012

Mr. Hsin Pai
Arizona Department of Revenue
Tax Research & Analysis Section
1600 West Monroe, Rm. 810
Phoenix, AZ 85007-2652

Re: ATRA's Comments on Proposed Arizona Transaction Privilege Tax Ruling on Prime Contracting

Dear Hsin:

The Tax Policy Committee of the Arizona Tax Research Association (ATRA) has reviewed the proposed Arizona Transaction Privilege Tax (TPT) Ruling TPR 11-___ issued by the Arizona Department of Revenue (Department) regarding the prime contracting classification. We appreciate the opportunity to comment on the draft ruling and the additional time granted to allow for public comment.

The Committee's primary concerns with the draft ruling are on permanent attachment and services. Furthermore, we are offering comments and suggested changes on the remainder of the draft ruling.

With regard to permanent attachment, we believe that the intent of the Arizona Legislature in approving Senate Bill (SB) 1280[1] in 1996 was clear to return to a pre-*Brink* status in law.[2] Specifically, machinery or equipment that was merely bolted down to prevent it from moving during operation would not cause it to be either permanently attached to the realty or the installation and assembly labor to be taxable under the prime contracting classification. Yet, on page 15, the Department makes the definitive statement that an example of permanent attachment includes "*equipment bolted into a concrete base*." This expanded definition is completely misaligned with the legislative intent, history and structure of A.R.S. § 42-5075(B)(7) on permanent attachment. To further support the legislative intent and history, attached is a 2002 response letter on permanent attachment to then Department Director Mark Killian from Stan Barnes, former State Senator and Prime Sponsor of SB 1280. Thus, the Committee strongly urges that the Department reconsider this issue and we welcome the opportunity to discuss it further.

As for services, the prime contracting classification is comprised of the business of prime contracting and dealership of manufactured buildings. Prime contracting encompasses supervising, performing or coordinating the modification, construction, alteration, repair, addition to, subtraction from, improvement, movement, wreckage or demolition 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 a contract. However, the Department contends that prime contracting TPT is a tax on service activities and further supports this position through numerous examples that "link" non-taxable services to taxable contracting activities. The Committee suggests that the Department clarify that the services taxed are only those specifically included within the scope of the tax (i.e. modifying real property).

[1] Chapter 319, Laws 1996, Second Regular Session.
[2] *Brink Electric Construction Company v. Arizona Department of Revenue*, 184 Ariz. 354 (App. 1995).

Outlined below are additional comments and suggestions that ATRA offers regarding the remainder of the proposed ruling:

1. Page 3, paragraph "2." - The second paragraph under paragraph "2" could be interpreted to imply that proceeds from contracts with tribal governments for modifications on reservation lands are subject to tax. We suggest adding a footnote to the end of this paragraph, stating that certain contracts for modifications on reservation lands may be exempt from this tax, as set forth in TPR 95-11, Ruling I.C, so that the ruling facilitate a better overall understanding of the tax.

2. Page 4, second paragraph "c." - Regarding the tests for permanent attachment, the draft ruling states that substantial damage to real property "*includes damage such that subsequent corrective or remediation action would have to be taken to return the property to a substantially similar condition as existed before removal…*" While remediation may connote that the damage was substantial, the use of "corrective" as a descriptor does not blend with the requirement that the damage be substantial. A corrective action can be very minor. Under rules of statutory construction, words in a statute must be given their plain and ordinary meaning. A dictionary definition of "substantial" is "ample" or "considerable amount." Corrective action can be as simple as fixing a nail hole.

3. Page 5, paragraph "3."- The last sentence defining a "prime contractor" states, "*Rather, it merely needs to be responsible for completion of modifications set forth in its contract.*" A recommended revision could be, "**Rather, it must be responsible to the owner of the Project for completion of …**"

   Additionally, a recommended revision to the first sentence of the next paragraph is: "***Subcontracting activities:*** **All contractors who are responsible to the owner of the Project are generally presumed….**"

4. Page 5, paragraph 3(c) - It is recommended that "c." be deleted in totality. The reality is that a contractor cannot prove that payments received from a prime contractor came from a particular project. As long as the subcontractor is being paid by the prime contractor, it is irrelevant where the funds came from and the contractor should not bear the burden of proving the payments were paid from that Project's gross receipts.

5. Page 5, the paragraph that begins with "*Contactors who timely…*" - This statement is in direct conflict with the statute, as the statute does not impose a time limit on when the certificate must be issued, thus the Department should not arbitrarily set such a time limit. The recommended revision of the word "timely" should be struck from the first sentence so that it reads "**Contractors who receive a fully completed Prime Contractor's Certificate….**"

   In the second sentence of the same paragraph, we recommend the period after "TPT" be struck and replaced with a comma and the following should be inserted after the comma: "**unless the contractor received a fully completed Prime Contractor's Certificate in good faith.**" The reason for the recommended change is that the Department has already stated in the previous paragraph that one does not have to be a prime contractor to issue one of these certificates.

6. Pages 6 and 7, paragraph "4." - The draft ruling identifies examples of prime contracting activities. Under "*Construction managers,"* the Committee recommends the following changes:

   a. Omit the word "generally" in the first sentence, and rather, specifically explain what is required for a construction manager to be subject to tax as a prime contractor;
   b. Clarify the tax base for construction managers in the second sentence to avoid misinterpretation;
   c. Change "e.g." to "i.e." in the third sentence; and
   d. Clarify the tax base for a construction manager in the fourth sentence because that sentence may also be misinterpreted.

   These suggested changes also apply to the "Construction Management" paragraph on page 21.

   The example, "*Trade contractors performing offsite improvements,"* should also be changed to omit the word "generally" and should explain who is subject to tax under different circumstances, including when a Prime Contractor's Certificate should be issued. These suggested changes also apply to the "*Offsite Improvements*" section on page 21.

7. Pages 7 and 8 - The proposed ruling discusses an understanding of the common and ordinary meanings of undefined terms used in the prime contracting context under the "What is Prime Contracting" discussion. The second bullet point discusses the term "*alteration*." The definition of this term seems to be very broad to even include rekeying door locks (e.g., by replacing a cylinder or reconfiguring tumblers) as an alteration of the real estate that causes some physical change to the property without changing the identity of the real property.

   The next bullet point gives the impression that just because a repair is performed by a contractor, the proceeds should be subject to the contracting tax. This is not true if a contractor is engaged to perform a *repair on* exempt machinery & equipment. Additionally, the terms "general" and "generally" should be avoided in a ruling such as this.

8. Page 8, first full paragraph - This appears to be a "catch-all" statement by the Department. If activities by a contractor do not meet the Department's definition of an "alteration," "repair" or an "addition," this paragraph makes it clear that they can still tax the activity if they feel it is incidental and inseparable from the principal business and interwoven into the operation. This interpretation is excessively broad.

9. Page 10, first full paragraph - The Department disallows a contractor a deduction for the costs of materials it will incorporate into real property and also disallows a credit for tax paid on those materials if it fails to provide a retailer with an Arizona Form 5000. This is an example of double taxation and the prime contractor should be able to deduct these costs. In addition, this comment defeats the purpose of A.R.S. § 42-5009 (B), which specifically states that if an exempt certificate is not provided, the deduction can still be taken but the burden of proof remains with the taxpayer.

10. Page 10 - In the paragraph beginning with "Consequently," the Department wants to determine whether TPT applies to certain receipts of a taxpayer by examining the totality of the taxpayer's business activities and not reviewing receipts on a transaction-by-transaction basis. On page 21, the Department reiterates, "*that determining whether TPT applies to the receipts of a prime contractor performing both taxable and nontaxable improvements will necessitate examining the totality of the contractor's activities rather than reviewing receipts on a transaction-by-transaction*

basis." The Department's review of receipts of a taxpayer should be limited to only the business activity in Arizona.

11. Pages 10 through 14 - The Committee has multiple concerns with the Department's discussion of the "Separate-Line-of-Business Analysis." The Department relies heavily on the 1976, Arizona Supreme Court case *State Tax Commission v. Homes & Narver, Inc.*, 113 Ariz. 165 (1976), in which the court held that gross receipts from a service are not part of the taxable gross receipts of the major business if three conditions are met:

    a. The portion of the business that is the service at issue can be readily ascertained without substantial difficulty;
    b. The revenues from the service, in relation to the taxable revenues of the business, are not inconsequential; and
    c. The service cannot be said to be incidental to the other taxable activity.

    The Committee's concern with this comes from defining the bright line test to apply what is consequential and what is inconsequential. Additionally, the same applies to the question of incidental versus non-incidental. In the ruling, these questions appear to always be answered in a method that is most favorable to the Department's position and does not clarify its application.

    Further, on page 12, in the first full paragraph beginning with, "*If the relevant facts… Failure to maintain appropriate books and records will result in the presumption that a taxpayer's gross receipts are subject to TPT at the highest tax rate applicable to a classification under which the taxpayer is doing business.*" The term "appropriate" is subjective and may not facilitate taxpayers' understanding of their recordkeeping requirements. We suggest that a more objective standard be used, such as books and records kept in accordance with industry standards within Arizona. It is recommended that the first and last sentence of the paragraph be deleted altogether. The "*failure to maintain…*" statement is made again in the last sentence of page 12 and continues on page 13, "*If the business fails to maintain."* It is recommended that this sentence also be deleted.

12. Page 15, first paragraph - "*Under A.R.S. § 42-5061(B)(7), if a prime contractor…"* This appears to be a typographical error as A.R.S. § 42-5061(B)(7) refers to aircraft, navigational and communication instruments, not prime contracting machinery and equipment. The correct statutory reference should be A.R.S. § 42-5075(B)(7).

    Further down in the paragraph, "*The third question is whether the receipts are directly attributable…*" The language "directly attributable" departs from the statutory language. The Committee recommends deleting this verbiage.

    Lastly, the last sentence in the paragraph determines that "*receipts are only exempt from the prime contracting TPT base if the answer is yes to all three questions.*" However, question number 2 is "*Is the property permanently attached?*" A.R.S. § 42-5075(B)(7) exempts installation, assembly, repair or maintenance of deductible machinery, equipment and property that does <u>not</u> become permanently attached. Therefore the last sentence of the paragraph needs correction.

13. Various pages - Below are comments regarding the various examples used by the Department:

a. Page 9, *Island Shades* – Based on this example, the Department arrives at the conclusion that the *Island Shades* cannot be a manufacturer and therefore does not qualify for manufacturing or retail exemptions simply because it **installs** window shades. However, this is not always the case because *Island Shades* could just sell its shades without installation. Perhaps the Department could emphasize the point that, while contractors are entitled to purchase building materials tax free, the purchase of tools and equipment for use in their own business are subject to tax.
b. Page 13, *Imperial Heating and Cooling* –The Committee's point made above for *Island Shades* is the same for the Department's conclusion to tax cleaning and inspection services simply because the taxpayer is an HVAC contractor.
c. Page 17, *Norm*- This example is misleading because electricians that are engaged by prime contracts rather than by owners are likely subcontractors rather than prime contractors.

Thank you for the opportunity to present comments regarding the proposed prime contracting classification ruling. Please feel free to contact me if you would like to discuss these recommendations further.

Sincerely,

Kevin McCarthy
President

CC: Steve Barela, ATRA Tax Policy Chairman
Bill Molina, ATRA Tax Policy Vice Chairman

Attachment: Stan Barnes 2002 comments letter