STATE OF ARIZONA

Department of Revenue
Office of the Director
(602) 716-6090

Janet Napolitano
Governor

J. Elliott Hibbs
Director

CERTIFIED MAIL

The Director's Review of the Decision of the Administrative Law Judge Regarding:	)	**O R D E R**
[TAXPAYER]	)	**Case No. 200200180-S**
ID No.	)	

On May 21, 2003, the Administrative Law Judge issued a decision regarding the protest of [REDACTED] ("Taxpayer"), upholding the assessment of late filing and late payment penalties but reversing the rest of the assessment. Both Taxpayer and the Transaction Privilege and Use Tax Audit Division ("Division") timely appealed. As the appeal was timely, the Director of the Department of Revenue issued a notices of intent to review the decision.

In accordance with the notice given the parties, the Director has reviewed the Administrative Law Judge's decision and now issues this Order.

STATEMENT OF CASE

The Division issued a deficiency assessment to Taxpayer for the period of January 1, 1998, through July 31, 2001. Taxpayer deducted certain receipts from two construction project for architectural engineering and design fees. The Division determined that those receipts were subject to transaction privilege tax under the prime contracting classification. The Administrative Law Judge upheld the assessment of late filing and late payment penalties but reversed the assessment on the receipts of architectural engineering and design fees. On appeal, the Division argues that the architectural engineering and design fees are taxable under the prime contracting classification. Taxpayer contends that the penalties were not warranted in this matter.

FINDINGS OF FACT

The Director hereby finds as follows:

1. The Division audited Taxpayer for the audit period from January 1, 1998, through July 31, 2001.

2. Taxpayer reported receipts from its construction activity but deducted receipts for architectural engineering and design fees ("design fees") from two projects from [REDACTED].

3. Taxpayer was a [REDACTED]-based corporation performing large commercial building contracting projects in Arizona. The contracts called for Taxpayer to both design and build the projects under a standard design-build form of agreement.

4. Approximately 10%-20% of Taxpayer's contracts are for design/build work. The rest is general contracting work where no design is included.

5. Taxpayer would not undertake to perform a design-only contract.

6. The contracts at issue clearly set forth both design services and construction services. The contracts called for a "design portion" and "construction portion" for each project.

7. Taxpayer subcontracted the design portion on the [REDACTED] project to an architectural firm ([REDACTED]) and to two firms on the [REDACTED] Project.

8. The design firms itemized and billed Taxpayer monthly for their services, which Taxpayer in turn itemized and separately stated to [REDACTED] in monthly pay applications.

9. Taxpayer separately identified gross receipts from the design and construction portions of the projects.

10. Taxpayer calculated the percentage of its gross receipts for the audit period attributable to design services as 12.6% (about $[REDACTED] million out of $[REDACTED] million).

11. The design portion of the [REDACTED] project was $[REDACTED]. The total construction, design and owner's cost estimate was [REDACTED]. Under the contract documents, design represented 4.27% of the total contract price.

12. The design portion of the [REDACTED] project was $[REDACTED]. The total construction costs were in the amount of $[REDACTED]. Under the contract documents, design represented 5.88% of the total contract price.

13. During the audit period, Taxpayer received $[REDACTED] in design revenues from both projects, which represented approximately 62.3% of the total contracted design revenues for the projects.

14. During the audit period, Taxpayer received $[REDACTED] in contracting revenues from both projects, which represented approximately 29% of the total contracting portion of the contracts.

15. The Division assessed $[REDACTED] in transaction privilege taxes under prime contracting classification, including income derived from design and engineering services.

16. The Division also assessed late payment, late filing, and negligence penalties in the total amount of $[REDACTED], plus interest.

17. Taxpayer, as a [REDACTED] corporation, did not have much knowledge about Arizona transaction privilege tax before these two projects.

18. Taxpayer had obtained a transaction privilege tax license from the Department in 1992 and filed 22 transaction privilege tax returns over a three-year period ending in 1995, then did not do any business in Arizona until 2000.

19. Taxpayer's Secretary/Treasurer was in charge of Taxpayer's accounting.

20. Taxpayer's Secretary/Treasurer was unfamiliar with Arizona filing and payment requirements, and did not file most transaction privilege tax returns until September 2001. The April 2000 return was filed June 2000.

21. Taxpayer's Secretary/Treasurer testified at the hearing before the Administrative Law Judge that he was aware of Taxpayer's responsibility to file returns, but he let them "sit on his desk" because he was involved in other tax issues on the federal level and because he was confused about the transaction privilege tax.

22. Taxpayer collected tax on the construction portions of its projects.

CONCLUSIONS OF LAW

1. The Arizona legislature has imposed a privilege tax on persons engaging in certain businesses in the state. Title 42, Chapter 5.

2. The tax is measured by the gross proceeds of sales or gross income arising from such business activities. A.R.S. § 42-5008, *State Tax Commission v. Garrett Corporation*, 79 Ariz. 389, 391, 291 P.2d 208 (1955); *State Tax Commission v. Quebedeaux Chevrolet*, 71 Ariz. 280, 289, 226 P.2d 549 (1951).

3. A.R.S. §42-5023 provides that a person's gross receipts are presumed to be the tax base for the business until the contrary is established by the taxpayer.

4. A.R.S. §42-1125(A) and (D) provide that the late filing and payment penalties may be abated only upon a showing by the taxpayer that the failure is due to reasonable cause and not due to wilful neglect.

5. A.R.S. §42-1125(S) provides that with respect to transaction privilege taxes, "reasonable cause" means a reasonable basis for the taxpayer to believe that the tax did not apply to the business activity.

6. Taxpayer is engaged in taxable prime contracting. A.R.S. §42-5075(J)(2).

7. Taxpayer was not engaged in the separate business of providing design or architect services.

8. Taxpayer's receipts for the design portion of the contract at issue was a part of Taxpayer's prime contracting activity.

9. A person's activities may be such as to constitute more than one business and the taxpayer be obligated to pay the appropriate tax on each. If activities are incidental in the sense that they are inseparable from the principal business and interwoven in the operation thereof to the extent that they are in effect an essential part of the major business, they cannot be taxed as a separate business. *Trico Electric Cooperative, Inc, v. State Tax Commission*, 79 Ariz. 293, 288 P.2d 782 (1955).

10. Not all activities of a corporation are necessarily taxable based on the fact that one of the activities engaged in is that of contracting. *Ebasco Services Incorporate v. Arizona State Tax Commission,* 105 Ariz. 94, 459 P.2d 719 (1969).

11. Income from concededly non-taxable services may be a part of a taxpayer's gross income from a taxable activity. *Walden Books Company v. Arizona Department of Revenue,* 198 Ariz. 584, 12 P.3d 809 (2000).

12. Where non-taxable services are substantial the fact that they are included in one contract is not controlling. *State Tax Commission of Arizona v. Holmes & Narver, Inc.,* 113 Ariz. 165, 548 P.2d 1162 (1976)

13. Where it can be readily ascertained without substantial difficulty which portion of the business is for non-taxable professional services (design and engineering), the amounts in relation to the company's total taxable Arizona business are not inconsequential, and those services cannot be said to be incidental to the contracting business, the professional services are not merged for tax purposes into the taxable contracting business and are not subject to taxation. *State Tax Commission of Arizona v. Holmes & Narver, Inc.,*

14. The ***Holmes & Narver*** test applies whether or not a contract separately prices its

constituent parts. The applicability of the three-part test does not depend on the absence of separate pricing within the contract. *Walden Books Company v. Arizona Department of Revenue,* 198 Ariz. 584, 12 P.3d 809 (2000).

DISCUSSION

Taxpayer's contract agreed to perform both design services and contracting services. Taxpayer subcontracted the design portion of the contract to architectural firms. Taxpayer argues that the assessment is erroneous because design services are not taxable. Its taxable contracting receipts should not include the designated amounts it received for the design services since they were separately itemized and detailed and, therefore, should be treated as nontaxable amounts under *Ebasco Services, Inc.* Taxpayer contends that the three part test in *Holmes & Narver* does not apply because the case dealt with a single contract which did not separately itemize its constituent portions.

Taxpayer argues in the alternative that the design fees should not be included under the three part test of *Holmes & Narver.* First, the design fees were separately identified in the offer and in the [REDACTED] contract. Second, Taxpayer contends that the fees, which constituted approximately 12% of the assessed income during the audit period, were substantial in relation to its Arizona income during the assessment period. Third, the design services were not integral to its contracting business since the services were subcontracted to architectural firms.

The Division contends that Taxpayer's gross receipts from the project are taxable unless it can be shown these design receipts are from a separate line of business. Taxpayer has not satisfied the second two prongs of the *Holmes & Narver* test. The design fees of 4.27% and 5.88% of the contract amounts were inconsequential and the design services were interwoven into Taxpayer's construction activity as an integral part of the contract. Therefore, the receipts from the design fees are taxable as a part of Taxpayer's prime contracting business.

In summary, Taxpayer argues that design fees are not taxable, and if those fees are separately stated, they must be excluded. The Division argues that design fees

incorporated into a construction contract are not automatically excluded from the tax base, even if the receipts are separately stated. The Division contends Taxpayer's activities must meet the three part *Holmes & Narver* test before those receipts may be excluded. For the reasons that follow, the Director believes the Division's position is more consistent with current law.

The question in this case is whether nontaxable activity included in an otherwise taxable contract can be separated. The question whether one's activities could constitute more than one business was addressed by the Arizona Supreme Court in *Trico Electric Cooperative, Inc, v. State Tax Commission*, 79 Ariz. 293, 288 P.2d 782 (1955). The question was whether an electric utility was subject to tax under the retail classification on its sales of surplus supplies. While both activities in *Trico* were held taxable, the court's holding is instructive. The court held that one's activities may be such as to constitute more than one business and the taxpayer be obligated to pay the appropriate tax on each. If, however, activities are incidental in the sense that they are inseparable from the principal business and interwoven in the operation thereof to the extent that they are in effect an essential part of the major business, they cannot be taxed as a separate business. Accordingly, the analysis must be whether Taxpayer was engaged in more than one business. The cases decided after *Trico* helped refine the analysis whether a taxpayer was engaged in more than one business.

Ebasco Services Incorporated v. Arizona State Tax Commission, 105 Ariz. 94, 459 P.2d 719 (1969) involved a question very similar to the one in this case, whether a contractor was subject to tax under the contracting classification for its receipts for design and engineering services on the same project. Ebasco had several divisions under its corporate umbrella performing a complete range of services. In addition to the construction division, there was a division specializing in the engineering and design of steam-electric generating facilities. These corporate divisions and their functions were separate and distinct. The court held that the engineering and design were not integral functions of Ebasco's contracting business. The court was not willing to tax all activities of a corporation based on the fact that one of the activities engaged in is that of contracting.

While the court did not use the term, it in essence considered Ebasco to be engaged in separate lines of business.

The issue was again raised in *State Tax Commission of Arizona v. Holmes & Narver, Inc.,* 113 Ariz. 165, 548 P.2d 1162 (1976). The issues were similar to *Ebasco*, but involved a single cost plus fixed fee contract that provided for both design and engineering and construction. About 43% of the total fixed fee and approximately one-sixth of the total hours spent on the project were for design and engineering services. Holmes & Narver was engaged for the project primarily because of its design and engineering expertise. The Tax Commission argued that the design and engineering services were an essential part of the contracting business and did not constitute a separate business. The court considered forty-three percent of the total fixed fee attributable to design and engineering to be substantial in relation to the other services required by the contract. The court therefore held that the business was two-fold: design and engineering, and construction. The court then stated what is now the *Holmes & Narver* test that where it can be readily ascertained without substantial difficulty which portion of the business is for non-taxable professional services (design and engineering), the amounts in relation to the company's total taxable Arizona business are not inconsequential, and those services cannot be said to be incidental to the contracting business, the professional services are not merged for tax purposes into the taxable contracting business and are not subject to taxation.

The Marriott Corporation and Marriott Management Services Corp. v. State Of Arizona, Ex Rel. Arizona Department Of Revenue, 189 Ariz. 175, 939 P.2d 808 (1997) noted that the *Holmes & Narver* test helps identify the nature of the parties' business activities. The case involved the question whether Marriott's sale of food to a youth camp was a non-taxable sale to a restaurant. The Department argued that the Council was not engaged in a business within the restaurant classification because it actually sold indivisible, unitary "camping packages," and did not prepare food or provide food services. The court agreed, citing *City of Phoenix v. Arizona Rent-A-Car Systems, Inc.,* 182 Ariz. 75, 893 P.2d 75 (App.1995) and *State Tax Commission v. Holmes & Narver,* 113 Ariz. 165, 548 P.2d 1162 (1976).

Marriott argued that the three part *Holmes & Narver* test was inapplicable. The court disagreed. The court held that the Council's food service activities were an essential part of the Council's principal business activity of operating recreational and educational camps. The Boy Scouts at the Council's camps could not readily participate in the camping experience without the availability of food. These camps could not operate without a food service. The Council's arranging for a third party to provide food for its camp attendees did not alter the purpose of the Council nor transform it into a dining hall or lunch room for tax purposes. The Council hired Marriott precisely so the Council could avoid running a food service.

City Of Phoenix, v. Arizona Rent-A-Car Systems, Inc., 182 Ariz. 75, 893 P.2d 75 (1995) applied the *Holmes & Narver* test to the personal property classification. The case involved the question whether refueling charges paid by automobile rental company customers who returned rental cars with less than full tanks of gasoline were an integral part of the car rental business, and therefore, were taxable as gross income from car rental business for purposes of city's privilege tax. Budget argued that the refueling charge was an exempt sale of gasoline and that the refueling charge was a separate transaction from the car rental and not an integral part of it.

The court used the *Holmes & Narver* test for determining whether activities conducted during the course of taxpayer's business are taxable. The court held that although the refueling charges were easily calculated, refueling charges were inconsequential since they accounted for only about two percent of the company's gross income, and the refueling charges were integral to the car rental business since they were a built-in condition of every car rental contract even though approximately 90% of the cars were returned with full gas tanks.

The most recent case addressing the *Holmes & Narver* test is *Walden Books Company, v. Arizona Department Of Revenue,* 198 Ariz. 584, 12 P.3d 809 (2000). Walden is a book retailer who began offering a Preferred Reader Program to customers for a ten dollar annual fee. The court applied the *Holmes & Narver* test to determine that Waldenbooks' membership fees attributable to the discount component of the Program constituted part of

its gross income from the retail sales business.

Taxpayer here argues that receipts from design services should be excluded from the tax base because the receipts were separately identified. A similar argument was rejected by the court in *Walden.* 198 Ariz. at 588, 12 P.3d at 813. The court therefore applied the *Holmes & Narver* test to determine whether Walden's receipts from the Preferred Reader Program were receipts from Walden's retail business. The court did note that the *Holmes & Narver* test is not applicable in determining whether a statutory exclusion applied.

The prime contracting statute involved here does not include a specific exclusion for receipts from services such as design. The *Holmes & Narver* test is therefore applicable in this case for determining whether Taxpayer's design fees constitute part of its gross income from the prime contracting business. *Walden*, 198 Ariz. at 587, 12 P.3d at 812. The *Holmes & Narver* test helps identify the nature of the parties' business activities. *Marriott,* 189 Ariz. at 178, 939 P.2d at 811. It helps answer the question whether the receipts sought to be included in the taxable base came from Taxpayer's principal business, or a separate line of business that would be taxed, or not taxed, on its own merits.

Taxpayer argues in the alternative that even under the *Holmes & Narver* test the design fees should be excluded from its prime contracting tax base. The court in *Walden* found that Walden failed the *Holmes & Narver* test since the total Program membership fees amounted to an inconsequential 1.09% of Walden's total Arizona sales for the audit period and Walden's sales of discount purchase rights were incidental or "integral" to Waldenbooks' retail sales business. The discount component of the Program was functionless standing alone. *Walden*, 198 Ariz. at 588, 12 P.3d at 813.

Similarly, the *Holmes & Narver* test indicates that Taxpayer's design fees came from its prime contracting business. The design fees were inconsequential in relation to its total taxable Arizona business. The percentage of the design work to the total contract is less than 6 percent in each instance. Taxpayer's calculated percentage of approximately 12% was based on a comparison of the design fees to the contract amount received during the

audit period, not the total contract amount. Audit periods are usually determined by the date an assessment is issued. While activities during an audit period can accurately represent a taxpayer's total Arizona business, here the assessment was based on one construction project. The receipts during the audit period fairly reflected the ratio of Taxpayer's design receipts to its total activities in Arizona. Taxpayer received 62% of the total design receipts during the audit period while receiving only 29% contracting receipts during the audit period. Therefore, in this case, the total contract amount more accurately represents the ratio of Taxpayer's design fees to its total Arizona business.

The courts have not established a threshold percentage at which point the amounts are no longer considered inconsequential. In *Holmes & Narver,* the court considered design fees of 43% to be significant. By contrast, the percentage found by the court to be inconsequential in *Arizona Rent-A-Car Systems, Inc.* was approximately 2%. A percentage of less than 6% suggests that Taxpayer was not engaged in a separate design business.

This conclusion is bolstered by looking at the third prong of the *Holmes & Narver* test, were the design services incidental to Taxpayer's contracting activity. In *Holmes & Narver*, the court clearly found that the taxpayer's business was two-fold, design and engineering on one hand, and construction on the other. 113 Ariz. at 169, 548 P.2d at 1166. Taxpayer in this case was not otherwise engaged in the architectural design business. Arranging for architectural firms to provide the design service did not transform Taxpayer into a design firm. Taxpayer did not provide separate design services. Taxpayer hired the architectural firms so it could avoid running an architectural design firm. *The Marriott Corporation and Marriott Management Services Corp. v. State Of Arizona, Ex Rel. Arizona Department Of Revenue,* 189 Ariz. at 178, 939 P.2d at 811.

Taxpayer also relied on *Dennis Development Co. v. Arizona Department of Revenue*, 122 Ariz. 465, 595 P.2d 1010 (App. 1979) for the proposition that some activities may be nontaxable even if a person is engaged in an otherwise taxable activity. That is an accurate statement of the law. However, *Dennis* did not cite *Holmes & Narver,* and did not consider the *Holmes & Narver* test. The court's more recent decisions in *Arizona Rent-A-Car Systems* and *Walden* specifically addressed when the activities of a person may be

nontaxable even if the person is engaged in an otherwise taxable activity. As discussed above, these cases support the position that Taxpayer did not have a separate design business.

Finally, Taxpayer seeks an abatement of the late filing and late payment penalties that were imposed by the Division. The penalties were imposed under A.R.S. § 42-1125(A) and (D). Those subsections provide that the late filing and payment penalties may be abated only upon a showing by the taxpayer that the failure was due to reasonable cause and not due to wilful neglect. A.R.S. § 42-1125(S) further provides that with respect to transaction privilege taxes, "reasonable cause" means a reasonable basis for the taxpayer to believe that the tax did not apply to the business activity.

Taxpayer, is a [REDACTED] corporation that did not have much knowledge about Arizona transaction privilege tax before these two projects. While Taxpayer's [REDACTED] acknowledged that he was aware of Taxpayer's responsibility to file returns, he let them "sit on his desk" because he was involved in other tax issues on the federal level and because he was confused about the transaction privilege tax. The record shows willful neglect by Taxpayer. Taxpayer knew its duties, but put off compliance. The returns sat on Taxpayer's [REDACTED] desk for many months while he was occupied with other matters. The penalties were therefore properly imposed.

O R D E R

The Administrative Law Judge's decision is reversed to the extent it held that Taxpayer's receipts for architectural engineering and design fees were not subject to the transaction privilege tax under the prime contracting classification.

The Administrative Law Judge's decision is upheld regarding the imposition of the late filing and late payment penalties.

This decision is the final order of the Department of Revenue. Taxpayer may contest the final order of the Department in one of two manners. Taxpayer may file an appeal to the State Board of Tax Appeals, 100 North 15th Avenue, Suite 140 Phoenix, AZ 85007 or may

bring an action in Tax Court (125 West Washington, Phoenix, Arizona 85003) within sixty (60) days of the receipt of this order. For appeal forms and other information from the Board of Tax Appeals, call (602) 364-1102. For information from the Tax Court, call (602) 506-3763.

Dated this 26th day of November, 2003.

ARIZONA DEPARTMENT OF REVENUE

J. Elliott Hibbs
Director