STATE OF ARIZONA

Department of Revenue
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CERTIFIED MAIL [redacted]

The Director's Review of the Decision of the Administrative Law Judge Regarding:	)	**O R D E R**
[redacted] [redacted],	)	**Case No. 200500180-S**
ID No. [redacted]	)	

On February 27, 2006, the Administrative Law Judge issued a decision regarding the protest of [redacted] ("Taxpayer"). Taxpayer appealed this decision on March 28, 2006. As the appeal was timely, the Director of the Department of Revenue ("Director") issued a notice 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 Transaction Privilege and Use Tax Audit Section of the Audit Division ("Division") issued a deficiency assessment to Taxpayer for the periods October 1999 through October 2003. The Division first determined that Taxpayer was liable for use tax on the basic equipment Taxpayer had purchased tax-free and installed in subscribers' homes at no charge, on the theory that Taxpayer was removing items from its inventory of equipment. After Taxpayer protested and an informal conference was held, the Division amended its original assessment by changing the liability from use tax to transaction privilege tax under the prime contracting classification. The Division concluded that all of Taxpayer's receipts from installations performed by Taxpayer in Arizona were taxable under the prime contracting classification. After the Amended Assessment was issued, Taxpayer protested and, after a formal hearing, the Administrative Law Judge denied the protest.

On appeal, Taxpayer argues the monitoring contracts are separate from its sales and installation contracts and that no one in its business pays tax on the monitoring revenues.

Findings of Fact

The Director adopts and incorporates into this order from the findings of fact set forth in the decision of the Administrative Law Judge and makes additional findings, as follows:

1. Taxpayer is an Arizona corporation which sells and installs residential security alarm systems and monitoring service contracts.

2. Taxpayer holds a Registrar of Contractors ("ROC") license allowing it to install and repair low voltage alarm, intercom, telephone, call, clock and televisions systems, including towers and antennas.

3. When customers purchase an alarm security system, they execute two agreements with Taxpayer. The first is a sales and installation agreement in which the customer purchases a basic system along with its installation both at no cost or in which the purchaser purchases upgraded equipment with installation at an extra charge. The second agreement is an alarm monitoring agreement for a (two or) three year 24-hour monitoring service at a set cost per month, with a lifetime service trip fee and with any activation fees.

5. The basic alarm system equipment kit has a wholesale value of $[redacted] and a wireless alarm system kit is valued at approximately $[redacted]. Taxpayer purchased the equipment used in the alarm systems tax-free.

6. The average labor cost to install the basic kit is approximately $[redacted] and the average labor cost to install a wireless kit is approximately $[redacted].

7. In a separate contract Taxpayer "sells" the alarm monitoring service contract to $[redacted] ("[redacted]"), a [redacted] alarm monitoring company and gives [redacted] the first right of refusal to purchase the monitoring contracts.

8. The contract between Taxpayer and [redacted] did not give [redacted] the right to supervise, control or direct the installation activities. The contract also provides that Taxpayer "relinquished title to and ownership of" the installed equipment to [redacted].

However, Taxpayer's contract with [redacted] states that neither party attributes any value to the equipment conveyed (by Taxpayer) to the subscriber.

9. At the time of installation, the purchaser/new subscriber pays Taxpayer for any upgraded equipment, any activation fee, and the first month of the alarm monitoring service; all remaining monthly payments for the alarm monitoring service are paid to [redacted].

10. According to their contractual agreement, [redacted] pays Taxpayer for transferring the monitoring service contract to [redacted]. The amount of payment is [redacted] to [redacted] times the monthly monitoring contract payment amount; an average payment from [redacted] to Taxpayer was [redacted] times a typical monthly amount of approximately $[redacted] to $[redacted].[1]

11. According to the contract with the purchasers, Taxpayer is required to provide one year of warranty service on the alarm security system. Typically, [redacted] provided the repair or replacement equipment and paid Taxpayer $[redacted] for the warranty repair service.

12. According to the agreement with [redacted], [redacted] had a right of first refusal to buy any monitoring contract Taxpayer obtains with a subscriber. In addition, Taxpayer agreed not to engage in the alarm business or otherwise transfer or originate for others any monitoring contracts.

13. Taxpayer does not claim that it actually performed any monitoring.

14. Taxpayer reported its proceeds to the Department under the prime contracting classification, but deducted the first month's alarm service payment, any activation fees, and the monitoring service contract payments from [redacted], paying the transaction privilege tax only on the proceeds from the installation of the upgraded equipment.

15. The Division audited Taxpayer for the periods October 1999 through October 2003. The Division first assessed Taxpayer for a use tax deficiency, and then on April 5,

[1] The differential in the "number" of the monthly payments which comprise this payment from [redacted] relates to the credit worthiness of the customer and the projected likelihood of no default and the customer's completion of the entire contract with [redacted].

2005, the Division issued its Amended Assessment based on a deficiency of Arizona prime contracting transaction privilege tax and interest instead of use tax. The Amended Assessment resulted in $[redacted] of tax due and $[redacted] of (updated) interest; the penalties were abated. Taxpayer protested the Amended Assessment.

16. While the increased gross receipts under and higher tax rate of the prime contracting classification would have resulted in an assessment greater than the original assessment, the Division did not increase the amount of the assessment in accordance with A.R.S. § 42-2059(B).

Conclusions of Law

The Director adopts and incorporates into this order from the conclusions of law set forth in the decision of the Administrative Law Judge and makes additional conclusions, as follows:

1. Taxpayer's activity of installing security alarm systems falls within the definition of prime contracting under A.R.S. § 42-5075 and A.A.C. R15-5-615.

2. All gross proceeds of sales and gross income derived by a person from business activity classified under a taxable business classification is presumed to comprise the tax base for the business until the contrary is established. A.R.S. § 42-5023.

3. Transaction privilege tax is to be measured by all of the business activity of the taxpayer rather than merely a part of it. *Duhame* v. *State Tax Commission*, 65 Ariz. 268, 179 P.2d 252 (1947).

4. While taxpayers may have more than one business, "[i]f 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 v. State Tax Commission,* 79 Ariz. 293, 297, 288 P.2d 782 (1955).

5. Income from services that may be concededly non-taxable if carried on by a business that is not otherwise taxable under a taxable classification may be a part of a taxpayer's gross income from a taxable activity that is the basis of the taxpayer's principal

activity. *Walden Books Company v. Arizona Department of Revenue,* 198 Ariz. 584, 12 P.3d 809 (2000).

6. The monitoring contracts are so interwoven with Taxpayer's prime contracting activities as to be an integral part of or incidental to its prime contracting business.

7. Taxpayer failed to establish a separate business of monitoring.

8. Taxpayer asserted it was an exempt subcontractor; however, exemptions from tax are to be narrowly construed against the exemption. *Kitchell Contractors* v. *City of Phoenix,* 151 Ariz. 139, 144, 726 P.2d 236 (App. 1986). A taxpayer must satisfy the burden of overcoming strict construction against an exemption. *Meredith Corporation* v. *State Tax Commission*, 23 Ariz. App. 152, 531 P.2d 197 (1975).

9. Subcontractors are not subject to tax if they can demonstrate that the project was within the control of a prime contractor who is liable for the taxes on the gross proceeds from the job from which the subcontractors were paid. A.R.S. § 42-5075(D).

10. The contracting activity or projects, installation of the monitoring equipment, were not in [redacted] control because [redacted] did not have contracts with the customers relating to the installation and the contract between Taxpayer and [redacted] did not give [redacted] the right to supervise, control or direct the installation activities.

12. [redacted] could not have liability for taxes on the gross proceeds from the jobs because [redacted] was not entitled to and received no proceeds from the contract for the transfer and installation of the security equipment.

13. Taxpayer failed to meet the requirements for the subcontracting exemption.

14. Taxpayer is subject to tax for all its receipts under the prime contracting classification as ruled by the Administrative Law Judge.

Discussion

Arizona imposes a privilege tax on persons engaging in certain businesses in the state. The tax is measured under A.R.S. § 42-5008 by the gross proceeds of sales or gross income arising from such business activities. A.R.S. § 42-5075 imposes a transaction privilege tax on 65% of the gross proceeds from the business of prime contracting. A.R.S. § 42-5075(K)(6) defines "prime contractor" to be the "contractor who supervises, performs or coordinates the construction, alteration, repair, addition, subtraction, improvement, movement, wreckage or demolition of any building…" A.R.S. § 42-5075(K)(2) defines "contractor" to include "a person, firm … or other organization … that undertakes to or offers to undertake to …construct, alter, repair, add to, subtract from, improve, move, wreck or demolish any building…"

Installation of a security system is the alteration of a building and constitutes contracting. A.A.C. R15-5-615 states that "…communication, intercommunication, and security alarm systems installed in a structure by a contractor are taxable." Taxpayer correctly reported its revenues under the prime contracting classification. However, Taxpayer maintains that not all of its proceeds should be taxed.

Taxpayer deducted certain proceeds as subcontracting receipts, exempt under A.R.S. § 42-5075(D). In addition, Taxpayer has argued that its receipts from the first month's alarm service payment, any activation fees paid by the customers and the monitoring service contract payments from [redacted] are from interstate telecommunications and should not be taxed.

A person's gross receipts are presumed to be the tax base for the business until the contrary is established by the taxpayer. A.R.S. § 42-5023. Taxpayer admittedly has a business of prime contracting. Taxpayer's argument that the monitoring revenues are exempt interstate telecommunications suggests that it has a second, non-taxable telecommunication business.

Separate Business

The Arizona Supreme Count in *Duhame* v. *State Tax Commission*, supra, held that the privilege tax is to be measured by all of the business activity of the taxpayer rather than merely a part of it. However, the Court later found that a person's activities may constitute more than one business and the taxpayer will be obligated to pay the appropriate tax on each business. *Trico Electric Cooperative v. State Tax Commission,* supra. The Court stated that "[i]f 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,* 79 Ariz. at 297.

In 1976, the Arizona Supreme Court again addressed this principle in *Holmes & Narver,* 113 Ariz. 165, 548 P.2d 1162 (1976) (en banc). After stating that not all business is the subject of the transaction privilege tax, only those businesses specifically set forth in the statutes, the Court set forth the following three-part test to determine when a service is not part of the major business: (1) the portion of the business that is the service in issue can be readily ascertained without substantial difficulty; (2) the revenues from the service, in relation to the taxable revenues of the business, are not inconsequential; and (3) the service cannot be said to be incidental to the other taxable activity.

In 1995 the Arizona Court of Appeals explained the Holmes & Narver test noting "when the amount involved is not minimal, when it can be easily calculated, and when the service it relates to is not an integral part of the main business, the main and ancillary services can be separated for tax purposes." *City of Phoenix* v. *Arizona Rent-A-Car Systems,* 182 Ariz. 75, 78, 548 P.2d 1162 (App. 1995). The Court determined that income from concededly non-taxable activity (the sale of gasoline) was part of the rental of personal property tax base under the City of Phoenix tax code. The Court held,

> In summary, we conclude that because every Budget car rental contract includes a refueling charge, the charge is an integral part of Budget's car rental business. Because most customers return with a full gas tank, thus avoiding the refueling charge, the charge accounts for a minimal percentage

> of Budget's car rental business. Accordingly, refueling charges paid to Budget are taxable as gross income from the car rental business.

Arizona Rent-A- Car, 182 Ariz. 79.

By contract, [redacted] had a right of first refusal to buy any monitoring contract Taxpayer obtains with a customer. Furthermore, Taxpayer agreed not to engage in the alarm business or otherwise transfer monitoring contracts to others or originate any monitoring contracts for others. Taxpayer has not alleged that it actually performed any monitoring. Taxpayer provided and installed equipment. Taxpayer entered into contracts to provide monitoring service to its customer, but [redacted] actually provided the service. While the customer gave Taxpayer a payment which was designated as for the first month's monitoring service and [redacted] paid Taxpayer based on the monthly monitoring service fee to be paid by the customer, it is clear Taxpayer would not have received these "monitoring" proceeds if it had not performed contracting activity by installing the equipment. Taxpayer's expertise in installation was why [redacted] entered into its contract with Taxpayer. The monitoring contracts are interwoven in and an integral part of Taxpayer's prime contracting business. Taxpayer fails to meet its burden to show a part of its receipts are from a separate non-taxable business.

Income from services that may be concededly non-taxable if carried on by a business that is not otherwise taxable under a taxable classification may be a part of a taxpayer's gross income from a taxable activity that is the basis of the taxpayer's principal activity. *Walden Books Company v. Arizona Department of Revenue,* 198 Ariz. 584, 12 P.3d 809 (2000). There being only one business, all proceeds are taxable under the primary contracting classification, unless Taxpayer qualifies for a specific exemption.

Subcontracting exemption

Taxpayer actually reported all its gross receipts as prime contracting. However, Taxpayer deducted the payments from [redacted] as exempt subcontracting income. Exemptions from tax are to be narrowly construed against the exemption. *Kitchell Contractors* v. *City of*

Phoenix, supra. A taxpayer must satisfy the burden of overcoming strict construction against an exemption. *Meredith Corporation* v. *State Tax Commission*, supra.

Subcontractors are not subject to tax if they can demonstrate that the project was within the control of a prime contractor who is liable for the taxes on the gross proceeds from the job from which the subcontractors were paid. A.R.S. § 42-5075(D). Taxpayer must show that the two requirements of this exemption have been met to qualify for the subcontracting exemption.

First, the projects must be in control of a prime contractor. The projects, the installation of security systems, were not in [redacted] control. As the Division points out, [redacted] did not have contracts with the customers relating to the installation and the contract between Taxpayer and [redacted] did not give [redacted] the right to supervise, control or direct the installation activities. Second, a prime contractor must be liable for taxes on the gross proceeds from the job. [redacted] received no proceeds from the contract for the transfer and installation of the security equipment. The Administrative Law Judge correctly concluded that Taxpayer met neither of the two requirements for the subcontracting exemption.

Taxpayer is engaged in prime contracting. A person's gross receipts are presumed to be the tax base for the business until the contrary is established by the taxpayer. Taxpayer has not established the contrary with regard to the "monitoring" proceeds. The Administrative Law Judge correctly denied Taxpayer's protest.

O R D E R

The Administrative Law Judge's decision is affirmed.

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 9th day of July 2007.

ARIZONA DEPARTMENT OF REVENUE

Gale Garriott
Director

Certified original of the foregoing
mailed to:

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GG:st

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