STATE OF ARIZONA

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

CERTIFIED MAIL [REDACTED]

Janet Napolitano
Governor

Gale Garriott
Director

The Director's Review of the Decision of the Administrative Law Judge Regarding:	)	**O R D E R**
[REDACTED]	)	**No. 200700012-S**
	)	**No. 200700014-S**
	)	**No. 200700016-S**
	)	**No. 200700017-S**
	)	**No. 200700018-S**
	)	**No. 200700019-S**
	)	**No. 200700021-S**
	)	**No. 200700022-S**
	)	**No. 200700045-S**

On January 4, 2008, the Administrative Law Judge issued a decision regarding the protest of [REDACTED] and its affiliated entities captioned above (collectively referred to as "Taxpayers"). Taxpayers timely appealed this decision. 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 the memoranda filed by the parties and now issues this order.

Statement of Case

Taxpayers hired two off-site contractors, [REDACTED] and [REDACTED] to improve roads and install water pipes, storm drains and sewer pipes. Taxpayers issued Form 5005 prime contracting exemption certificates ("Certificates") to [REDACTED] and [REDACTED] for these projects. The Transaction Privilege and Use Tax Audit Section of the Audit Division ("Division") issued two sets of proposed deficiency assessments to Taxpayers for additional transaction privilege tax due based on these exemption certificates. Taxpayers protested the assessments, and the Administrative Law Judge denied the protests. On appeal, Taxpayers argue that they were the prime contractors and already paid the transaction privilege tax. Additionally, Taxpayers argued that A.R.S. § 42-2059 prohibits the Department from issuing a second assessment and that the second set of assessments were untimely.

FINDINGS OF FACT

The Director adopts from the findings of fact of the Decision of the Administrative Law Judge and makes additional findings as follows:

1. The [REDACTED]s are in the business of developing and building residential subdivisions in the [REDACTED], Arizona area.

2. The [REDACTED]s created a multi-entity structure for developing each subdivision.

3. Each subdivision's multi-entity structure consists of three affiliated entities: a Development arm, a Construction arm, and a Sales arm.

4. Taxpayers are the Development arms of eight subdivisions: [REDACTED].

5. Taxpayers owned the real property in these subdivisions on which homes were built and on which off-site improvements were made.

6. Taxpayers contracted with [REDACTED] to build streets and roads and with [REDACTED] to install water pipes, storm drains and sewer pipes on the unimproved land. Taxpayers paid [REDACTED] and [REDACTED] (collectively "Off-site Contractors") for completing these off-site improvements.

7. Taxpayers contracted with the Construction arms to build the homes.

8. Taxpayers sold the homes to the Sales arms when the homes were completed.

9. Taxpayers reported and paid the transaction privilege tax on the sale price of the completed homes to the Sales arms.

10. The construction and sale of the homes by the Taxpayers were governed by a rolling option agreement with the Sales arm for each subdivision.

11. The rolling option agreement stated that the off-site improvements were already completed.

12. The property on which the off-site improvements were constructed was not sold to the Sales arms.

13. The rolling option agreement provided that within ten days after the option on a lot was exercised the Sales arms will deliver to the Taxpayers the plans and specifications for the dwelling to be constructed on the lot designated in the notice of exercising the option.

14. The Sales arms sold the completed homes to the private homebuyer.

15. Taxpayers were not responsible under contract to any party for the completion of the off-site improvements.

16. The Taxpayers issued Form 5005 exemption certificates to [REDACTED] between [REDACTED].

17. After auditing Taxpayers the Division in [REDACTED], issued proposed assessments under A.R.S. § 42-1108 ("[REDACTED] Assessments") to Taxpayers for the amount of [REDACTED]'s tax liability for the projects covered in the Certificates issued by Taxpayers.

18. Taxpayers timely filed protests to the [REDACTED] Assessments and in February [REDACTED], filed supplemental protests.

19. While these matters were in informal status, the Division audited [REDACTED]'s activities.

20. Taxpayer [REDACTED]'s issued a Certificate to [REDACTED] on November 29, [REDACTED], effective from [REDACTED]. The remaining Taxpayers issued Certificates to [REDACTED] on [REDACTED].

21. [REDACTED] executed a Waiver of Confidentiality to the Department for the documentation related to the work performed for Taxpayers and the Certificates from Taxpayers.

22. These Certificates were issued to [REDACTED] approximately two years after the last of [REDACTED]'s work had been completed, after payments to [REDACTED] had been made and after the Department audited the Taxpayers.

23. The Division determined that in issuing the Certificates to [REDACTED], the Taxpayers assumed [REDACTED]'s prime contracting transaction privilege tax liabilities for certain tax periods. As a result, and pursuant to A.R.S. § 42-1109(B), the Division issued Demand to File Supplemental Return letters to Taxpayers.

24. Taxpayers did not supplement their returns, so in September [REDACTED], the Division issued Notices of Proposed Assessments to Taxpayers under A.R.S. § 42-1109 for the amounts paid to [REDACTED] ("September [REDACTED] Assessments").

25. Taxpayers protested the September [REDACTED] Assessments, arguing, as they previously had for the [REDACTED] Assessments, that [REDACTED] was an exempt subcontractor, as defined by A.R.S. § 42-5075(D), and that Taxpayers already paid the transaction privilege tax. Taxpayers also protested that the September [REDACTED] Assessments were issued outside the statute of limitations under A.R.S. § 42-1104(A).

26. Taxpayer requested abatement of interest pursuant to A.R.S. § 42-2065 for unreasonable error or delay on the part of the Department, but the Department's Problem Resolution Officer denied the request in a separate review.

CONCLUSIONS OF LAW

The Director adopts from the conclusions of law of the decision of the Administrative Law Judge and makes additional conclusions as follows:

1. The transaction privilege tax is levied on the privilege of engaging in business in Arizona, measured by the income from the taxable activity. *Arizona State Tax Commission* v. *Southwest Kenworth, Inc.*, 114 Ariz. 433, 561 P.2d 757 (1977).

2. A.R.S. § 42-5075 imposes the transaction privilege tax on the business of prime contracting.

3. A.R.S. § 42-5075(G)(6) defines "prime contractor" as the "contractor who supervises, performs or coordinates the construction . . . and who is responsible for the completion of the contract." A.R.S. § 42-5075(G)(2) defines "contractor" to include "a person, firm or other organization … that undertakes to … or does personally or by or through others, construct, alter, repair, add to, subtract from … any … project, development or improvement, or to do any part of such a project …"

4. Building streets and roads and installing water pipes, storm drains and sewer pipes on unimproved land constitutes contracting under A.R.S. § 42-5075.

5. The tax base for prime contracting is 65% of the gross proceeds of sales or gross income from the business under A.R.S. § 42-5075(B). "Gross proceeds of sales" means "the value proceeding or accruing from the sale of tangible personal property *without any deduction on account of* the cost of property sold, *expense of any kind or losses*, but cash discounts allowed and taken on sales are not included as gross income." *See* A.R.S. § 42-5001(5), emphasis added here. "Gross income" means

"the gross receipts of a taxpayer derived from trade, business, commerce, or sales and the value proceeding or accruing from the sale of tangible personal property or service, or both, and without any deduction on account of losses." *See* A.R.S. § 42-5001(4).

6. A.R.S. § 42-5075(D) provides that subcontractors or others who perform services in respect to any improvement, building, highway, road, railroad, excavation, manufactured building or other structure, project, development or improvement are not subject to tax if they can demonstrate that the job was within the control of a prime contractor or contractors and that the prime contractor is liable for the tax on the gross income, gross proceeds of sales or gross receipts attributable to the job and from which the subcontractors or others were paid.

7. The jobs at issue involved the construction of off-site improvements consisting of building streets and roads and installing water pipes, storm drains and sewer pipes on unimproved land.

8. The Development arms (Taxpayers) were not prime contractors regarding the construction of the off-site improvements.

9. The Off-site Contractors were not exempt subcontractors pursuant to A.R.S. § 42-5075(D).

10. The Off-site Contractors were prime contractors for the off-site improvements at issue pursuant to A.R.S. § 42-5075.

11. A.R.S. § 42-5075(E) allows a contractor to exclude from its own prime contracting gross proceeds amounts it receives if the person who hired that contractor executes and provides a certificate "stating that the person providing the certificate is a prime contractor and is liable for the tax …" Further, the statute provides that "[i]f the person who provides the certificate is not liable for the tax as a prime contractor, that person is nevertheless *deemed* to be the prime contractor in lieu of the contractor

and is subject to the tax … on the gross receipts received by the contractor." Emphasis added.

12. By issuing the Certificates, the Taxpayers assumed the prime contracting transaction privilege tax liabilities of the Off-site Contractors.

13. Double taxation occurs when "the same property or person is taxed twice for the same purpose for the same taxing period by the same taxing authority." *Miami Copper Co. v. State Tax Commission*, 121 Ariz. 150, 589 P.2d 24 (App. 1978) quoting from *Milwaukee Motor Transportation Co. v Commissioner of Taxation*, 292 Minn., 66, 193 N.W.2d 605, 612 (1971).

14. Taxpayers cannot create double taxation by voluntarily assuming the liability of another person.

15. A.R.S. § 42-1104(A) provides that every notice of additional taxes found to be due is required to be mailed within four years after the return is required to be filed or within four years after the return is filed, whichever period expires later.

16. A cause of action accrues, and the statute of limitations commences, when one party is able to sue another. *Gust, Rosenfeld & Henderson v. Prudential Ins. Co. of America*, 182 Ariz. 586, 588, 898 P.2d 964, 966 (1995).

17. The liability at issue in this appeal is the liability Taxpayers assumed by issuing Certificates. Before Taxpayers assumed the liability, the Department did not have a cause of action against Taxpayers for the liability at issue.

18. The statute of limitations did not begin to run with respect to the Taxpayers' liabilities until Taxpayers became liable for the tax by voluntarily assuming the liability of the Off-site Contractors. Therefore all of the assessments were issued timely.

19. A.R.S. § 42-1108 allows the Department to issue deficiency assessments when a taxpayer fails to file a required return or when the Department is not satisfied with a return or payment of tax required to be paid. A.R.S. § 42-1109(B) provides that the

Department may, at any time, require a return or may make an estimate and propose to assess the amount of tax, penalties and interest if a person fails to file a return within fifteen days after a departmental written demand to do so. Additionally, an assessment of tax pursuant to A.R.S. § 42-1109(B) does not preclude a subsequent issuance of a deficiency assessment under A.R.S. § 42-1108.

20. A.R.S. § 42-2059(A) prevents the Department from conducting an additional audit once it has completed an audit and the deficiency has been completely determined unless (among other circumstances) a taxpayer has failed to disclose material information, has falsified books or records, or has otherwise engaged in an action that prevented the Department from conducting an accurate audit. A.R.S. § 42-2059(B) allows the Department to increase the amount of a proposed assessment when a taxpayer makes material misrepresentations, fails to disclose material facts or fails to provide information after a departmental request.

21. By not issuing the Certificates until after the Division issued the [REDACTED] Assessments, Taxpayers engaged in an action that prevented the Division from conducting and making an accurate audit finding. Therefore, the Division is not precluded from issuing the [REDACTED] demands and the September [REDACTED] Assessments.

22. A.R.S. § 42-1125(A) provides that if a taxpayer fails to file a return on or before the due date, a penalty "shall be added to the tax" unless the failure is due to reasonable cause and not due to willful neglect. Similarly, A.R.S. § 42-1125(D) provides that if person fails to pay the tax within the time prescribed, a penalty "shall be added to the amount shown as tax" unless the failure is due to reasonable cause and not due to willful neglect.

23. A.R.S. § 42-1125(S) defines reasonable cause as a reasonable basis for the taxpayer to believe that the tax did not apply to the business activity in this state.

24. Taxpayers have not shown that there was a reasonable basis to believe tax does not apply to the business activity at issue.

25. A.R.S. § 42-1123(C) provides that if the tax "or any portion of the tax" is not paid when due, "the department shall collect, as a part of the tax, interest upon the unpaid amount" until the tax has been paid. A.R.S. § 42-1123(A) provides that interest compounds annually. The interest portion of the assessment becomes a part of the tax under A.R.S. § 42-1123(B) and the entire principal amount continues to accrue interest until the liability is paid.

DISCUSSION

A.R.S. § 42-5075(E) allows a contractor to exclude from its prime contracting gross proceeds amounts it receives if the person who hired that contractor executes and provides a certificate "stating that the person providing the certificate is a prime contractor and is liable for the tax …" The Department has prescribed Form 5005 ("Certificate") as the certificate to be used under A.R.S. § 42-5075(E).

The facts demonstrate that Taxpayers executed and issued Certificates to the Off-site Contractors. As a matter of law when Taxpayers issued the Certificates they expressly assumed what would have been [REDACTED]'s and [REDACTED]'s prime contracting tax liability on monies received for the off-site contracting work performed. The question thus presented is whether the Off-site Contractors would have been liable for transaction privilege tax on the off-site work they performed for the Taxpayers had Taxpayers not provided the Certificates.

A.R.S. § 42-5075 imposes transaction privilege tax on the business of prime contracting. A.R.S. § 42-5075(G)(6) defines "prime contractor" as the "contractor who supervises, performs or coordinates the construction . . . and who is responsible for the completion of the contract."

Building streets and roads and installing water pipes, storm drains and sewer pipes on unimproved land constitutes contracting. The Off-site Contractors are subject to the transaction privilege tax unless they can demonstrate they were exempt subcontractors under A.R.S. § 42-5075(D).

Under subsection D, an exempt subcontractor is one who can demonstrate that the job was within the control of a prime contractor or contractors and that the prime contractor is liable for the tax on the gross income, gross proceeds of sales or gross receipts attributable to the job and from which the subcontractors or others were paid. With respect to the off-site contracting work, the job was not within the control of another prime contractor who was responsible for the transaction privilege tax.

The job at issue was the construction of off-site improvements consisting of building streets and roads and installing water pipes, storm drains and sewer pipes on unimproved land. The Taxpayers were not acting in the capacity of prime contractors regarding the off-site improvements at the time the off-site improvements were completed. The Taxpayers were not responsible for the completion of contracts requiring the installation of off-site improvements. Therefore, the Taxpayers did not fall within the definition of "prime contractor" in A.R.S. § 42-5075.

Prime contracting transaction privilege tax was due on the Off-site Contractors' taxable gross receipts. Having issued the Certificates, the Taxpayers assumed the Off-Site Contractors' liability for the prime contracting tax on the payments that Taxpayers made to the Off-site Contractors.

Taxpayers argued that there is only one source of funds (from the sale of the completed home to the Sales arms) from which the Off-site Contractors were paid. The subcontractor exemption contemplates a subcontractor who is working for a prime contractor under contract with an owner at the time the subcontractor performs its work. That was not the case here. While the costs associated with the off-site contracting work were later recouped by the Taxpayers in the sales of the individual completed homes, Taxpayers did not contract to complete off-site improvements. Furthermore, the land on which the off-site

improvements were made was not even transferred to the Sales arms and the home purchasers.

Imposing The Tax On The Off-site Contracting Does Not Result In Double Taxation.

Taxpayers have contended that imposing the tax on the off-site contracting results in double taxation. Double taxation occurs when "the same property or person is taxed twice for the same purpose for the same taxing period by the same taxing authority." *Miami Copper Co. v. State Tax Commission*, 121 Ariz. 150, 589 P.2d 24 (App. 1978) quoting from *Milwaukee Motor Transportation Co. v Commissioner of Taxation*, 292 Minn., 66, 193 N.W.2d 605, 612 (1971). In these cases, the same person is not being taxed twice for the same purpose or for the same period. The *liability* for contracting work performed by the Off-site Contractors is not the same liability as that of the Taxpayers on their prime contracting gross receipts from the sales of the completed homes to the Sales arm. Had Taxpayers not issued the Certificates, the tax on constructing the off-site improvements would have been paid by the Off-site Contractors. Taxpayers cannot create double taxation by voluntarily assuming the liability of another person.

The Assessments Resulting From Taxpayer Issuing Certificates Were Timely.

Taxpayers argue that some of the periods in the September [REDACTED] Assessments fall outside the statute of limitations. The argument is based on the erroneous premise that the statute of limitations started to run when [REDACTED] first became liable for the tax. However, as a general matter, a cause of action accrues, and the statute of limitations commences, when one party is able to sue another. *Gust, Rosenfeld & Henderson v. Prudential Ins. Co. of America*, 182 Ariz. 586, 588, 898 P.2d 964, 966 (1995). The liability at issue in this appeal is the liability Taxpayers assumed by issuing Certificates. Before Taxpayers assumed the liability, the Department did not have a cause of action against Taxpayers for the liability at issue. The statute of limitations did not begin to run until Taxpayers became liable for the tax by voluntarily assuming [REDACTED]'s liability. Therefore all of the assessments were issued timely.

A.R.S. § 42-2059 Did Not Bar The Assessments For The Assumed Liability.

Taxpayers argue that the September [REDACTED] Assessments that the Department issued under A.R.S. § 42-1109 were additional assessments and are precluded by A.R.S. § 42-2059. Taxpayers did not issue the Certificates until after the Division issued the [REDACTED] Assessments under A.R.S. § 42-1108. The Taxpayers had not yet assumed [REDACTED]'s tax liability.

A.R.S. § 42-2059(A)(4) provides an exception where the taxpayer engages in an action that prevents the Division from conducting and making an accurate audit. By not issuing the Certificates until after the Division issued the [REDACTED] Assessments, Taxpayers engaged in an action that prevented the Division from conducting and making an accurate audit finding. Therefore, A.R.S. § 42-2059 does not preclude the Division from making the [REDACTED] demands and the September [REDACTED] Assessments.

Taxpayers Have Not Shown Reasonable Cause For Penalty Abatement.

Taxpayers requested penalty abatement based on their belief that the Off-site Contractors were exempt subcontractors. Penalties may be abated if the failure to timely comply is due to reasonable cause and not willful neglect. "Reasonable cause" is generally defined to mean the exercise of "ordinary business care and prudence." *Daley v. United States,* 480 F. Supp. 808 (D.N.D. 1979). In addition, A.R.S. § 42-1125(S) (now subsection (V)) provides that "reasonable cause" means a reasonable basis for the taxpayer to believe that the tax did not apply to the business activity in this state. Taxpayers have not presented reasonable cause for the abatement of the penalties.

Taxpayers' Request For Interest Abatement Is Not Appropriate In This Appeal.

Based on A.R.S. § 42-2065, the Taxpayers requested that the Department abate interest due to the Division's unreasonable delay in handling the [REDACTED] Assessments. Taxpayers base this request solely on the fact that over 4 years transpired between date of Taxpayer's request for a formal hearing and the date when the hearing was scheduled. As the Division points out, there are many factors to consider in determining whether there

was unreasonable delay. In a separate action the Department's Problem Resolution Officer reviewed these factors, made a decision to deny the request and forwarded that determination to Taxpayers.

O R D E R

The Administrative Law Judge's decision is affirmed.

This decision is the final order of the Department of Revenue. Taxpayers may contest the final order of the Department in one of two manners. Taxpayers 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 8 day of September, 2008.

ARIZONA DEPARTMENT OF REVENUE

Gale Garriott
Director

Certified original of the foregoing mailed to:

[REDACTED]

Copy of the foregoing mailed to:

[REDACTED]

Cc: Audit Division
Transaction Privilege Tax Audit Section
Transaction Privilege Tax Appeals Section

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