

PRIVATE TAXPAYER RULING LR02-002

February 21, 2002

The following private taxpayer ruling is in response to your request of March 5, 2001, as amended by your letter of October 8th. Your letter requests a ruling regarding the taxability of activities engaged in by . . . in connection with the construction of a multi-conduit fiber optic cable network. Specifically, you question:

1. Is . . . subject to tax as a prime contractor?
2. If . . . is a prime contractor, what is the tax base? Is it 65% of the management fees that . . . receives for acting as the lead joint build participant?

Statement of Facts:

The following is a restatement of the facts presented in your request.

. . . is a regulated telecommunications carrier that provides local and long distance telecommunications services to business customers located within Arizona. . . . remits Arizona transaction privilege tax under the telecommunications classification. . . . also provides similar telecommunications services throughout the United States. . . . is currently constructing (through contractors) an international, multi-conduit network (Network). (Conduit is the insulating material used to bundle and protect the fiber optic cable that subsequently will be installed and utilized by The fiber optic cable can be removed for repair or replacement purposes without causing damages to the conduit.)

The Network will enable . . . to install fiber optic cable and other transmission media which will be used to provide telecommunications services. As new and more cost effective fiber optic cable and other carrier equipment become available, the Network is designed to allow . . . to easily remove and replace the fiber optic cable and other carrier equipment previously installed.

To facilitate construction of the Network, . . . has entered into cost sharing agreements (Agreements) with other telecommunications service providers (Joint Build Participants) in order to construct certain segments of the Network within Arizona. (Several municipalities in Arizona require telecommunications carriers to work jointly or in cooperation with one another in the installation of their underground facilities to avoid excessive disruption along city thoroughfares.) Pursuant to the Agreements, separate facilities (i.e., fiber optic cable, lines pedestals ducts, conduit, access points, boxes and associated equipment, devices and hardware which are owned or designated for particular Joint Build Participants) will be installed for . . . and each of the Joint Build Participants. However, fiber optic cable and other transmission media are outside the scope of the Agreements. Individual Joint Build

Participants generally provide those items. . . . and each of the Joint Build Participants own their separate and respective facilities.

In the Agreements, the Joint Build Participants and . . . have agreed that . . . should act as the lead carrier for the Work. The Work involves the installation of underground conduits and manholes (access points to the Network). Pursuant to the Agreements, . . . is "responsible" to the Joint Build Participants for all necessary installation, management, engineering, placement, and preparation required for the Work. However, . . . does not engage in any construction activities. The contractor Level 3 hired is responsible for completion of all construction activities. Thus, . . .'s actual activities include: hiring the contractor who is responsible to perform the Work, supplying its own materials (Joint Build Participants generally are responsible for supplying their own materials), paying the contractor, and testing the end product to ensure that the system meets specific pre-defined industry standards. The contractor that . . . hired is responsible for selecting, hiring, supervising and paying all subcontractors. . . . is required to pay the contractor it hired whether or not . . . gets reimbursed by Joint Build Participants.

In exchange for acting as lead carrier, . . . receives a management fee from the Joint Build Participants. Although the contract states that the management fee is "compensation for the management and supervision of the Work," the true business purpose for the management fee is to compensate . . . for its role in hiring and interacting with, as a construction manager or owner's representative, the contractor and for other overhead expenses which increase due to the participation of Joint Build Participants. In addition to the management fee, the Agreements allow . . . to recover from each of the Joint Build Participants their respective share of the costs associated with the Work (i.e., for their separate facilities).

Your Position:

The contractor hired by . . . to provide construction services is the prime contractor for purposes of Arizona's transaction privilege tax because it is responsible to . . . for completion of the construction and it selected, hired, supervised and paid all subcontractors from its taxable gross proceeds. While . . . is "responsible" to the Joint Build Participants for the Work, it is not a prime contractor for purposes of the transaction privilege tax because it is not a contractor.

. . . is not a "contractor" as that term is defined in Arizona Revised Statutes (A.R.S.) § 42-5075 (H)(2). Rather, . . . is merely a construction manager/owner's agent. . . . does not perform, coordinate or supervise any of the actual construction activity, nor does it select, hire, supervise or pay subcontractors - the contractor it hired is responsible for all of those activities. While . . . does test the final product, product testing is customary for owners. . . . does not hold itself out as a contractor -- it is and holds itself out as a telecommunications company. Clearly, . . . is not a prime contractor and its proceeds as a construction manager are not

subject to Arizona's transaction privilege tax.

This rationale is consistent with Arizona Administrative Code (A.A.C.) R15-5-602(C)(1), which provides, in pertinent part, that: "A subcontractor is considered to be a prime contractor, and therefore liable for the tax, if . . . work is performed for and payments are received from an owner . . ." The contractor . . . hired worked for and received payments from . . . as *an owner* of its facilities. Accordingly, the contractor . . . hired is the prime contractor for purposes of Arizona's transaction privilege tax.

Under normal circumstances, each Joint Build Participant, as an owner of the underground facilities, would contract directly with a local contractor who obviously would be the prime contractor for transaction privilege tax purposes. However, in the present case, in part because of the requirements imposed by local jurisdictions to minimize disruption along thoroughfares, . . . contracted directly with the prime contractor on the behalf of all Joint Build Participants. This does not change the fact that . . . and the Joint Build Participants are owners of their respective underground facilities, and, therefore should be treated as such.

While . . . is an owner, it sometimes acts as a construction manager/owner's agent for its Joint Build Participants. On other occasions which are beyond the scope of this private letter ruling request, . . . is an owner in joint build projects but does not assume the role of construction manager/owner's agent. *Black's Law Dictionary* summarizes the concept of agency by referring to the definition of agency in section one of the American Law Institute's Restatement of the Law, Second, Agency, which provides: "Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act".

The contracts between . . . and the various Joint Build Participants establish . . .'s role as agent of, or construction manager for, the various Joint Build Participants. They clearly demonstrate the three elements of a valid agency relationship summarized above, namely: (1) Manifestation of consent by one person to another that the other shall act on his behalf, (2) Subject to his control, and (3) Consent by the other so to act. For example, the contracts provide that (1) . . . shall act on behalf of Joint Build Participants as "Lead Company" responsible for administering particular Joint Build Agreements, (2) the Joint Build Participants retain the authority (control) to approve plans, approve acceptance testing, approve changes, and intervene if . . . fails to comply with any provisions of the contracts relating to the character or time of performance, and (3) . . . consented to act as "Lead Company".

As agent of, or construction manager for, the various Joint Build Participants, . . . is not subject to tax as a prime contractor for management fees it receives from the Joint Build Participants.

Applicable Statutory Provisions:

A.R.S. § 42-5008 levies a transaction privilege tax measured by the amount or volume of business transacted by persons on account of their business activities.

A.R.S. § 42-5001(1) states that "business" includes all activities or acts, personal or corporate, engaged in or caused to be engaged in with the object of gain, benefit or advantage, either directly or indirectly, but not casual activities or sales.

A.R.S. § 42-5075 levies the transaction privilege tax on the business of prime contracting. The tax base for the prime contracting classification is 65% of the gross proceeds of sales or gross income derived from the business.

A.R.S. § 42-5075(D) provides that subcontractors are not subject to tax if they can demonstrate that the job was within the control of a prime contractor 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 subcontractor was paid.

A.R.S. § 42-5075(H)(2) states:

"Contractor" is synonymous with the term "builder" and means any person, firm, partnership, corporation, association or other organization, or a combination of any of them, that undertakes to or offers to undertake to, or purports to have the capacity to undertake to, or submits a bid to, or does personally or by or through others, construct, alter, repair, add to, subtract from, improve, move, wreck or demolish any building, highway, road, railroad, excavation, manufactured building or other structure, project, development or improvement, or to do any part of such a project, including the erection of scaffolding or other structure or works in connection with such a project, and includes subcontractors and specialty contractors. For all purposes of taxation or deduction, this definition shall govern without regard to whether or not such contractor is acting in fulfillment of a contract.

A.R.S. § 42-5075(H)(6) defines "prime contractor" as a contractor who supervises, performs or coordinates the construction, alteration, repair, addition, subtraction, 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 the contract.

A.A.C. R15-5-602 states that every person engaging in a contracting activity is considered to be a prime contractor unless it can be demonstrated to the satisfaction of the department that he is not a prime contractor. A person is considered to be a prime contractor, and therefore liable for the tax, if work is performed for and payments are received from an owner or lessee of real property.

Discussion:

Arizona's transaction privilege tax is a tax on the privilege of conducting business in the State of Arizona. It is a tax on the seller, not on the purchaser. The seller may pass the burden of the tax on to the purchaser; however, the seller is ultimately liable to Arizona for the tax.

The transaction privilege tax is levied on the *business* of prime contracting. "Business" includes all activities or acts engaged in with the object of gain, benefit or advantage, either directly or indirectly. [A.R.S. § 42-5001(1)] . . . benefits from its activities as the lead carrier under the Agreement with the Joint Build Participants.

The term "contractor" includes persons who construct "by or through others". [A.R.S. § 42-5075 (H)(2)] A "prime contractor" is a contractor who supervises or coordinates the construction, including the contracting with any subcontractors or specialty contractors and who is responsible for the completion of the contract. [A.R.S. § 42-5075(H)(6)] A person is considered to be a prime contractor, and therefore liable for the tax, if work is performed for and payments are received from an owner of real property. [A.A.C. R15-5-602]

. . . constructs through others by hiring the contractor or specialty contractor that actually performs the work on the Network. . . . receives payment from the owners and, under the joint build agreements, is responsible for the completion of the contract.

Conclusion and Ruling:

The following ruling is given based on the facts presented in your request.

The department rules that . . . is subject to tax as a prime contractor with regard to its activities as "lead carrier" in the construction of a multi-conduit fiber optic cable network. The tax base is 65% of the gross income derived from contracts with the joint build participants, including amounts received from participants for their pro rata share of project costs, materials purchased and management fees.

The conclusions in this private taxpayer ruling do not extend beyond the facts as presented in the request for a private taxpayer ruling dated March 5, 2001, and amended by your letter of

October 8th.

This response is a private taxpayer ruling and the determination herein is based solely on the facts provided in your request. The determination in this taxpayer ruling is the present position of the department. This determination is subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the department's making of an accurate determination, this taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law or notification of a different department position.