PRIVATE TAXPAYER RULING LR06-003

June 1, 2006

The Department issues this private taxpayer ruling in response to your letter of June 14, 2005, in which you request a ruling on behalf of your client . . . ("Company") . . . on the applicability of Arizona transaction privilege tax to certain revenue attained from Company's business operations. You provided supplemental information requested by the Department in letters dated July 6 and July 22, 2005.

Statement of Facts:

The following facts are excerpted from your June 14 letter:

> Among other services, [Company] performs off-site contracting for homebuilders in southern Arizona, including the construction of streets, sewers and sidewalks. . . . [Company]'s principal has steadfastly refused to accept any Arizona [F]orm 5005s [also known as "Prime Contractor's Certificates"] from homebuilders as respects offsite improvements. . . .
>
> This [request] addresses the situation where [Company] constructs offsite improvements for the contracting arm of a homebuilder that is utilizing the two-tier homebuilder technique. In particular, this [request] pertains to situations wherein at the time of contracting with [Company] the contracting arm for the homebuilder ("Contracting Arm") does not own the real property being improved with the offsite improvements. The land to be improved is held by an affiliate of the Contracting Arm, referred to herein as "Marketing Arm", which contracts with Contracting Arm for the provision of construction services, including the offsite improvements ultimately to be performed by [Company].
>
> [Company] also seeks guidance as to the municipal tax implications of the factual situation described herein. For purposes of the second ruling [request] here sought, please assume that the activity in question will transpire within an incorporated municipality that does not allow a fair market value deduction for the value of the land as improved. That being the case, when the homes are sold, the value added by the offsite improvements as reflected in the value of the underlying lots will be taxed by the municipality when the home ultimately is sold by the homebuilder.

For reference purposes, you provide sample copies of a construction agreement, subcontractor agreement, and special warranty deed pertaining to the improvement of a project, wherein Party A owns real property, Party B serves as the prime contractor on the project, and Party B hires Company to perform off-site improvements to Party A's real

property as a subcontractor. You indicate that these contracts contain confidential information and should not be revealed to the public.

Your Issues:

Based on the arguments presented in your request, you raise the following issues:

1. When Company is hired by a homebuilder's Contracting Arm, which in turn is under contract with the homebuilder's Marketing Arm (or any other party) to provide offsite improvements on land owned by the Marketing Arm (or any other affiliate of the homebuilder other than the Contracting Arm, or even a third party such as a land trust), is Company acting in the capacity of a nontaxable subcontractor under A.R.S. § 42-5075?

2. If Company believes that it is a nontaxable subcontractor under the circumstances described in Issue 1 after ascertaining that:

   a. Company's construction contract is with the homebuilder's Contracting Arm,

   b. the Contracting Arm produces what it asserts is and on the face appears to be a current vesting deed with respect to the property to be improved reflecting ownership in an individual or entity other than the Contracting Arm,

   c. the Contracting Arm provides Company with what it asserts is and on its face appears to be a binding construction contract between the Contracting Arm and any other party for the construction of improvements to the real property in question,

   d. the Contracting Arm and the party listed as the owner of the property on the deed described in subparagraph (b) above have separate and distinct legal existences, and

   e. the Contracting Arm tenders to Company a fully completed and executed Arizona Form 5005 with respect to the particular project,

   will Company be deemed to have accepted the Form 5005 in good faith and be absolved of tax liability under such contract pursuant to A.R.S. § 42-5075(E), even if resulting events suggest that the Contracting Arm would not have been considered a prime contractor by definition if it had not provided Company with the Form 5005?

3. In those Arizona cities and towns under the collection administration of the Department ("Program Cities") that do not permit a fair land value deduction, is Company permitted to accept written declarations under Model City Tax Code ("M.C.T.C.") § 415(c)(2) from homebuilders and thereby have the gross receipts derived from offsite improvements excluded from Company's taxable receipts?

Your Positions:

Your positions on the above-mentioned three issues are as follows:

1. When Company is hired by the Contracting Arm of a homebuilder, which in turn is under contract with the Marketing Arm of such homebuilder (or any other party) to provide the offsite improvements in question on the land owned by the Marketing Arm, an affiliate of the homebuilder other than the Contracting Arm, or a third party, Company is acting in the capacity of a nontaxable subcontractor as regards such contract. The Contracting Arm's gross receipts should be subject to transaction privilege tax because the Contracting Arm is serving as a prime contractor. Under such circumstances, Company should not be taxable.

2. The proper party to report taxes is the Contracting Arm because it does not own the land and it is in contractual privity with the Marketing Arm (or any other party) and is responsible to such party for the completion of the offsite improvements. As Contracting Arm bears primary tax liability, in that context it has a more compelling case to pay the tax itself to assure that such obligation is satisfied. If Company believes the situation described in Position 1 to be factual after performing the due diligence listed in Issue 2 *supra*, it should be deemed to have accepted the Arizona Form 5005 in good faith and be absolved of tax liability under such contract pursuant to Arizona Revised Statutes ("A.R.S.") § 42-5075(E), even if for any reason it ultimately turns out that the Contracting Arm would not be taxed as a prime contractor if it had not delivered the Arizona Form 5005 to Company. 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 receipts attributable to the job from which such subcontractor was paid.

3. With respect only to those cities and towns that constitute Program Cities under the collection administration of the Department, when Company makes offsite improvements at subdivisions that are within those municipalities that do not permit fair market value land deductions, the offsite contractors are permitted to accept written declarations from the

> homebuilder pursuant to M.C.T.C. § 415(c)(2) and have the gross receipts from such undertaking excluded from their taxable receipts. In lieu of the offsite contractor paying tax, the homebuilder reports and pays tax on the ultimate sale of the homes (with the value of the offsite improvements reflected therein).

Conclusion and Ruling:

For state transaction privilege tax purposes, A.R.S. § 42-5075 imposes tax on the business of prime contracting. A "prime contractor," as defined in A.R.S. § 42-5075(K)(6), is

> 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.R.S. § 42-5075(D) provides that subcontractors are exempt from the 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 subcontractors . . . were paid." Moreover, under A.R.S. § 42-5075(E), a contractor can exclude from its taxable receipts income for which the person who hired the contractor executes and provides the contractor with an Arizona Form 5005 "Prime Contractor's Certificate" that the contractor has no reason to believe is "erroneous or incomplete." A person who presents a validly executed Arizona Form 5005 to a contractor is "deemed to be the prime contractor in lieu of the contractor *and* is subject to the tax under this section on the gross receipts or gross proceeds received by the contractor," even if the person would not otherwise be a "prime contractor" under the statutory definition. A.R.S. § 42-5075(E) (emphasis added).

For city privilege tax purposes, the M.C.T.C.'s local options add or substitute language to the tax code adopted by a particular Arizona city or town. Local Option N exempts the fair market value of land from the gross income of a speculative builder's sale of improved real property when a charge for the land is included in the total selling price of the real property sold.[1] To preface the discussion of the M.C.T.C. that follows, please note that the conclusions and ruling reached on this issue are limited in application to those Program Cities that do not permit the M.C.T.C. Local Option N fair market value land deduction *and*

[1] To determine the fair market value used, Local Option N provides two options. The taxpayer must either: (1) document the fair market value to the satisfaction of the taxing authority and maintain and provide such documentation with other required books and records or (2) use an amount equal to 20 percent of the total selling price of the improved real property to estimate the fair market value of the land.

that do not have supplemental local audit authority through adoption of M.C.T.C. Appendix IV.[2]

M.C.T.C. § 415 imposes privilege tax on the "gross income from the business upon every construction contractor engaging or continuing in the business activity of construction contracting within the City." Most contractors—include subcontractors, specialty contractors, and prime contractors—fall within the M.C.T.C. definition of "construction contractor" found at § 100. Nevertheless, M.C.T.C. § 415(b)(1) excludes from the tax base gross income derived from "acting as a 'subcontractor,'" as the term is defined in subsection (c). "Subcontractor" means, in pertinent part:

> a construction contractor performing work for either:
>
> (1) a construction contractor who has provided the subcontractor with a written declaration that he is liable for the tax for the project and has provided the subcontractor his City Privilege License number.
>
> (2) an owner-builder who has provided the subcontractor with a written declaration that:
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> (A) the owner-builder is improving the property for sale; and
>
> (B) the owner-builder is liable for the tax for such construction contracting activity; and
>
> (C) the owner-builder has provided the contractor his City Privilege License number.

M.C.T.C. § 415(c) (emphasis in original). An "owner-builder" is "an owner or lessor of real property who, by himself or by or through others, constructs or has constructed or reconstructs or has reconstructed any improvement to real property." M.C.T.C. § 100.

M.C.T.C. § 416 imposes city privilege tax on "the gross income from the business activity upon every person engaging or continuing in business as a speculative builder within the City." The taxable gross income includes the "total selling price from the sale of improved real property at the time of closing of escrow or transfer of title," but M.C.T.C. § 416(c)(3)(B) provides the taxpayer with a credit "equal to the amount of privilege taxes paid to this City, or charged separately to the speculative builder, by a construction contractor, on the gross income derived by said person from the construction of any improvement to the real property." A "speculative builder" is broadly defined under M.C.T.C. § 100 as either:

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[2] There are currently thirty-two Program Cities that fall within these parameters: Benson, Bisbee, Clarkdale, Clifton, Coolidge, Duncan, Eagar, Fredonia, Globe, Hayden, Huachuca City, Jerome, Kearny, Litchfield Park, Miami, Oro Valley, Page, Patagonia, Payson, Queen Creek, Sahuarita, San Luis, Sierra Vista, Somerton, Springerville, Taylor, Tolleson, Tombstone, Wellton, Winkelman, Youngtown, and Yuma.

(1) an owner-builder who sells or contracts to sell, at anytime, improved real property (as provided in Section ___-416) consisting of:

A) custom, model, or inventory homes, regardless of the stage of completion of such homes; or

B) improved residential or commercial lots without a structure; or

(2) an owner-builder who sells or contracts to sell improved real property, other than improved real property specified in subsection (1) above:

A) prior to completion; or

B) before the expiration of twenty-four (24) months after the improvements of the real property sold are substantially complete.

Based on the facts provided by Company, the Department rules as follows:

1. Company is acting in the capacity of a subcontractor when it contracts to provide offsite improvements for:

   a. A homebuilder's Contracting Arm that is under contract with the homebuilder's Marketing Arm, on land that is owned by the Marketing Arm or affiliate of the homebuilder other than the Contracting Arm.

   b. A homebuilder's Contracting Arm that is under contract with an unrelated third party (*e.g.*, land trust) on land owned by the third party.

   Under these two circumstances, Company's gross receipts derived from the contract are exempt from state transaction privilege tax under the prime contracting classification because the homebuilder's Contracting Arm constitutes the taxable prime contractor under A.R.S. § 42-5075.

2. Under either of the two circumstances described in Part 1 of this section, Company is deemed to have accepted the Form 5005 in good faith and be absolved of state transaction privilege tax liability under such contract pursuant to A.R.S. § 42-5075(E) if Company ascertains that all of the following conditions are satisfied before its acceptance:

   a. Company's construction contract is with the Contracting Arm.

   b. The Contracting Arm produces what it asserts is and on the face appears to be a current vesting deed for the real property to be

improved that reflects ownership in the Marketing Arm or another party described in Part 1 of this ruling.

c. The Contracting Arm provides Company with what it asserts is and on its face appears to be a binding construction contract between it and the Marketing Arm or other party for the construction of improvements to the real property.

d. The Contracting Arm and the party listed as the owner of the real property on the deed have separate and distinct legal existences.

e. The Contracting Arm tenders to Company a fully completed and executed Arizona Form 5005 with respect to the contract.

3. In Program Cities that do not permit the M.C.T.C. Local Option N fair market value land deduction and that do not have supplemental local audit authority through adoption of M.C.T.C. Appendix IV, Company is permitted to accept written declarations as provided in M.C.T.C. § 415(c)(2) from homebuilders and thereby have the gross receipts derived from offsite improvements excluded from its taxable receipts as a subcontractor for purposes of the Program Cities' privilege tax on construction contracting activities. In lieu of the offsite contractor paying tax, the homebuilder, which generally constitutes a "speculative builder" as defined in M.C.T.C. § 100, would report and pay privilege tax on its gross receipts derived from the ultimate sale of the homes (with the value of the offsite improvements reflected therein), pursuant to M.C.T.C § 416(c)(3)(B).[3]

This private taxpayer ruling does not extend beyond the facts presented in your letters of June 14, July 6, and July 22, 2005.

This response is a private taxpayer ruling and the determination herein is based solely on the facts provided in your request. The determinations are 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.

[3] References to a "homebuilder" or "homebuilders" in Part 3 of this ruling can mean the Contracting Arm, Marketing Arm, or other affiliated entity of a homebuilder, such that it does not matter which entity provides Company with a written declaration for city privilege tax purposes. Nevertheless, Company cannot disregard the party with whom it contracts or from whom it accepts an Arizona Form 5005 for purposes of state transaction privilege tax, as such factors can impact the party who is designated the taxable prime contractor under A.R.S. § 42-5075(E).

The determinations in this private taxpayer ruling are only applicable to the taxpayer requesting the ruling and may not be relied upon, cited, nor introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling.

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