

Ms. Christie Comanita, Manager
Tax Policy & Research Division
Arizona Department of Revenue
1600 West Monroe
Phoenix, AZ 85007

Dear Christie:

The Tax Practitioner Committee of the Arizona Tax Research Association (ATRA) has reviewed the proposed ruling interpreting the phrase “direct costs” in A.R.S. § 42-5075(J) and has the following comments and/or concerns:

1. Use of Generally Accepted Cost Accounting Principles. The committee sees a problem in trying to apply a GAAP definition of direct cost to this legislation because the definition varies by source and industry. For example, under cost accounting, the Financial Accounting Standards Board (FASB) now uses the term “prime costs” and defines that as direct labor plus direct materials. Direct labor is all labor that can be easily identified and traced to the product. Direct materials are all materials that can be easily identified, traced and consumed in the product. The National Association of Accountants defines direct cost as “any cost that can be specifically identified with a cost object in an economically feasible manner.” As both manufacturing and service companies move to activity based costing, cost allocation changes from unit based to a focus on the activities required to provide each service based on that service’s consumption of activities, according to the Institute of Management Accountants. Even traditional definitions break direct costs into initial direct costs and direct costs.¹ Direct costs in the Handbook referenced below are “costs that have a clearly identifiable or causal relationship (a) to the product produced for inventory or sold or to the services performed, or (b) to the level of services performed for a group of customers (e.g., servicemen’s labor, repair parts included as part of a service agreement).” Initial direct costs are those directly associated with negotiating and consummating revenue transactions. As you can see, there is significant variation in the definition of direct cost even within GAAP and by accounting organizations and resources.

¹ *Handbook of Accounting and Auditing, 2nd Edition*, Robert S. Kay and D. Gerald Searfoss, Warren, Gorham & Lamont, 1981

2. The Department's Application of Direct Costing Is Overly Restrictive. Using the definition of direct cost from the National Association of Accountants as specified above, it is clear that the proposed ruling varies significantly. The proposed ruling appears to require that direct costs be incurred directly and solely for each contract. It holds that a cost could not be allocated to, nor deductible from, a contract if that cost was applicable to numerous contracts but a portion could be identified as applicable in an economically feasible manner. If a cost is not expensed at the time it is incurred to a specific contract, but it is then determined that the cost applies to a number of contracts and is then charged to each contract in an economically feasible manner, it would be considered a direct cost under cost accounting practices and techniques, but not under the ruling because it was not solely and directly expensed to the contract at the time it occurred.

3. The Use of Title 32 Definitions of "Architectural or Engineering Services" is Inconsistent With Prior Ruling Treatment. When the Department drafted TPR 02-2, taxpayers requested the use of definitions of water be derived from the Arizona groundwater code, because there was comprehensive definitional treatment of key words and significant Arizona caselaw on relevant water issues. The Department refused, saying that "Arizona courts have held that definitions which pertain to statutes serving another purpose and having nothing to do with the subject of the statute in question are not persuasive in interpreting the statute." In that ruling, the Department used a dictionary definition. In this situation, since the Legislature did not cross-reference title 32, it would appear that the Department should do likewise to be consistent.

4. In Calculating Labor Costs on Pages 3 and 4 of the Ruling, the Department is Inconsistent with Cost Accounting Principles. Under cost accounting principles, direct labor includes the employer's portion of FICA, efficiency bonuses, cost of living allowances, health insurance, group life insurance, holiday pay, vacation pay, pension benefits, worker's compensation expense and unemployment compensation insurance costs, along with basic compensation. The proposed ruling is much more restrictive regarding what is included in labor costs and terms many of the costs specified above as indirect.

5. The Department's Treatment of Internal Costs Creates a Disparity with Third Party Engineering and Architectural Costs. Under the proposed ruling, third party engineering and architectural costs are deductible as billed (page 4, lines 126-129), regardless of what the third party included in those costs. The ruling requires a formula approach to the calculation of in-house costs that is likely to result in a reduced deduction, particularly given the Department's restrictive definition of direct costs. This is very clear from the example on page 5, as the third party provider would likely bill, and the ruling would allow a deduction for, the \$80,000 total cost, rather than the \$55,000 for in-house services.

ATRA believes that the Department should ensure that the approach used in interpreting A.R.S. § 42-5075(J) provides an equitable, consistent approach to determining direct costs such that there is no disadvantage regardless of the source of architectural and engineering services used.

If you would like further information on these issues, please contact Barb Dickerson at (602) 234-5246 or Jennifer Schuldt at (602) 253-9121.

Sincerely,

Kevin J. McCarthy
President