

October 30, 2006

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

Dear Christie:

The ATRA Practitioner Committee has reviewed the proposed transaction privilege tax ruling (“TPR”) pertaining to qualifying direct costs under the prime contracting classification of the Arizona transaction privilege tax (“TPT”).

We appreciate your responsiveness to the concerns and suggestions that the committee had with the Department’s initial draft TPR; however, the committee still has some concerns with the current draft.

First, we believe that the definition of “direct costs” remains overly restrictive. Black’s Law Dictionary defines “direct costs” as the costs of direct material and labor and variable overhead incurred in producing a product. Clearly, from a legal perspective, that phrase encompasses more costs than are reflected in the ruling.

As a result of the restrictive nature of the ruling, we remain concerned that the components of cost included in internally performed architectural and engineering services under the draft TPR create a disparate result when compared with those costs that are likely to be included in third party invoicing for comparable services. As expressed in our prior letter on this issue, we believe that the Department should ensure that the draft ruling provide an equitable, consistent approach in determining direct costs such that there is no disadvantage regardless of the source of architectural and engineering services used.

Finally, it is critical that the determination of the gross proceeds that are attributable to direct costs be administratively efficient and realistic. Lines 151-153 on page 5 appear to require an exact tie between gross proceeds and direct costs in the same tax period. That is not going to be the case. Costs will likely be incurred in one month and neither billed nor paid until a subsequent month; therefore, the gross proceeds derived from the costs incurred will rarely, if ever, occur in the same month. In addition, most contracts have a

retention component that will cause a portion, usually 10%, to not be paid until the end of the contract. While lines 155-159 seem to somewhat rectify the problem described above, the conflict between the two paragraphs creates confusion and the Department's position in this situation is unclear.

If you have any questions, please contact either Barb Dickerson at (602) 234-5246 or Jennifer Schuldt at (602) 253-9121.

Sincerely,

Kevin J. McCarthy
President

Cc: Barb Dickerson