

# State of the States

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*By Joseph A. Pickart and Douglas A. Pessefall*

## *Morton Buildings, Inc. v. [Insert State Here]: A Case Study of the Sales and Use Tax Treatment of Contractor-Manufacturers\**

Contractors engaged in real property construction activities are subject to a complicated maze of rules and regulations relating to their sales and use tax obligations. While the sales and use tax treatment afforded their purchases and sales may be confusing at times, the treatment is generally uniform among the states. However, as discussed below, uniform tax treatment is not present in cases where a contractor purchases materials and then manufactures or assembles them into another article for use in its real property construction activities.

### **Background**

Contractors often fulfill several different roles during the course of a construction project. With each different role, the contractor must be aware of the different sales and use tax rules that apply. For example, when a contractor performs real property improvements, it is deemed a consumer of the tangible personal property incorporated into the real estate and, thus, must pay tax on its purchases of the construction materials. Or, when a contractor sells tangible personal property (e.g., a refrigerator), it is deemed a retailer of such personal property and may claim a resale exemption on its purchase of the property. A third example is when a contractor performs repair services, in which event the contractor's sales and use tax treatment generally follows the treatment of the item being repaired: if the item is real property, the contractor is deemed to be the consumer of the materials, whereas if the item is personal property, the contractor is deemed the reseller of the materials used in the repair activities. Finally, a contractor might also manufacture some of the materials that it incorporates into its real property construction activities. Using a series of cases, all involving Morton Buildings, Inc. ("Morton"), this article identifies the unique issues that arise in the contractor-manufacturer context, the states' disparate tax treatment afforded



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**Joseph A. Pickart** is an Attorney and the State and Local Tax Practice Group Leader in the Milwaukee office of Whyte Hirshboeck Dudek S.C.



**Douglas A. Pessefall** is an Attorney and heads the Tax Exempt Organizations Practice Group in the Milwaukee office of Whyte Hirshboeck Dudek S.C.

these transactions, and the arguments that have been advanced to support the disparate treatment.

## Facts and Issue

Morton is a construction contractor engaged in the business of producing, selling and erecting prefabricated warehouses and other buildings (collectively “Buildings”) for use in farming and industry. Morton often purchases and stores lumber, steel and other materials (collectively “Materials”) outside of the state in which it erects the Buildings. The Materials purchased by Morton are not for use in any particular customer order; rather, Morton obtains the amount and types of Materials it needs after reviewing sales projections and supply storage histories. Morton then assembles the Materials into trusses, columns, purlins and metal panels (collectively “Building Components”), again often in states other than in which it constructs the Buildings. The Building Components are incorporated into Buildings constructed in the state that then seeks to impose use tax on the Materials.

At issue in all of the Morton cases is whether the Materials purchased by Morton, and used to make Building Components that are eventually assembled into Buildings in the taxing state, are subject to that state’s use tax.

## Morton Owes Use Tax on the Materials

N.C. GEN. STAT. §105-164.6(b) imposes use tax on the purchase price of tangible personal property “purchased inside or outside the state that becomes a part of a building or other structure in the state.” In *Morton Buildings, Inc. v. Tolson*, North Carolina Court of Appeals (2005),<sup>1</sup> Morton did not dispute that it purchased the Materials, nor that the Materials were tangible personal property. Instead, Morton argued that the Materials (i) did not become a “part of a building or other structure in the state” and (ii) were consumed and transformed into Building Components outside of the state (*i.e.*, it was the Building Components—not the Materials—that

became a “part of a building or other structure in the state”). Because it did not purchase the Building Components, and because the Materials purchased were not incorporated into the Buildings in their “unaltered state,” Morton reasoned that the Materials were not subject to North Carolina’s use tax. The court rejected Morton’s argument that the Materials “ceased to exist” when they were incorporated into the Building Components. Concluding that the Materials as incorporated into the Building Components remained tangible personal

A third example is when a contractor performs repair services, in which event the contractor’s sales and use tax treatment generally follows the treatment of the item being repaired: if the item is real property, the contractor is deemed to be the consumer of the materials, *whereas* if the item is personal property, the contractor is deemed the reseller of the materials used in the repair activities.

property that became a “part of a building or other structure” in North Carolina, the court found that the Materials were subject to use tax under subsection (b) of N.C. GEN. STAT. §105-164.6. The court *also* ruled, in the alternative, that the Materials were subject to use tax under subsection (a) of that same statute, which imposes use tax on “the storage, use or other consumption in [the] state of tangible personal property inside or outside the state for storage, use,

or consumption in the state.” According to the court, “[b]y incorporating the lumber and other materials ... into buildings [Morton] constructed in North Carolina, [Morton] exercised a right, power, and dominion over, and therefore used the lumber and other materials” in the state. The court also rejected Morton’s argument that the Building Components were “a manufactured product distinct from” the Materials on the notion that while Morton’s “rudimentary process may change the form of the [Materials] ... it [was] difficult to discern” how the Building Components were a different article with a “distinctive ... character or use,” as was required for a finding of manufacturing.

KY. REV. STAT. §139.310 imposes use tax “on the storage, use, or other consumption in [the] state of tangible personal property ... for storage, use or other consumption in [the] state.” Accordingly, for use tax to apply, (i) the matter to be taxed must be deemed tangible personal property, (ii) the property must have been purchased, (iii) the property must have been intended for storage, use or other consumption in the state, and (iv) the property must actually have been stored, used or consumed in Kentucky. In *Morton*

*Buildings, Inc. v. Revenue Commissioner*,<sup>2</sup> Morton argued that the third requirement was not satisfied because the Materials were not purchased for application to a particular customer order in Kentucky but, instead, were purchased for use only in its out-of-state manufacturing factories. The court was not convinced, holding that “specific intent is not required to establish whether an item is intended for use in a particular state as intent can be inferred from the taxpayer’s activities within the taxing jurisdiction.” Here, the record contained evidence that Morton maintained sales offices in Kentucky and that it had performed over 700 jobs in the state during the years at issue. Morton alternatively argued that the fourth requirement was not satisfied based on the notion that the processing of the Materials in locations outside the state precluded their latter “use” in the construction of the Buildings because the Materials were being consumed beforehand.

The court again rejected Morton’s arguments, finding that “there [was] no question that the raw materials, despite their alteration at the out-of-state facilities, constitute[d] tangible personal property actually used in Kentucky as components for Morton’s prefabricated buildings,” meaning that Morton exercised taxable control over the Materials. The court also pointed out that the “plain language” of the taxing statute imposed use tax on the Materials “regardless of whether or not [the Materials] were first manufactured.”

32 VT. STAT. ANN. §9773(1) imposes use tax on “any tangible personal property purchased at retail” unless that property has previously been subject to use tax. Accordingly, for the Materials to be subject to use tax, the Department was required to demonstrate that (i) Morton purchased the tangible personal property at retail and (ii) that Morton used the “same tangible personal property in Vermont” in the Vermont Supreme Court decision in *Morton Buildings, Inc. v. Dep’t of Taxes*.<sup>3</sup> Morton argued that the first condition was not satisfied because the Building Components were manufactured by Morton and, thus, not purchased at retail. The Department countered by pointing out that Morton

sold Buildings, not Building Components, and that the Building Components were themselves raw materials. According to the Department, the partial assembly of the Materials did not transform the Materials into something else. In finding for the Department, the Court identified three reasons for imposing use tax on the Materials. First, the Court noted that the statutory language “taken as a whole” supported a finding of use tax since the statutes did “not specifically state that raw ma-

terials that [were] used in manufacturing lose their separate identity as personal property purchased at retail subject to use tax.”<sup>4</sup> Second, the Court rejected Morton’s claim that the Materials were manufactured, holding that “[e]ven if the purlins, trusses and columns have a ‘form, composition or character’ different from the wood and metal components from which they [were] made, it [was]

difficult to discern how they [were] a ‘different product’ with a ‘distinctive ... character and use.’” Finally, the Court noted it would be “inherently unfair” to similarly situated in-state taxpayers not to impose a use tax on the Materials.

MINN. STAT. §297A.14 imposes use tax “for the privilege of using, storing or consuming in Minnesota tangible personal property ... purchased for use, storage or consumption” in the state. Again, in *Morton Buildings, Inc. v. Commissioner of Revenue*,<sup>5</sup> Morton was subject to use tax only if (i) the item of tangible personal property was used, stored or consumed in Minnesota, (ii) the item of tangible personal property was purchased, and (iii) the purchase of the tangible personal property was for use, storage or consumption in Minnesota. The Minnesota Tax Court found in favor of Morton, holding that the tangible personal property used in Minnesota (*i.e.*, the Building Components) was not the same tangible personal property purchased by Morton and that the Building Components themselves were not purchased but, instead, manufactured. The Supreme Court reversed the Tax Court, noting that Minnesota

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courts had never “required that raw material be unaltered when used in Minnesota in order to trigger liability for the use tax,” the Supreme Court reversed the Tax Court and found that Morton’s manufacturing process did not transform the Materials into something else. And, while acknowledging that Morton made its “strongest argument” in connection with the third requirement (*i.e.*, that the Materials were not “purchase[d] ... for use, storage or consumption in Minnesota,” the Court found that the presence of Morton’s sales offices in the state were sufficient to demonstrate intent and that it was not necessary to determine “precisely which two-by-four or bracket would be used in Minnesota.”

## Morton Does Not Owe Use Tax on the Materials

As demonstrated above, in cases in which Morton was found to owe use tax on its Materials, tribunals have identified several different, and alternative, reasons for doing so. By contrast, in cases in which Morton has been found not to owe use tax, tribunals have been rather consistent in their approach. For example, in *Morton Buildings, Inc. v. Commissioner of Revenue*,<sup>6</sup> the Tax Court relied on the “fundamental rule of statutory construction” that tax imposition statutes are to be construed in favor of the taxpayer and against the taxing authority, and that the statutory language should not be extended to reach transactions that do not fall clearly within the language. The court then went on to conclude that (i) the Materials had not been used, stored, or consumed by Morton in Minnesota, (ii) the tangible personal property brought into the state—the Building Components—were not “purchased” by Morton, and (iii) the Materials were not purchased for use in the storage or consumption in the state. In finding that Morton engaged in the manufacture of the Building Components, the court also rejected the Commissioner’s argument that use tax should be imposed to account for Morton’s “integrated system incorporating its stor-

age facilities and factories outside of Minnesota and extending through its transportation system to the building site.” *See also, Morton Buildings, Inc. v. Chu*,<sup>7</sup> (“when [Morton] manufactured the raw materials into building component it changed their identity”); *Morton Buildings, Inc. v. Director of Revenue*,<sup>8</sup> (“Although the lumber, steel sheeting, nails and other raw material that go into the building components ... may be suitable for common use before that are made part of the building components, these raw materials nevertheless lose their individual identities and become part of a manufactured product”); *Morton Buildings, Inc. v. Wisconsin Dep’t of Revenue*,<sup>9</sup> (the Building Components were never purchased from any retailer and the Materials were transformed into completely different and distinct articles outside of Wisconsin thereby losing their identity); and *Morton Buildings, Inc. v. Bannon*,<sup>10</sup> (Morton’s “conversion of raw materials into identifiably different building components precludes the levy of the use tax on [the] raw materials”).

In each of these cases, the tribunals found that Morton’s subsequent manufacture of the Materials into the Building Components was a “use” that preceded the transfer of the Building Components to the state in which the Buildings were being erected.

## Conclusion

A contractor engaged in real property construction activities must address many difficult questions when attempting to identify its sales and use tax obligations. These questions are further complicated when that contractor assumes different roles during the course of a construction project, such as the role of retailer or repairman. As the *Morton* cases illustrate, where the contractor also manufactures or assembles the Materials used in its real property construction activities, it is even more difficult to discern—from state to state—the appropriate tax treatment regarding the contractor’s purchases of raw materials.

## ENDNOTES

\* The author wishes to acknowledge several individuals who contributed to this article. Special thanks to Bruce Nelson, M.A., CPA, and to John Healy, M.S.T., CPA, who prepared and presented an outline that served as the basis for this article; to Yousuf Kahn,

intern, who performed much of the research; and to Jenn Jin, Esq., who served as an editor on this piece.

<sup>1</sup> *Morton Buildings, Inc. v. Tolson*, 615 SE2d 906 (N.C. App. 2005).

<sup>2</sup> *Morton Buildings, Inc. v. Revenue Commis-*

*sioner*, No. 2002-CA-001787 (unpublished) (Ky. App. 2003).

<sup>3</sup> *Morton Buildings, Inc. v. Dep’t of Taxes*, 167 Vt. 371, 705 A2d 1384 (Vt. 1997).

<sup>4</sup> The court also pointed out that the statutory scheme contained use tax exemption for

tangible personal property that became an ingredient or component part of tangible personal property destined for sale and that what Morton argued for was a “virtually identical exemption for ingredients or component parts of real property through a statutory construction of the general provisions setting forth what constitutes a taxable use.”

<sup>5</sup> *Morton Buildings, Inc. v. Commissioner of Revenue*, 488 NW2d 254 (Minn. 1992).

<sup>6</sup> *Morton Buildings, Inc. v. Commissioner of Revenue*, No. 5385 (Minn. Tax Ct. 1991), subsequently reversed on appeal.

<sup>7</sup> *Morton Buildings, Inc. v. Chu*, 126 AD2d 828, 510 N.Y.2d 320 (3d Dep’t 1987), *aff’d* 70 N.Y.2d 725, 513 NE2d 1304 (1987).

<sup>8</sup> *Morton Buildings, Inc. v. Director of Revenue*, No. 88-001879RZ (Mo. Admin. Hearing Comm’n 1989).

<sup>9</sup> *Morton Buildings, Inc. v. Wisconsin Dep’t of Revenue*, No. 89-S-438 (Wis. Tax App. Comm’n 1991).

<sup>10</sup> *Morton Buildings, Inc. v. Bannon*, 222 Conn. 49, 607 A2d 424 (Conn. 1992).



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