

Sales Tax Corner

Contractors, Construction and Building Your Own Tax Exposure

By John Healy and Bruce Nelson

Overview

Take it from us; there are dozens of careers with less anxiety, stress and potential problems than being a construction contractor. What with potential problems in materials supply, delivery holdups, wayward subs, liability risks, weather and contract disputes—the one thing contractors do not need are tax complications. And yet, the sales/use tax issues for contractors present some of the more perennially complicated issues in sales and use tax.

The causes of these sales and use tax complications can be many, but generally the tax problems stem from one of three related issues: the nature of the work undertaken, the type of contract language used, and the different types of sales a contractor may make. Unfortunately, each of the issues is related to the others, so let's try to break them down.

Which Sales Hardhat Are You Wearing Today?

To begin with, contractors often engage in at least three different types of sales activities: contract jobs on real property, time and material work on real or tangible personal property, and over-the-counter retail sales.

Generally, contractors who are performing construction contracts on real property are deemed to be the end users of the tangible personal property that they consume to create the real property. In effect, they are not selling tangible personal property but a construction service, and they must pay tax on the materials they consume to perform that service. When the contractor walks away from the job, the tangible personal property has been consumed in the creation of the real property. Thus, as the end user of the tangible personal property, the contractor simply pays sales tax on all



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John Healy, M.S.T., CPA, is a Lecturer in the graduate tax programs at the University of Wisconsin-Milwaukee.



Bruce Nelson is a CPA with the firm of Silverstein & Pomerantz LLP in Denver.

his or her purchases, and life is simple in most states. That's it; no worries. Sales tax is paid, no returns to file—life is good. An obvious example of this type of work is the contractor who contracts to do the plumbing for 75 homes in a new subdivision.

Contractors may also perform repair or installation work on real or tangible personal property. For example, our plumbing contractor may come to your house to replace a garbage disposal, hook up a new toilet, or repair some other piping. In many states, if the contractor bills the job time and material, *i.e.*, separately stating the sales price for parts and labor, the plumber need only charge sales tax on the parts. This seemingly simple transaction, however, is complicated by the fact that, in some states, installation labor is taxable. The state may also draw a distinction between work on new construction (installation) versus already existing structures (repairs).

Finally, contractors may put on their retailer hat and make traditional over-the-counter retail sales. For example, some people (not us) are competent enough to visit the plumber's place of business and simply purchase that new garbage disposal over the counter, take it home, and install it. When contractors act as retailers, they should be purchasing their inventory for resale and collecting sales tax on their over-the-counter sales.

If we assume that our contractor provides all three types of these sales—contract jobs on real property, time and material repairs, and over-the-counter retail sales—he or she is faced with seemingly contradictory requirements. For example, purchasing inventory tax-free for resale as a retailer is inconsistent with the obligation to pay tax on the tangible personal property used in contract jobs on real property. In any case, each of these activities has a distinct impact on the sales/use tax treatment of the contractor. Therefore, contractors must carefully track their activities in each taxing jurisdiction by customer to make sure they are adequately fulfilling their tax obligations.

Bill It Like You Bid It

In addition to making the sale, the contractor is faced with properly billing the sale. Sales tax, like many transaction taxes, is more form-driven than income tax. Where the doctrine of “economic substance over legal form” may be persuasive in the income tax arena, it is often the legal form that is the trump card in sales tax. Most states, for example, hold that if exempt and taxable items are sold together in a single price, tax will apply to both items. In other words, the format of the bill can determine the taxable measure of the sale.

Contractors are often confronted with this issue in states where the type of contract (lump-sum, time and materials, or cost-plus) may dictate the tax treatment. For example, replacing a garage door on a residential home might be treated either as a contract job on real property, where it is billed lump-sum; or as a retail sale with a nontaxable agreement to install,

where it is billed time and material. The sales and billing confusion both stem from a more fundamental issue—the nature of the work. The question of whether the contractor is performing a construction service or making a retail sale of tangible personal property is inextricably linked to the distinction between real and tangible personal property.

Contractors engaging in so-called turnkey projects, where the contractor provides real property improvements and tangible personal property under one contract, should be aware that in some jurisdictions, they will become consumers of not only the tangible personal property incorporated into the real estate but the “trade fixtures” as well.

Distinguishing Real from Tangible Personal Property

In most jurisdictions, the key to understanding the application of sales tax for construction contractors is tied to the distinction between real and tangible personal property. Although states may have varying criteria in drawing the distinction, most states refer to the following principles in making the determination:

- *Actual physical annexation of an item to the real property.* Generally, the tax administrator looks to the degree of attachment of the tangible personal property to the real property. Would

its removal cause irreparable damage to the real estate? If removal of the item would cause irreparable damage to the real estate, that is an indication that the property has become an intrinsic part of the real property. Under such circumstances, the contractor is the end consumer of the item installed and generally would pay tax on his or her material costs. By contrast, if tangible personal property is easily removed from the real estate, without damaging its function or use, that is generally considered evidence that the item has retained its character as tangible personal property. Therefore, the contractor is deemed to be the retailer of those items and is required to collect tax on the selling price to his or her customer and any labor incurred in its installation if the state taxes labor and the customer is subject to tax.

- *Application or adaptation of an item to the purpose to which the real property is devoted.* The more integrated into the overall function of the real estate, the more an item tends to assume the characteristics of the real estate and therefore the more likely that the contractor is subject to sales tax on his or her material costs. If the item is more independent of the real estate in function, it tends to retain its character as tangible personal property. In other words, can the real property still serve its function without the attached personal property? For example, a large machine may be attached to a building for its safe operation; however, it functions independently from the real estate and therefore is not considered part of the real estate once it is installed. However, the dining room window of your home is an integral part of what a house is all about. The window is integrated into the overall function of the home. The real property, *i.e.*, the house, cannot really function as a house without the window. (We are ignoring for the moment the place you lived in during college.)
- *An intention on the part of the person making the annexation to make a permanent accession to the real property.* Admittedly, this is one of

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the more difficult factors to assess, since it deals with the presumed intent of the person making the annexation to real property. Generally, it involves applying a “prudent person” standard to the facts and circumstances to make a reasonable determination of the person’s intent, based on his or her actions. Auditors will often look to the federal depreciation schedule to help determine intent. If the items have been treated as tangible personal property rather than real property on the depreciation schedule, the auditor may use the schedule as evidence of intent. Thus, cost segregation studies have sometimes been used by auditors for the basis of a sales/use tax assessment.

It is probably not an exaggeration to say that if a successful determination can be made between work on real property and a sale of tangible personal property, many billing and sales problems simply go away.

“I Am Tax-Exempt, Really I Am.”

Another perennial problem area for construction contractors is performing contract work for a tax-exempt entity or organization. State sales tax treatment of contractors performing real property improvements for tax-exempt entities or organizations varies. Some jurisdictions allow contractors to assume the exempt status of the tax-exempt entity or organization in making their purchases, thereby allowing the contractor to make his or her purchases free of sales tax. In other states, the contractor is deemed to be the consumer of the materials incorporated into the real estate, not the tax-exempt entity or organization. As the consumer, the contractor is subject to tax regardless of whether his or her customer is a tax-exempt organization or even a governmental agency.

Particular care must be taken in this area. Tax-exempt entities will often proffer their sales tax exemption number to the contractor thinking that the job must be exempt, because “after all, they are exempt.” Absent specific statutory authority, the contractor should never assume he or she can make materials purchases tax-free because, “After all, they are acting on behalf of the tax-exempt entity.”

Building Materials and Trade Fixtures

When are building materials not construction materials? When they are trade fixtures. Fixtures are those building materials that do not become an integral, inseparable part of real property, but retain their separate identity. Many states further complicate contractors' lives by distinguishing between materials and trade fixtures. These real estate components are typically items such as water heaters, water softeners, dishwashers, furnaces, air conditioners and the like. When a contractor repairs such items, even though they are real estate in nature, their repair is often treated as a repair of tangible personal property. The contractor is required to charge tax on the material charges for repair of the items, and the labor too, in those states that tax repair charges.

Contractors engaging in so-called turnkey projects, where the contractor provides real property improvements and tangible personal property under one contract, should be aware that in some jurisdictions, they will become consumers of not only the tangible personal property incorporated into the real estate but the "trade fixtures" as well. This can wreak havoc for manufacturing facilities that might be eligible for a sales tax exemption on machinery used in manufacturing. The state may take the position that under a turnkey project, the manufacturer is not eligible for the sales tax exemption because it purchased completed real property, while the contractor is not eligible for the exemption because he or she did not purchase the machine for use in manufacturing. (We have noticed over the years that states have not always been consistent about such things.) To avoid such problems, contractors might consider separate contracts for the real property improvements and the tangible personal property elements of the contract.

Some states have addressed this problem through regulation or ruling, so as with all tax questions, specific research by jurisdiction is necessary.

"But I Already Paid Tax on That!"

Lastly, contractors should be aware that tax might be due on the cost of their supplies, tools, machinery and equipment brought into a state to perform a contract. For example, a contractor may move items such as cement mixers, arc welders, or even heavy-duty cranes from jobsite to jobsite. If sales tax was not paid upon the purchase of those items, the jurisdiction in which the item is used will demand that tax be paid to it. If tax was paid upon the purchase, a credit will be given for any tax legally due and paid. An assessment will be made only if the rate in the jurisdiction of use is higher than that where the item was originally purchased or taxed. That said, many states have "old and cold" rules that provide that no additional use tax may be imposed on tangible personal property that has been used for more than six months or a year in other jurisdictions. The theory of excusing tax payment under these circumstances is the recognition that the value of the item after six months to a year of use is significantly diminished.

The sales and use tax obligations of contractors are a heavy burden. The key to success in handling these burdens lies in focusing on proper documentation of costs and expenses by job, accurate and consistent billing practices, and a proper regard for the correct determination of the nature of the project and appreciation for the ambiguous interaction and overlay of real and tangible personal property, not to mention a recognition that each state's sales and use tax laws are unique and require some level of analysis before undertaking a construction bid or job.

Or perhaps, another career path.

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