

ABA / IPT – 2010 ADVANCED SALES TAX CONFERENCE

TAX ISSUES FOR CONTRACTORS & GOVERNMENT CONTRACTORS

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- ▶ What is a Construction Contract
- ▶ Contracts for Exempt Entities or Use
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Who is a Construction Contractor?

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 - Sales and use tax due on purchases, but the sale of the services is generally not taxable.

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What is a Construction Contract?

► A contract to perform services to real property

► Most States Apply a Two Part Test

- Are the materials so attached to the land or to a structure that is real property that they become a permanent part of the land or structure
 - Intent to make permanent
 - Issues with leased realty
- Are the materials physically affixed in such a way that removal would cause damage or destruction to the land or structure
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Contracts with Exempt Entities or Exempt Use

► In certain instances, construction contractors may purchase property free of sales and use tax

- Depending on the state, applicable when the service is performed on property owned by an exempt person such as a government, a religious or charitable entity, or other tax exempt organization.
- The flow-through exemption applies only to materials to be incorporated in the project
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- Consider procedural issues

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Other Considerations

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- ▶ **Contractor Doing Business in Multiple States**
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- ▶ **Bonding Requirements**
 - Are the materials so attached to the land or to a structure that is real property that they become a permanent part of the land or structure
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STATE & LOCAL TAX ISSUES FOR CONSTRUCTION CONTRACTORS

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I. Who is a Construction Contractor?

A. Service Providers

1. Construction contractors are providers of a service to real property. Service providers are generally liable for tax on their purchases of materials and equipment used in providing such services as they are deemed to be the consumer of all materials that are used in the performance of the service.

a) Sales taxes are ordinarily imposed on sales of tangible personal property, and only those services expressly enumerated. Construction contracts and labor services associated with improvements to real property are not generally enumerated as taxable in most jurisdictions.

B. Contractors are generally not retailers or manufacturers.

1. A retailer purchases property it intends to resell free of sales and use tax, using a resale certificate and collects sales tax upon sale of the same property.

2. Manufacturers purchase raw materials and ingredients free of tax because these pass through to the ultimate consumer. The manufacturer collects sales and use tax on its sales of the manufactured item.

3. A person who is a contractor may also be either a retailer or a manufacturer, or both. This is further discussed in Paragraph IV (D) and (E) below.

II. What is a Construction Contract?

A. A construction contract is a contract to perform services to real property. In distinguishing whether the contract is for real or tangible personal property, most states apply a two-part test.

1. Are the materials so attached to the land or to a structure that is real property that they become a permanent part of the land or structure?

a) Manufacture and installation of billboards on real property is a sale of tangible personal property. *Richard Boyd Industries, Inc. v. Board of Equalization*, 107 Cal. Rptr. 2d 520 (2001).

b) In determining whether the removal of property will cause damage or destruction, the courts will often look to whether there was an intent to make the article a permanent part of the real property.

(1) This becomes a significant issue in the case of leased realty because items that are to be removed at the termination of a lease are generally presumed not to be permanent.

(a) Leased Realty

(i) The installation of certain items listed as capital improvements in Publication 862 might constitute the installation of tangible personal property if the items are installed by commercial tenants as trade fixtures.

(ii) Specific lease provision that counter the presumption of impermanence include.

(a) immediately upon installation, title to such installation vests in the lessor.

(b) At termination the installed items become or remain the property of the lessor.

(c) A provision granting the lessor the right to require removal of an improvement may or may not tend to counter such proof of permanence. The New York Department has held that it does not, *See*, TSB-M-83(17)S.

2. Are the materials physically affixed in such a way that removal would cause damage or destruction to the land or structure?

a) States generally look to how an item is affixed to the property – is an electrical item “hard wired” into a wall; was an item cemented or bolted to the real estate, etc.

(1) A concrete slab on which a house is erected is real property, but a similar slab supporting only a temporary building may not be.

b) A property tax assessor may come to a different conclusion from that of a sales tax auditor.

(1) The property tax assessor tends to come to a higher valuation when an item is nondepreciable real property. The sales tax auditor can set up a higher assessment by treating the contractor’s labor as part of the price rather than including only the cost of materials purchased by the contractor.

B. Installation of Equipment

1. The question whether the purchase of equipment is the purchase of tangible personal property that is then installed in real property or, alternatively, the

purchase of realty as part of a construction contract can have very significant sales tax effects.

a) Manufacturing Machinery. In most states, a purchase of manufacturing machinery is a purchase of tangible personal property exempt from sales tax. However, if the purchase of machinery is the purchase of real property, the tax department may take the position that the exemption does not apply. Also, a state taxing authority could take the position that the construction contractor's purchases are not exempt because the contractor is not a manufacturer.

b) In *Northeastern Pennsylvania Imaging Center v. Commonwealth*, 635 F.R. 2007, 978 A.2d 1055 (Pa. Comm. Ct. July 29, 2009), the Pennsylvania Commonwealth Court held that MRI and PET/CT Scan systems installed in an imaging center were "real estate" for Pennsylvania sales tax purposes. The Center had purchased these from the manufacturer, who spent over two weeks altering the Center's building to accommodate the equipment. Because the Center purchased real property, there was no tax due on the purchase. Under the court's analysis, use tax was due on the seller's cost of materials.

c) Sale and installation of kitchen cabinets and prefabricated stairs was a sale of tangible personal property. *H. B. Sanson, Inc. v. Tax Commissioner*, 187 Conn 581, 447 A.2d 12, (1982). Manufacturer and installer of concrete pilings was a seller of tangible personal property. *Green v. Reed Construction Corp.*, 91 So. 2d 634 (Fla. Supreme Ct. 1956).

C. State Nuances - Taxable v. Nontaxable Services

1. A number of states tax contractor services. Some, such as Hawaii tax all services, which includes contractor services. Other states tax only enumerated services, taxing contractor services as "services to real property" "maintaining, servicing or repairing real property and tangible personal property" or some other form of words. It is important to determine with certainty whether a state taxes contractor services and any exceptions that may apply.

a) Consider the following nuances in each state:

(1) Connecticut – Treats only the services element of the contract as taxable and excepts "new construction", a result that appears to mirror New York's but does not. Most renovations are not "new construction" even when they are clearly capital improvements. *See*, Conn. Agencies Regs. § 12-407(2)(i)(I)-1.

(2) Mississippi - Mississippi grants an exemption for all residential and commercial construction contracts under \$10,000. If the contract is over \$10,000, the tax is imposed at a 3.5% rate. Construction contracts for a residence, contracts in excess of \$100

million dollars and contracts for the restoration, repair and replacement of utility systems that were damaged or destroyed by a “natural disaster” are also exempt. *See* Miss. Sec. 27-65-21(1)(b)).

(3) New Mexico – Construction services are taxable, but contractors may purchase materials exempt from tax. *See* N.M. Stat. Ann. 1978, § 7-9-3M

(4) New York – Treats only the service element of the contract as taxable and exempts contracts that amount to a “capital improvement,” but “repair and maintenance are taxable. *See*, N.Y. Tax Law § 1105(c)(3); N.Y.C.R.R. § 541-1(d).

(5) Texas – Texas offers a wide range of confusion.

(a) Construction contractors that perform under lump-sum contracts for new construction or are performing residential real property improvements are consumers of the materials they use and must pay the tax.

(b) However, construction contractors performing new construction and who separately state labor and materials can buy the materials exempt of the tax under a “sale for resale” exemption and must charge tax on the separately stated materials charge.

(c) Contractors that remodel or repair non-residential real property pursuant to either a lump-sum or separately stated contract, are deemed the retailer, and the underlying service becomes a taxable service upon which the contractor can buy the materials under a “sale for resale” exemption.

(d) Contractors that perform both the construction of a new building and the remodeling of an existing building to conform with the new building, could be both consumer and retailer on the same project. For contractors who buy materials in bulk to save money and achieve an identical look for both buildings, this could be problematic. The best way to handle this project would be to bar scan all the materials or maintain strict inventory control to ascertain which products went into each building

III. Contracts for Exempt Entities or for Exempt Use

A. Contrary to the General Rule that the subcontractor is the end-user of materials incorporated into real estate, construction contractors may often purchase materials exempt from tax.

1. Many states permit such purchases when the materials are to be incorporated in property owned by an exempt person such as a government, a religious or charitable entity, or other tax exempt organization.

a) Treatment of contractor purchases as if the exemption “flowed through” to the contractor runs counter to the concept that it is the contractor, not the exempt entity, that is the end-user of the materials, but, where it exists, the practice of providing the exemption is of long standing and generally is part of the regulations.

2. Similarly, a contractor may be able to purchase materials exempt from tax when they are for an exempt use, such as certain manufacturing or research and development equipment.

a) The contractor’s ability to make such purchases may be based on the same “flow-through” treatment as purchases for exempt persons, but more often requires proof that a purchase is for resale or is made on an agency basis.

B. The flow-through exemption applies only to materials to be incorporated in the project.

1. It does not apply to supplies, tools and equipment use by the contractor, even if purchased or leased specifically for the exempt project and fully consumed in performing the project.

2. If a state does not allow a “flow thru” of the exemption, it may be that the exempt entity can purchase the materials itself and the contract drafted so that the exempt entity purchases the materials and then allows the contractor to utilize them in fulfillment of the contract.

a) Be very cautious here. If the regulations do not permit purchase on either a flow-through or agency basis, the tax department can be expected to resist bifurcation of what they see as a unified construction contract.

C. Many states’ statutes do not specify that the federal government is an exempt person, leaving the relevant exemption to be one that provides that the state does not tax transactions which it is prohibited from taxing under the U.S. Constitution.

Consequently, the fact that the owner of the finished facility is the federal government may not be enough to support exempt purchases of materials. In order for the exemption

to flow thru, the contractor may actually need to be appointed agent-in-fact of the government.

1. Many government projects are accomplished on a “turnkey” basis: The government may own the underlying land, but the developer or construction manager is the owner of the building under construction and is obligated to deed it to the government agency when complete. Under these circumstances a tax department may well take the position that the “flow-through” exemption is unavailable because the owner of the real property under construction is not exempt.
2. Governments may prove unwilling to sanction an agency approach to purchases and virtually never let a contract as a bifurcated purchase of materials/installation. As a result, in the absence of legislation, the project may well not be exempt.

D. Procedural Issues

1. Most states have very specific forms that must be completed in order for contractors to avail themselves of these exemptions. These forms can involve a tremendous amount of work, and in some instances, may require that each item purchased for exempt use be sufficiently detailed.
2. Be careful to confirm that the party purchasing the service is, in fact, an exempt entity, and does, in fact, own the property:
 - a) State will always exempt itself and its agencies.
 - (1) May not exempt every municipal corporation. For instance, tax districts formed to make sewer or sidewalk may be governments, but not exempt.
 - b) Exempt persons for purposes of the sales tax exemption are often not the same as one exempt from income tax under IRC § 501(c)(3).
 - (1) “Charitable” for state law purposes may not be coextensive with federal tax exemption.
 - (2) May need to refer to state property tax law to determine which entities are exempt.
3. From the states’ perspective, the contractor bears the burden of verifying that it can avail itself of these exemptions.
 - a) The contractor should carefully protect itself by providing for remedies related to these issues directly in the contract (i.e., adjustment of purchase price, etc.).

IV. Other Considerations

A. Construction Manager v. General Contractor

1. Most do not distinguish between a Construction Manager and a General Contractor for sales and use tax purposes, however exceptions exist in some states.

a) Arizona - If viewed as a prime contractor, a construction manager is subject to the transaction privilege tax based on 65% of the gross receipts derived from its construction activities, as discussed in detail below. If viewed as a construction manager and not a contractor, the construction manager may not have any transaction privilege tax reporting responsibilities related to its services. Instead, the general contractor for the project would be responsible for reporting the transaction privilege tax.

b) Kansas - Kansas distinguishes between contractual arrangements whereby a company only provides consulting or coordinating services for a construction project for a property owner and those involving the actual performance of labor services on a construction project. The services provided by a construction manager, which can include consulting, coordinating the work of specialty contractors, and furnishing project progress reports, are not separately enumerated services and therefore not subject to sales tax. However, if a company holding itself out as a construction manager begins to perform any installation, repair, or other taxable service, then its classification will change and it will be required to collect and report tax as a contractor. *See* Kansas Information Guide No. EDU-26 (5/31/2005).

2. Despite the potential differences in activities, some of the states will impose the same tax liabilities on a Construction Manager as they would onto a General Contractor. In others, the General Contractor will be subject to the sales and use tax rules of the respective states on the materials used in the performance of the construction services. In contrast, a Construction Manager will generally provide only services, which may or may not be subject to tax.

B. Contractor Doing Business in Multiple States

1. Materials Used or Consumed in Rendering Contract

a) Credit for out-of-state purchases

(1) States are required by the US Constitution to provide a credit for sales taxes properly paid to another state.

(a) Auditors often disallow a credit they think was not properly paid. For example, the contractor picked up the

property in its own trucks rather than having it shipped to the job site.

b) Temporary Storages Exceptions - Property temporarily stored in one state for use in another state and actually used in another state may not be subject to tax.

(1) In some states only out-of-state purchases are entitled to the temporary storage exception.

(a) Massachusetts provides such a limited exception – it is only applicable to use tax, not sales tax.

(b) Such exemptions may or may not apply to property iht is subject to manufacturing as other processes to produce another product.

c) Some states, such as Connecticut, provide an exemption regardless of the state of purchase.

(1) Connecticut enacted a statue that left the traditional out-of-state purchase exemption in place and adopted a separate exemption applicable to in-state purchases, requiring a purchaser to pay the tax and seek a refund. *See*, Conn. Gen. Stat. § 12-408(c).

(2) The temporary storage exception may have a definite time limitation.

d) Some states offer more unique exemptions which may apply. Pennsylvania offers what is referred to a special resale exemption.

(1) Pa. Reg. 32.3(a)(2) provides an exemption for “Personal property purchased or having a situs within this Commonwealth solely for the purpose of being processed, fabricated, or manufactured into, attached to or incorporated into personal property and thereafter transported outside the Commonwealth for use exclusively outside the Commonwealth.”

2. Equipment Used in Rendering Services

a) Owned Equipment

(1) Moving equipment used in one state to a jobsite in another state will ordinarily trigger a use tax obligation. However, a credit should be available, as discussed above.

(2) Nevertheless, some states do not impose use tax when property has been used for a time outside the state. Even states that have

this rule, however, will ordinarily not apply it to motor vehicles and other equipment that must be registered with the state.

b) Leased Equipment

(1) Tax is ordinarily charged on each lease payment and so is paid where use occurs. Lessee should notify lessor prior to movement of property.

C. Bonding and Withholding Requirements

1. Many states require out-of-state contractors to post bonds and/or require those who deal with out-of-state contractors to withhold from payments due them to insure that all taxes have been paid in the performance of a construction contract. For example:

a) In Arizona, a licensed contractor that has not had a principal place of business in Arizona for one year or more is required to furnish a bond, ranging in amount from \$2,000 for small contractors to \$102,000 for bridge builders. A contractor with a satisfactory two-year payment history may be exempted from this requirement. Ariz. Rev. Stat. Ann. § 42-5006; Ariz. Admin Code § R15-5-601.

b) In Connecticut and Massachusetts, a contractor without a permanent place of business in the state is required to post a bond equal to a percentage of the contract price. If the contractor does not provide a certificate to that effect, the person hiring the contractor must withhold the same percentage of the total price of the contract. (in Conn. 5%; in Mass. 6.25%). Conn. Gen. Stat. § 12-430(7); Mass. Gen Laws ch. 64H, § 30A, ch. 64I, § 31A.

c) Kansas requires nonresident contractors to register with the secretary of revenue for each Kansas project they work on if either the total project price or the compensation received by the contractor is more than \$10,000. In addition, nonresident contractors must execute and file with the secretary a surety bond as a condition precedent to commencing work on any contract in Kansas. The bond must be in a sum of at least \$1,000 and may be increased if this amount is deemed insufficient to cover the taxes associated with project work.

(1) However, the contract registration and bonding requirements are waived for nonresident contractors who are registered with the Kansas Secretary of State as a foreign corporation authorized to do business in Kansas.

D. The Contractor as Retailer of Tangible Personal Property

1. A contractor cannot be a retailer because a contractor is the end-user of purchased property and cannot purchase it for resale, while a retailer is a reseller of property and purchases inventory items for resale.
2. However, a contractor can “wear two hats”, one as a contractor and another as a retailer.
 - a) If a contractor operates a retail store at which it sells goods to the general public or to other contractors – apart from any service contract – the contractor qualifies as a retailer.
 - b) State law or regulation may permit a contractor to act as a retailer under other circumstances.
 - (1) A contract to sell materials and install them may be treated as a retail sale of the materials. Fla. Admin. Code Ann. § 12A-1.051(3)(d).
 - (2) However, a contractor who makes only few such sales may well be barred from treating himself as a retailer.
3. A contractor acting as a retailer may purchase materials of the type it sells at retail free of tax – even though they are identical to the items the contractor incorporates into real property when acting as a contractor.
 - a) However, the contractor must pay use tax on such items when they are removed from inventory for use in a contract, just as if they were being purchased from an independent supplier.
 - b) If the materials removed from inventory are for an exempt job, no tax will be due, but the contractor (acting as a retailer) will need to maintain appropriate exemption certificates just as would any other retailer.

E. The Contractor as a Manufacturer

1. A contractor who manufactures or fabricates product for use in contracts, e.g., HVAC ductwork or paving aggregate) may qualify as a manufacturer, that is, “wear two hats” and function as both a manufacturer and contractor.
2. In general, a manufacturer is one who produces tangible personal property for resale.
 - a) States have varying standards for the activity that qualifies as manufacturing, from an industrial process that changes the name, nature,

quality and use of property conducted in an industrial plant to definitions that include processing, fabricating or, simply production, with no requirement that the process occur in an industrial plant.

b) A contractor who uses the product in performing his own contracts is not making sales.

(1) There may be some exceptions such as Massachusetts and Connecticut asphalt producers.

c) Generally must make sales to third parties such as other contractors.

(1) State may require that sales predominate over use or that sales be substantial.

3. A manufacturer may purchase raw materials exempt from tax as in the case of a retailer, but in most states the benefits to manufacturers include exemptions for the purchase of manufacturing machinery and equipment, and materials, tools, fuels and utilities used in manufacturing.

4. As in the case of a retailer, a manufacturer charges tax on sales of product to its customer and, when acting as a contractor, when it removes product from finished inventory for use on its own contracts, it pays the use tax.

a) The use tax is generally assessed on the cost of the raw materials, not the retail value of the finished product.

5. Because one requirement for qualifying as a manufacturer is that product must be sold and the contractor's use of the product in its own projects is not a sale, a contractor/manufacturer may find it difficult to impossible to qualify as a manufacturer.

a) In such a case, one may consider organizing separate entities, one to perform manufacturing and the other to perform contracting. Careful analysis is required before making such a decision.

F. Contractual Provisions

1. In bidding a contract, most contractors include sales tax in computing their cost. If the contractor improperly calculated this amount, the contractual provisions will often specify the party who will ultimately bear the burden for both the underpayment and overpayment of tax.