

Department: Sales and Use Taxes

Contractors Confront Sales and Use Taxes: General Concepts Plus New Developments

A discussion, state-by-state, of recent significant, contractor-related sales and use tax statutory enactments and new rules, administrative decisions, and court cases, as well as some hurricane-related tax relief.

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In general, real estate contractors are deemed the final consumers of tangible personal property (TPP) that they purchase for use in their construction contracts. Contractors take TPP and convert it into real property. The general rule is that sales of TPP to contractors are sales at retail and, thus, subject to sales and use taxes, unless they are otherwise exempt. Contractors' sales of real property to their customers are not subject to tax. Also, contractors generally are not subject to tax on construction services or labor in most states.¹ The sales and use tax treatment of contractors can vary based on the type of contract (e.g., lump sum, time-and-materials, separated, or cost-plus) and/or the scope or type of work provided (e.g., renovation or remodeling vs. new construction, maintenance and installation (if separately stated)).

Contractors should look for potential sales and use tax exemptions that could apply to their purchases of TPP, including (1) exemptions or tax reductions for manufacturing or production machinery,² (2) a resale exemption for TPP installed under a time-and-materials contract (rather than a lump-sum contract) and the charge for TPP is separately stated, (3) exemptions for pollution control equipment,³ (4) various tax breaks for construction projects located in economically disadvantaged areas (e.g., enterprise zones),⁴ (5) other economic development exemptions (e.g., tax-abated facilities owned by governmental units, financed by industrial revenue bonds, and leased back to the customers), and (6) flow-through exemptions for sales to exempt entities.⁵

The following discussion summarizes, by state, the vast majority of significant, contractor-related sales and use tax laws, rules, administrative decisions, and court cases that were enacted, promulgated, or decided between July 2004 and July 2005. Overall, considerable activity occurred with regard to federal and state government contracting issues, and providing tax benefits in economic development incentive programs.

Alabama's Government Contractor Exemption

For contractors performing under certain government contracts in Alabama, Attorney General Opinion 2004-170, 6/30/04, provides guidance in coping with that state's repeal of the contractor's sales and use tax exemption (Ala. Code §40-9-33, repealed by Act 2004-638, effective 7/1/04). The opinion clarifies that:

- Contracts awarded prior to July 2004 that qualified for the sales and use tax exemption will continue to qualify until completion.
- Despite confusing language in Act 2004-638, the Alabama legislature would have to reenact the exemption in order to resurrect it.
- All applicable contracts entered into after June 2004 will be governed by Alabama's rules that were in effect prior to the original enactment of §40-9-33.
- Any specific statutory sales and use tax exemptions that existed prior to the original enactment of §40-9-33 and that provided similar exemptions applicable to government contracts have not been repealed.

Purchases of additional TPP pursuant to changes to government contracts executed prior to the repeal of Ala. Code §40-9-33 are not exempt, but a contract change or revision that does not require such additional purchases will not cause the contract to lose its original exempt status.

Arizona Deductions, Reporting

Under guidance issued in connection with the transaction privilege tax retroactive deduction for architectural or engineering services incorporated into a prime contracting agreement (Ariz. Transaction Privilege Tax Proc. No. 04-2, 9/1/04), contractors may seek refunds of transaction privilege taxes, penalties, and interest that they paid for architectural and/or engineering services *for tax periods dating back to 10/17/69*, up to an aggregate limit of \$100,000 per contractor. Claims for retroactive refunds had to be made by 12/31/04, or otherwise be compatible with Arizona's four-year statute of limitations.

Also, effective 2/5/05, the Arizona Department of Revenue has repealed Ariz. Admin. Code. §R15-5-617, which concerned contractors' sales and use tax reporting rules, because the rule contained "redundant, erroneous and misleading information."

Arkansas' New Taxable Services, New Exemption

Effective 7/1/04, various new services, including certain contractor installation work, became subject to Arkansas sales and use tax. In *Arkansas State Revenue Tax Quarterly* (Vol. X, No. 4, 10/1/04, Ark. Dept. of Finance and Admin.), the Department offered guidance on the taxability of, among other things, remodeling contractors and the installation of home security systems. An earlier edition of *Revenue Tax Quarterly* (Vol. X, No. 2, 4/1/04) discussed installation of certain other items.

Remodeling. Contractors involved in remodeling must obtain tax permits and collect taxes on charges for both labor and materials for the initial installation of flooring, machinery, and heating and air conditioning equipment in existing buildings. Labor for such installations either in a new building or as a substantial modification to an existing building is deemed nontaxable construction contracting. In the latter case, the contractor is subject to sales or use tax on the equipment and materials installed. Invoices involving both taxable and nontaxable services must separately state the charges for each, or the entire invoice will be subject to tax.

Security systems. The installation, replacement, or repair of home security systems (e.g., wiring, alarms) that become part of or are permanently affixed to real estate continue to be exempt under Arkansas law, even if furnished in an existing building. Charges for the service of monitoring security systems, however, are taxable.

Other installations. Initial installation of motors of all types, electrical appliances, flooring, engineering instruments, machinery of all kinds, office machines and equipment, mechanical tools, and shop equipment is subject to tax. If, however, the item being installed is eligible for a sales tax exemption, the installation service for that item also will be exempt.

Qualified art museums. Arkansas has enacted a new sales and use tax exemption for qualified art museums that also applies to their contractors' purchases of materials used in the construction, repair, expansion, or operation of such museum facilities (H.B. 2480, 4/8/05; L. 2005, Act. No. 1865; codified at Ark. Code §§26-52-438 and 26-53-145). A "qualified museum" is a nonprofit organization that acquires artwork valued at more than \$100 million for purposes of establishing (at a cost exceeding \$30 million) a museum, to be completed before 2013.

In order to obtain an exemption certificate from the Department of Finance and Administration, the qualified museum must file a statement demonstrating its intent to meet these requirements. Another statement, to be filed by 6/30/13, must then show that all requirements were in fact satisfied before 2013. Although the Department can revoke a museum's exemption certificate for failure to meet the requirements, and assess applicable sales and use taxes, penalties, and interest, third parties (such as construction contractors) that relied in good faith on the exemption certificate prior to its revocation are held harmless under the statute.

Colorado

Effective 1/1/05, Colorado's Regional Transportation District (RTD) tax, a sales tax, increased to 1% in the Denver metropolitan area. According to the Colorado Department of Revenue's information release of the same title, the "RTD Tax Increase: Effect on Leases and Construction Contracts" is as follows:

Leases. The tax rate on a leases is established at the start of the lease and remains in effect over the entire lease period. Accordingly, leases entered into after 2004, as well as month-to-month leases after that date, are subject to a 1% RTD tax.

Contractors. For purchases after 2004, taxpayers are subject to the higher tax. Accordingly, contractors purchasing materials after 2004 must pay tax at the new rate even if the purchase is in connection with a construction contract entered into prior to

2005. Contractors thus would be wise to ensure that their contracts provide for the customer to absorb any increases in tax rates over the life of the contract. Otherwise, a contract bid out at a fixed price based on the lower tax rate can prove costly.

Connecticut Contractors' Guidebook

The Connecticut Department of Revenue Services (DRS) has published the *Building Contractors' Guide to Sales and Use Taxes* (Conn. Information Pub. No. 2004(29), 12/15/04), offering general guidance for the proper treatment of sales and use taxes as they relate to the construction industry (this publication replaces the previous guide, No. 99(19), 9/20/99). In contrast to most other states, Connecticut sales and use tax law treats building contractors both as consumers of materials used to complete their construction contracts and as suppliers of construction services to their customers.

The guidebook explains how to obtain a sales and use tax permit and describes the different types of construction contracts. Other topics include accounting methods, nontaxable contracts, direct pay permits, and installation vs. repair or maintenance of property, as well as details regarding the treatment of specific items from air conditioning and alarm systems to windows and wiring.⁶

District of Columbia

In *ACS State and Local Solutions, Inc. v. District of Columbia*,⁷ the District of Columbia Superior Court, Tax Division, held that a contractor was entitled to a refund of use taxes the contractor paid on parking meters it purchased and installed for the District. Under the terms of the \$25 million lease-purchase contract, the contractor was required to install 15,000 electronic parking meters and service them for seven years, after which title to the meters transferred to the District.

The court found that the terms of the contract did not give the contractor sufficient power over the parking meters such that it could be said to "use" the meters within the meaning of the D.C. tax statutes. The District had final approval over all aspects of the installation and management agreement and also controlled the use of the parking meters. Further, the meters had an estimated 30-year useful life, and thus the contractor was not the end-user of the property. Under the contract, the District would obtain legal title to the parking meters after seven years, at which time the meters retained at least 75% of their useful life. Thus, with regard to the purchase of the parking meters, the court concluded that the contractor met the requirements for the resale exemption. The Court also held that the contractor had merely a security interest in the parking meters, and therefore was not liable for the personal property tax either.

Florida

Contractors in Florida will be interested in several items of administrative guidance issued by the Department of Revenue.

Exemption for materials under government contracts. A "technical assistance advisement" (Fla. TAA No. 04A-049, 8/19/04) discussed the sales tax consequences where a school board contracted with a construction manager to replace the roof of a high school. The Florida Department of Revenue considered whether purchases of materials in connection with roofing project were exempt from sales and use taxes. The Department determined that the purchases would be exempt if the government entity

(i.e., the school board) rather than the contractor purchased the materials. That requirement would be met if the parties satisfied all of the following conditions:

- The school board must execute the purchase orders (which must include the board's exemption number) for the tangible personal property, although the contractor may present the purchase orders to the vendors.
- The board must acquire title to and assume liability for the property from the time it is delivered to the job site until it is incorporated into the realty. Liability would be indicated by the board's acquiring, or being included as the insured party under, an insurance policy on the materials.
- The vendors must directly invoice the school board for the materials and supplies, and the board must directly pay the vendors.
- Ultimately, under the contract terms, the sales of material must be, in substance, direct sales to the government entity.

Similar rulings were issued in Fla. TAA No. 05A-004, 1/20/05 (materials used to construct a new elementary school building), and Fla. TAA No. 05A-012, 2/23/05 (public works construction contract between a contractor and a county). Both of these rulings cited the same criteria as discussed in TAA No. 04A-049. All three TAAs contain examples of contractual language that meets the requirements of the Florida statutes and, thus, are useful resources for government entities seeking to avoid sales and use taxes in connection with planned construction projects. ⁸

Tax on asphalt. In a "Tax Information Publication" (TIP 05A01-07, 6/21/05), the Florida Department of Revenue announced that the per-ton indexed use tax rate for asphalt manufactured by contractors for their own use increased to 54 cents (from 50 cents) for 7/1/05 through 6/30/06. The TIP also clarified that Florida's 40% exemption remains in effect for such asphalt used in a federal, state, or local public works project. In such projects, the tax rate is 33 cents per ton. The release also provides details regarding the computation of the tax.

Contractor's purchase of fill dirt subject to sales tax. Fla. TAA No. 05A-007, 1/26/05, concerned a contractor's purchase of nearly 1.4 million cubic yards of fill from a site owned by a municipality. The city did not normally sell fill material, and the contractor claimed the transaction was an exempt occasional sale.

In the TAA, the Department noted that Fla. Stat. §212.06(15)(b) specifically requires that a contractor pay sales tax on fill dirt procured from land not owned by the contractor. Thus, the Department held that such a purchase could not qualify as an exempt sale. Further, the Department noted that the city had at least two sales tax accounts in the state's system, which indicated that the city was in the business of selling tangible personal property.

Electric generating facility. Fla. TAA No. 05A-017, 3/23/05, involved construction, installation, start-up, testing, and commissioning services for two power-generating units at a city's electric-production facility. The contractor entered into an agreement with the city to construct the units at an existing facility. While no new buildings would be built, certain facilities would be purchased to enclose and shelter some of the new machinery. The Department noted that since the facility would burn natural gas and distillate oil fuels to produce electrical energy for sale, an exemption could apply.

Specifically, the exemption would cover items that constituted permanent parts of the machinery and equipment integral to the production of electrical energy. Although materials consumed in any real property improvement activities would be taxable, any

structure or facility whose purpose is to enclose or protect qualifying machinery and equipment is deemed an integral part of the machinery and equipment and, thus, qualified for the exemption. In contrast, the renting of construction equipment (e.g., cranes, scaffolding, earthmovers) is fully taxable. In order to pass the exemption through to the contractor and its subcontractors, the city must issue an affidavit to the contractor, which, in turn, would issue its own affidavit (together with a copy of the city's) to its subcontractors, with all affidavits ultimately included with the purchase orders given to the vendors.

Georgia Exemptions

The Georgia legislature extended, from 1/1/05 until 1/1/07, the exemption for "overhead materials" purchased or used by a contractor in the performance of a contract with either the U.S. Department of Defense or the National Aeronautics and Space Administration (H.B. 1238, 5/13/04; L. 2004, Act 562). "Overhead materials" include any tangible personal property used or consumed in the performance of the contract, the cost of which is charged and allocated to such contract. Title to the materials must pass immediately to the government under the contract terms. The exemption does not cover TPP that is incorporated into real property construction.

Effective 7/1/05, with regard to property owned by Georgia or any of its political subdivisions and used in the performance of a government contract, no sales or use tax will be imposed when such property is *not* used up and consumed in the performance of the contract (H.B. 306, 5/2/05; L. 2005, Act 83; adding Ga. Code Ann. §48-8-63(g)). TPP that is incorporated into real property and that loses its identity as TPP is deemed so used up and consumed, however. Thus, the state or other government agency that furnishes TPP to a contractor for incorporation into a real estate construction, renovation, or repair project must give the contractor advance written notice of the applicable tax due. Otherwise, the government is liable for the tax.

Idaho Rebates

Effective 1/1/05, taxpayers that construct new headquarters facilities in Idaho can receive a rebate for sales and use taxes paid in 2005-2009 by either the taxpayers or their contractors in connection with property constructed, located, or installed at the project site (H.B. 306, 4/13/05; L. 2005, ch. 369). To qualify, a taxpayer must invest at least \$50 million in the new facility, create at least 500 new jobs, and meet certain other job-related requirements.

Under the Idaho Small Employer Incentive Act of 2005 (H.B. 323, 4/13/05; L. 2005, ch. 370), a similar sales tax rebate applies, limited to 25% of the tax paid in connection with smaller headquarters projects. That is, qualified taxpayers must invest at least \$500,000, create at least ten new jobs, and meet certain other, less-stringent job-related requirements.

To obtain these rebates, the taxpayer must file a written claim with the Idaho Tax Commission no later than the end of the third calendar year following the year in which the tax was paid. Failure to meet specified requirements can result in recapture of the rebate. This sales tax rebate is in addition to investment tax credits, new jobs credits, real property improvement tax credits, and a temporary property tax abatement also available for qualifying new headquarters projects.

Indiana Tax Court Rules on Hauling Dirt

In *Galligan v. Indiana Department of State Revenue*,⁹ an excavating and construction company located in Jeffersonville, Indiana objected to the imposition of sales and use taxes in various transactions involving the purchase or delivery of topsoil, dirt, sand, rock, and stone, and services such as the machining and repair of the company's equipment, asphalt paving, material testing, and the construction of concrete curbs.

Delivering dirt. The Indiana Department of State Revenue assessed sales tax on approximately 15 different transactions in which it believed the company sold dirt, sand, and rock to its customers, but failed to collect sales tax thereon. The company's invoices merely indicated various quantities of sand, dirt and topsoil, but the taxpayer testified that it had not sold these items but simply delivered them to its customers. The company explained that its business involved excavating sewer and water lines, and building streets and roads. As part of that process, it was necessary to dispose of the dirt that it had excavated.

The dirt was available to anyone for the taking and the taxpayer never purchased the dirt for resale. Rather, when someone wanted the dirt but was unable to transport it, the taxpayer would haul the dirt for them to the desired location. The company charged these customers a hauling fee per load, but there was never a charge for the dirt. Thus, according to the taxpayer, the transactions were not retail sales of goods but, rather, a service, and therefore not taxable.

Noting that the taxpayer had the burden of proving the proposed assessment wrong, the court found that the company had met that burden. The testimony at trial constituted direct and reasonable evidence that the subject transactions did not involve a retail sale of tangible personal property. Moreover, the Department failed to rebut the taxpayer's case and merely argued that more evidence was required from the company.

Use tax on deliveries of stone. The Department also attempted to assess use taxes on delivery charges the company paid for certain purchase of stone. Quoting a regulation (45 Ind. Admin. Code r. 2.2-4-3), the court noted that "[s]eparately stated delivery charges are considered part of selling at retail and subject to sales and use tax if the delivery is made by or on behalf of the seller of property not owned by the buyer." In that regard, the regulation states:

- (1) "Delivery charge separately stated with F.O.B. destination [is] taxable."
- (2) "Delivery charge separately stated with F.O.B. origin [is] nontaxable."
- (3) "Delivery charge separately stated where no F.O.B. has been established [is] nontaxable."
- (4) "Delivery charges included in the purchase price are taxable."

The parties did not dispute that the delivery charges were separately stated; rather, they disagreed as to the delivery terms. The court noted the taxpayer's detailed testimony that the stone had been delivered by common carriers that were hired by the quarries themselves, that the stone was delivered to the taxpayer F.O.B. origin and, because title to the stone passed upon transfer of the material from the quarries to the common carriers, if a carrier had an accident and lost the stone, the carrier was required to reimburse the taxpayer for the stone. Accepting the unrefuted testimony of the taxpayer, the court held that the stone was delivered F.O.B. origin, and thus was nontaxable.

Mixed nature of service transactions. Finally, the court considered whether services such as the machining and repair of the company's equipment, asphalt paving, material testing, and construction of concrete curbs were subject to tax. The taxpayer argued that, as "services," these transactions were not taxable. The Department countered that

because the service-providers transferred tangible personal property to the taxpayer in the course of providing their services, the transactions, in their entirety (i.e., both materials and the service), were taxable as retail unitary transactions.

The court noted that the legislature has set forth rules to govern the taxation of such mixed transactions. Citing Ind. Code §6-2.5-4-1(c)(2), the court said, "taxable property does not escape taxation merely because it is transferred in conjunction with the provision of non-taxable services." Then, citing §6-2.5-4-1(e)(2), the court noted that "services, generally outside the scope of taxation, are subject to tax to the extent the income represents 'any bona fide charges which are made for preparation, fabrication, alteration, modification, finishing, completion, delivery, or other service performed in respect to the property transferred *before its transfer, and which are separately stated on the transferor's records.*'" (Emphasis added by the court.) Finally, the legislature imposed tax on services that are provided in a retail unitary transaction, i.e., "a unitary transaction that is also a retail transaction" (Ind. Code §6-2.5-1-2(b)). A unitary transaction is one that "includes all items of personal property and services which are furnished under a single order or agreement and for which a total combined charge or price is calculated" (Ind. Code §6-2.5-1-1(a)). The court then applied these rules to the various invoices at issue.

Machining and repair. With regard to the various machining services on the taxpayer's own equipment, the vendors occasionally provided parts, such as pins or screws, in connection with their services. One vendor's invoices indicated that the taxpayer was charged one undivided price per sales contract, a total that included the combined costs of the material, the sales tax on the materials, and the cost of the machining services. Such charges, the court said, clearly constitute retail unitary transactions. Nevertheless, "services rendered in retail unitary transactions are taxable only if the transfer of the property and the rendition of services are inextricable and indivisible ... (citation omitted). Generally, the transfer of property and the rendition of services are inextricable and indivisible when the services are performed before the property was transferred to the transferee. See Ind. Code §6-2.5-4-1(e)... Services provided after a transfer of property, however, indicate a divisible transaction in which the sale is taxed but the services are not."

Here, the machining services were provided concurrently with the transfer of parts to the taxpayer. Therefore, the court said, "the temporal relationship of the two events does not indicate whether the transaction is inextricable and indivisible." Looking to other factors to make that determination (e.g., the service-provider's records, the overall nature of its business, as well as the nature of the unitary transactions themselves), the court found that the only evidence presented at trial (i.e., the invoices from the service-provider to the taxpayer) did not indicate that the vendor intended to treat the transfer of property and the provision of its services separately. Thus, the court affirmed the Department's assessment of use tax against these transactions.

With regard to a second vendor's charges for a similar service, however, the Department's audit report noted that the invoice indicated that, in fabricating two pins, the vendor "only taxed material." Based on the auditor's comment, the court found that, clearly, some type of delineation was made on the invoice to indicate what materials were sold and the applicable sales tax charged thereon. In this situation, the court said, "[o]bviusly, then, the invoice ... indicated [the vendor's] intent to treat the sale of its services and the sale of materials separately. Consequently, the Department's assessment of use tax against the service component of this transaction is reversed."

Asphalt paving. In the course of providing the taxpayer with asphalt paving services, the vendor also provided the "cold patch" paving materials. The vendor's invoices simply

listed the amount of cold patch purchased by the taxpayer and the sales tax charged thereon. These invoices did not provide a charge for, and did not even mention, the service component of the transaction. Thus, according to the court, with respect to these invoices, the vendor clearly treated the sale of its services and the sale of the cold patch materials in a very divisible manner. Therefore, the Department's assessment of use tax against the service component of these transactions was in error.

Material testing. The Department also assessed use tax against the taxpayer for a service-provider's charge for deflection and air testing. According to the taxpayer, no materials whatsoever were transferred in connection with this transaction. The court found this testimony to be corroborated by the service-provider's invoice. Finding the transaction a "pure service," the court held it was not subject to taxation.

Construction of concrete curbs. The taxpayer also hired another construction company to "slip form" some curbs on a project. As part of that process, the other contractor furnished flumes (used to carry concrete down into the ditches) and plastic (used to protect the concrete curbs from rain and freezing). As noted above, when the transfer of property and the rendition of services are concurrent, the court must look to other factors to determine whether the transaction is inextricable and indivisible. Here, based on the only evidence presented at trial (i.e., the taxpayer's testimony), the court found that the overall nature of the second contractor's business was to provide a service, and the use of flumes and plastic in providing that service was incidental. Such a finding, the court said, supports the divisibility of the transactions at issue and, consequently, it reversed the Department's assessment of use tax against these transactions.

Repairs. Finally, the Department assessed use tax on a charge the taxpayer paid for repair services performed on its excavator equipment. The repair included the rechroming of a shaft and the repacking of a shaft, as well as the incidental furnishing of a rod piston. As with the concrete curb construction, the court found that the evidence in the record as to this transaction supported a finding that the rendition of the repair service and the provision of material were divisible. Consequently, the court also reversed the Department's use tax assessment against this transaction.

Iowa Legislation

Effective 7/1/05, new Iowa Code §423.3.85 (added by S.F. 413, 6/3/05; L. 2005, ch. 140) provides an exemption for the following: self-propelled building equipment, pile drivers, and motorized scaffolding, or attachments customarily drawn or attached to such items, including auxiliary attachments that improve the performance, safety, operation, or efficiency of the equipment, and replacement parts, that are directly and primarily used by contractors, subcontractors, and builders for new construction, reconstruction, alterations, expansion or remodeling of real property or structures.

This legislation, which also furthers Iowa's conformity with the Streamlined Sales and Use Tax Agreement, also expands Iowa's exemption for leases and rentals of construction equipment and subjects construction equipment to a new excise tax in lieu of Iowa's sales tax.

Kansas DOR Issues Guidance

In connection with the new federal individual income tax deduction for sales and use taxes, in lieu of state income taxes, the Kansas Department of Revenue issued Public

Notice 05-01, 3/28/05, with regard to sales taxes on construction materials. Apparently, individuals have been asking Kansas contractors to reissue their bills to show the sales tax paid on construction materials. The Department noted, however, that taxpayers may not deduct taxes paid by a third party, such as a contractor that did work for the taxpayer. In Kansas, while contractors must pay sales tax on materials used in the construction work, residential construction services are not subject to sales tax. Thus, individuals who contract for residential improvements are not charged tax. Accordingly, the Department said that contractors should not reissue bills to customers to show the sales tax the contractor paid; that tax is not deductible on the individuals' federal or Kansas income tax return.

As a result of legislation enacted by Kansas to conform to the Streamlined Sales and Use Tax Agreement, the state's taxable point of sale changed from where goods are sold (point of origin) to where goods are delivered (destination point).¹⁰ In PLR P-2005-017, 6/23/05, the Department determined that a roofing contractor was subject to state and local sales tax at its warehouse upon taking delivery of materials, rather than at the job site where the contractor fabricated the roof panels, framework, and flashing.

Louisiana Repairs, Manufacturing Machinery

In Rev. Rul. 05-001, 3/1/05, the Louisiana Department of Revenue has issued the following guidance regarding sales taxation of the repair and servicing of movable vs. immovable property.

Movable property. Charges for repair services and related replacement parts (even if separately stated) for movable property are subject to tax under La. Rev. Stat. Ann. §47:301(14)(g). The ruling makes clear that dealers may claim credits on their sales tax returns for Louisiana advance sales taxes that they paid to wholesale suppliers for such parts. Dealers are not liable for use tax to the extent advance sales taxes were not collected, but then the tax the dealer collects from a customer must be remitted to the state without any claim for advance tax. If the dealer fails to collect the tax, the customer must remit tax directly to the Department. Both the dealer and the customer remain liable until the tax is remitted to the state.

Immovable property. Under Louisiana law, services for repairs to immovable property are not subject to sales or use tax. Also, parts furnished in connection with such repairs are not subject to tax provided that title to the parts does not pass to the customer until the parts have been incorporated into and made components of the immovable property. Accordingly, the dealer must pay sales tax on its purchases of parts from its suppliers. Moreover, the dealer is liable for the tax if the supplier fails to collect it.

Nevertheless, the Department stated that dealers and their customers have some flexibility in determining whether repair parts are (1) sold as movable property prior to their being incorporated into immovable property, or (2) not sold until after becoming components of the customers' immovable property. The terms of sale must be disclosed on the dealer's invoice, and must be consistent with the parties' business practices.

Phase-out of sales tax on manufacturing machinery and equipment. Effective 7/1/04, Louisiana began phasing out the state sales tax on manufacturing machinery and equipment by excluding from taxation 5% of the sales price (La. Rev. Bulletin No. 04-012-A, 5/18/04). The exclusion will reach 100%, effective 7/1/10, as follows:

7/1/04

5%

7/1/05	19%
7/1/06	35%
7/1/07	54%
7/1/08	68%
7/1/09	82%
7/1/10	100%

To qualify for the exclusion, the machinery and equipment must be tangible personal property or other depreciable property that is used by a manufacturer in a plant facility predominantly and directly in either manufacturing for agricultural purposes or manufacturing tangible personal property for ultimate sale to others, and not for internal use, at one or more fixed locations in Louisiana. Manufacturers must be certified as such by the Department of Revenue. Political subdivisions of the state have the option to adopt similar exclusions.

Maine

New legislation enacted in Maine (S.B. 147, 6/9/05; L. 2005, P.L. 351) repeals the Pine Tree Development Zone sales tax exemption for contractors. The exemption, which was to go into effect on 7/1/05, apparently has been replaced by a sales and use tax reimbursement scheme that applies to sales on or after that same date.

Under rules similar to those for the exemption, construction contractors may now claim reimbursements for taxes paid on purchases of tangible personal property physically incorporated in, and becoming a permanent part of, real property that is owned by or sold to a qualified Pine Tree Development Zone business and that is used in the business's qualified activity in a Pine Tree Development Zone. Among other requirements for qualification, the sale to a construction contractor must occur by the earlier of (1) ten years from the date business receiving the property is certified as a qualified Pine Tree Development Zone business, or (2) 12/31/18.

The Maine legislation also modified many other aspects of the original Pine Tree Development Zone incentives program. [11](#)

Massachusetts

In Ltr. Rul. 05-02, 3/8/05, the Massachusetts Department of Revenue considered the sales tax aspects of constructing a water purification plant to supply water to various municipalities in the state. In Massachusetts, the sale, furnishing, or service of water is exempt from sales and use tax, as are sales of machinery and sales of materials that become part of tangible personal property used in the furnishing of water.

Here, the water purification facility and related pipeline would be built under a fixed-fee/cost-reimbursement contract. The Department ruled that if the contractor qualified as an agent of the owner of the plant, it could take advantage of the owner's sales tax exemption on qualified purchases. Regardless of the contractor's agency relationship, however, any materials or other items used by the contractor in fulfilling its obligations under the contract that do not become part of the water-furnishing facility (e.g., not incorporated into the plant or used in actually furnishing water) would be taxable to the contractor.

Minnesota

In connection with the Minnesota Job Opportunity Building Zones (JOBZ) program, the Department of Revenue issued a "JOBZ Fact Sheet" (2/1/05) offering guidance on the program's various tax exemptions. According to the Department, a JOBZ exemption applies to both state and local sales and use taxes and includes construction materials and supplies used to construct or improve real property in a Zone if the finished property is used by a qualified business there. The exemption applies whether purchases are made by the qualified business or by the contractor.

Mississippi

Effective 7/1/05, new legislation (S.B. 2746, 3/21/05; L. 2005, ch. 434) amended Miss. Code Ann. §27-65-21 (contractor's sales tax) to add to the tools available for the Mississippi Department of Revenue to enforce the state's 3.5% contractor's sales tax. Now, the Department can employ a jeopardy assessment, filing a notice of tax lien and issuing a jeopardy warrant against contracts for which sales taxes have not been properly prepaid or bonded or that are otherwise not in compliance with Miss. Code Ann. §27-65-21.

Missouri Administrative, Judicial Rulings

Three recent Missouri decisions involved the payment or collection of sales and use taxes by contractors.

Plaintiff contractor granted refund, awarded attorney's fees. In *Brewers Flooring & Sales, Inc. v. Director of Revenue*,¹² a Missouri corporation that sold and installed flooring materials in homes and businesses sought to recover attorney's fees and expenses that it incurred in its successful appeal to recover erroneously collected sales taxes. For about 20 years, the taxpayer had been collecting taxes on its sales of flooring materials, whether sold over-the-counter or installed (net of labor charges).

Following an audit, the state's examiner assessed approximately \$900 in sales tax for the taxpayer's purchases of supplies that did not become a final part of the flooring (the taxpayer had incorrectly issued an exemption certificate for those purchases). Also, while explaining to the taxpayer's independent accountant that the company should not be charging tax on sales of installed flooring, the auditor neither told the accountant of the existing overpayment nor advised the company to register for use tax. Moreover, the auditor did not attempt to determine the amount of the taxpayer's sales tax overpayment, and imposed the \$900 assessment even though the auditor knew the taxpayer had overpaid its sales tax liability for the period because of its remittance of tax on the installed sales. The taxpayer's accountant explained that the company's method of collecting sales tax was an easier way to do its invoicing, and as long as it remitted the collected tax, the method did not matter. In any event, the accountant did not inform the taxpayer of the auditor's comments, and the taxpayer continued to collect sales tax on installed flooring material.

In 2001, a couple of years after this audit, an outside consultant told the taxpayer that it might be entitled to a refund for overpaid taxes on sales of installed flooring. The consultant explained that the refund would consist of (1) sales tax paid on any mark-up of installed materials, and (2) the difference between the sales tax and the lower use tax on the cost of those materials. Also any installed materials that were purchased from out-of-state vendors would be subject to the lower use tax rate.

Having been made aware of the proper sales/use tax procedures, the taxpayer, after confirming the details with its accountant, filed refund claims for nearly \$90,000 for the open portions of the audit period and subsequent years. The state auditor conducted a second audit and agreed to the refunds but the auditor's supervisor denied the claims on the grounds that the taxpayer had continued to collect sales tax on installed flooring after it was told not to do so (although apparently the taxpayer had not been informed of the correct way to report its sales and use taxes). In addition, the Department of Revenue assessed a penalty, equal to the over-collected sales tax, for intentionally over-collecting the tax in order to claim a refund.

On appeal by the taxpayer, the Missouri Administrative Hearing Commission granted the sales tax refunds and dismissed the penalties.¹³ The Commission found that, at the time the taxpayer was collecting tax on sales of installed flooring material, it was unaware that its method was incorrect. Moreover, the auditor had not informed the taxpayer of any overpayments, and the taxpayer was not aware of the possibility of a refund until the consulting firm advised it to file a claim.

In the present case, the taxpayer sought to recover attorney's fees and expenses it incurred in the dispute. The Commission found that the taxpayer was the prevailing "party" in the earlier, underlying proceeding (i.e., a corporation with a net worth of not more than \$7 million and no more than 500 employees at the time the underlying case was initiated). Furthermore, the state's position in the matter was not substantially justified (i.e., it had no reasonable basis in fact and law). Accordingly, the taxpayer was entitled to the fees and expenses.

Contractor's status as "engineering firm." Under Mo. Rev. Stat. §144.030.2(28), a sales and use tax exemption applies to computers, computer software, and computer security systems purchased for use by architectural or engineering firms headquartered in Missouri. In *Murphy Company Mechanical Contractors and Engineers v. Director of Revenue*,¹⁴ the Missouri Supreme Court affirmed the Missouri Administrative Hearing Commission's finding that a contractor qualified as an "engineering firm" for purposes of that exemption.

The taxpayer is a "design-build" contractor that provides both construction and engineering services, and holds a license to provide engineering services in Missouri. The company employs several hundred construction workers as well as a staff of professional engineers and technical draftsmen. About 40% of the company's contracts are design-build contracts, constituting approximately 20% of the company's revenues.

The Department of Revenue, while acknowledging that the taxpayer provided engineering services, argued that it was not an "engineering firm" under §144.030.2(28) because it was "primarily" a contractor or design-build contractor. The court rejected that argument, however, finding that §144.030.2(28) imposes no requirement that a firm engage "primarily" in providing engineering services for the exemption to apply. In contrast, some other subsections of §144.030.2 expressly require a use "primarily" for a particular purpose before the tax exemption applies.

Vendor can rely on out-of-state contractor's exemption certificate. In a Missouri private letter ruling (LR 2297, 2/4/05), a Missouri vendor sold material to an out-of-state contractor that purchased the material on behalf of its customer, a water district in that other state. The contractor provided an exemption certificate issued by the other state's revenue department to the water district.

In holding that the vendor can accept the exemption certificate and not collect tax on the sale, the Missouri Department of Revenue cited Mo. Rev. Stat. §144.030.2(36), which provides an exemption for all purchases by a contractor on behalf of an entity in another state, provided that the entity is authorized to issue a certificate of exemption for purchases to a contractor under the provisions of that other state's laws. For this purpose, a "certificate of exemption" includes any document evidencing that the entity is exempt from sales and use taxes on purchases pursuant to the laws of the state in which the entity is located. The contractor making purchases on behalf of such entity must retain a copy of the entity's exemption certificate as evidence of the exemption.

Nebraska Guidance for Accrual-Basis Contractors

Effective 7/1/04, Nebraska contractors must collect and remit sales tax on their gross receipts for labor in performing construction services as payments are received. In Rev. Rul. 01-04-1, 6/24/04, the Department of Revenue stated that contractors that maintain their books and records on the accrual basis of accounting and that receive multiple payments on construction projects (e.g., down payments, progress payments, etc.) may report the tax on each payment either when the amount is billed (recorded as a sale), or when the payment is received, provided the same method is used consistently for all contracts.

Accrual-basis contractors that receive only one payment for a project may continue to remit sales tax on their construction services when the sales are recorded. Also, cash-basis contractors should continue to remit sales tax as payments are received. This ruling supersedes the provisions in Neb. Sales & Use Tax Reg. §1-009.03 to the extent they do not reflect the rules for contractors reporting sales tax on down payments or progress payments.

New York Laws, Rulings

Doing business with the state. Under N.Y. Tax Law §5-a (effective 8/20/04), New York generally requires contractors, subcontractors, and their affiliates to register with the state for sales and use tax collection purposes as a prerequisite to doing business with state agencies. The new rule applies to contracts valued at more than \$15,000 resulting from solicitations to purchase issued after 2004 by governmental entities. Registration is required for any contractor, subcontractor, and affiliate that has made cumulative sales in excess of \$300,000 delivered in the state during the four quarterly periods ending on the last day of February, May, August, and November that immediately precede the quarterly period in which the taxpayer is certified as registered.¹⁵

Reconstruction as capital improvement. In *John Gallin & Sons, Inc. v. Eristoff*,¹⁶ the taxpayer applied for a refund of sales tax paid to subcontractors for floor covering installed during the reconstruction of existing office space in various buildings around New York. Under N.Y. Tax Law §1101(b)(9)(iii), floor covering installed as the initial floor covering in new construction or an addition to or "total reconstruction" of existing construction, is an exempt capital improvement.

The New York Appellate Division noted that "total reconstruction" means the complete rehabilitation or replacement of most of the major structural elements of an existing building. Thus, the court concluded that reconstruction of several, but not all, floors of a multi-storied structure did not constitute total reconstruction. Accordingly, the exemption was denied.

Purchases by New York governmental entities. The New York Department of Taxation and Finance has issued a Technical Services Bureau Memorandum (TSB-M-05(6)S, 6/8/05) to provide guidance in connection with purchases by New York governmental entities through agents. The state and its agencies, instrumentalities, public corporations, and political subdivisions all are tax exempt. These entities also may make exempt purchases through third parties, but only where the third party has been properly appointed to act as agent on the entity's behalf. This memorandum (along with the Department's "Publication 765: Sales and Fuel Excise Tax Information for Properly Appointed Agents of New York Governmental Entities") explains the scope of the exemption, the legal requirements that must be met for an agency relationship to exist, and the new procedures that an agent must follow in order to make exempt purchases.

North Carolina

Land surveyor's purchase of film prints. In *Matter of Proposed Assessment of Sales and Use Tax by the Secretary of Revenue v. EarthData International of North Carolina, LLC*,¹⁷ a land surveying company that purchased undeveloped aerial photography film, prints, negatives, data tapes, and compact disks from subcontractors for use in providing nontaxable aerial topographical services was subject to use tax because the items purchased were considered taxable property. The taxpayer argued that it was purchasing nontaxable "information" from the subcontractors, which were providing services that were an integral step in the process of photogrammetry. The North Carolina Tax Review Board disagreed and held that the true objects of the purchase were the prints, negatives, and other tangible personal property that the taxpayer subsequently used in providing its nontaxable services.

Exemption certificates. The North Carolina Department of Revenue has issued guidance explaining new exemption certificate procedures (N.C. Directive No. SD-04-1, 6/1/04). Effective 1/1/05, in connection with the national Streamlined Sales and Use Tax Project, the state has adopted a new exemption certificate (Form E-595E, "Streamlined Sales Tax Agreement Certificate of Exemption") to be used for purchases for resale or other exempt purchases. The directive indicates that various prior certificates, including Form E-580 "Contractor's and Subcontractor's Certificate," are being discontinued and will no longer be accepted by vendors.

New privilege tax. Effective 1/1/06, N.C. Gen. Stat. §105-187.5 imposes a new 1% privilege tax on the purchase of mill machinery, parts, and accessories, including such items purchased by (1) a contractor or subcontractor for use in the performance of a contract with a manufacturing industry or plant, or (2) a subcontractor for use in the performance of a contract with a general contractor that has a contract with a manufacturing industry or plant. The tax is limited to \$80 per item. The rates and application of the privilege tax are the same as the former sales tax (N.C. Gen. Stat. §105-164.4A(2), repealed effective 1/1/06) it replaces, but the new tax is imposed on the purchaser, who pays the tax directly to the state (instead of to the retailer).

Oklahoma

Effective 6/11/05, amendments to Okla. Admin. Code §§710:65-1-7, 710:65-7-13, and 710:65-19-56 reflect a new exemption for contractors with regard to purchases of items needed to carry out public contracts with the Oklahoma Ordinance Works Authority, the Durant Industrial Authority, and the Ardmore Development Authority. Those agencies had been granted exempt status for purchases of tangible personal property as of 7/1/04 (H.B. 2213, 6/3/04; ch. 384).

Effective 7/1/05, a sales and use tax refund is available in connection with sales to, among others, contractors or subcontractors that enter into a contract with a public trust or nonprofit entity for the construction of improvements to or the expansion of a hospital or nursing home owned and operated by the trust or entity in certain counties (H.B. 1570, 6/6/05; ch. 296). This refund does not apply to routine repairs or general maintenance. Further, given the restrictions in the legislation, this refund may have been intended to benefit only one or two particular trusts or entities.

Pennsylvania Legislation, Rulings

Exemptions and other benefits are available under Pennsylvania's First Class Cities Economic Development District Act (H.B. 1321, 12/1/04; Act 226). Effective 12/1/04, residents and businesses in certain areas of deteriorated property designated as economic development districts can qualify for a variety of tax and financial incentives, including a sales and use tax exemption. For construction contracts performed in a qualified area, the exemption applies to the qualified business or its contractor for retail purchases of building machinery and equipment for the exclusive use or consumption at the business located within the economic development district.

Keystone Opportunity Zones. In a sales and use tax ruling (SUT-05-001, 1/4/05), the Pennsylvania Department of Revenue determined that the sale of ready-mix concrete to a qualified business for use in a Keystone Opportunity Zone did not qualify for the exemption from sales tax for purchases made in connection with construction performed in a Zone. The exemption applies only to the sale or use of "building machinery and equipment" sold to a qualified business or to a contractor pursuant to a construction contract with a qualified business.

The Department explained that "building machinery and equipment" means generation, storage, conditioning, distribution, and termination equipment, if used in one of several specified qualifying building systems (e.g., air conditioning, plumbing, communications, etc.). Such machinery and equipment includes, e.g., boilers, humidifiers, pumps, telephones, and motion detectors. The exemption also covers furniture, cabinetry, and kitchen equipment. Concrete or cement, however, is a building supply the sale of which is subject to tax.

Developer's construction of sewer lines. Another ruling (SUT-04-024, 11/3/04) involved a regulation (61 Pa. Code §31.13) that exempts from sales tax a developer's purchases of certain property made pursuant to a contract with a public utility. Here, the Department interpreted the regulation to hold that a private developer's purchases of equipment, machinery, and parts for use by a contractor to install water and sewer lines in a residential subdivision will be exempt from sales tax, provided that on completion, the system is transferred to a public utility or municipal authority engaged in a sanitary sewer operation. The exemption applies to, e.g., water mains, sewer treatment equipment, pipes, manholes and covers, cement, and pumping equipment. It does not apply to any items that would become commercial or private residential property.

To claim the exemption, the developer must provide the supplier with a properly executed exemption certificate (Form REV-1220) that includes a description of the construction job, the exempt entity to which the property will be transferred, and a list of the items purchased. A copy of the ruling should accompany the form.

Installation, resurfacing of athletic fields. Pennsylvania sales tax law provides an exemption for certain purchases of tangible personal property made by organizations that

qualify as purely public charities. Both the qualifying organization and its construction contractor have an exemption for purchases of building machinery and equipment for the construction, reconstruction, renovation, repair, and remodeling of a real estate structure.

In SUT-05-005, 3/28/05, the Department held that a qualified college's contracts for the purchase and installation of an artificial playing surface (for a soccer/lacrosse field) and for the installation of sod (to resurface a football field) were construction contracts, and not contracts for the purchase of tangible personal property. Thus, the college was not liable for sales and use tax on its purchase price for this work.

The contractor, however, would be subject to sales or use tax on all property or services it obtained for the contract except for property that qualified as "building machinery and equipment." In the ruling, the Department found that artificial turf, sod, lime, and fertilizer did not qualify as building machinery and equipment, and thus their purchase by the contractor was taxable. The contractor may include this expense in its total contract price but it cannot be separately stated.

Federal government contract. In SUT-05-002, 1/28/05, the Department ruled that a contractor's purchases of building machinery and equipment in connection with a construction contract with the federal government qualified for exemption from sales and use taxes under 72 Pa. Stat. §7204(57). As in SUT-05-001 (discussed above), the Department noted that "building machinery and equipment" means generation, storage, conditioning, distribution, and termination equipment, if used in one of several specified qualifying building systems.

The contractor must provide its suppliers with a properly completed exemption certificate (Form REV-1220) within 60 days of making a purchase. The certificate must state that the purchases will qualify as building machinery and equipment and will be transferred to the federal government pursuant to the construction contract. Where purchases also include nonexempt items, the contractor's and the vendor's records must be sufficient for the Department to determine whether the exempt items qualify as building machinery and equipment.

South Carolina

In order to comply with environmental laws, a manufacturer may construct an on-site wastewater treatment facility or may have the wastewater treated at a government-operated facility. With regard to such a government facility, purchases of the pollution-treating machinery or the materials used to construct such machinery may be exempt from sales and use tax. The exemption may be claimed by the governmental entity or by a contractor the entity hires to construct the facility.

In S.C. Rev. Proc. 05-1, 6/16/05, the South Carolina Department of Revenue ruled that, in addition to any other requirements for this sales and use tax exemption, more than one-third of the wastewater processed at a governmental wastewater treatment facility must come from machines that qualify for the sales tax exemption under S.C. Code §12-36-2120(17). That section provides a general exemption for "manufacturing" machinery, which the Department has determined means "substantially" used in manufacturing. According to the Department, "substantial" means more than one-third of the machine's use.

South Dakota

A recent case alleging a failure to file South Dakota contractor's excise tax returns may have prompted a subsequent legislative change to the filing requirements. In *South Dakota v. Brekke*,¹⁸ the South Dakota Supreme Court found the jury instructions at trial faulty and, therefore, overturned a taxpayer's conviction on ten counts of failing to file the state's contractor's excise tax return. The taxpayer had appealed the denial of his motion for acquittal, arguing that the offenses that the Department of Revenue proved at trial were not the offenses that were alleged in the pleadings. The taxpayer similarly argued that the jury had been instructed on elements of offenses that were not alleged in the pleadings.

The operative statute (S.D. Codified Laws §10-46A-1.6) contained two return-filing requirements, one for "the holder of a contractor's excise tax license" and, alternatively, for "a contractor whose receipts are subject to contractor's excise tax in this state." A violation of only the second alternative had been alleged, i.e., that Brekke was a contractor who had gross receipts subject to the tax. At trial, however, the state did not prove that allegation; its evidence was restricted to proof that Brekke was a license holder who failed to file excise tax returns.

The supreme court stated that "while the State elected to charge Brekke as a contractor who had gross receipts subject to the tax, the State did not prove that allegation." Because the state had failed to prove that the contractor owed any excise tax liability and the jury instructions on these points were flawed, the court held that the contractor's motion for a judgment of acquittal should have been granted.

Legislative response. Recent legislation (S.B. 223, 3/22/05; L. 2005, ch. 77, §3) added the following new section to ch. 10-46A (realty improvement contractors' excise tax): "A person licensed pursuant to this chapter shall file the applicable tax return whether or not the person has gross receipts subject to tax." This legislation also added other new sections imposing similar filing requirements under ch. 10-46B, the "alternate realty improvement contractors' excise tax," as well as ch. 10-45 (retail sales and service tax), ch. 10-45D (gross receipts tax on visitor-related businesses), and ch. 10-52A (municipal gross receipts tax).

Other legislation. Effective 7/1/05, the definition of an "agricultural processing facility" for purposes of the refund or credit for contractors' excises taxes imposed on the construction of a new facility is broadened. Such construction now includes an expansion to an existing soybean processing facility if the expansion will be used for the production of biodiesel fuel. (S.B. 214, 3/15/05; L. 2005, ch. 79.)

Also effective 7/1/05, sales and use tax refunds are available for a contractor or subcontractor that has paid tax on tangible personal property fabricated in South Dakota for use in another state in which the property would be exempt. The taxpayer must submit claims for refunds on prescribed forms, along with supporting documentation. The Department of Revenue retains the right to reject incomplete or fraudulent claims. (H.B. 1142, 3/4/05; L. 2005, ch. 86.)

New refunds. Amendments to chs. 10-45B (tax refunds for construction of manufacturing, agricultural processing, and power generating facilities), and 10-46A and 10-46B (regular and alternate realty improvement contractors' excise taxes) offer businesses operating in South Dakota refunds of sales or use tax and contractors' excise taxes in connection with certain new business facilities for which the costs exceed \$10 million. The greater the construction costs, the larger the tax refund. (H.B. 1261, 3/17/05; L. 2005, ch. 78; as amended by H.B. 1122, 3/9/05; L. 2005, ch. 80.)

The refund applies to project costs incurred and paid after 2/1/05 and up to 36 months following the "construction date" (the first date earth is excavated for the purpose of constructing a project). If the project costs exceed \$60 million, the qualifying refund period extends to up to 72 months following the construction date. Taxpayers must apply to the Department of Revenue for a refund permit at least 30 days prior to the construction date. Qualifying projects do not include structures used for residential housing, transient lodging, retail sales (other than for the sale of electricity to individual consumers), or to provide health care services, or that are exempt from real property or equivalent gross receipts taxation.

The portion of the taxes that are refunded are based on the total project costs, as follows:

Project cost	Portion of tax refunded
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Less than \$10 million	No refund
\$10 million but less than \$20 million	25%
\$20 million but less than \$60 million	50%
\$60 million but less than \$600 million	75%
At least \$600 million	90%

Tennessee

In *Wylie Steel Fabricators, Inc. v. Commissioner of Revenue*,¹⁹ the Tennessee Court of Appeals held that a steel fabricator was not entitled to a sales tax exemption in connection with three church construction projects, but the court also determined that the trial court erred in holding that the taxpayer was precluded from presenting at trial evidence of an overassessment.

Wylie Steel, the taxpayer, was engaged in fabricating steel products for use in various structures. Under purchase orders from three churches then under construction, the taxpayer secured the raw materials and contracted with the general contractor for each church project to fabricate, deliver, and install fabricated steel products. The payments to Wylie Steel under each subcontract represented its costs for securing the raw materials and fabricating them, as well as its overhead and profit. Wylie Steel did not pay sales or use tax on the materials it purchased.

Following an audit, the Tennessee Department of Revenue assessed sales and use taxes. The taxpayer paid the assessment and sought a refund in chancery court, claiming the exemption provided under Tenn. Code §67-6-209(b), which generally imposes tax on a contractor or subcontractor that uses tangible personal property in the performance of a contract, or to fulfill contract or subcontract obligations, *except where the title holder is a church, private nonprofit college, or university and the tangible personal property is for church, private nonprofit college or university construction.*

No exemption. The court agreed with the Department that the taxpayer was not entitled to the contractor's use tax exemption under §67-6-209(b) because "Wylie Steel either purchased or used all of the materials at issue in Tennessee, ... none of the churches involved purchased any of the materials at issue, and ... Wylie Steel could not, by law, resell and transfer title to any of those materials to those churches as tangible personal property since Wylie Steel contracted to install those materials as a part of realty." Furthermore, the court also agreed that "the Tennessee Code contains an explicit codification of this legal concept in ... §67-6-209(c), which clearly states that any transfer by Wylie Steel of materials that [are] install[ed] as part of realty cannot be considered a

sale of tangible personal property for sales and use tax purposes." Thus, the court concluded that "the churches involved did not have title to the tangible personal property involved prior to its installation as realty. Wylie Steel purchased all of that property, the materials at issue, and then later transferred those materials to the churches in the form of realty by installing them as part of a building. Thus, the materials were not transferred to the churches as tangible personal property."

Court found merit in challenge to audit method. The taxpayer also challenged the audit sampling method used by the Department to determine the taxes owed. Here, the appellate court reversed the trial court's dismissal of that challenge. The taxpayer had argued that the trial court erred in not permitting the taxpayer to illustrate the actual volume of certain types of transactions in order to show that the Department's "test period" audit method resulted in an overassessment of tax liability.

The appellate court noted: "In evaluating a taxpayer's challenge to the assessment issued by the Department, our [state] supreme court has provided the courts of this state with the following guidance: The burden of proof is upon the taxpayer to prove that the assessment made is incorrect and to prove its right to recovery by clear and convincing evidence ... (citation omitted). In this case, Wylie Steel presented sufficient evidence to raise a factual issue as to whether the Department over-assessed its tax liability." The court then concluded that "Wylie Steel has done more than make a perfunctory allegation that the Department has miscalculated its tax obligation. [Footnote omitted.] Accordingly, the trial court erred in holding that Wylie Steel was precluded from presenting evidence of an over-assessment at trial because it did not present such evidence during the audit." Therefore, the appellate court reversed the trial court's decision to grant summary judgment to the Department on this issue and remanded the matter, instructing the trial court to determine whether the Department overassessed Wylie Steel's tax liability.

Exemptions for resale, testing. Tennessee vendors' sales of materials and supplies to contractors for use on construction jobs are subject to sales tax. Sometimes, however, a contractor is also a dealer buying items for resale. In Ltr. Rul. 05-05, 1/20/05, the Tennessee Department of Revenue ruled that vendors may accept resale certificates for carpeting that a contractor-dealer has indicated is intended for resale. If, however, the carpet is tagged or marked for a particular job being performed by the contractor or is delivered to a job site, the vendor must collect sales or use tax.

An amendment to Tenn. Code Ann. §67-6-209 (enacted by H.B. 1781, 6/7/05; L. 2005, ch. 371) expands the existing sales and use tax exemption for property owned by the U.S. or any federal agency that is temporarily loaned to a contractor or subcontractor for testing. The exemption now applies regardless of who owns the property, provided the testing takes place at a facility owned by the federal government or any federal agency. In all cases, the exemption applies only to property that is the subject of the test (and property into which the tested property must be incorporated in order to conduct the test), and not to any equipment, machinery, or other property used to conduct the test.

Washington

The Washington Department of Revenue issued Special Notice No. 08-09-2004, 8/9/04, to summarize legislative changes made to tax incentive programs for high technology businesses by H.B. 2546, 2/19/04 (L. 2004, ch. 2). For example, the high-tech business and occupation (B&O) tax credit program for research and development was extended until 1/1/15 and a new method applies for calculating the credit. In addition, the Department explained modifications to the high-tech sales/use tax deferral/waiver program, including the following clarification for federal government contractors:

"Persons engaged in construction activities for the federal government are not liable for sales and use tax on tangible personal property incorporated into a structure, if the construction project would have qualified for the deferral if undertaken by a private entity."

Revised regulations for government contractors. The Department has also amended Wash. Admin. Code §458-20-190, effective 2/5/05. This regulation provides guidance on the tax and reporting responsibilities of persons making sales to the U.S. and persons carrying on business within federal reservations (i.e., any land or premises within the state that are held or acquired by and for the use of the U.S. or any of its agencies or departments).

According to the regulation, persons selling goods or services to the U.S. are subject to taxes imposed on the seller, such as the B&O tax on gross receipts and public utility taxes, unless a specific tax exemption applies. The same holds true for persons receiving income under contracts with the U.S. government to administer federal programs.

Also, persons performing services for the U.S. are subject to the retail sales or use tax on property they use or consume when performing those services, unless specifically exempt. In addition, a person that provides services to the U.S. under contract and uses government-supplied tangible personal property in performing the services, must pay use tax on the fair market rental value of the government-supplied property. Any concessionaire operating within a federal reservation under a federally authorized grant or permit is taxable to the same extent as any private operator engaging in a similar business outside a federal reservation and without specific federal authority.

Persons operating under some federal contracts may, for federal accounting purposes, be required to invoice goods or services provided to the U.S. by third parties. The purpose of this procedure is to match the expenditures with the appropriate category of congressional funding. These amounts should be excluded from the person's Washington gross income when reporting on the combined excise tax return, provided that, with respect to the goods or services: (1) the third party directly invoices the U.S.; (2) the U.S. directly pays the third party; and (3) the person has neither primary nor secondary liability for paying the third party.

The regulation also refers to additional guidance in Wash. Admin. Code §458-20-17001, "Government contracting—construction, installations, or improvements to government real property," for persons engaged in those activities, as well as Wash. Admin. Code §458-20-171, for persons building, repairing, or improving streets, roads, and similar transportation facilities owned by the U.S.

Construction contractor liable for tax on temporary labor. In a tax determination, the Washington Department of Revenue held that a general contractor that developed and built high-end single-family housing was liable for sales taxes on its payments to staffing agencies for temporary contract labor used at construction job sites.²⁰ In considering whether temporary labor provided to a general contractor may subject to retail sales tax, an administrative law judge (ALJ) with the Department's appeals division quoted portions of the governing statute, Wash. Rev. Code §82.04.050:

"The term 'sale at retail' or 'retail sale' shall include the sale of or charge made for ... labor and services rendered in respect to the following: ... (b) The *constructing* ... or *improving of new or existing* buildings or other structures under, upon, or above real property of or for consumers, *including the installing or attaching of any article of tangible personal property therein or thereto*, whether or not such personal property

becomes a part of the realty by virtue of installation, and shall also include the sale of services or charges made for the clearing of land and the moving of earth ... [and] (d) *The sale of or charge made for labor and services rendered in respect to the cleaning ... of existing buildings or structures, but shall not include the charge made for janitorial services.*" (Emphasis added by the ALJ.)

The ALJ noted that when a temporary staffing company's temporary workers performed construction activities for prime contractors, "it was to report its activities under the retailing or wholesaling classifications, as appropriate." Further, the ALJ rejected the taxpayer's claim that it would be an unreasonable administrative burden to accurately account for the activity of each of the laborers provided by the staffing company. Thus, the ALJ held that when the contractor obtained temporary workers from a staffing company that did not charge retail sales tax but should have, the contractor "is liable for the deferred retail sales tax." Because the contractor did not provide adequate records to support a finding that some workers provided nonretail services, the ALJ upheld the assessment of deferred retail sales on the labor charges.

West Virginia

An administrative decision by the West Virginia Office of Tax Appeals concerned a contractor that sold and installed small mobility-enhancing elevators, stair lifts, and similar products in customers' homes. While the contracting services were not subject to sales tax, the state Tax Commissioner's Office, following an audit, assessed use tax on the contractor's purchase of the equipment it installed.

The Office of Tax Appeals rejected the assessment and held that the purchases were not subject to tax when the installation was pursuant to a doctor's prescription. The contractor had the burden of proof in that regard, however. ²¹

Contractor's blasting services qualified for natural resource producer exemption.

In *Mt. State Bit Service, Inc. v. Department of Tax and Revenue*,²² the West Virginia Supreme Court of Appeals reversed the lower court and held that a contractor was entitled to the state's "producer" exemption from use tax with respect to its purchase of explosive materials from out-of-state vendors for use in providing blasting services to its coal-mine customers.

The exemption under W.Va. Code §11-15-9(g) (1987) (now generally recodified at §11-15-9(b)(2) (2002)), in pertinent part, applied to "[s]ales of property or services to persons engaged in ... contracting, manufacturing, transportation, transmission, communication or in the production of natural resources," provided such property or services are "directly used or consumed" in those businesses. In finding that the taxpayer was entitled to the exemption, the supreme court held that even though the taxpayer was not subject to the state's severance tax, the blasting services for which it sought exemption from use tax clearly constituted a direct use under both the statutory definition and the regulations, which expressly identify blasting and explosive materials as items that are directly used in the production of natural resources.

Subcontractor's concrete pumping activity was not exempt contracting service.

Another West Virginia Office of Tax Appeals administrative decision²³ involved a subcontractor, the taxpayer, that employed specialized equipment to place concrete (e.g., walls, footers, slabs, etc.) for various construction projects. The taxpayer was typically brought onto a job by a general contractor or a builder or by the owner of a plant or factory. The general contractor would tell the taxpayer's equipment operator

where to place the concrete, which was supplied not by the taxpayer but by the contractor or a subcontractor concrete supplier.

The Office of Tax Appeals noted that construction contracting services generally are exempt and, similarly, "subcontractors who furnish services to prime contractors in fulfillment of the prime contractor's contract resulting in a capital improvement to a building or other structure or to real property are treated as contractors" (W.Va Code of State Rules §110-15-107.2.1.2).

In this case, however, the Tax Commissioner's Office argued that the subcontractor's activities were a taxable service under §110-15-129.5.2.1.a, which states: "A lease of equipment and an operator to a contractor for use in providing tax exempt contracting services will be treated as a tax exempt subcontract only when the contractor can exercise no control (beyond specification of desired results or work to be accomplished) or supervision over the equipment and the operator thereof. In such a case the denominated lessor is viewed as a subcontractor providing equipment and labor in fulfillment of a contract with a prime contractor."

The Office of Tax Appeals agreed, finding the taxpayer's activities, limited solely to concrete pumping and placement, were "essentially identical to that conducted by redi-mix concrete businesses, which are not contractors." Moreover, the control exercised by a general contractor over the activities of concrete pumping and placement is greater than that with respect to redi-mix concrete activities, because of the many ways in which the general contractor must assist with concrete pumping and placement (e.g., vibrating the concrete; providing the concrete mixing truck and an operator; employing workers who moved hoses and pipe; and hoisting, lowering, and moving the pumping equipment). Thus, the taxpayer's services did not qualify for the contractor's exemption. The appeals office did note, however, that in this case the taxpayer did no concrete finishing, which normally consists of the use of a specific machine to screen, level, bullfloat, and/or trowel (i.e., flatten), and which would have constituted the activity of contracting.

Recent Hurricanes Spur Tax Relief

Following the devastation wrought by Katrina and other hurricanes, the revenue departments in Alabama, Louisiana, and Mississippi have issued various pronouncements that may affect contractors in those states. Also, updates are continuing; the latest information should be available via department websites or by contacting the authorities directly by phone, mail, or e-mail (contact information is also on the websites).

Significant tax credits and other incentives also are being proposed by the federal government (the Gulf Opportunity Zone Act (H.R. 4440) was signed into law 12/21/05, as this article went to press). Some federal benefits may also be available at the state level; states will have the opportunity to either conform to or deviate from the federal tax Code in that regard.

Louisiana. The Louisiana Department of Revenue has issued multiple press releases and bulletins that address the extension of filing deadlines.²⁴ For example, to file and pay individual and corporate estimates and withholding taxes that were otherwise due 8/30 through 12/31/05, and individual income, partnership, and corporate income and franchise taxes for which a valid extension was previously filed, the due dates are extended to 2/28/06. Also, the 2005 fourth quarter individual income tax declaration, originally due 1/15/06, is extended to 2/28/06.

Taxpayers affected by the hurricane may be eligible for tax relief regardless of where they live (e.g., their books, records, or professional tax advisor may be in the hurricane area). People living in areas designated by the Federal Emergency Management Agency (FEMA) as "individual assistance areas" will receive tax relief automatically. Taxpayers in "public assistance areas" or otherwise outside the impacted areas should identify themselves as hurricane victims when filing with the state (e.g., write "hurricane Katrina" at the top of a return). ²⁵

All workers assisting in the relief efforts in covered disaster areas are eligible for tax relief whether or not they are affiliated with a recognized government or philanthropic organization. Thus, contractors working in Louisiana may be covered by this provision. ²⁶

Where to file. For several parishes where normal tax operations were disrupted, the Department has established a central address (Department of Revenue, P.O. Box 91338, Baton Rouge, LA 70821-9138) where it will accept returns and tax payments (made payable to the appropriate local taxing jurisdiction) on behalf of the parish. This address applied to taxpayers (including, of course, contractors) based in Orleans, Plaquemines, and St. Bernard Parishes. Jefferson Parish had also been included but, as of 10/24/05, its Bureau of Revenue and Taxation in Gretna had reopened and was receiving local returns and remittances. ²⁷

More for contractors. One item that may be of specific interest to contractors in Louisiana is Revenue Information Bulletin No. 05-031 (La. Dept. of Rev., 11/9/05), which concerns when government employees can claim a sales tax exemption on hotel lodging charges. Louisiana generally exempts such individuals when the tax burden would fall on the government employer, e.g., when the government reimburses the actual charge for lodging. Employees receiving per diem allowances for travel are not eligible for the exemption.

In this bulletin, the Department notes a FEMA memorandum which states that FEMA travelers are not automatically entitled to tax-exempt status for lodging when traveling on official FEMA business. The FEMA memo, quoting a Comptroller General decision, states, in part: "...Hotel-Motel rental tax is on the Federal employee when [the] government reimburses its employees via per diem or actual expense allowance." Contractors working under contract for FEMA could be deemed to fall under this new rule even if exempt prior to the issuance of the FEMA memo. ²⁸

Alabama. On 10/18/05, following the IRS's lead, the Alabama Department of Revenue issued an order extending until 2/28/06 the time for filing and paying tax on any monthly, quarterly, and annual income and business privilege tax returns that are otherwise due after 9/22/05 and before 3/1/06. This extension applies to taxpayers in any of the federally declared disaster areas who suffered extensive property damage and/or personal injury. ²⁹

Mississippi. The Mississippi State Tax Commission has stated that it will follow the federal extensions granted for those directly affected by the storms and unable to meet their filing or payment obligations for income tax returns or payments with an original or extended due date after 8/28/05. Monthly withholding tax returns and payments are now due as originally scheduled but requests for extensions will be handled on a case-by-case basis.

Contractors and vendors that accept for payment the "relief debit cards" issued by the U.S., Red Cross, and others must charge Mississippi sales tax on otherwise taxable

transactions. The Commission notes that only sales directly sold and billed to, and paid by, the governmental entity are exempt.

With regard to casualty losses, Mississippi will follow IRS guidelines (e.g., taxpayers affected by hurricane Katrina may claim losses on their income tax returns for either the 2004 or 2005 tax year). Businesses and individuals that have suffered damages to property may seek relief from property taxes on a case-by-case basis. Applications for relief must be filed and approved before 8/28/06. ³⁰

Conclusion

While some states follow the concept that contractors are taxable as the consumers of any tangible personal property used in the performance of an underlying contract, other states provide various exemptions and exclusions, but planning is necessary—one cannot assume that purchases are exempt or taxable. As a general rule, contractors and their tax advisors should always review the statutes, regulations, and other rules in each state where work is performed. This is especially true when contracts require work in multiple states. Available benefits can include use tax exemptions for construction machinery and equipment, and organizational-based exemptions (for contracts with, e.g., charities or other tax-exempt entities). Proper planning with regard to passage of title for fixtures and tangible personal property affixed to real property can result in lower tax liabilities.

Contractors working with federal, state, or local authorities should determine if any special exemptions or exclusions are available. Merely because work is done under a government contract, however, does not guarantee that the contractor will enjoy the same exemptions granted to the government agency itself. Nevertheless, contractors should resolve, e.g., passage of title issues prior to purchasing tangible personal property for use in government projects; exemptions often apply when ultimate title passes to the federal, state, or local government.

Clearly, given the evolving multistate nature of construction and service contracts, contractors cannot rely on a "one-state-determines-all" business plan when considering a response to a proposal or bidding on a new contract. Unexpected tax liabilities, plus penalties and interest, can undermine the profitability of any construction project. Good multistate tax planning can improve the bottom line. []

¹

Exceptions to this rule include Arizona, Connecticut, Hawaii, Kansas, Mississippi, New Mexico, Texas, and Washington.

²

Over half the states have some kind of production or manufacturing exemption.

³

Fewer than ten states provide such an exemption.

⁴

A few states, but the trend to provide such benefits seems to be increasing.

⁵

Fewer than 15 states have pass-through exemptions for federal and state governments, and a few states provide charitable pass-through exemptions. Most states require charitable organizations to purchase materials directly from the vendors in order to qualify the purchase as tax exempt.

⁶

For more information, see the DRS website at www.ct.gov/DRS. Also, copies of the guide may be ordered by writing to Department of Revenue Services, Mail Unit, Building Contractors' Guide, 25 Sigourney Street, Hartford, CT 06106-5032. Include a 9" x 12" self-addressed envelope with \$1.98 postage affixed.

[7](#)

D.C. Super. Ct., Tax Div., No. 8132-02, 1/31/05.

[8](#)

For more on Florida's rules, generally, regarding the proper treatment of tangible personal property used in connection with contractors' real property improvement contracts, see de Moya and Arrigo, "Tangible Personal Property and Real Property Improvements: A Contractor's Sales Tax Dilemma," 15 J. Multistate Tax'n 18 (October 2005).

[9](#)

825 NE2d 467 (Ind. Tax Ct., 2005).

[10](#)

See DiBello, "The Changing Sales Tax Regime: Kansas Seeks to Adapt to the Streamlined Sales Tax Project," 14 J. Multistate Tax'n 28 (May 2004).

[11](#)

For background on the Pine Tree Development Zone program, see Good and Liddell, "Maine Adds Economic Development Zones to Its Incentives Tool Kit," 14 J. Multistate Tax'n 30 (June 2004).

[12](#)

Mo. Admin. Hearing Comm'n, No. 04-0561 AF, 3/22/05, Mo Admin 4-561 AF, 2005 WL 1123504 .

[13](#)

Brewers Flooring & Sales, Inc. v. Director of Revenue, Mo. Admin. Hearing Comm'n, No. 02-1826 RV, 4/1/04, Mo Admin 2-1826 RV, 2004 WL 1109573 .

[14](#)

156 SW3d 339 (Mo., 2005). (One of the authors of this article was counsel for the Director of Revenue in this case.)

[15](#)

For more information, see "Pub. No. 222: Questions and Answers Concerning Tax Law Section 5-a, Contractor, Affiliate, Subcontractor, and Subcontractor Affiliate Sales and Compensating Use Tax Registration" (N.Y. Dept. of Tax'n & Finance, 12/1/04).

[16](#)

16 App Div 3d 784, 791 NYS2d 672, 2005 WL 549344 (3d Dept., 2005).

[17](#)

N.C. Tax Rev. Bd., Admin. Decision No. 451, 9/9/04.

[18](#)

694 NW2d 46 (S.Dak., 2005).

[19](#)

Tenn. Ct. App., No. M2003-02482-COA-R3-CV, 4/28/05, 2005 WL 1000229 .

[20](#)

Wash. Dept. of Revenue App. Div., ALJ Det. No. 04-0287E, 12/30/04, 24 WTD 275 (2005).

[21](#)

Admin. Decision No. 04-082 U, W.Va. Office of Tax App., 1/7/05.

[22](#)

217 W.Va. 141, 617 SE2d 491 (2005).

[23](#)

Admin. Decision No. 04-482 C, W.Va. Office of Tax App., 1/11/05.

[24](#)

See, e.g., La. Dept. of Revenue Press Releases dated 9/30/05 and 11/28/05. Press releases are available on the Department's website at www.revenue.louisiana.gov (click on Publications). The website also contains contact data and other useful information with

regard to relief assistance in connection with hurricanes Katrina and Rita.

[25](#)

Id.

[26](#)

Id.

[27](#)

Press Release: "Jefferson Parish Bureau of Revenue and Taxation in Full Operation, Louisiana Department of Revenue Continues to Accept Returns and Payments for Orleans, Plaquemines, and St. Bernard Parishes" (La. Dept. of Rev., 10/24/05).

[28](#)

The Revenue Information Bulletin is available on the Department's website at www.revenue.louisiana.gov (click on "Katrina" and "Revenue Information Bulletins").

[29](#)

See Information Release: "ADOR Will Follow Federal Feb. 28 Extension Date for Hurricane Rita Victims" (Ala. Dept. of Rev., 10/18/05), available on the Department's website at www.ador.alabama.gov (click on "News & Publications" and "News Releases").

[30](#)

For these and other announcements, see "Hurricane Katrina Information" on the Mississippi State Tax Commission's website at www.mstc.state.ms.us.

Document Title: Contractors Confront Sales and Use Taxes: General Concepts Plus New Developments, *Journal of Multistate Taxation and Incentives*

Checkpoint Source: *Journal of Multistate Taxation and Incentives* (WG&L)

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