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Expanding What's Possible

Avoid Headaches for Sales and Use Tax on Construction Contracts

Michael Colavito, Jr. | May 19, 2022



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Ask or chat your questions during the webinar at any time.

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How to Earn CPE Credits

We are using **Zoom** as the learning webinar platform.

To earn CPE credits for this course, you must respond to at least **75% of all polling questions**.

- **You will receive credit if you answer the polls**, not whether you get them correct.



Learning Objectives



By the end of this course, you should be able to:

- Recall general sales tax rules and concepts that apply to construction contractors.
- Identify common exceptions to the general rule for construction contractors.
- Describe differences in the sales tax rules applicable to construction contractors in the DMV and other unique states.
- Discuss sales tax administrative/compliance issues and audit preparedness.



Agenda

General Rules and Concepts for Contractors

Common Exceptions to the General Rule

Regional Overview and Update, and other Unique Tax Types

Administrative, Compliance, and Audit Preparedness

Conclusion and Q&A



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Poll 1: Your Familiarity

How familiar are you with sales and use tax rules for contractors?

- Very familiar
- Somewhat familiar
- Familiar
- Not familiar at all










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General Rules and Concepts for Contractors

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Factors That Can Impact Sales Tax Treatment

-  Where projects located
-  Materials purchased in one state used in another
-  Will materials be affixed to real property
-  Is the work repairing or improving real property
-  How is the contract billed
-  Is the customer tax-exempt (e.g., nonprofit organization)
-  Are construction services taxable

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Definition of a Contractor

Virginia

- Any person who contracts to perform **construction**, reconstruction, installation, **repair** or any other service with respect to **real estate or fixtures** thereon and in connection therewith to furnish tangible personal property, whether such person is a **prime contractor or subcontractor**. *Va. Admin. Code 10-210-410.*

Pennsylvania

- A person that **permanently attaches** tangible property to real estate, including the performance of repairing real estate.

Two Basic Sales Tax Rules for Contractors

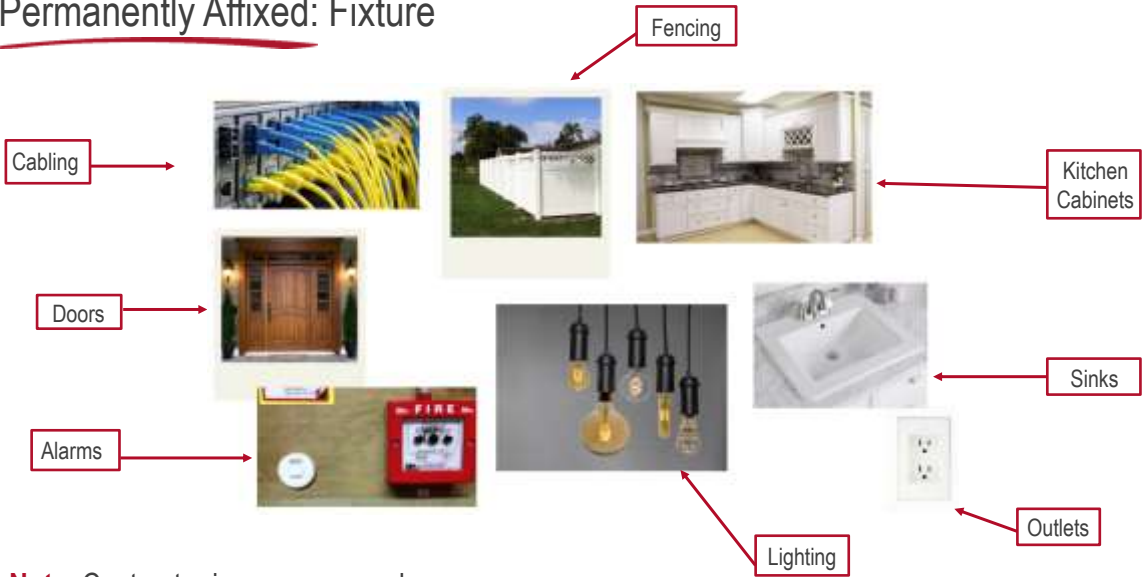
Fees charged for construction services are generally not taxable.

- Nontaxable service.
- Transfer of real property is not subject to tax.
- Sales tax generally applies to sale of tangible personal property.
- Property affixed to real property is no longer characterized as tangible.

Contractors are consumers of materials, supplies, and equipment.

- Liable for sales or use tax on materials permanently affixed to real property.
- Resale exemption not applicable to contractor purchases.
- Contractor separately itemizing materials and labor does not change the tax treatment, in most states.

Permanently Affixed: Fixture



Note: Contractor is consumer and user.



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Not Permanently Affixed



Note: Contractor is the retailer and must collect and remit tax.



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Factors in Determining if Items are Permanently Affixed

Intent	Was this item intended to be permanently affixed? Is there an understanding or agreement?
Removal Difficulty	What is the difficulty level of removing the item?
Damage	If item is removed, will there be damage to the real property?
Commonly Installed	Item affixed is one that is normally affixed to real property versus being a business-specific item.

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Summary of General Rule



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Poll 2: Fixtures

Which of the following items is the most likely to be treated as **not permanently affixed** to real property?

- Ceiling-mounted projector
- Door
- Fencing
- Fiber optic cabling



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Common Exceptions to the General Rule

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Common Exceptions to General Rule

Structure of the contract/pricing terms

Contracts for exempt entities (*i.e., government or nonprofit*)

- Sales to certain organizations such as government or charities
- Customer's exempt status may flow through to contractor
- Some states require the materials to be purchased by the exempt entity rather than "on behalf of" exempt entity

Sales in interstate commerce

Dual contractor/retailer



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Price Defined in a Contract

Price	Sales Tax Treatment
Lump-sum	General rule typically applies in most states.
Cost-plus	General rule typically applies in most states.
T&M (time and materials)	Some states treat sale of materials as separate retail sale by contractor.



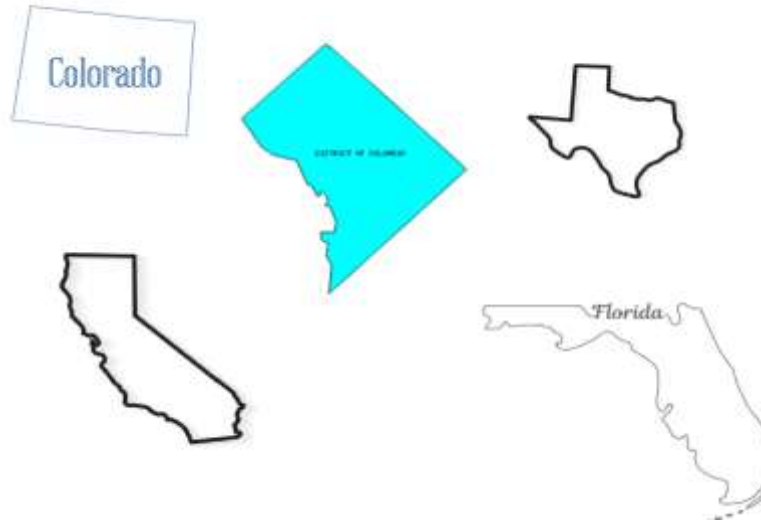
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Minority of States have Different Treatment for T&M Contracts

States that treat T&M contracts as a taxable retail sale of tangible personal property:



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Minority of States have Different Treatment for T&M Contracts



Sales Tax Impact

- Contractor's purchase of materials is deemed a non-taxable sale for resale.
- Subsequent sale of materials to customer is subject to sales tax.
- Price for materials separately itemized.
- Contractor required to collect and remit sales tax on price of materials.

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Contracts for Exempt Entities

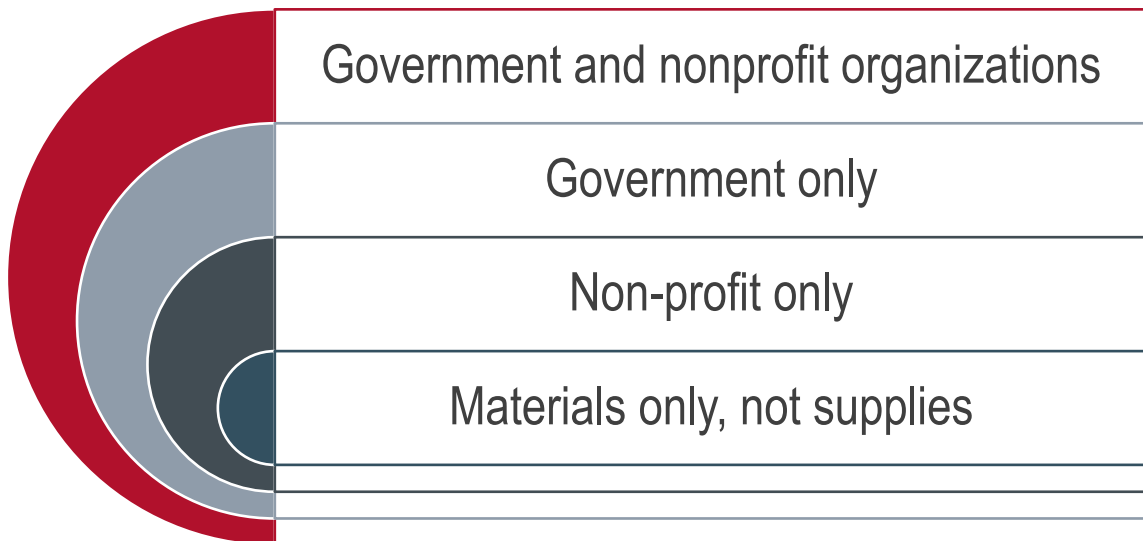
Exception to general rule: Some states will permit contractor to purchase materials tax-free if the materials will be incorporated into real property owned by a tax-exempt organization.

Main two factors to consider when dealing with exempt entity rules;

1. Scope of exemption
2. Compliance requirements



Scope of Exemption



Compliance Requirements for Exempt Entity Projects

Compliance Requirement
Contractor exemption certificate: Contractor must complete certificate and provide to supplier.
Property owner's exemption certificate: Contractor can use exemption certificate of property owner.
Pre-approval required: Application may be required for purchases to be made tax for the project.
Direct purchase by customer: Materials must be purchase directly by the property owner.



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Poll 3: T&M Contracts

Which state treat T&M contracts as a **taxable retail sale** of the materials?

- Colorado
- Maryland
- New Hampshire
- Virginia



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Flow-Through of Customer Exemption

Alabama

- No sales tax on purchases of materials and supplies by contractor performing construction contract for an Alabama government entity.
- Excludes highway, road, and bridge contracts.

New York

- Purchases of materials used to construct, maintain, service, or repair property of an exempt entity that are not taxable.
- Materials must be incorporated into real property.

Pennsylvania

- Purchases of building machinery and equipment for a construction contract with a nonprofit or government entity.
- HVAC, communications equipment, building or parking lot access systems, and alarms.



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Interstate Sales: When Property is Purchased in One State and Used in Another

Substantive Issues

- Tax due in state of delivery and use?
- Does taking possession = use?
- Is there a temporary storage exemption in delivery state?
- Credit for taxes paid in project state?
- What if there's a rate differential?
- Exemption in state of use?

Practical Issues

- Sales tax may impact where to have materials delivered, such as no exemption in storage state and exemption or lower rate in project state.
- What documentation is needed?
- Internal procedures are needed to track interstate transaction.



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Dual Contractor and Retailer

What if contractor makes **both retail sales** of materials and uses materials in its **own projects**?

- Impossible to identify, upon purchase, materials for use and those for resale

Example:

- Company installs fences and sells fencing materials to other contractors
- Company maintains an inventory of items for resale and uses portion of inventory to perform its own fence installations for customers

Issue:

- Does the contractor/retailer pay tax on the purchase of the materials?



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Varying Approaches to Dual Contractor and Retailer

1. Allows dual contractor or retailer to purchase all materials tax-free with resale certificate.

- Use tax remittance is required on items used in their own contracts.
- Sales tax collection required for items resold.
- This is the approach in Florida and Colorado.

2. Require contractor to pay sales tax on all purchased materials.

- Refund claim permitted for items resold to another contractor.
- State gets their money upfront.
- This is the requirement in New York.

3. Predominant nature of taxpayer's business.

- For example, West Virginia.



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Regional Overview and Update

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Regional Overview

All three jurisdictions follow general rule on contractor material

DC's sales tax applies to significant number of services

Virginia and Maryland tax a limited number of services

Virginia 0.7% regional rates in NOVA and Hampton Roads at a total rate of 6.0%

For Virginia, Effective 7/1/2021, 6.3% rate in Charlotte, Gloucester, Northampton, and Patrick

For Virginia, Effective 7/1/2018, 7.0% rate in City of Williamsburg and Counties of James City and York, known as Historic Triangle

Digital products, electronically delivered software, SaaS, and information services taxable in Maryland as of March of 2021; also taxable in D.C.



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Jurisdiction and Rates

Jurisdiction	Rates	Scope of Tax Base
D.C.	6.0%	Broad
Maryland	6.0%	Narrow
Virginia	5.3%, 6.0%, 6.3%, 7.0%	Narrow



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Real Property Maintenance Services in DC

Fees for **real property maintenance** are subject to sales tax.

Real Property Maintenance (RPM) keeps land or premises of a building clean, orderly, and functional, including minor adjustments, maintenance, and repair.*

*D.C. Mun. Regs. 472.

Taxable RPM:

- Trash removal
- Pest control
- Cleaning
- Restroom cleaning and stocking
- Parking lot and/or garage maintenance
- Grounds maintenance such as mowing and mulching

RPM excludes:

- Major repairs
- Complete overhaul of equipment associated with property, such as replacing a sink
- Tasks requiring building permit



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Poll 4: Taxable RPM

Which of the following are **taxable RPMs**? Select all that apply.

- Major repairs
- Trash removal
- Pest Control
- Cleaning



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T&M Contracts in DC

- Contractor is considered a retailer when it agrees to sell materials at agreed price with work to be done for an additional price or based on time.
- Contractor should give its supplier a resale certificate.
- Contractor must collect and remit sales tax.
- Contractor considered the user or consumer of materials under a lump-sum or cost-plus contract.
- Virginia and Maryland do not have a similar T&M rule.



Contracts With Exempt Entities in Virginia

- No exemption from tax on purchases of materials or supplies for contracts with exempt entities.
- Regardless of whether customer is a government agency, church, school, or nonprofit.
- **General rule applies**, contractor pays tax on its purchases.

Sales tax can only be **avoided if**:

- Contractor has been officially designated as purchasing agent for a governmental entity; or
- Materials are purchased directly by exempt entity.

Contracts With Nonprofit Organizations in Maryland

Exemption for purchases of materials incorporated into real property of certain nonprofits.

- Private, nonprofit charitable, educational, religious organizations, volunteer fire departments, ambulance, and rescue companies.
- Contractor must provide supplier with exemption certificate issued to organization and signed statement that materials will be incorporated into property of exempt organization.



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Contracts With U.S. or State Government Entities in Maryland

Government contracts

- No exemption
- Contractor pays tax on its purchases
- State of Maryland, U.S. Government, diplomatic embassies, or credit unions



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Contracts With Exempt Entities in DC

- Purchases of materials/supplies incorporated into real property of **semipublic institution** or federal/DC government agency are exempt.
- Contractor must provide supplier **Contractor's Exempt Purchase Certificate**.
- Contractor should also obtain and maintain a copy of **semipublic institution's exemption certificate**.
- Purchase of materials and supplies that are not physically incorporated in finished job, including supplies that are completely consumed, are not exempt. This includes items such as fuel, small tools, and form lumber.

Semipublic Institution: Any corporation, community chest, fund, or foundation, organized exclusively for religious, scientific, or charitable purposes.



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Interstate Transactions in Virginia

Temporary storage exemption.

- Contractor can make **tax-free** purchases of construction materials that will be temporarily stored in Virginia and used in an **exempt construction project in another state**.
- Request for exemption certificate must be made in writing to Department of Taxation.
- Exemption is contingent upon rules of another state.



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Interstate Transactions in Maryland

- No temporary storage exemption for exempt contracts like Virginia.
- Maryland **sales tax applies when contractor takes possession of materials in Maryland**, even if it will be transported out of state immediately.
- Other state likely has credit for taxes paid.



Interstate Transactions in DC

Exemption for purchases of materials that are temporarily stored in DC for no longer than 90 days to be transported outside DC for project in other state.

DC's temporary storage exemption is not contingent on purchases being exempt from tax in other state.

DC has no guidance on how to claim this exemption.

Recommended method is to provide vendor with resale certification.

Whether or not you choose to utilize this exemption may depend on tax rates in other state. You will be more likely to claim this exemption if rate in other state is less than DC.



Poll 5: Interstate Transactions

A contractor receives a **full credit for taxes paid** by the state where materials are used regardless of the tax rate imposed by the state where the contractor paid tax.

- True
- False



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Example of Exempt Entity and Interstate Sales

Facts

- BuildIT Co. purchases materials for delivery to its Virginia location.
- Materials are for renovation to property owned by a 501(c)(3) organization located in DC.
- BuildIT Co. stores materials for two weeks in Virginia.
- Subsequently transports them to DC jobsite when job begins.



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Exempt Entity/Interstate Sales Example: Questions

Is BuildIT Co. liable for Virginia sales tax on purchase of materials?

- **No.** Virginia has temporary storage exemption. BuildIT Co. can make tax-free purchases of materials for temporary storage in Virginia to be used in an exempt project in another state

Does BuildIT Co. have a DC use tax obligation with respect to the materials transported and used in DC?

- **No. Semipublic institution** exemption applies

What if property owner is a for-profit business?

- Temporary storage exemption does not apply
- Tax due in Virginia
- Use tax due in DC
- Credit for taxes paid



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Administrative and Compliance Matters in DC

All types of exemption certificates **must** be applied for online.

- MyTax.DC.gov
- Including resale certificate and contractor's exempt purchase certificate.

Contractor's exempt purchase certificate.

- Contractors can no longer self-certify.
- DC processes online applications and issues certificates per project.
- Subcontractors being used by contractor can be indicated on the application so subks can make tax-free purchases.

Certificates **now have** expiration dates.

- Resale certificates are valid for one year.
- Must be renewed annually online.



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Unique Tax Regimes or Taxability Rules

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Unique Tax Regimes and States That Tax Contractor Services

Hawaii

- Gross excise tax imposed on contractor gross receipts, with purchases of materials taxable at 1% wholesale rate.
- Deduction for subcontractor payments.

Mississippi

- Contractor's Tax: 3.5% tax on contract price of prime contract.
- Does not apply to residential construction.
- Tax applies to federal and state government projects.

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Unique Tax Regimes and States That Tax Contractor Services

New Mexico

- Construction services subject to tax.
- Contractor's purchase of materials not taxable.

South Dakota

- Contractor's excise tax imposed on receipts of prime contractor at 2.0%
- Contractor subject to sales and use tax on materials.
- Tax applies to federal and state government projects.

States with gross receipts tax

- Ohio, Oregon, and Washington
- Virginia local business license tax (BPOL) with a \$25,000 rule for contractors.



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States That Treat Real Property Repair as a Taxable Service: **New York**

Sales tax applies to receipts from services of **maintaining, servicing or repairing real property**, including interior cleaning and maintenance services.

- Keeping or restoring property in a fit, efficient, ready, or safe condition.
- Includes activities such as painting, lawn service, tree removal, sewage service and snow removal.

Credit for tax paid on materials

- If service provider paid NY sales tax on purchase of material transferred to customer, credit can be claimed on sales tax return.

Resale of taxable services

- General contractor hires subcontractor to perform taxable work.
- General contractor can use Form ST-120.1 to purchase subcontractor's services for resale.
- Sales tax is charged by general contractor on total charge to customer.



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States That Treat Real Property Repair as a Taxable Service: **North Carolina**

- Capital improvements contract not subject to sales tax.
 - Gross receipts derived from **repair, maintenance, and installation services** and subject to tax.
- Mixed Transaction**
- Contract that includes both real property contract for capital improvement and repair, maintenance, and installation services for real property that are not related to capital improvement.
 - Sales tax applies to price allocated to repair, maintenance, and installation services if allocated price is greater than 25% of total contract price.



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Administrative, Compliance, and Audit Preparedness

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Bidding Process

Inaccurately estimating sales tax on a bid **can impact** a contract.

- Will you need to pay sales tax on materials purchased for the job, or will you be treated as a retailer and be required to charge sales tax to your customer?
- Are there any tax exemptions that apply to the contract?
- Tax should be included in costs shown for supplies, materials, and equipment.
- Is project in a state with a unique tax regime?

Be proactive.



Audit Preparedness

Maintain records for a **minimum** of four years, depending on the state SOL.

- Invoices for materials
- Exemption certificates
- Sales and use tax returns and evidence of payments

- Sampling periods used in audits to derive an extrapolated **error rate**.
- Potential removal of outliers that distort **error rate**.
- Burden of proof is on taxpayer.
- Periodically revisit state rules.
- Consider indemnification clause from property owner if questionable exemption is being claimed.



Keys to Successful Sales Tax Compliance

Recognize rules vary by jurisdiction.

Determine if any exclusions or exemptions apply to project.

Develop a process.

Understand general rules in each jurisdiction for different transaction types.

Know when and how to document nontaxable sales and purchases.



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Conclusion and Q&A

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Poll 6: Your Comfort Level

I feel like I am walking away feeling very knowledgeable about construction contracts and sales and use tax.

- Strongly agree
- Agree
- Disagree
- Strongly disagree



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