Wolters Kluwer

When you have to be right

Sales Tax Compliance and Preparation for Audits

Tax & Accounting

# *Pitfalls and Best Practices for Construction Sales and Use Taxes*

**Being aware of the sales and use tax consequences of construction jobs is crucial in managing the finances of a construction-based business. Most understand that sales tax applies to retail purchases, but it comes as a surprise to many that construction jobs also have sales and use tax implications.**

***In construction, what you do and how you do it has an impact on how these jobs are taxed.***

**Consider this example.** A Georgia contractor with a specialty in cabinets and a relationship with a restaurant group contracts for a buildout of a bar/restaurant in Fresno, California. He contracts to build and install cabinets for a set price, and invoices on a percentage-of-completion basis. The contractor ships cabinets that they fabricated in Georgia to California. Subcontractors transport the cabinets to the site, along with their tools and some materials, stopping on the way to pick up some incidentals. The subcontractors install the cabinets and send the contractor a receipt that says "Cabinet Installation — $1,000.00. Sales tax included."

*What are the sales and use tax implications of this job?*

You must consider questions like who owes the sales and use taxes, when are they due, how are they reported and paid, and to which states? How are the taxes computed? Does it matter that the cabinets were built in Georgia and installed in California? Do the contract terms matter? Does the transportation matter? Are taxes different because this is a restaurant? Does the subcontractor's invoice have the detail needed?

Sales and use taxes are usually imposed on the **ultimate consumer** — the person that buys and uses the item. When it comes to construction, however, it can be difficult to determine who that ultimate consumer is for each of the many transactions involved.

As it turns out, each of these questions must be analyzed separately to get to the correct overall sales and use tax "answer". As a CEO or CFO for a construction business, it's critical to have an understanding of the tax consequences of all types of construction transactions to avoid or reduce penalties, interest and assessments in the future. Except for the simplest of businesses, determining the correct amount of sales and use tax for a construction business is not a "do-it-yourself" project.

Most construction businesses convert tangible personal property, e.g., raw materials, into real property, e.g., buildings. But there is where the similarity ends. Each business goes about it differently. Keeping appropriate records is crucial when a sales tax auditor comes knocking. More and more construction businesses will face a sales tax audit in the future. The auditor needs your records to help understand your business for the purpose of the audit and as proof that you have complied with the law.

Here are some of the most common factors that affect the determination of sales and use tax obligations of construction companies.

## Your Business Practices and Taxation

The nature of your business, the types of projects that you do, your contractors, customers and contracts all have an impact on the tax consequences of your transactions.

Factors that affect the taxability of your transactions include:

- **Project category** — Commercial or residential
  - **Commercial real estate** is defined as buildings or land that is intended to generate a profit from capital gain or rental income.
  - **Residential projects** are buildings designed primarily to be dwellings.
- **Construction Type** — New, repair or maintenance
  - **New construction** — Entirely new structures and/or significant extensions to existing structures, whether or not the site was previously occupied.
  - **Repair** — A restoration to return a structure or property to operating or usable condition.
  - **Maintenance** — Making or keeping a structure, fixture, or foundation (substrates) in proper condition in a routine, scheduled, or anticipated fashion.

*Construction Contractors — Prime, Subcontractor or U.S. Contractor*

In general, a construction contractor performs construction contracts. Construction contractors can include prime contractors, subcontractors and United States construction contractors.

- **Prime Contractors** — The contractor that has a contract with the owner of a project or job and has the full responsibility for its completion. A prime contractor undertakes tasks to perform a complete contract and may employ (and manage) one or more subcontractors to carry out specific parts of the contract. This contractor may also be known as a main contractor.
- **Subcontractors** — A subcontractor is an individual or business contracting to perform part or all of another's contract. Some prime contractors may do all or most of their work internally without the use of subcontractors; other contractors use subcontractors almost exclusively. In general, most contractors do some of the work themselves and use subcontractors for the rest.
- **United States Construction Contractors** — A United States construction contractor is a construction contractor who performs a construction contract for the United States government.

*Sales and Use Tax Implications*
Usually, the subcontractor becomes the contractor and the contractor becomes the customer. Each subcontractor has a contract that governs the subcontractor's tax responsibilities. Under most circumstances, subcontractors may not accept a resale certificate from a prime contractor for fixtures that the subcontractor furnishes and installs. If the fixtures are furnished and installed by a subcontractor, the subcontractor is the retailer and the prime contractor is the consumer. As a result, no additional tax is due under the prime contractor's contract with the real property.

Often, subcontractors pose a recordkeeping risk for the contractor. Invoices from subcontractors may lead to problems during an audit. Invoices from subcontractors need to be accurate, provide proper descriptions and have an adequate breakdown of all the items that were applied to and billed to each invoice. In addition, invoices that indicate "sales tax included" should specify the taxes that are included and the amounts.

*Customers*
Your customers will also have an impact on the taxability of transactions, and the way you conduct your business can have a positive or negative effect.

For example, if your customer is exempt from sales and use tax, such as a nonprofit civic or community organization, a good option may be to have your customer purchase the materials that you're going to use in the construction.

Why? Because in some states, exempt organizations are allowed to buy materials and supplies for a construction project tax-free. If this exemption is allowed to flow through to the material purchased for a construction job they have hired you for, then you may realize a tax savings. However, keep in mind that tax authorities tend to look at these types of transactions very carefully to make sure that the exempt organization or an agent authorized to act on behalf of the exempt organization is making the purchase.

Many states do not allow contractors to use an organization's exemption unless the contractor is the exempt organization's authorized agent. While the distinction of who can purchase the supplies and materials may seem trivial, states use it as a check to prevent abuse of the organization's exempt status.

There are also important distinctions between government contracts and private sector projects. And, not all governments are the same. In the same way, there are important distinctions between state, federal and local contracts, especially when it comes to exemptions.

## Contracts

The nature of your contracts will affect the taxability of transactions. In some states, the type of contract you use may affect when you will have to pay sales taxes on materials and supplies purchased.

Generally, construction contracts are agreements to erect, construct, alter, pave or repair a structure, building or infrastructure. Tax can also apply to owners that manage their own construction projects. Regardless of the nature of the construction, it is likely that sales and use tax will be assessed on the use of tangible property and services applied to the project.

For tax purposes, contracts should be detailed, but not technical where possible. Remember that a tax auditor will be reviewing the contract and will need to be able to understand it. As with any contract, be sure to include the scope of work, the price and the tax responsibility. If you intend to pass tax costs on to the customer, be sure to estimate the costs and communicate the costs in your bids, quotes and contracts.

There are some instances where credits or exemptions can apply.

### *Lump-Sum Contracts*

Although every state treats these types of contracts differently and must be evaluated individually, in general, a **lump-sum contract** is one in which the agreed-upon contract price is one lump-sum amount. The charges for materials are built right into the job and are not separate from the charges for labor.

#### *Sales and Use Tax Implications*

With this type of contract, the contractor is considered the **final consumer**. This means that the contractor owes tax on the purchases of materials, equipment, consumable items and taxable services. The contractor does not collect tax from the customer when using a lump-sum contract.

### *Separated or Time and Materials Contracts*

A **separated or time and materials contract** is one in which the agreed-upon contract price is divided into separately stated agreed upon prices — one for materials and one for labor.

#### *Sales and Use Tax Implications*

Under this type of contract, the contractor is considered a **retailer** of the materials and must collect sales tax from the customer. The contractor may maintain a tax-free inventory of items held for resale. Items purchased exclusively for resale may be purchased tax-free by issuing a resale certificate to suppliers. The contractor must hold a sales tax permit to issue a resale certificate. However, the contractor owes tax on the purchases of equipment, accessories, most consumable items and in some states, taxable services (e.g., Texas).

### *Cost-Plus Contracts*

A **cost-plus contract** is used when the contractor is paid for all allowed expenses — plus additional payment — to allow for a profit to be made.

#### *Sales and Use Tax Implications*

With a cost-plus contract, the state may determine a sale to be part property that would be subject to sales tax, and part service, which is tax-exempt. This type of contract is not a standard method of contracting, and although clients might think that it's more cost-effective, lenders will often not issue a loan to projects using cost-plus contracts.

## Purchases

Different types of purchases are taxed differently, based in part on how they are related to real estate.

### *Materials*

Materials include construction materials, components and other tangible personal property that lose their identity when incorporated into real property. Examples include bricks, cement, doors, wiring, flooring, lumber, paint, piping, stucco, tile, windows, fasteners and more.

### *Fixtures*

Fixtures do not lose their identity when incorporated into real property. Examples include HVAC units, awnings, furnaces, lighting fixtures, plumbing fixtures, prefabricated cabinets, blinds and more.

### *Machinery and Equipment*

Machinery and equipment are properties used to process tangible personal property into real estate.

### *Transportation Charges*

Transportation charges may or may not be taxable, depending on the condition of the sale and the nature of transportation. Factors to consider include: freight charges are separately stated, charges are from a common carrier or the seller, charges exceed the actual value cost of delivery, contract type and transfer of title.

### *Customer-Purchased Items*

Occasionally, customers will purchase items for projects. When property owners purchase and hire a contractor to install the item, the property owner should be responsible for the sales tax on the item.

For statutorily exempt entities, having the customer make purchases directly may be a method to exempt items from sales tax. Exemptions may flow from contractors or subcontractors. Tax treatments vary from state to state.

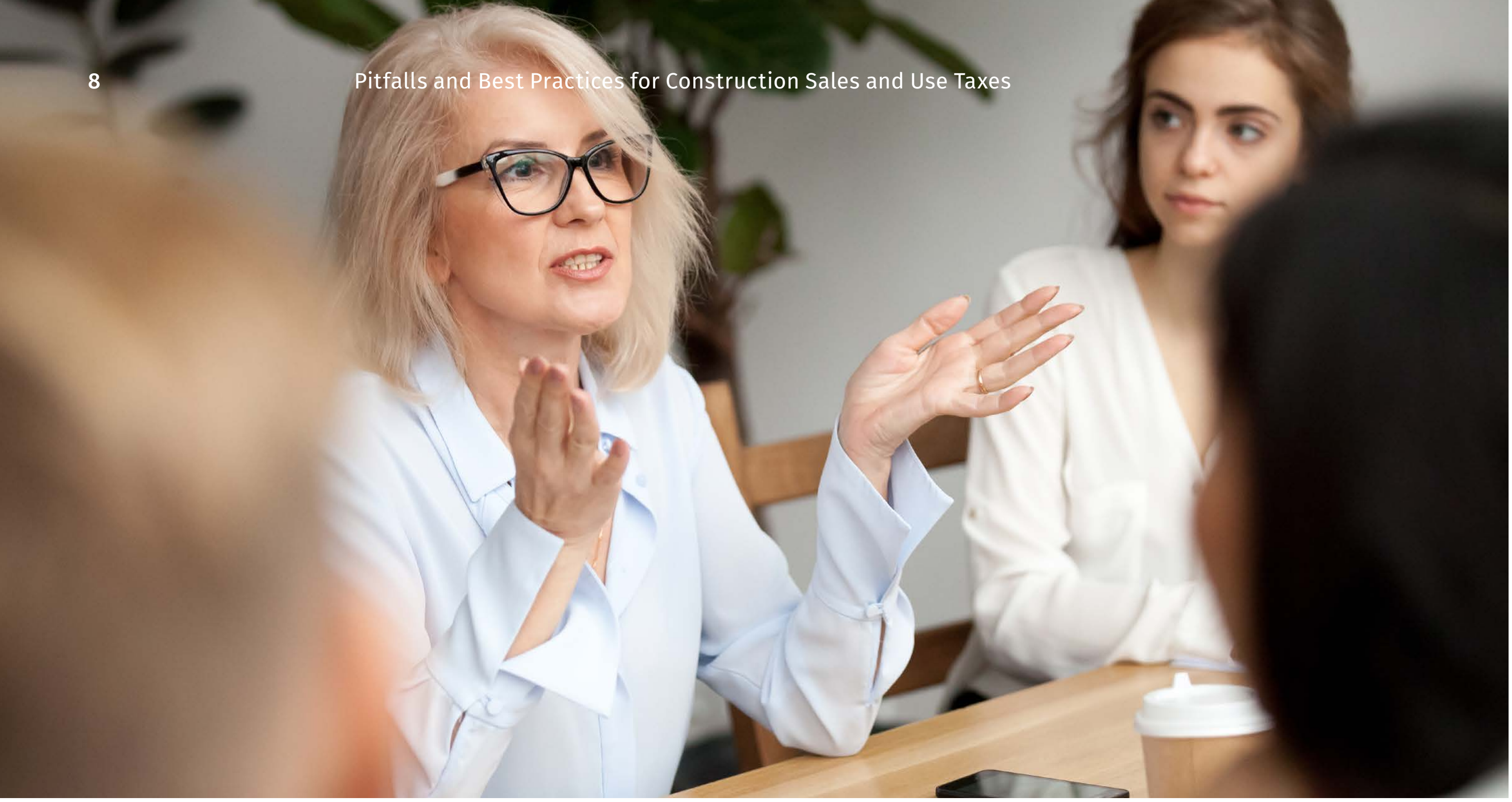
## Tax Calculation

For each construction transaction, there can be a tax implication. The taxes that apply are based on the tax jurisdiction that has authority for your project. The jobsite is considered the place of business of a construction contractor or subcontractor. This location is used to determine the state, local and district that have authority over your transactions.

Tax calculations often are complex, especially as businesses perform work in multiple tax jurisdictions, with multiple items and across state lines. That is why it is important to know all the states that have the right to tax you — that is called nexus.

Tax rates and tax rules that apply to transactions will vary, based on the nature of the transaction, and can change over time as taxing authorities update rates and rules.

Automated tax calculation solutions integrate with accounting systems to calculate taxes for transactions — and are essential for productivity and accuracy. They can also facilitate audit defense by tracking the details of how each tax was calculated.



## When Taxes Are Due

In many states, contractors must pay sales taxes when they purchase materials used in construction. So, any materials and supplies you purchase are taxable at the time of purchase. You won't have to pay sales or use tax upon the sale of the finished construction, and in some cases, this can be an advantage because any markup you charge to your customer on the materials, supplies and labor won't be subject to sales tax.

A few states treat construction contractors like resellers, who purchase materials solely for resale to an end-user, and do not require that the contractor pay sales tax when purchasing materials. More states provide this treatment for itemized contracts than lump-sum contracts. State laws have to be researched.

The states that require construction contractors to pay sales tax on purchases may provide exceptions to this general rule. Whether you qualify for an exemption or other exceptions will depend not only on the type of contracts that you negotiate with your clients, but also who your clients are (i.e., nonprofit or governmental agencies).

Generally, work is done under a signed written agreement with your customer that lays out the terms of the work to be done, the type of materials to be used, and an estimate of the total cost of the job. It is up to you whether you want to include a stated provision in your contract for the payment of sales taxes. When you negotiate a contract with a customer, it is crucial that you've accounted for the right sales or use tax rate when bidding on a job. Be sure to check with the states that you operate in to verify that you have included the right tax rate, either to roll into the contract or to pass directly onto the customer.

When negotiating a construction contract, most contractors use either a lump-sum contract or a time and material contract for non-governmental contracts. When contracting with the government, different types of contracts may be used. If you use a lump-sum contract, you are agreeing to perform the contract for a single stated amount. This amount will include materials, supplies, services, overhead and profit all "lumped" together on one line-item. Using a time and material contract, the stated contract amount will be based on and include actual rates for all workers at the site, and separately charge for supplies and materials used. In fact, you may even bill separately for overhead and profit margin.

In some states, the type of contract you use may affect when you will have to pay sales taxes on materials and supplies purchased.

## Records and Reports

Detailed recordkeeping is essential for audit defense.

Recordkeeping for contractor invoices is often not done properly, especially in those situations where contractors can perform inventory transactions or submit invoices from multiple locations. Contractor invoices should be specific as to the nature of their transaction. Invoices should contain the needed to determine the correct taxability of the transactions. Simple terms such as “labor,” “materials,” and “sales tax included” may be signs that the contractor invoices lack the necessary detail.

Records should include:

- **General Ledger** — This can include the contracts that the contractor is obliged to follow and the discharge of the liability as the job progresses and billings are made.
- **Books of Original Entry** — A purchase journal and cash disbursement journal can show material purchases to inventory or specific jobs. A sales journal can reflect billings, over-the-counter sales, time and material contracts and fixture sales prices.
- **Subsidiary Records** — Items can include a contract register that includes specifics of the job, such as owner name, job location, project description, contract type, contract amount and completion dates. A job cost journal reflects material cost, labor, overhead, sub-contract, etc. A requisition journal records material and fixture drawdowns.
- **Supporting Documents** — These items can include billing details, job costs folders with plans and specifications, cost estimates, contract, purchase invoices, material drawdowns, time cards, paid invoices and applicable certificates.

## Resale

If you operate in a state that requires construction contractors to pay sales or use taxes on purchases of supplies and materials, you should check to see if your state provides an exemption that allows construction contractors to buy materials and supplies tax-free if the property is specifically designated as resale property. If there is an exemption allowance, you can buy resale property tax-free and collect sales taxes when you resell the material.

However, if the state you operate in does not allow construction contractors to buy material for resale tax-free, you’re going to have to check with the state to find out the procedure for applying a credit for sales taxes paid against the tax incurred when the material is resold.

In all cases, you must keep track of all the exemptions that the state allows.

## Special Circumstances

Although every project has a number of common elements applicable to all jobs, each state has special rules that they determine to be special circumstances. When special projects are taken on by construction companies, it's important to note that additional tax research will be needed. For example, Texas identifies a number of these "special cases" that may require "special handling." Some special circumstances include:

- U.S. Contractors
- Enterprise zones
- Customer exemptions
- Customer-provided fixtures
- Bad debt
- Price changes

## Audit Defense

Since businesses may now be subject to sales and use tax compliance obligations in more states, businesses can expect not only a greater number of audits, but those audits will become more aggressive, as states struggle to find new resources to support growing demand for state-provided services. An area that might not have been a particular major focus of audits in the past — tax exemptions — may now become one. In addition, state auditors have the ability to use more sophisticated tools and data analytics to get more "bang for the buck" with their audit targets. Audits can be very disruptive to business operations, especially if the information that tax authorities typically ask for is not readily available. So, from a pure operations perspective, it is important to be able to produce this information quickly.

Audits for construction businesses are different from audits of regular retailers because retailers are taxed based on their retail price, whereas construction companies are taxed on a taxable measure basis.

Another difference is that in construction, the type of business, size, accounting practices and reporting methods can vary greatly across companies. The documentation that you provide, including your contracts, can help the auditor to understand the nature or your business so that they can understand your intentions, the facts, and tax consequences of your transactions.

In addition, auditors will look at the scope of your activities, contracts, bills, purchases, records and reports as they plan and conduct their audit.

### Tips for Accurate Compliance

Accounting for the tax consequences of construction activities can range from the simple to the complex, based on the complexity and locations where you perform business.

For complex businesses, the risk and amounts at stake with an audit grow, and it makes sense to install a system that helps your business to prepare for audit defense on an ongoing basis, especially for tax calculation and recordkeeping.

Here are a few points to consider:

- Build a team of experts to solve your business' sales tax issues. Engage professionals that have the experience to guide you away from pitfalls.
- Look at audit preparation from a systems perspective. Look for areas where you can reduce errors and improve recordkeeping.
- Focus on typical problem areas: contracts, construction equipment and contractors.
- Meet with customers up front to agree on tax responsibilities and develop a tax matrix.
- Automate your tax calculation. Tax calculation can be very complex, especially across items, jurisdictions and situations. An automated solution can help you to avoid overpayment and underpayment, as well as provide records showing how your taxes were calculated.
- If you are going to claim it, be prepared to produce it. Often the weakest point in the process is with documentation from subcontractors. Enforce a process that provides detail and clarity for their invoices.
- Construction equipment is a high-cost item, so be sure the documentation is in place and complete. Contractors are notorious for poor invoice practices.
- In doing work for governments and agencies, expect to provide all documentation for exempt purchases.

### Building and Planning Your Success

As you can see, a first step in getting a solid handle on sales and use tax compliance is to truly understand what factors impact the construction industry, and what you need to do to accurately comply and prepare for audits. Having the right people making the right decisions, while following a system that produces favorable results, is crucial to moving your business processes forward while avoiding unnecessary risks.

To protect your business and increase productivity, one strategy is to implement an automated solution that makes sense for the operations and tax requirements of your particular business. Implementing an ERP solution with tax calculation and reporting capabilities can reduce the operational complexities and risks associated with construction tax compliance.

*Construction tax compliance is complex.*

Learn how the how the rates and rules affect your business.
Visit **EngageTax.WoltersKluwer.com/Construction** today.

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