

An Update on Payroll and Sales Tax for Contractors

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By

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Today's Agenda

- General sales tax rules
- Who is considered the end user of materials
- What is generally taxable vs. exempt
- Real property or tangible personal property what's the difference?
- Tax impact of various services offered by contractors
- The tax exempt contracts
- Contracts outside your home state
- Dealing with subcontractors
- Payroll

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Goals

- Help you understand the how the states view different transactions
- Use these tools for a competitive advantage
- Minimize your taxes and exposure
- Be proactive

Taxation of construction

- Depends on several factors
 - Contracts
 - Type of service
 - Customer

Issues

What impacts sales tax?

- Ø Type of contract?
 - Ø Lump sum vs. time and materials
- Ø Real of personal property?
 - Ø What is a real property improvement?
- Ø Services provided?
 - Ø Repair, fabrication labor
- Ø Customer?
 - Ø Tax exempt?
- Ø Where does title transfer?
 - Ø Purchasing in one state – project in another state

General rules

- Contractors are considered to be the consumers of materials they incorporate into realty.
- Tax burden falls on the contractor rather than the customer .
- Some states require tax be passed onto customers allowing the contractor to buy materials as if they will be resold.
- Contractors may buy materials as agents of exempt customers. Title passes directly from vendors to tax exempt entity.

General rules

- Not all states recognize agency agreements.
- Those that do have varying qualifications to valid agreements.
- Some states refuse to recognize agency agreements but require the contractor to pay the tax even if the tax exempt entity purchased the materials directly.
- Unlike materials, services provided by contractors (installation, repairs, etc.) are considered sold to the customers rather than used by the contractors. Therefore exempt agency may not have to pay tax on these services even if an agency agreement is not in place.

Contract Issues

- The type of contract can determine the tax in some states:
 - Cost-plus contracts – reimbursed for cost of materials and labor plus a percentage
 - Time and materials- separated listed items with marked up prices
 - Lump sum- job is completed for single price and typically results in the lowest tax liability.

Contracts can alter the tax treatment

- AZ, HI, NM and WA consider contractors to be retail sellers and the contractor must charge sales tax on the materials
- Some states consider the type of contract (CA, CO, DC, IN, TX) to determine whether the contractor should charge the property owner sales tax. In effect, the contractor is treated as a retailer.
- The wording in a contract can completely alter the transaction. A key point is whether title to property occurs before or after installation.

Keep your documentation

- On audit all contract documents are important:
 - Request for bid
 - Bid
 - Contract
 - Progress billings
 - Changes orders or supplemental agreements

Real Property vs. Tangible Personal Property

- One key point is distinguishing between tangible personal property (TPP) and real property.
 - Real property includes land, buildings and other structures attached to the land. It includes items that started out as TPP but because it is affixed to the land it becomes real property. It cannot be easily removed without damaging the item itself or the underlying property or evidence shows it was meant to be installed permanently.
Relocating the item is impractical
 - TPP is not affixed to the land and is readily moved without damage.

What are the consequences TPP vs. RP?

- Real property – generally contractor pays tax and labor is not taxable
- TPP – considered a sale of property and contractor is an installer. Tax is on the transaction between contractor and customer and installation may be taxable.
- Line distinguishing real property and tangible personal property is blurred
- Examples – cabinets, bleachers, lockers, carpeting, cabling for computers, etc.

Key terms

- Materials- become real property and not separately identified (lumber, nails, etc.) *contractor is considered the consumer and pays sales tax on purchases*
- Fixtures- remain identifiable after installation but are affixed to the real property (cabinets, sinks, lighting, HVAC, etc.) *generally contractor pays sales tax*
- Machinery and equipment – relate to the customer's business and are considered TPP after installation (stoves, machines, etc.) *contractor should charge tax on entire bill*

Examples where confusion exists

- Wall to wall carpet and linoleum
- Drapery and other window treatment
- Cabinets
- Wallpaper
- Trade fixtures
- Bleachers and lockers

The treatment will vary state by state

Example: wall to wall carpet

- Iowa and Arkansas consider the installation of wall to wall carpet to be a retail sale (entire price – materials and labor is taxable to property owner)
- Illinois taxes this as a retail sale if the carpet is separately listed on the invoice.
- Indiana contractors are consumers of materials they install under a *lump sum contract* but retailers if the materials are installed under a *time and material contract*.
- MO, OK and TN view this as a construction contract

Resale certificates

- Tax exempt purchases of materials as “sales for resale” are allowed in nearly every state. The sales tax applies to the end consumer.
- In most states, the contractor is the final consumer.
- If the contractor both sells and installs materials and at the time of purchase the use of the product is unknown, most states will allow the purchases to be tax exempt and use tax will apply when withdrawn from inventory and installed.

Resale certificates - audits

- Disallowed sales for resale are among the top sources of additional tax liabilities on audit.
- Many transactions are disallowed because the exemption certificates are not on hand or are improperly completed.
- If exemption certificates contain tax identification numbers, the name and address of the purchaser; a signature and tax exempt purchase – most states will accept as valid under the good faith provisions and hold the seller harmless.

Sale for resale

- Can a contractor purchase materials and fixtures exempt as a sale for resale under the following contracts?
 - Lump Sum – can not purchase exempt under a lump sum contract in IL, KY, MO, OK and TN.
 - AR- contractors are consumers of non-mechanical fixtures in AR which includes plumbing and lighting fixtures but not ceiling fans. Mechanical fixtures such as air conditioning units, elevators and ceiling fans must be taxed to the contractor's customer exempt for the first installation into a newly built or substantially modified building or other structure.

Sale for resale cont

- IA- contractors who both install materials and sell materials without installation may buy all materials for resale and then report use tax or items withdrawn from inventory for use on construction projects. If the contractor only installs without retail sales of the material all sales tax must be paid at the time of purchase
- KS- a contractor holding inventory for both retail sale and construction projects may buy the property for resale. Use tax applies to the cost of property withdrawn (called sales tax in KS).

Other situations

- IL allows contractors to purchase materials exempt when temporary stored in IL for use outside the state.
- NE allows contractors to buy materials for resale if an election was made to be treated as a retailer, tax-paid consumers or consumers that self-report their use tax liabilities. The tax treatment when dealing with tax exempt entities depends on this election.
- TN and OK contractors are consumers of materials and fixtures and must pay sales or use tax even if the property will be installed outside the state.

Taxation of construction services

- Adding complexity to construction contracts is the type of service the contractor is performing
 - In states where the tax base is primarily restricted to transfers of tangible personal property, nearly all construction services are exempt: IL, KY, NE, TN
 - SD exempts construction services from sales tax but imposes a separate “contractor excise tax”.
 - All or nearly all services are taxable. HI and NM have taxes on “business privilege”. AZ imposes a “transaction privilege” tax measured by gross receipts under a “prime contracting classification”.

Taxation of construction services –cont.

- Specific construction services are taxed that may be based on type of service; type of item being installed; or type of construction (commercial vs. residential)
- Iowa exempts repairs that do not involve enumerated services. However, these enumerated services include: carpentry, electrical repairs and installation, excavating and grading, pipe fitting and plumbing, etc. Such services are taxable if performed in connection with repairs but exempt if performed in connection with new construction, reconstruction, alteration, expansion or remodeling of buildings or structures (it may not be easy to distinguish a repair contract from a remodel)

Taxation of construction services –cont

- Taxed according to the nature of job – has the underlying realty been substantially improved? NY, NJ, and WV state the contract must result in a capital improvement for the contractor services to be exempt. CT, IA, NE, TX and WI have similar provisions.
- Taxed according to the nature of item installed – AR exempts the first time installation of mechanical or electrical fixtures and equipment. OH exempts most construction services except certain tangible personal property is taxable and installation service it taxable.

Taxation of construction services –cont

- Taxed according to type of structure- several states give more favorable treatment to residential property than commercial property. KS and TX do not tax reconstruction, remodeling, and repair of residential property, but tax those services for commercial property. KS provides a similar exemption for bridges and highways.

Contract labor

- New construction contract labor is exempt in AR, IL, IA, KS, KY, MO, OK and TN.
- Reconstruction, remodel or repair contract labor is generally exempt except:
 - AR the second installation or repair of mechanical or electrical equipment.
 - IA taxable enumerated services including electrical, carpentry , etc.
 - KS taxes reconstruction, remodeling and repair labor except for bridge, highway or residence.

Fabrication

- Fabrication is more akin to manufacturing and may be treated as such
- Fabrication labor is the act of creating tangible personal property that is different in form or function from the materials that went into its creation.

Fabrication example

Drilling holes in a flat length of metal and then bending the metal to create a bracket is considered fabrication. Since fabrication labor is taxable in virtually every state that imposes a sales tax, the entire sale price of the bracket would be taxed, whether or not the labor to make it was billed separately.

The problem is this is now the sale of a manufactured tangible property and the labor is taxable.

Repairs

- Repair labor is the act of restoring property to its original condition. Repairs may be made to real property (e.g., fixing a hole in a wall) or to personal property (e.g., patching a hole in a tire). Some states consider maintenance (keeping property in good condition, e.g., by cleaning, calibrating or lubricating it) a separate category from repairs, while others lump the two together.

Repair

- More and more states are turning repairs and maintenance into taxable activities, although several still regard them as exempt. States that do tax repairs may or may not include some or all maintenance activities in their tax bases. Some states tax only specific types of repairs or maintenance that are named by statute. Many states that tax repairs of tangible personal property exclude repairs of real property from the tax base, but some do not.

Installation

- Installation is the act of putting an item in place so it can perform its proper function. With respect to construction, it also includes building activities such as framing a house, wiring, plumbing, bricklaying and other forms of labor that improve realty. A majority of the states do not tax installation labor, but a significant minority do tax some or all installation categories.

Installation

- In some states, an agreement to furnish and install a kitchen cabinet might be considered either a construction contract or a retail sale. The distinction usually depends on the amount of fabrication that occurs before the cabinet is affixed to the wall. If the cabinet is substantially completed before it is attached (and “substantially completed” can mean different things in different states), it will be considered a prefabricated unit, and the transaction will be a retail sale.

Installation

- If the affixation to the wall is separately itemized in the contract and the state exempts installation labor, the tax will be due on the total contract fee minus the billed installation. If the contract only stipulates a lump-sum price, the entire fee may be taxed, whether or not the state normally taxes installation.

Installation

- However, if the cabinet is only partly fabricated when it is attached, most states will treat the transaction as a construction contract. This means *all* of the labor will be considered installation, before and after affixation, and tax will only be due on the contractor's costs of materials. (The latter result is based on the assumption that the state in question is among those that regard contractors as consumers of materials and do not tax installation.)

Engineering and architecture

- Not taxable in most states.
 - Fully taxed in HI, NM and SD.
 - MS subject to tax on nonresidential contracts over \$10,000
 - WA subject to the Business & Occupation taxes – not sales tax

Project Management

- Taxability generally depends on the project itself. If the project is taxable the management fees will likely be taxed.
 - Applies in CT, IA, MS, NJ, NY, WV and WI
 - Taxable in HI, NM, SD and WA

Taxability of certain entities

	U.S. Govt		State and Local Govt		Other entities	
	Installed Materials	Labor	Installed Materials	Labor	Installed Materials	Labor
Arkansas	Taxable	Exempt	Taxable	Varies	Taxable	Varies

General rules for labor applies with very few specific exemptions

Taxability of certain entities

	U.S. Govt		State and Local Govt		Other entities	
	Installed Materials	Labor	Installed Materials	Labor	Installed Materials	Labor
Illinois	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt

Taxability of certain entities

	U.S. Govt		State and Local Govt		Other entities	
	Installed Materials	Labor	Installed Materials	Labor	Installed Materials	Labor
Iowa	Varies	Exempt	Varies	Exempt	Varies	Varies

Contractor provides customer a written statement showing the name and address of the supplier, type of material, purchase price and amount of tax paid and what jurisdiction tax was paid (form 35-002). The exempt entity then files for a refund. Labor is exempt if provided to a “designated exempt agency”.

Taxability of certain entities

	U.S. Govt		State and Local Govt		Other entities	
	Installed Materials	Labor	Installed Materials	Labor	Installed Materials	Labor
Kansas	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt

Exemptions apply to: political subdivisions of the state; water districts; nonprofit zoos; religious organizations; and public or private (nonprofit) hospitals and schools. For the materials to be exempt, the agency must obtain a Project Exemption Certificate from the KS DOR and issue a copy to the contractor. Although a KS city, county or township may obtain a project exemption certificate, the state and its agencies do not qualify.

Taxability of certain entities

	U.S. Govt		State and Local Govt		Other entities	
	Installed Materials	Labor	Installed Materials	Labor	Installed Materials	Labor
Kentucky	Taxable	Exempt	Taxable	Exempt	Taxable	Exempt

General rules for labor applies with very few specific exemptions

Taxability of certain entities

	U.S. Govt		State and Local Govt		Other entities	
	Installed Materials	Labor	Installed Materials	Labor	Installed Materials	Labor
Missouri	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt

Tax is not due on materials that will be incorporated into a construction project for the federal government, the State Highways & Transportation Commission or Dep't of Transportation, a county or other political subdivision, a religious or charitable organization, or a public or private nonprofit school. The contractor must obtain an exemption certificate from the customer and provide copies to the suppliers.

Taxability of certain entities

	U.S. Govt		State and Local Govt		Other entities	
	Installed Materials	Labor	Installed Materials	Labor	Installed Materials	Labor
Oklahoma	Taxable	Exempt	Taxable	Exempt	Taxable	Exempt

Contractors may purchase materials without tax on behalf of certain specific state, municipal and private agencies, all of which are named in Okla. Stat. Sec. 1356. Materials consumed in contracts with all other entities are taxable to the contractor.

Taxability of certain entities

	U.S. Govt		State and Local Govt		Other entities	
	Installed Materials	Labor	Installed Materials	Labor	Installed Materials	Labor
Tennessee	Taxable	Exempt	Taxable	Exempt	Taxable	Exempt

A few limited specific exemptions apply. In general, the contractor will be liable for use tax even if the government body provides its own construction materials and the contractor only installs them.

Subcontractors

- Most states treat contractors and subcontractors equally – they are consumers of the materials used in projects.
- In states where contractors are performing services, the subcontractors are likely also performing services. If these services are taxable then the subcontractor can sell the services “sale for resale” to the contractor who then collects the tax from the customer.

Subcontractors – continued

- In some states (AZ) where the subcontractor is selling services directly to the customer, then the subcontractor may also be classified as a prime contractor.
- In KS the payments to subcontractors are a deduction from the contractor's liability when calculating tax (labor services are taxable in KS)
- Many states require detailed information on subcontractors and require withholding of payments until proof is provided that tax was paid.

Payroll

- Tax must be paid on income earned while performing services in a state?
- Question is when do you need to register and withhold state income tax when an employee is performing services in state outside your base of operations?
- What about unemployment?

Payroll

- Generally a legal requirement is created and tax must be withheld whenever an employee is performing services and thereby earning wages or income in another state.
- CT allows an employee to work in the state up to 14 days before the employer is required to withhold, however, this not eliminate the employee's requirement to file and pay tax on that money earned in the state in the first 14 days.
- Maine allows 10 days, while AZ is at 60 days before withholding is required.

Payroll – A practical approach

Arkansas	\$4,000
Illinois	\$2,000
Iowa	\$9,000
Kansas	\$5,250
Kentucky	\$3,140
Missouri	\$1,200
Oklahoma	\$8,450
Tennessee	\$1,250

Federal action is pending

- Mobile Workforce State Income Tax Simplification Act
 - Seeks to establish a 30 day period of employment in a state before wages are subject to that state's withholding requirements.

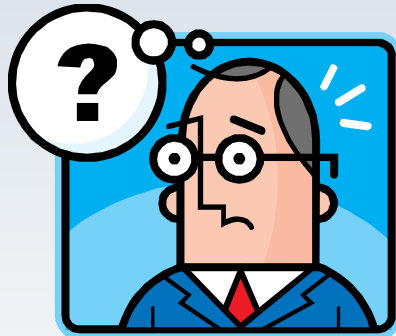
Reciprocity

- There is generally no need to withhold if reciprocity is in place between the states:
 - Illinois- IA, KY, MI, WI
 - Iowa- IL
 - Kentucky- IL, IN, MI, OH, WV, WI, VA

Unemployment

- How do you handle unemployment when activity is in more than one state?
- Using MO as the contractors home state.
 - The employment is performed primarily in MO and the employment performed outside MO is incidental to the employment in MO, or
 - The employment is performed in MO and the base of operations or the place from which the employment is directed or controlled is in MO, or
 - The base of operations or place from which the employment is directed or controlled is not in any state where part of the employment is performed, but the employee's residence is in MO.

Questions?



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