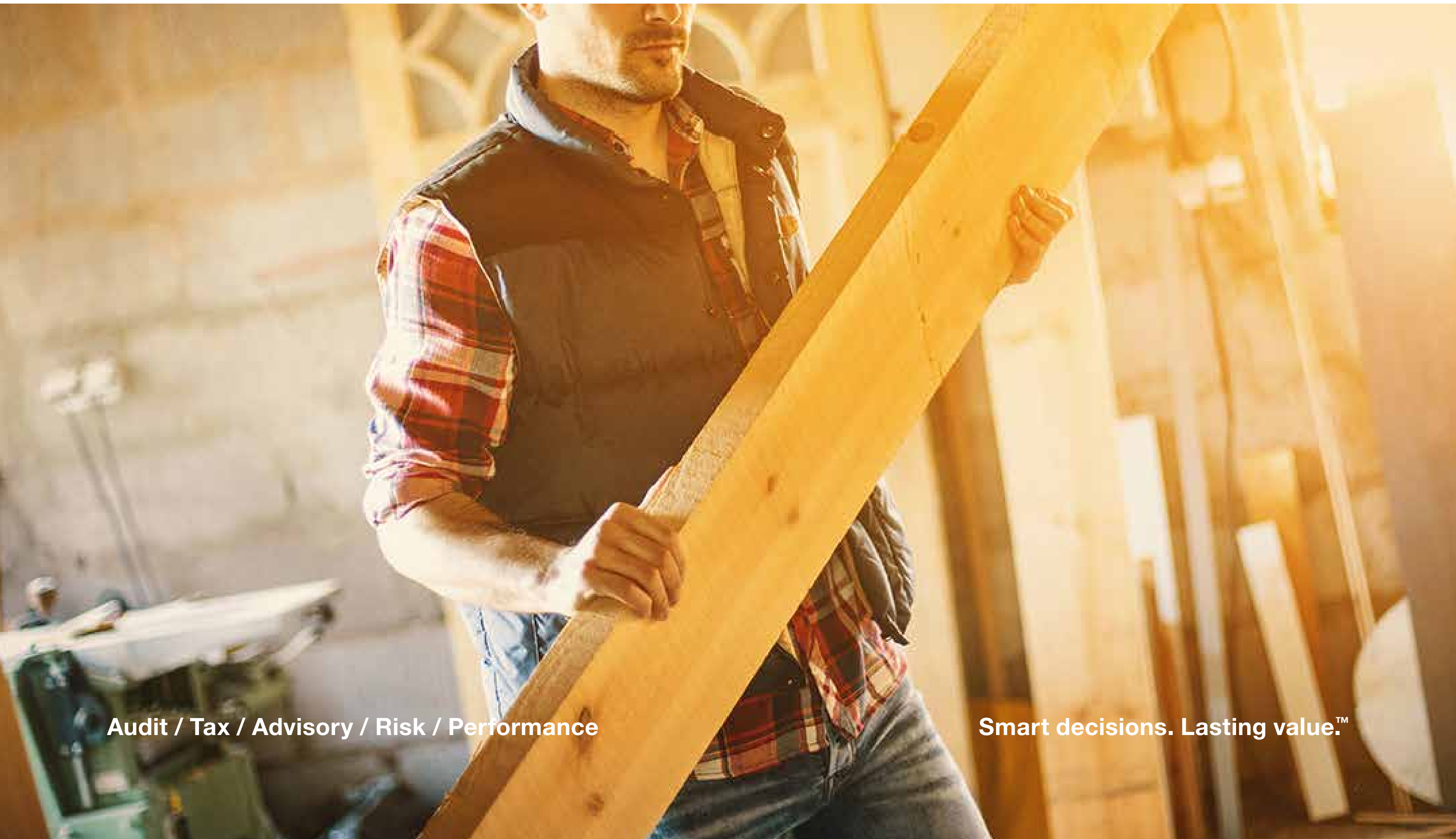
October 2017

Sales and Use Tax Pitfalls in the Construction and Real Estate Industries

An article by Chris A. Johnson, J.D.



Being aware of the taxability of the various expenditures associated with a construction project or the management of a building is crucial in preventing a hefty use tax assessment with penalties and interest, as is managing the relationship a real estate or construction company has with its vendors and subcontractors. This discussion examines the most common sales and use tax problems that arise for the construction and real estate industries and the preventive measures that companies can take to avoid these issues or handle them in an audit.

Sales and use tax is imposed in all states except Alaska, Delaware, Montana, New Hampshire, and Oregon, and in a few limited cases, transaction-based taxes are imposed in those states as well (e.g., local sales tax in Alaska and hotel room tax in Delaware). In the construction and real estate industries, sales and use tax issues arise every day, whether it is new construction, the renovation or expansion of an existing property, or the ongoing operation of a property or complex.

Companies often deal with hundreds of vendors and subcontractors, many of whom are small businesses that do not always properly identify what they have sold or charge sales tax when they are required to (or do a poor job of indicating they have charged it). Additionally, companies that manage or own new real estate projects may mistakenly believe the contractor will pay the tax when, in fact, the project is actually a repair or maintenance that requires the building owner to pay the sales tax.

How Sales Tax Should Be Charged and Paid in an Ideal World

Depending on whether a project is new construction, a capital improvement, a renovation, or ordinary repairs, or the type of work being charged for, sales or use tax has to be paid on most tangible personal property and some services. Exactly who pays the tax and when they pay it depends on the situation.

New Construction and Capital Improvements

In the case of new construction or capital improvements made to real estate, the construction company is generally responsible for paying sales tax on the materials and taxable services used to complete the project. A construction company must collect and remit sales tax on any materials or services in a capital improvement on which the company charges a markup to its customer as well.

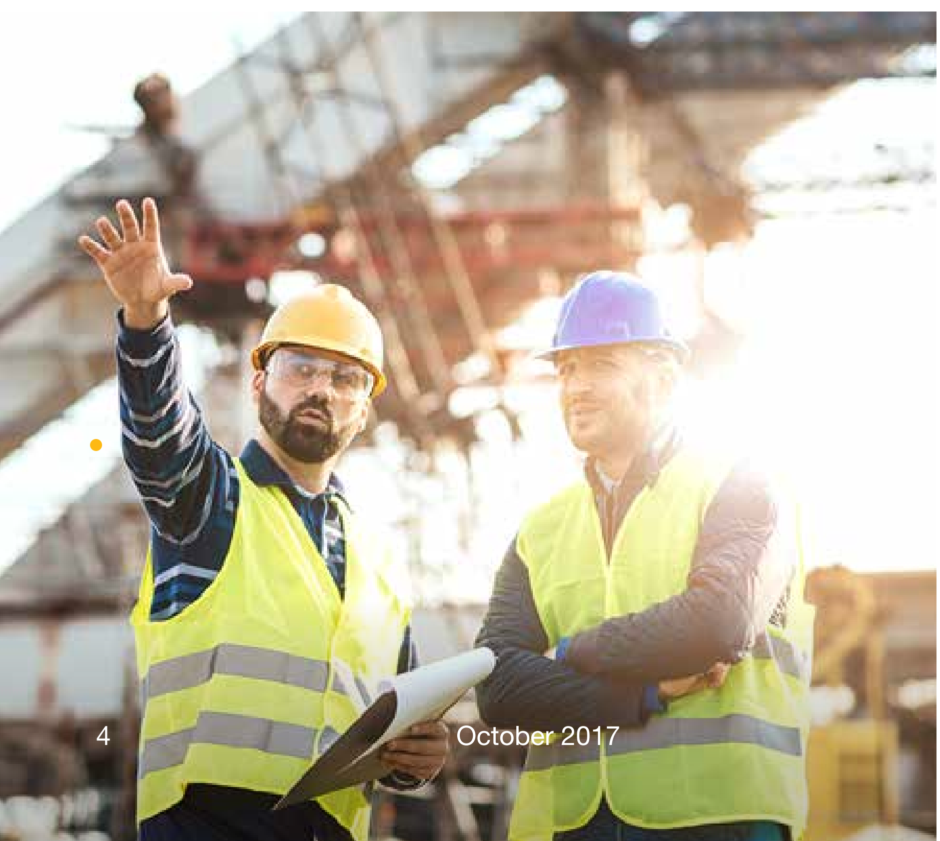
Arizona, Hawaii, Mississippi, Nebraska, and New Mexico follow different rules and do not automatically impose tax on the full amounts paid by contractors for taxable materials and services for new buildings and capital improvements; these states may either impose sales tax at special wholesale rates on part of the contract proceeds or give the contractor the option to charge and remit sales tax from its customers.

Repairs and Maintenance: In the case of repairs and maintenance, contractors may purchase the materials or services without paying sales taxes under a resale exemption, bill customers for the items, charge sales tax on the invoice, and then remit the sales tax to the state. The sales tax must be a separately identified charge on the invoices; any invoice that says "sales tax included" will have sales tax assessed on the full amount in the event that the contractor or its customer is audited.

Self-Assessed Use Tax: In the event that sales tax should have been charged on an invoice for a repair- or maintenance-related expense or for a taxable item purchased during new construction or capital improvement (e.g., new furniture) but was not, the purchaser should self-assess use tax and pay the state on its own. This often occurs when an out-of-state vendor without a physical presence in the state ships tangible property to the customer, or when vendors do not realize they were required to charge sales tax. In most states, taxable purchases for repairs or maintenance that were not taxed at the time of purchase are self-reported on a monthly, quarterly, or annual sales tax return as "taxable purchases."

As a practical matter, some in-state vendors and contractors may not always collect and remit sales tax from their customers when they are required to do so because they do not want to bother with the added work associated with collecting the sales tax from their customers and remitting it to their state and then filing sales tax returns. Additionally, some vendors or contractors may deliberately omit sales tax charges from their bids on a project when they are competing against other contractors. The fact that the contractor or vendor was required to comply with state sales tax laws and did not do so does not absolve the buyer of the taxable property or services from paying use tax on a taxable purchase. Furthermore, the buyer can be assessed penalties and interest on any use tax that the buyer was required to pay that it did not self-assess.

Of course, it is not always clear when a construction- or real estate-related purchase is taxable at the time of purchase or sale (or at all), given that some areas of construction and work performed on existing real estate lie in a gray area as to whether they are to be considered repairs and maintenance or capital improvements. Additionally, not all states tax the labor charges associated with repairs and maintenance, provided these charges are itemized separately on invoices—something many contractors and vendors fail to do.



Construction- and Real Estate-Related Activity Not Easily Categorized as Taxable or Nontaxable

A good (but not absolute) rule of thumb is if the physical property in question cannot be removed without causing damage to the structure, it is a capital improvement. While some types of work, such as the installation of a new elevator or a new overhead lighting system, are fairly obviously classified as capital improvements, some types of work are subject to frequent disputes over taxability. Model and uniform state tax laws do not have a definition for capital improvement, and the Streamlined Sales and Use Tax Agreement does not address the definition either, but most states have an established definition for capital improvement.

New York Comp. Codes R. & Regs. Title 20, Section 541.2(g)(1), for example, defines a capital improvement as an addition or alteration to real property that (1) substantially adds to the real property's value or appreciably prolongs its useful life; (2) becomes a part of or is permanently affixed to the real property so that it cannot be removed without causing damage; and (3) is intended to become a permanent installation.

Ohio refers to a capital improvement as "a permanent addition, enlargement, or alteration that, had it been constructed at the same time as the building or structure, would have been considered a part of the building or structure" under Ohio Rev. Code Section 5701.02(D).

Painting: Painting buildings, inside or out, is not always regarded as a simple repair or maintenance activity. Painting new structures, buildings, or additions typically is regarded as a capital improvement, while the painting of existing structures, buildings, or additions is usually identified as routine maintenance. However, for painting done in conjunction with an extensive renovation, an argument can be made either way. If the painting is directly incorporated into the renovation and regarded as an important part of it, then it can be considered a capital improvement. Painting done at the end of a renovation as a sort of cleanup measure, on the other hand, usually is considered taxable maintenance.

Floor Covering: Carpet, carpet tile, carpet padding, linoleum and vinyl roll floor covering, linoleum tile, vinyl tile, and other similar items fit the definition of floor covering. When installing floor covering as part of a complete rehabilitation or renovation of a building, the sale of the covering and installation charges generally are regarded as a nontaxable capital improvement. New floors that are installed to permanently cover the subfloor (e.g., board, plywood, concrete, etc.) also are usually considered nontaxable capital improvements. A new floor can be intended to permanently cover the subfloor when it is installed under a variety of different materials and methods (e.g., wall-to-wall carpeting installed with tackless strips, vinyl or linoleum tiles installed with peel-and-stick glue backing, laminate floors installed with planks that lock or glue together, etc.). When replacing part or all of an existing worn floor covering when no major renovation is occurring, the sale and installation can be treated as a taxable repair. Some states also treat the installation of floor covering on walls or ceilings as a nontaxable capital improvement.

Software: Building security systems, electronic management programs, and on-site machines (e.g., ATMs and laundry card dispensers) are considered capital improvements, and all use software to run efficiently and correctly. Generally, the upfront cost of software that is not customized but is part of a capital improvement needs to be separately stated and include charges for sales tax. The same is true for ongoing upgrades and support and maintenance charges. Software that is fully customized for its users generally is treated more like a service and is not taxable in most states.

Reception Desks: Building lobbies often have a reception or security desk. While a desk is often thought of as a piece of easily removed furniture and might appear to be taxable personal property, some desks are built into the floor and are intended to be “permanently affixed” to the building structure. Auditors often mistakenly overlook that fact and try to assess tax on the cost of the desk. A desk is considered “permanently affixed” and a nontaxable capital improvement if its removal could damage the floor and if the desk cannot be easily reused elsewhere. This does not mean that a reception desk that is simply bolted to the floor automatically qualifies as a nontaxable capital improvement, as desks are sometimes fastened to the floor for safety reasons and still can be removed with little or no damage and reused elsewhere when necessary.

Taxable Items Purchased as Part of a Nontaxable Capital Improvement: Sometimes, during the course of a capital improvement, a buyer purchases taxable items at the same time as it purchase items for the capital improvement. Although the work done and items used for the capital improvement are not taxable to the purchaser of the improvement, the items purchased along with the capital improvement as part of the job are taxable. For example, a company might be contracted to fully renovate a building lobby by replacing the floors and walls, which are nontaxable capital improvements. The same company might also sell the building owners new furniture for the lobby as part of the contract, and those sales are taxable. Either the building owner must be charged tax on the furniture with the contractor remitting the tax to the state, or the building owner must self-assess the tax and pay it separately.

Work for Exempt Entities

Contractors and vendors doing projects for not-for-profits, government agencies, and other tax-exempt entities also can face a number of tricky situations related to sales tax. Contractors that perform repair and maintenance work for, or vendors who sell tangible personal property to, tax-exempt entities might not need to charge sales tax on their invoices. However, the contractor should clearly indicate on its invoices that the customer is an exempt entity and retain a copy of the entity's exemption certificate that is readily available for production in the event of an audit. Furthermore, exempt entities that have repair or maintenance work done on facilities that produce unrelated business income for them (e.g., work done at a gift shop or cafeteria in a not-for-profit hospital) are required to pay sales tax on this work in most states.

Contractors doing construction and capital improvements for exempt entities usually pay tax on the materials they buy to do the work, but in some states, they may purchase the materials tax-free "on behalf of" the exempt entities by showing the exemption certificate to the vendors from whom they purchase the materials. Other states will allow the contractor to use the exemption by acting as an agent for the exempt entity, by either ordering the materials and billing the cost directly to the exempt entity or ordering as the exempt entity's agent with title to the materials passing directly to the entity at the time of purchase.

Avoiding Problems During an Audit

Any time a building undergoes a major renovation, addition, or large-scale repairs, auditors will seize the opportunity to perform a full-scale sales and use tax audit in an attempt to assess sales or use tax that should have been paid. If a taxing authority is auditing a construction company, it is important that invoices are well-organized, sales tax payments are well-documented, and the work or items paid for are adequately itemized and described.

The following issues frequently arise in such audits:

- **Inaccurate descriptions of work done:** The terminology used in an invoice is key to an auditor's determination whether to assess tax. If an auditor sees words such as "clean," "maintain," or "repair" on an invoice with no sales tax charged, the work instantly is a target for additional tax to be assessed. Words such as "install," "retrofit," "update," or "rebuild" are probably less likely targets. It is important that contractors and vendors accurately describe the work performed in the invoice and charge sales tax when appropriate.

- **Lack of clarity on work done and tax charged:** Invoices that come from smaller construction and real estate contractors and vendors that do their own billing are a common problem as they typically poorly describe the work done and fail to clearly indicate whether any sales tax was charged. When auditors cannot determine what the charges on the invoices are for and whether sales tax was charged, they often automatically assume a taxable item or service was sold and no sales tax was charged. This will result in an assessment of sales taxes against the contractor.

  If the amount of tax being assessed on an invoice is large enough to dispute, the construction or real estate company should require a subcontractor or vendor to make clear descriptions of what was sold and the sales tax charged, if any. Subcontractors and vendors can be motivated to improve the appearance of their invoices if they understand that it will be beneficial to them in case of an audit.

- **Inadequate breakdown of different work items:** While many contractors and vendors have invoices that are legible with the sales tax broken out, they might mistakenly combine taxable and nontaxable items on an invoice. For example, a contractor might charge a single price for the nontaxable sale and installation charges of an on-site ATM along with the taxable upfront cost of the software required to run it. This could result in the appearance of an invoice that has undercharged sales tax, and as a result, most state auditors will assume the entire amount is taxable and assess tax on the balance. To avoid paying the added tax, the purchaser should require its vendors and contractors to itemize each taxable and nontaxable charge on the invoice from the outset. Having an itemized invoice will negate the need to rush to obtain a revised and itemized invoice during an audit.

- **"Sales tax included":** It also is crucial that contractors and vendors be instructed to specifically separate sales tax as a line item on every invoice where sales tax would apply. Any invoice with the words "sales tax included" is an instant red flag for auditors, and they will assess sales tax automatically on the full amount of charges on the invoice. A buyer should immediately return any invoice that includes this phrase to the contractor with a request that it list the sales tax charge separately. The contractor also stands to benefit from correcting the invoice if it is audited for sales tax in the future.

Implementing Strict Controls on Payment and Billing Practices

Construction companies and their subcontractors, vendors, and real estate customers alike need to be as proactive as possible with billing and payment practices to minimize audit exposure. Failure to do so is a common problem in these industries and can result in a large sales tax assessment, which will be difficult to defend without the intensive task of contacting each vendor and subcontractor to obtain the necessary detail associated with the work done.

Extreme clarity about the nature of the work being performed (particularly in areas where the nature of work being done could be construed as either a repair or a capital improvement), itemizing taxable and nontaxable work, obtaining exemption certificates from exempt customers ahead of time, and separating out sales tax as its own line item on an invoice are all essential to complying with sales and use tax laws and reducing the possibility of substantial tax, penalties, and interest in an audit. All of these practices result in a smoother operation for the construction and real estate industry, a common target of state sales tax auditors because of the inevitable amount of additional taxes collected.

Learn More

Chris Johnson
+1 630 575 4373
chris.johnson1@crowe.com

Howard Wagner
Managing Director
+1 502 420 4567
howard.wagner@crowe.com

This article originally appeared in *The Tax Adviser* ©2017, AICPA. Reprinted by permission.

Text created in and current as of October 2017; Cover and artwork updated in May 2018.

TAX-18000-072B