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Construction

Untangling the Web of Sales and Use Taxes Associated with Government Contracts

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Contractors and subcontractors that build, install, or repair property for government agencies face a unique set of sales and use tax challenges that may be unfamiliar to those who've traditionally worked in the private sector.

These liabilities, which are a possible addition to other taxes, fees, and licenses that normally apply to private sector jobs, can be complex—particularly if a public sector contract involves work in multiple states. Because each state has its own regulations that dictate whether and when someone has a sales tax liability, it can be difficult keeping track of which state requires a contractor to pay taxes on labor, materials, and gross contract price.

Given this tangle of taxes, many contractors and subcontractors don't fully understand which sales and use taxes are due, and they often underestimate their obligations and cost of sales.

State-Based Tax Treatments

While it's not generally part of private sector projects, sales or use tax may be due in some states on purchases of tangible personal property that will be incorporated into a public sector project. Conversely, some states allow contractors to purchase property as agents for the federal government and not pay the sales tax from contractor to vendor.

This intricate tax situation intensifies for construction companies doing business with various types of public entities. For example, a contractor's sales tax consequence may be drastically different when working for a local municipality versus the federal government. In states where sales tax is due from the contractor—rather than the customer—the contractor generally remains liable even though the project may be for the tax-exempt federal government. Another complex problem arises when certain states define a government contractor as the consumer of purchased property used on certain government projects; this requires the contractor to pay the sales or use tax on the purchase of materials and, in some cases, the tax on subcontracts.

All states are prohibited from taxing the United States government. In addition, many states provide sales and use tax exemptions for sales made directly to state and local government agencies and certain not-for-profits. These exemptions are based on specific conditions set by each state. In Arizona, for example, contractors are not entitled to a tax exemption when working for these types of entities. This is because liability for the tax rests with the contractor—not the buyer of the construction services.

Moving beyond exemptions, many states have unique tax provisions that reinforce the need for construction companies to remain vigilant.

In New Mexico the gross receipts tax is due from the seller of goods and services. A seller may deduct sales to contractors that provide evidence that materials purchased are to become a component part of a construction project. In practical day-to-day terms, this means that receipts from the sale of nails are deductible, but those from selling hammers are not. The contractor is liable for gross receipts tax on the construction services whether for a private or public entity.

In California and a few other states, fixtures for private construction projects may be purchased without the payment of sales tax. However, construction contractors on federal projects are consumers of fixtures, and sales or use tax applies to those purchases.

In Washington, sales tax is due on state and local government projects but not on federal projects. Also, roadwork is taxed differently when the road is owned by subdivisions of the state as opposed to local municipalities or the federal government.

The Bottom Line

Understanding and dealing with these nuances is becoming increasingly essential for construction companies today because, even with fiscal constraints, the public sector is spending money on building and infrastructure initiatives. Regardless of November's electoral outcome, government spending is likely to continue as a way of bolstering an uncertain economy.

Contractors that haven't previously sought government work should carefully evaluate the specific and complex tax implications that stem from working in individual states and remember that the qualification process takes time. It's also critical to remember that transporting property across state lines has distinct sales and use tax consequences.

Focusing on these state rules and regulations is an absolute must for construction companies to ensure they don't underbid projects only to see tax liabilities after the project has been completed erode profitability. There's little question that sales and use taxes are exceedingly complicated, but with the right strategy they don't have to be financially disruptive.

Marke Greene has more than 12 years of experience identifying and implementing tax-planning opportunities for public and closely held companies.

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