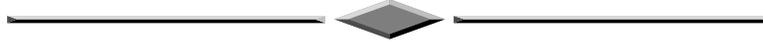


GENERAL TYPES OF TAXABLE TRANSACTIONS CONTRACTORS/CONSTRUCTION MACHINERY



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GENERAL TYPES OF TAXABLE TRANSACTIONS **CONTRACTORS/CONSTRUCTION MACHINERY**

INTRODUCTION

Regulation 103 KAR 26:070 Section 2(1) – Definitions - Contractor and Subcontractor

A **construction contractor** is one who contracts to perform a task such as erecting, remodeling or repairing real property. The term contractor is construed in its common meaning and includes general contractors and subcontractors engaged in the building trades. Such trades include roofing, aluminum siding, storm windows and doors, carpentry, electrical work, plumbing, painting, central heating and air conditioning, wall-to-wall carpet, etc.

Even though the general contractor actually is awarded the bid, it is common practice for the general contractor to obtain subcontractors for the purpose of fulfilling the contract. In this situation the subcontractor or the one that actually performs the work would be responsible for remittance of the tax.

AREAS OF CONCERN

Regulation 103 KAR 26:070 Section 2(2) – Definition - Construction Contract

A **construction contract** is a contract for erecting, remodeling or repairing a building or other structure on land and includes lump-sum, cost plus and time and materials contracts. A construction contract does not include a contract for the sale and installation of tangible personal property which do not become part of the realty.

Contracts are written in unlimited variations. The process of awarding a contract is generally the same for each project and it is important to understand the process. After a property owner determines his needs, plans and specifications are prepared by an architect. General contractors are then invited to bid upon the project. The invitation provides instruction on how the bids are to be submitted. After a contractor has been selected on the specified date on the invitation, the owner's plans and specifications and the contractor's bid are incorporated into a contract for constructing the project. It is not uncommon during the course of the construction process for the owner to make changes in the original contract. The changes are negotiated by the two parties and result in a change-order to the original contract. The change-orders can be numerous and are numbered for identification.

Unless a project is small or to be completed within a short time, the contract provides a method for payments to be made during the term of the contract. Normally, payments are based on a percentage of completion of the project and the owner is permitted under the contract to withhold or retain a percentage of the contract price until acceptance of the completed project.

Retainage is the owner's guarantee that the contractor will perform the contract as provided and is normally withheld from each payment to the contractor.

The general contractor usually utilizes much the same process as the property owner in obtaining subcontractors for the project. The general contractor obtains bids from subcontractors prior to submitting his bid to the property owner. These bids of subcontractors should be retained in the contractor's job records.

Regulation 103 KAR 26:070 Section 2(3) & (4) – Definitions - Materials and Fixtures

Materials include all the tangible personal property, other than fixtures, which becomes a permanent part of a structure. **103 KAR 26:070 Sec. 2(3)**, examples: brick, lumber, nails, roofing, drywall, etc.

One of the more difficult areas dealing with construction contractors is whether an item becomes a part of the realty, such as a "fixture", or whether it remains tangible personal property. The regulation defines a **fixture** as things which are accessory to a building and do not lose their identity as accessories but which do become a permanent part of the realty **103 KAR 26:070 Sec. 2(4)**. Examples of fixtures are: lights, plumbing fixtures, hot water heaters, furnaces, elevators, hoists, burglar and fire alarm fixtures, central air conditioning, cabinets, and built-in refrigeration units, oven-range units and dishwashers.

There is a 3-part test to determine if property has become a fixture: (1) annexation to realty; (2) application on adaptation of the item to the use of the realty; and (3) the parties' intent that the item becomes a permanent part of the realty. Tarter v. Turpin, 291 S.W.2d 547, 548 (Ky. 1956). Of these, intent is the controlling factor.

Some examples of items that the Department considers to be fixtures include:

- bleachers installed in a school gym
- cabinets permanently fastened to a wall
- tables with electrical and plumbing connections

An example of an item which the Department does not consider to become a part of the realty is telephone equipment that is designed to plug into pre-wired outlets, i.e., telephone hand set, and telephone control unit.

Question: Are boilers real property or tangible personal property?

Answer: The answer depends on the intent. Boilers used to heat a building would be treated as a fixture (real property). However, a boiler that is used in conjunction with equipment would be considered tangible personal property.

Question: When is a building or fixture not considered real property?

Answer: First, when it does not become permanently attached to real property and second, when it maintains its identity as tangible personal property. For example, a manufactured prefabricated building or a type of fixture is bolted to real property. The fact that the building or fixture can be easily unbolted and moved to another location should indicate that the building or fixture has not become part of the realty (real property) and has not lost its identity as tangible personal property. The installer of the prefabricated building or fixture is a retailer of tangible personal property and should not be treated as a construction contractor. Don't automatically assume that a building or fixture is real property because it is attached to real property. It may be tangible personal property. This concept is discussed further in the section regarding prefabricated and modular homes. See Section A of this manual.

Wall-to-Wall Carpet

Revenue Cabinet v. Bryant-Burnett Co., Inc., 725 S.W.2d 19 (Ky. App. 1987) involved a heating and air conditioning contractor. This court decision supports the treatment of contractors as consumers.

Entities providing and installing (using either their own employees or independent contractors working on behalf of the seller) wall-to-wall carpet are liable for tax on the purchase price of the carpet, pad and other installation materials and not on the "retail" price. Entities engaged in furnishing and installing wall-to-wall carpet will be treated as a retailer when such carpet is sold without installation. In such cases, the carpet dealer would be considered a retailer and therefore subject to tax on the sales price of carpet.

Audit situation - entity furnishes and installs wall-to-wall carpet and is treating itself as a retailer instead of contractor. Some persons engaged in furnishing and installing such carpet have continued to report and pay the sales and use tax in a manner not in accordance with instructions given by the Department.

Reporting Agreement

It is standard audit procedure for the Department to conduct and/or reduce sales and use tax audits of taxpayers warranting a contractor classification by permitting a tax credit offset on a transaction by transaction basis. For example, the tax collected and remitted by XYZ Company on a transaction involving the sale and installation of carpet for John Smith can be applied as credit up to the amount of tax due from XYZ on the **carpet purchase price** paid by XYZ and used on the John Smith transaction. Any remaining tax amount left after the offset cannot be applied to tax due on other transactions (i.e., equipment and material purchases consumed in transactions with exempt purchasers, etc.) Of course, should the customer desire refund of the tax erroneously collected and paid (amount in excess of use tax due) the taxpayer can seek refund in accordance with **KRS 139.770** after refunding to the customer.

This allowance of credit is contingent upon the taxpayer entering into a "Reporting Agreement" with the Department. This agreement (word document) is located in the Audit Forms folder under Field Division\Common Folder. This "Agreement" that the auditor is asking the taxpayer to sign, providing that the taxpayer wants or is in a position to be allowed credit for sales tax paid against use tax due, should be signed by the audit supervisor, district manager or regional manager based on the availability of a notary. The agreement must be notarized. If a notary is not available to the audit supervisor or district manager, the auditor needs to attach a Special Handling Notice requesting the regional manager's signature.

The "Reporting Agreement" may be used in any situation where a business has reported as a retailer but should have reported as a consumer under **103 KAR 26:070**.

KRS 139.640 - Offset of Overpayments Against Tax Owing

As indicated in the "Reporting Agreement", the Department agrees to offset per **KRS 139.640** the sales tax collected against the use tax owed on specifically identified transactions. This offset is a one-time only allowance. Any sales tax collected over the offset amount shall be refunded to the taxpayer only upon the taxpayer's compliance with **KRS 139.770**. The taxpayer further agrees to indemnify the Department for any tax, interest, attorney fees, court costs, or other litigation expense should customers of the taxpayer claim refunds from the Department for the sales tax erroneously collected from them during the audit period. Also, it is agreed that this reporting method will be in full force and effect and binding on the taxpayer and the Department for all times hereafter until such time as there is a change by statute and/or regulations or by a published decision of a Kentucky court.

In that the "Reporting Agreement" covers only specific transactions and situations, **the taxpayer is not enjoined from any future action on activity not covered by the agreement**. For example, if the taxpayer has accrued use tax on a capital addition in error, the taxpayer would be allowed to file a refund claim.

Application of Tax to Contractors

Contractors are consumers of all materials and fixtures purchased for use in fulfilling a contract. As consumers, tax applies to purchases of such property which will be incorporated or fabricated into any structure or improvement to real estate by the process of erecting, remodeling, or repairing such structure or improvement. This rule applies irrespective of the type of contract (lump sum, time and materials, cost plus fixed fee, etc.)

Pure Contractor

For the pure contractor, property consumed in Kentucky and purchased from out-of-state sellers are taxable. If the out-of-state seller is not registered for collection of the Kentucky tax, or if registered, fails to collect the tax, then it is the responsibility of the contractor to pay the tax directly to the Department. Also, purchases made from Kentucky resident retailers without payment of the sales tax, in most instances, cannot be assessed against the contractor and the liability rests with the Kentucky retailer. **The aforementioned notwithstanding, the authority**

of the Kentucky Department of Revenue to levy a use tax on consumable supplies purchased by a contractor in Kentucky from an out-of-state seller was addressed by the Kentucky Supreme Court in Genex/London, Inc. v. Kentucky Bd. of Tax Appeals, 622 S.W.2d 499 (Ky. 1981).

A contractor may not issue a resale certificate to a Kentucky vendor for materials and supplies that are to be used on a construction contract outside Kentucky. The only way that a contractor may purchase material tax exempt in this situation is to have the Kentucky vendor ship the material directly to the job-site out of state. If the contractor purchases material from an out-of-state vendor for use on a construction contract outside the Commonwealth that is only temporarily stored in Kentucky, the material would not be subject to Kentucky use tax.

Other Issues

A situation common to contractors is that costs incurred for jobs often precede recognition of revenue. Make sure that all jobs are included on the taxpayer's job list, including new jobs on which purchases have been made but on which no revenue has yet been recognized. Read the Annual Report, since it will usually make mention of large contracts for which revenues have not yet been recognized. Also, it is imperative to gain access to the jobs-in-progress file.

Highway construction firms use large quantities of stone in fulfilling their construction contracts. It is common for certain firms to quarry their own stone rather than purchasing the stone from another source. The firm's contract with a landowner for the right to enter upon that landowner's land and remove quantities of stone. This stone is then used by the firms in their construction projects. The contracts with the landowners sometimes contain provisions providing for a minimum monthly amount to be paid to the landowner regardless of the amount of stone quarried with an additional amount paid if more than a set amount of stone is quarried. Other contracts simply provide for payment to the landowner of a certain amount per ton of quarried stone.

The royalties and/or severance tax cannot be used to establish a cost for use tax purposes on stone extracted under a mineral lease and used by the lessee in construction activities, in that this type of transaction (arrangement) does not involve the purchase of tangible personal property. Accordingly, use tax under **KRS 139.310** does not apply.

Exemptions for Purchases of Exempt Property

Although the contractor is normally treated as a consumer of property utilized in the performance of a construction contract and as a result, tax being applicable to the sales price of the property to the contractor, there are certain types of tangible personal property that the contractor can purchase exempt from tax.

It should be recognized that such exemptions can be found under **KRS 139.480**, **Property Exempt**. This statute identifies the property which is exempt from sales and use tax, the use which is exempt from sales and use tax, not in most cases, the person that is buying such

property. Therefore, if the property meets the requirements under **KRS 139.480**, such property can be purchased exempt by a contractor as well as the original purchaser or end user.

Other exemptions for specific transactions are outlined in **KRS 139.470**. However, the pure contractor cannot take advantage of these because these transactions apply to retailers and not contractors. In **KRS 139.470**, the transaction is exempt based on the person who is buying such property.

Therefore, there are situations where a contractor can purchase property exempt from tax on behalf of his customer. In these situations, the contractor, jointly with his customer, would issue the appropriate exemption certificate. The contractor can purchase such property (tax free) through the issuance of such exemption certificate. These certificates contain two (2) signature blocks, one for the actual owner of the property and the other for the contractor. Therefore, this involves the joint issuance of the certificate that must be signed by not only the end user but also the contractor. Situations where a contractor can purchase, through the issuance of a joint certificate, property exempt from tax on behalf of his customer include, but are not necessarily limited to:

Machinery for New and Expanded Industry - Form 51A111

Certified Pollution Control Equipment - Form 51A149

Enterprise Zone Sales and Use Tax Exemption Certificate for Qualified Businesses, Machinery and Equipment – Form 51A151

Enterprise Zone Sales and Use Tax Exemption Certificate for Building Materials – Form 51A152

The 1992 General Assembly enacted HB 66, effective July 14, 1992, which amended **KRS 154.690** relating to enterprise zones. House Bill 66 liberalized the new and used equipment and machinery exemptions to exclude from the tax property moving in and out of a zone for business purposes.

Temporary location outside the zone for maintenance, mechanical failure or emergency short-term replacement does not disqualify the equipment or machinery from exemption provided; the property does not become a permanent fixture at a location outside of the zone. Thus, a contractor may purchase machinery or equipment tax free as long as the property will be used a portion of the time in the zone. Predominate use does not control as minimal use in the zone satisfies the statute. However, mere storage in the zone of machinery or equipment does not qualify for exemption.

See the Section related to Enterprise Zones for more information. Use caution to identify the appropriate Enterprise Zone and the appropriate expiration date.

Alcohol Production Facilities - Form 51A222. The exemption for alcohol production facilities was enacted at a time when the production of gasohol was being emphasized. Only 4 facilities were ever certified for exemption and 2 of these have now been withdrawn. Therefore, encountering this situation should be rare.

On-Farm Facilities Certificate of Exemption for Materials, Machinery and Equipment – Form 51A159

Most of the items mentioned in **KRS 139.480**, where there is a joint issuance of a certificate, can be purchased exempt by a contractor. Thus, there are exceptions to the rule that a contractor is subject to tax on all purchases.

Situations have been encountered where the contractor has tried to use the direct pay authorization issued to his customer as a means of making tax-free purchases. Direct pay authorizations are for the sole use of the taxpayer to whom it is issued. These may not be used by construction contractors. (See **Regulation 103 KAR 30:030 Section 6.**)

Purchases from Out-of-State Sellers

Contractors are consumers and as such tax applies to their purchases. If the purchase is made from an out-of-state seller, use tax is due on the purchase. If the out-of-state seller is not registered for collection of the Kentucky tax, or if registered, fails to collect the tax, then it is the responsibility of the contractor to pay the tax directly to the Department. This is the case even if the purchase was made from an out-of-state supplier authorized to collect the Kentucky use tax, but who had failed to do so through error, etc.

The foregoing statement should not be construed to mean that the Department would not make an assessment against the out-of-state registered vendor during an examination of his records, the goal being to assure payment of the tax only once (**See KRS 139.360**).

As indicated previously, the authority of the Department to levy a use tax on consumable supplies purchased by a contractor **in Kentucky** from an **out-of-state seller** was addressed by the Kentucky Supreme Court in the case styled Genex/London, Inc. v. Kentucky Bd. of Tax Appeals, 622 S.W.2d 499 (Ky. 1981).

Use tax does not apply to property purchased out-of-state which is stored in Kentucky and subsequently used by the purchaser outside of Kentucky in the performance of a construction contract. Also, use tax does not apply to property purchased out-of-state which is incorporated through a manufacturing or fabrication process into other tangible personal property which is subsequently used by the purchaser outside of Kentucky in the performance of a construction contract. In other words, property purchased out-of-state which is stored in Kentucky prior to being transported out-of-state for use is not subject to tax. Additionally, use tax would not apply to property purchased out-of-state for processing, manufacturing, fabricating or incorporating into other property which will be transported outside the state for use.

Use Tax on Construction Machinery

KRS 139.320 - Use Tax on Construction Machinery Brought into State for Construction Project

Regulation 103 KAR 25:110 - Use Tax on Construction Machinery

KRS Chapter 139 contains a separate and distinct levy for machinery brought into Kentucky for use in a **construction project**. This statute, **KRS 139.320**, sometimes referred to as the “Special Use Tax”, imposes a 6% use tax upon the storage, use or other consumption of any machines, machinery, tools, or other capitalized equipment brought into Kentucky for use on construction projects. The use tax levied under **KRS 139.320** is a separate and distinct levy from the sales tax imposed under **KRS 139.200** and the use tax imposed under **KRS 139.310**. Consequently, when discussing use tax due on tangible personal property and use tax due on construction equipment the mechanism and authority to tax is quite different.

Construction projects include but are not limited to: Constructing or repairing building, highway, street, sidewalks, bridge, sewer or water system, railways, reservoir or dam, electrical power systems including plant and transmission lines, etc.

The owner (construction contractor) is responsible for payment of the tax directly to the Department.

Computation of Tax

This methodology used to compute the use tax on construction machinery being brought into Kentucky is outlined in **KRS 139.320** and **Regulation 103 KAR 25:110**.

The formula is as follows:

$$\frac{\text{Original Purchase Price X Duration of Time of Use in This State}}{\text{Total Useful Life}} = \text{Taxable Amount}$$

For the purposes of the formula, duration of time of use in this state includes any down time, standby time, etc., that the equipment may not be in actual use. The duration of time of use in this state and total useful life must be expressed in the same units of time. If the equipment is fully depreciated at the time it is brought into the state or becomes fully depreciated while in use in the state, the total useful life shall be extended to include the time of use in this state. Total useful life includes the time the equipment is used outside Kentucky between the expiration of the depreciable life and the time the equipment enters Kentucky.

Useful life is the same as that used for income tax purposes under **KRS Chapter 141**. Different useful lives may not be used for income and sales tax purposes.

Example 1 – The use of equipment is within the useful life.

| | | | |
|---------------------------------|------------------------------|---|---------|
| Purchase Price - \$10,000 | $\frac{10,000 \times 8}{60}$ | = | \$1,333 |
| Used in State – 8-months | | | |
| Useful Life - 5 years | | | |
| Previous Depreciation - 2 years | | | |

Example 2 – The equipment becomes fully depreciated while in Kentucky.

| | | | |
|---------------------------------|-------------------------------|---|---------|
| Purchase Price - \$25,000 | $\frac{25,000 \times 18}{66}$ | = | \$6,818 |
| Used in State - 1½ years | | | |
| Useful Life - 5 years | | | |
| Previous Depreciation - 4 years | | | |

NOTE: One consequence is that this actually lowers the tax base.

Examples 3 – The equipment is fully depreciated prior to entering Kentucky.

| | | | |
|--|--------------------------------|---|---------|
| Purchase Price - \$30,000 | $\frac{30,000 \times 12}{132}$ | = | \$2,727 |
| Used in State - 12 months | | | |
| Useful Life - 5 years | | | |
| Depreciation - Full | | | |
| Age of Equipment at Time of Entering State - 10 years | | | |

When auditing contractors, it is necessary to determine which purchased machinery being brought into Kentucky has been purchased for "**first use**" in Kentucky and which purchased machinery has been used "previously" outside Kentucky before its use in this state. The distinction is critical as "**first use**" machinery is subject to the use tax levied under **KRS 139.310** on the full purchase price of the property, whereas, "previously owned property" is subject to the levy set forth in **KRS 139.320**. The distinction is based on whether or not the equipment has been used first within or without Kentucky, in contrast to what contractor used the equipment. A Kentucky based contractor doing business outside Kentucky can be subject to both the **KRS 139.310** and **139.320** levies as well as an out-of-state contractor.

For example, in the case of Genex/London, Inc., the Kentucky Department of Revenue assessed the use tax on some equipment using the formula even though Genex/London is a Kentucky based contractor. Some of the equipment purchased outside of Kentucky was first used in other states before being used in Kentucky. As a taxpayer completed its projects in the other states, the corporation would transfer the equipment to Kentucky and other states for used on other construction contracts. It was this equipment brought into Kentucky that was assessed under the formula. Additionally, not only did the Kentucky Department of Revenue tax the equipment based on the formula, but it denied a credit against the use tax due for sales tax paid to other states at the time of purchase. The reciprocity authorized under **KRS 139.510** for sales tax paid in another state does not apply to the tax imposed on construction equipment under **KRS 139.320**. **KRS 139.510** references only the use tax imposed under **KRS 139.310**. No reference is made to the use tax imposed under **KRS 139.320**.

Contracts with Exempt Purchasers (Entities)

Another area of concern when auditing is the proper application of the sales and use tax to contractors performing improvements to real property on behalf of tax exempt entities. Exempt purchasers are organizations such as federal, state and local governments and charitable, educational and religious institutions which have been exempted for payment of sales and use tax on their direct purchases.

However, contractors are consumers. Under the provisions of **Regulation 103 KAR 26:070**, a contractor may not claim that purchases of property are exempt from tax because the property is to be used in fulfilling a contract with a tax exempt organization. The purchase exemption authorization granted to the exempt organization may not be used by the contractors.

Where an exempt institution enters into a contract with a construction firm, regardless of the type of contract (lump-sum and materials, cost plus fixed fee, time and materials, or other), the purchase exemption cannot be extended to the sale of materials, supplies and fixtures to the contractor. The contractor is considered the consumer of all materials, supplies and fixtures used in fulfilling the contract.

As an auditor, you need to be aware that some neighboring states may treat contractors doing business with exempt purchasers differently than Kentucky. For example, Indiana contractors are often guilty of assuming that Kentucky provides an exemption from use tax on the fulfillment of contracts relating to purchase exempt organizations just because Indiana provides this exemption.

Kentucky Revised Statute 139.495(1), pertaining to the application of taxes to resident nonprofit educational, charitable and religious institutions, provides that the tax does not apply to sales of tangible personal property or services to such institutions for use solely within the educational, charitable or religious function. In the case of property purchased for use in making improvements to real property, **the sale must be made directly to the exempt institution to qualify for exemption.**

The largest organization which continually claims their contractors are exempt is the **federal government**. The basis for their claim is usually that you can't tax the federal government and their contractors are actually agents of the federal government.

Several states have litigated the taxation of federal contractors and the majority of cases have been successful. These states include Maryland, California, Virginia, Alabama, North Dakota, Tennessee and New Mexico. The case most pleasing to the states was United States v. New Mexico, 455 U.S. 720 (1982).

In reviewing the claim that a state cannot tax the federal government, the courts have applied the "legal incidence test". "Legal incidence" simply means who is legally liable under the law to pay the tax to the government body. If the "legal incidence" of the tax falls on the federal government, it cannot be imposed. However, as the U.S. Supreme Court noted in the New Mexico decision:

"Thus, immunity may not be conferred simply because the tax has an effect on the United States, or even because the federal government shoulders the entire economic burden of the levy."

The legal incidence of the sales tax is on the seller and the legal incidence of the use tax is on the purchaser (Marcum v. City of Louisville Municipal Housing Corp., 374 S.W.2d 865, 866 (Ky. 1964)). Since the legal incidence of the Kentucky taxes do not fall on the federal government, they may be imposed on federal contractors.

Most federal contracts contain a standard clause that states:

"Title to all property purchased by the contractor, for the cost of which the contractor is entitled to be reimbursed as a direct item of cost under this contract, shall pass to and vest in the government upon delivery of such property by the vendor."

In other words, if the contractor has the right to be reimbursed by the federal government for items, as soon as the contractor takes delivery, it becomes property of the federal government.

This clause has been claimed to create an agency relationship between the federal government and the contractor. However, a crucial element in determining whether an agency relationship exists is whether the contractor has the authority to pledge the credit of the United States. This provision does not go that far. It does not make the contractors private purchasing agents of the government nor does it give them the authority to enter into contracts on behalf of or pledge the credit of the government. The passage of title to the government upon delivery of any personal property purchased by contractors is a circumstance that does not create an agency relationship. **Therefore, purchases by federal contractors are subject to tax.**

A comparable problem has been encountered with **other exempt organizations**. In Pete Koenig Co. v. Department of Revenue, 655 S.W.2d 496 (Ky. App. 1983), Koenig had contracts with the Transit Authority of River City (TARC) to supply materials for construction and renovation of its headquarters. Koenig raised two (2) issues:

Whether the regulations which the Department has promulgated and upon which it relies are constitutionally and statutorily valid and enforceable.

Whether Koenig should be assessed a use tax on materials furnished under a separate contract with TARC, an exempt entity.

In essence, Koenig attempted to avoid the use tax by executing two (2) contracts, one for sale and one for installation. However, the end result is the same as they furnished all the material and made improvements to TARC's headquarters. The Department took the position that this separate contract angle was merely paperwork as what is present is a contract to make improvements to the headquarters and as such tax is due on such purchases.

In upholding the Department's position, the Kentucky Court of Appeals stated:

". . . **103 KAR 26:070** makes it clear that a contractor is a consumer of materials it uses in fulfillment of its contracts even if the entity it contracts with is itself exempt from tax. The regulation is neither arbitrary nor unconstitutional; it is a proper and reasonable clarification of the statute."

Therefore, regardless of the tax status of the contractor's client, the contractor is subject to tax on his purchases to fulfill the construction contract. Contractors performing improvements to real property for tax exempt entities are liable for tax on the materials they furnish in conjunction with the contract.

It is the Department's position that an exempt entity may purchase property exempt from tax only if certain conditions are met. Some of the more common methods that may be encountered of audits of contractors, dealing with the contractor attempting to purchase material exempt from tax are listed below:

- ◆ Contractors cannot avoid paying taxes by submitting a single bid for materials and installation (either by the contractor or by subcontractors hired by the contractor awarded the bid) and after being awarded the bid obtain a separate contract/purchase order from the exempt entity for the materials and a different contract/purchase order from either the exempt entity or the general contractor for installation.
- ◆ A current method being utilized by tax exempt entities is where a request is made for a lump sum bid with a provision that major material components will be purchased directly by the exempt entity after the bid is awarded. The exempt entity makes direct purchases of major material components from the supplier identified by the contractor in his bid. The exempt entity or general contractor then enters into a separate contract for the balance of the initial bid with the contractor. If the contractor and supplier are two different legal entities, then the contractor will not be subject to tax on the exempt entities purchase of the materials. However, in some cases the supplier and contractor have been the same entity. In this case it is the Department's position that the contractor is liable for tax on his purchase of the materials and there has not been a separate sale of tangible personal property to the tax exempt entity.
- ◆ The Department does recognize one condition where a contractor may sell the tangible personal property exempt from the tax to the governmental entity and then install the property. The taxpayer must be properly classified as a contractor/ retailer regularly engaged in the business of selling the type of building materials for which the contractor/retailer is claiming an exempt retail sale and the tax exempt entity must:
 - Utilize a separate competitive bidding process for materials vs. the erection or installation; and

NOTE: Lump-sum bids accepted during the initial process and renegotiated later will not be recognized as separate transactions.

- Awards separate contracts to the contractor/retailer for each bid.
- The exempt entity must prepare and submit its own purchase orders.
- Charges by the supplier must be billed to and paid directly by the exempt entity.
- Materials and supplies purchased by the exempt entity must be delivered to the exempt entity's job site.

In auditing a contractor/retailer, it is required that the contractor/retailer document that two separate bids were solicited by the exempt entity and two separate contracts were actually awarded.

Sales of Construction Assets

Sales of construction assets generally can be verified by examination of general ledger accounts, depreciation schedules and **Schedule 4797** and **Schedule D** that are included with income tax returns. Occasionally these asset sales may be in "other income" on the income tax return.

KRS 139.070 - Occasional Sale

It is not usual for a contractor to periodically sell some equipment especially if it was purchased for a specific job and is no longer needed. Such sales may be taxable or qualify for exemption based on the specific factual situation. These sales may be non-taxable because the contractor has secured a properly executed resale or exemption certificate for the sales. The sales also could be exempt because they are sales in interstate commerce.

If the asset sales are not exempt for the above reasons, the next determination that will have to be made is whether or not the sale or sales would qualify for the occasional sale exemption provided for in **KRS 139.070**. For the sale of construction assets to be taxable the contractor would have had to become a "retailer" of these construction assets. **KRS 139.110(1)(c)** defines a retailer to include every person making more than two (2) retail sales during any twelve-month period. The statute is very plain as to when a person becomes a retailer. The fact that sales of construction assets are made as the result of a liquidation or going out of business sale would not alter the application of tax to such sales.

This point was litigated in a case styled Gust K. Newberg Construction Co. vs. Commissioner, 516 S.W.2d 846 (Ky. 1974).

During a seven (7) month period, Newberg sold 15 pieces of equipment to 11 different purchasers. The contractor maintained that he was a contractor, not a retailer of construction equipment, therefore exempt from collecting sales tax because of such transactions being deemed **occasional sales** as defined by **KRS 139.070**. The statute defines an "occasional sale" to be:

"A sale of property not held or used by a seller in the course of an activity for which he is required to hold a seller's permit."

Newberg wanted to stop at this point with the statute. They did not want to read the qualifying portion of the statute in conjunction with the first part. To continue with the statute:

"...provided such sale is not one of a series of sales sufficient in number, scope, and character to constitute an activity requiring the holding of a seller's permit."

The Department took the position that Newberg was a retailer of the equipment within the meaning of **KRS 139.110(1)(c)** in that Newberg made equipment sales to eleven (11) different purchasers in a seven (7) month period.

The Kentucky Supreme Court concluded that Newberg was a retailer of the equipment and subject to tax on the sales.

The test for determining the application of the tax to equipment sales by the contractor is the **number of sales** made in any twelve month period. In this regard, it must be recognized that the number of pieces of equipment involved in the transaction is irrelevant in that the number of pieces of equipment sold and the number of sales may not always be the same. Consider the following:

- A contractor sells five pieces of equipment to five different purchasers during a twelve-month period. Tax would apply to the sale.
- A contractor sells 15 pieces of equipment to two different purchasers. One sale is for 10 pieces of equipment and the other sale is for 5 pieces of equipment. No other sales of equipment are made. The transactions would qualify as occasional sales.

KRS 139.110(1)(c) says that a retailer is anyone making more than 2 retail sales during any 12 month period; not a calendar period or a fiscal year, but any 12 month period. Example:

| | |
|------------------|--------|
| March 6, 2001 | 1 sale |
| April 14, 2001 | 1 sale |
| February 3, 2002 | 1 sale |
| May 4, 2004 | 1 sale |

In this given example, more than two retail sales were made in a twelve (12) month period, i.e., March 6, 2001 - February 3, 2002. Consequently, this established this taxpayer as a retailer of these types of assets. Additionally, the fourth sale would be taxable as it is the Department's position that once qualified as a retailer, always a retailer of that particular type of asset.

Contractor/Retailer/Manufacturer

Discussions up to this point have dealt with situations where the contractor has been viewed strictly as a consumer. However, it must be pointed out that a contractor may be in a dual business of selling or manufacturing the materials which are used in their construction business.

In many instances, a contractor may be operating in the capacity of a contractor-retailer by being engaged in selling to the general public on an over-the-counter basis the same type of building materials and supplies as is used by them in their construction business.

As a Kentucky retailer, the contractor/retailer must hold a Retail Sales and Use Tax permit and report the tax due on sales. As a permit holder the contractor/retailer is liable for the sales tax on Kentucky sales of tangible personal property unless the sale qualifies for the exclusions or exemption. Additionally, any use tax liability would be reflected on this same return, just like any other retail permit holder. The contractor/retailer will report retail sales on line 1 and amounts subject to use tax on line 23.

As a contractor/retailer the taxpayer can issue a resale certificate for all items of inventory purchased for resale and for items regularly held in stock when it is not known at the time of purchase whether such items will be resold or used in the construction business. If, at a later date, any of this inventory is withdrawn for use in fulfilling a construction contract, such purchase will be subject to the use tax and reported on line 23 of the return.

A contractor may also be the manufacturer of the materials used in the construction business. Manufactured property consumed by the contractor within the construction portion of the business is subject to the tax based on the **material cost** of the property incorporated into the product.

Some questions that tend to surface are as follows:

Question: Does the sales tax apply to property purchased from a Kentucky vendor under a resale certificate and then used outside the state on a construction project? Does the sales tax apply to property purchased from a Kentucky vendor under a resale certificate which is incorporated into other tangible personal property through a manufacturing or fabrication process and is subsequently used outside the state by the purchaser in the performance of a construction contract?

Answer: The taxpayer has used the materials in performing construction contracts and is subject to tax on the purchase price of such materials as provided by **Regulation 103 KAR 26:070**. The fact the property may have been incorporated into other tangible personal property does not alter the tax application. Since the taxpayer issued resale certificates and then used the property contrary to certification, he is liable for the sales tax imposed by **KRS 139.200**. Accordingly, there is nothing in the law or regulations that would permit construction contractors to purchase materials and supplies in Kentucky for use on out-of-state construction projects exempt from sales tax.

Question: Does the use tax apply to property purchased out-of-state which is stored in Kentucky and is subsequently used by the purchaser outside of Kentucky in the performance of a construction contract? Does the use tax apply to property purchased out-of-state which is incorporated through a manufacturing or fabrication process into other tangible personal property which is subsequently used by the purchaser outside of Kentucky in the performance of a construction contract?

Answer: The use tax imposed under **KRS 139.310** is applicable to tangible personal property purchased for storage, use or other consumption within Kentucky. However, **KRS 139.150(2)**, which defines storage and use, states in part:

'Storage' and 'use' do not include the keeping, retaining or exercising any right or power over tangible personal property for the purpose of subsequently transporting it outside the state for use thereafter solely outside the state, or for the purpose of being processed, fabricated or manufactured into, attached to or incorporated into, other tangible personal property to be transported outside the state and thereafter used solely outside the state."

Accordingly, property purchased out-of-state which is simply stored in Kentucky prior to being transported out-of-state for use is not subject to use tax. Additionally, use tax would not apply to property purchased out-of-state for processing, manufacturing, fabricating or incorporating into other property which will be transported outside the state for use.

Repairs by Contractors

Persons engaged in the repair business can be treated as a contractor or retailer depending upon the type of property being repaired. Persons engaged in the repair of tangible personal property are retailers while persons engaged in repairing real property are contractors. Questions arise when it is not clear if the repair is to tangible or real property.

Persons engaged in the repair of tangible personal property are retailers of the parts used to repair the property. **Regulation 103 KAR 27:150 - Repairers and Reconditioners of Personal Property** provides tax applies to the selling price of the property used in the repair. If charges for labor are not separately stated from the parts on the invoice given to the customer, tax applies to the total charge.

Regulation 103 KAR 26:070 - Construction Contractors provides that contractors are the consumers of the material used in the repair of structures or improvements to real estate. As consumers, tax applies to the material purchased by the contractor for use in the repair. Tax does not apply to the amount invoiced to the customer.

Questions arise when the repair is to items that have been attached to a structure such as lights, doorbells, etc. These items would appear to be identifiable as tangible personal property and as such, persons making repairs to these items should be treated as retailers under **Regulation 103 KAR 27:150**.

Prior to the court's decision in the case of Revenue Cabinet v. Bryant-Burnett Co., Inc., 725 S.W.2d 19 (Ky. App. 1987), the Cabinet treated persons repairing attachments to structures such as lights, central air conditioning units, etc., as repairers and reconditioners under **Regulation 103 KAR 27:150**. In this case, the Kentucky Court of Appeals determined that a company engaged in the repair of central heating and air conditioning systems was a contractor, not a retailer, in relation to the materials and parts used. The regulation that was held by the court to apply in this situation is **Regulation 103 KAR 26:070**. The taxpayer was engaged in the repair of “**fixtures**” as defined by the regulation. Accordingly, tax would apply to the contractor's purchase price of the materials and parts used.

NOTE: The repair of fixtures constitutes a repair of real property. Although the parts and materials used in the repair of a fixture are initially tangible personal property, they are converted during installation into fixtures which are part of the real property. Accordingly, tax would apply to the sale of the parts and materials to the contractor.

The question that must be answered to determine the proper application of the tax is if the person is repairing a “**fixture**” as defined in **Regulation 103 KAR 26:070**. If the repair is to a “**fixture**” as defined by the regulation, the person would be treated as a contractor for sales and use tax purposes.

The term “**fixtures**” is defined as things which are accessory to a building which do not lose their identity as accessories but which do become a permanent part of the realty.

Examples of fixtures are: burglar and fire alarms, lighting fixtures, central air and heating conditioning units, built-in refrigerators, ranges and cabinets. The regulation contains more examples; however, it must be pointed out that the list is not meant to be all-inclusive.

The Department has tried to inform the public of its interpretation of the impact of Bryant-Burnett. Some more examples include but are not limited to. . .

- Access Flooring
- Air Conditioner (wall or ceiling mounted)
- Alarm Systems
- Attic Fans
- Cabinets (built-in)
- Ceiling Fans
- Countertops
- Dehumidifiers (furnace mounted)
- Dishwashers (built-in)
- Exhaust Fans
- Fencing
- Filing and storage systems
- Garage Door Openers (automatic)
- Garage Doors
- Garbage Disposals
- Gas Grills (on-line)
- Hot Tubs (if part of realty)
- Hot Water Heaters
- Humidifiers (furnace mounted)

Instant Hot Water Dispensers
Intercom Systems (if built-in)
Jenn-Air Ranges (if built-in)
Light Fixtures (if built-in)
Microwave Ovens (wall mounted or built-in)
Modular Office Equipment
Ovens (built-in)
Range Hoods
Ranges (built-in)
Refrigerators (built-in)
Smoke Detectors
Sod
Storage Sheds (if part of realty)
Storm Doors
Tile/Floor Coverings
Trash Compactors (if built-in)
Wall Paper
Wall to Wall Carpe
Water Purifiers
Water Softeners
Window Treatments (drapery rods, curtain rods, mini blinds, custom made draperies/curtains)
Wood Burning Stoves

Construction Information Service

Many contractors purchase what are commonly referred to as "Dodge Reports". These reports provide up-to-date information concerning construction projects. Firms who specialize in providing such data enter into contracts with clients which specify the categories to be received as well as the geographic area to which the information is to be limited. Other services which may be provided include an individual analysis of the sales potential of a client's goods or services with recommendations and the availability for review of plans and specifications for various construction projects. The information supplied remains confidential with title not passing to the client.

Question: Are receipts received for providing services to a contractor which include periodic custom reports concerning construction projects subject to tax? Are receipts derived from providing this type of report subject to tax as a sale of tangible personal property?

Answer: No. Kentucky law defines retail sales subject to tax to include a sale of tangible personal property or the furnishing of certain facilities and services. The providing of information to customers is not one of the services subject to the tax. Also, the fact that the information is conveyed to the customer by tangible personal property is not sufficient to classify the sale as a taxable retail sale of tangible personal property. It is the real objective sought by the customer that is determinative as to whether the transaction is a service or a sale of tangible personal property. The receipt of tangible personal property by the customer in such a transaction is incidental to the services being provided.

IMPACT OF STREAMLINED SALES AND USE TAX AGREEMENT

Delivery Charge Transition Rules

In order to ease the implementation of this new law, the Department of Revenue offered the following transitional rule for sales of construction materials made to contractors who have entered into a bona fide written lump-sum or fixed-price construction contract that does not provide for allocation of future taxes. To qualify for this transition treatment, the construction contract must be executed prior to July 1, 2004. Delivery charges for construction materials purchased by contractors to fulfill qualifying contracts are not be subject to the law change if the delivery is made on or before December 31, 2004. This provision allows a six-month period of adjustment to this tax code change.

A contract to provide construction materials to a contractor for a fixed price and for a fixed period of time does not qualify for this transitional rule unless the materials delivered are to fulfill an existing lump-sum or fixed-price construction contract that meets the requirements described above.

To qualify for this transitional treatment, contractors must provide their suppliers with a signed statement indicating the following:

- ◆ The contractor's name, address, and Kentucky consumer's use tax account number (if number is assigned);
- ◆ The name and address of the party contracting for the construction project;
- ◆ The name and location of the project, the contract number, and the date of the contract; and,
- ◆ A statement that the materials are for use by the contractor under a lump-sum or fixed-price construction contract that does not provide for allocation of future taxes.

Vendors must retain this documentation as proof of an exempt delivery transaction on the same basis as other sales records according to provisions of **KRS 139.720**. When filing their sales tax returns for tax periods on or after July 1, 2004, vendors must not claim the freight and delivery deduction. This deduction is no longer valid because of the statute change. To claim a deduction for delivery charges for construction materials purchased by contractors to fulfill qualifying contracts described above, vendors should place the delivery charge on line 19 of the worksheet and use code 190 for the deduction on the return. Vendors should designate the code 190 deduction as *delivery transition rule*.