**Opinion Letter**

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| **Brief Description:** | **Contractor-retailer related sales tax issues.** |
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**Body:**

Office of Policy & Research

May 5, 2011

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RE: Your e-mail received on February 23, 2011

Dear XXX:

Thank you for your recent e-mail. I apologize for my late response. You indicate a department associate advised you that a contractor-retailer can only operate as a contractor or as a retailer. This advice is incorrect.

Unlike a contractor, a contractor-retailer is allowed to buy materials tax exempt. A contractor-retailer operates a retail business and maintains a resale inventory that includes untaxed construction materials. Tax is collected and reported when the materials are sold over-the-counter. The contractor-retailer is required to accrue and report sales tax when it withdraws materials from inventory to use in one of its in-state or out-of-state construction projects. When a small contractor-retailer buys materials for a specific construction project, the contractor-retailer may elect to pay tax on the purchases or buy the materials tax exempt and accrue sales tax as it does when it withdraws materials from inventory. A small contractor-retailer that buys materials tax exempt and does not place the materials in its resale inventory is required to accrue sales tax when it take deliver of the materials, as if it were withdrawing the materials from its untaxed inventory.

The department's experience is that many small contractor-retailers need to be able to claim the resale exemption when buying materials for a specific construction project even though the materials are never actually placed in their resale inventory. This is because the contractor-retailer's bookkeeping system cannot track an inventory that consists of both taxed and untaxed items.

EDU-26, *Sales Tax Guidelines for Contractors and Contractor-Retailers,* provides the following discussion of contractor-retailers":

**Basic rules for contractor-retailers.**Like a retailer, a contractor-retailer may claim resale exemption when it buys merchandise for its resale inventory. You, as a contractor-retailer, do this by giving a completed resale exemption certificate to vendors that sell you merchandise for your resale inventory. As with every other retailer, a contractor-retailer is responsible for self-reporting or accruing sales tax on any goods taken from inventory and used in their business. *K.S.A. 79-3603(l)(2).* This includes construction materials and supplies that the contractor-retailer takes from inventory to use in its construction jobs. A contractor-retailer should accrue sales tax on the cost of merchandise removed from inventory --- not on the price at which the merchandise is offered for sale to the public.

To "accrue" tax, a contractor-retailer enters the cost of merchandise taken from inventory on the appropriate line on its sales tax return. On a Form ST-16, this is Line 2, Part I: "Enter the cost of tangible personal property consumed or used by you that was purchased without tax. For example, items removed from inventory and used by you." On a Form ST-36, the appropriate line is the line assigned to the location of the resale inventory under Part III, Column 3: "Enter your cost of tangible personal property consumed or used by you that was purchased without tax."

This is the same accounting that all businesses use to accrue tax on: (1) merchandise removed from an untaxed resale inventory and used in their business; and (2) untaxed purchases when a vendor failed to charge them the correct Kansas sales or use tax. It is the same accounting contractors must use to pay tax on materials that are purchased under a project exemption certificate but not used on the project. How to accrue tax is discussed at length above in the*Contractor Guidelines: Accruing tax on untaxed purchases.*

Tax must be accrued during the reporting period when the merchandise is taken from inventory. The local sales tax to accrue is the one in place at the location of the resale inventory. As with other businesses, contractor-retailers must pay sales tax when they buy construction equipment and other items to use in their business, such as office equipment, office supplies, cash registers, shelving, construction equipment, tools, motor vehicles, and so forth.

**Taxing construction contracts performed by contractor-retailers.**When a contractor-retailer performs a construction contract, the contractor-retailer is treated as the consumer of the materials and supplies that it uses and as the retailer of the taxable construction services it performs. This is the same treatment accorded contractors. See*Overview: The two basic rules,* above*.* The two basic rules, restated for contractor-retailers, are:

1. Contractor-retailers *must accrue sales tax* as consumers when they remove materials and supplies from their untaxed resale inventory to use on their in-state and out-of-state construction projects.

2. Contractor-retailers *must collect sales tax* as retailers when they bill their customers for the taxable labor services they perform in Kansas on their construction projects.

The only difference in applying these rules is that contractors pay sales tax when they buy construction materials, while contractor-retailers claim resale exemption on their purchases and accrue sales tax when they remove materials and supplies from their untaxed resale inventory to use in their construction projects. *(Underlining added).*

As noted above, small contractor-retailers are allowed to claim a resale exemption when they buy materials for a specific construction project even though they don't actually place the items in their resale inventory. Nevertheless, most contractor-retailers choose to pay sales tax when they buy taxable materials for a specific project. This simplifies *their* accounting, although the practice complicates accounting for some small contractor-retailers. Contractors that are registered as contractor-retailers, but whose retail sales only amount to a small fraction of their receipts from construction contracts, are required to pay sales tax to their vendors at the time of purchase.

You also ask about a contractor-retailer's retail sales *(i.e. over-the-counter sales)* to exempt entities. There is a critical difference between materials a contractor-retailer sells as tangible personal property and materials the contractor-retailer uses in its construction projects.

Kansas sales tax is levied on retail sales of tangible personal property ("TPP" or "goods") and certain services listed in the sales tax act's imposition section, K.S.A. 79-3603. These taxable services are commonly referred to as "enumerated services" or "listed services." A "retail sale" is a sale to the final user or consumer. *See K.S.A. 79-3602(jj) ("Retail sale" or "sale at retail" means any sale, lease or rental for any purpose other than for resale, sublease or subrent.")* One important rule for the construction industry is that contractors are treated as final consumers of the materials, supplies, and equipment they buy and use to fulfill their construction contracts. Since sales to contractors are sales to final consumers, contractor purchases are taxable.

A construction contractor that improves real property is considered the final consumer of the construction materials it buys. This is because a construction contractor's job is to apply its skill and labor to transform the materials into buildings, structures, and other real property improvements. This is reflected in Black's definition of "general contractor" as "[o]ne who contracts for the completion of an entire project, including purchasing all materials, hiring and paying subcontractors, and coordinating all the work." *Blacks Law Dictionary, Eighth Ed. 2004, p. 351.*

Once construction material becomes part of a building or structure, the materials are no longer TPP whose transfer or sale is subject to sales tax. Sales tax is not imposed on the sale or transfer of real property. Accordingly, a property owner or buyer's acceptance of a completed project is not subject to sales tax as a sale of tangible personal property. As noted above, the last time materials can be taxed --- absent statutory provisions to the contrary --- is the sale to the contractor which is the last transfer of the materials as TPP.

Forty-five states and the District of Columbia impose sales tax. These laws, with remarkably few exceptions, tax contractors purchases of materials. This is because the final sale of the materials *as TPP* is the sale to a contractor. Courts accepted this principle early in the development of state sales tax laws, as reflected in the following discussion in *Duhame v. State Tax Commission,* 65 Ariz. 268, 179 P.2d 252, 171 A.L.R. 684 (1947)(reversed on other grounds):

[W]e hold that when the contractor buys materials and supplies for use in fulfilling his contract, he does not purchase them for resale as tangible personal property, but for use in producing the completed job. He is not a trader or dealer. *Acorn Iron Works v. State Board of Tax Administration,* 295 Mich. 143, 294 N.W. 126, 139 A.L.R. 368; *City of St. Louis v. Smith,* 342 Mo. 317, 114 S.W.2d 1017; *Wood Preserving Corp. v. State Tax Commission,* 235 Ala. 438, 179 So. 254; *State Board of Equalization v. Stanolind Oil & Gas Co.*, supra, [54 Wyo. 521, 94 P.2d 147]; *Atlas Supply Co. v. Maxwell,* 212 N.C. 624, 194 S.E. 117; *Albuquerque Lumber Co. v. Bureau of Revenue,* 42 N.M. 58, 75 P.2d 334; *Utah Concrete Products Corp. v. State Tax Comm.,* supra [101 Utah 513, 125 P.2d 408]; S*tate v. Christhilf,* 170 Md. 586, 185 A. 456; *State v. J. Watts Kearny & Sons,* 181 La. 554, 160 So. 77; and see 98 A.L.R. 837; *Blome Co. v. Ames,* 365 Ill. 456, 6 N.E.2d 841, 111 A.L.R. 943; *Herlihy Mid-Continent Co. v. Nudelman,* 367 Ill. 600, 12 N.E.2d 638, 115 A.L.R. 491; 139 A.L.R. 373.

This legal principle runs as a firm thread through many allied fields of the law. For example, after a contractor has fabricated personalty into realty, his statutory lien is not against the personalty he fabricated or installed, but against the realty, sec. 62-201, A.C.A.1939. Again, when by conditional sale, fixtures sold are affixed to realty, reservation of property rights in these fixtures are lost by the seller unless there is filing of the conditional sales agreement and/or consent by the property owner. Sec. 52-604, A.C.A.1939. See also 13 A.L.R. 448; *Abramson v. Penn,* 156 Md. 186, 143 A. 795, 73 A.L.R. 748; *People's Sav. & Trust Co. v. Munsert,* 212 Wis. 449, 249 N.W. 527, 250 N.W. 385, 88 A.L.R. 1318; *Smyth Sales Corp. v. Norfolk Bldg. & Loan Ass'n,* 116 N.J.L. 293, 184 A. 204, 111 A.L.R. 362; See also *J. W. Meadors & Co. v. State,* 89 Ga.App. 583, 80 S.E.2d 86 (1954), which quotes from *Duhame*.

This treatment is codified by K.S.A. 79-3603(l) and its imposition on:

the gross receipts received from the sales of tangible personal property to all contractors, subcontractors or repairmen for use by them in erecting structures, or building on, or otherwise improving, altering, or repairing real or personal property. . . . *K.S.A. 79-3603(l).*

A contractor recovers its costs, which include the purchase price it paid for materials and the sale tax imposed on that price, when it bills a customer for a completed project. When a contractor invoices its customer, the department recommends that the invoice not list the purchase price of the materials and the sales tax imposed on that price as separate amounts. The purchase price paid for the materials, the tax paid on that price, and any mark-up being charged by the contractor should be lumped together as a single amount. Separately listing the tax the contractor paid to its vendors can appear to be sales tax the contractor is collecting from customer and reporting to the department, which it isn't.

A contractor is required to pay sales tax when it buys materials, supplies, and other taxable items such as meals and equipment. This is so even though the contractor will recover these costs when it bills a customer for a completed project. *K.S.A. 79-3603(l).* The costs a contractor recovers include employee wages, transportation costs, insurance costs, the interest and taxes the contractor pays, and all other overhead expenses.

When a contractor that paid tax on materials performs taxable labor services, the contractor is required to account for its tax-paid purchases and the taxable labor service it charges to its customers by following the directives first announced in Bulletin Vol. V, No. 1, *Sales and Use: Basis of Tax: Computation of Sales Tax on Construction Contracts,*Kansas Department of Revenue (January 1, 1972). These directives are now codified in K.A.R. 92-19-66b, and are discussed at length in a number of department publications. *See e.g.*"Charging and reporting sales tax on your taxable labor services" in EDU-26, *Sales Tax Guidelines for Contractors and Contractor-Retailers*.

Kansas has never allowed vendors to accept a contractor's verbal or written exemption claim for materials the contractor intends to use to improve real property owned by an exempt entity. Instead, a qualifying entity is required to secure a numbered project exemption certificate (PEC) from the department. Only certain exempt entities are entitled to secure PECs.

Exempt entities, including schools, cities, and counties, must apply to the department for a Kansas Tax Exempt Entity Exemption Number. Once approved, the department issue a "Sales and Use Tax Entity Exemption Certificate," *PR-78,* to the entity. This entity exemption certificate explains what exemptions the entity can claim and whether or not the entity qualifies to secure a PEC.

A qualifying entity should apply to the department for a PEC each time it intends to hire a contractor or repairman to repair property that it affixed to reality or to do construction work. Once the PEC application is approved, the department issues a numbered PEC to the qualifying entity. The PEC identifies the exempt entity, the project, its starting date, its duration, and contains a PEC number. The PEC contains other lines for the general contractor and subcontractors to complete, i.e. the entity is issued a "blank" PEC that the general and subcontractors will fill out and issue. The entity maintain a copy of the blank PEC as part of its records and provides a copy of it to its general contractor, who will provide blank copies to its subcontractors.

When purchasing materials for a PEC project, the contractor and subcontractors complete the PEC and present the completed copy to the vendor. Each vendor will issue an invoice for materials that includes the project exemption number, in lieu of charging sales tax. Each subcontractor that bills its services to the general contractor or to another subcontractor will issue invoices that contains the PEC number. The project exemption number creates an audit trail from the vendors and subcontractors through the general contractor to the qualifying project.

There are a number of reasons for requiring PECs. One is that the Kansas sales tax act does not allow most entities that are exempt on their purchases to secure project exemptions. The PEC application process helps to assure project exemption certificates are only used by entities that are lawfully authorized to secure them.

Another reason is that subcontractors on a PEC project do not contract directly with the exempt entity. Subcontractors bill the general contractor or another subcontractor for their work. This means the subcontractor's invoice may not reflect who owned the real property being repaired or improved. It may only identify the general contractor or another subcontractor billed for the services. Establishing the work was done to an exempt entity's property can require additional proof. These audit and evidentiary problems are avoided if a PEC is secured for a project and the PEC number is shown on the invoices.

The PEC application process is simple, especially for small projects. As noted above, exempt entities are required to secure a Sales and Use Tax Entity Exemption Certificate before they can claim exemption. These certificates explain whether or not the entity is authorized to secure a PEC. If authorized, the entity can secure a PEC by completing an electronic application form posted on the department's website. A few entities have elected to secure authorization from the department to issue PECs for their own projects, although this is uncommon.

A PEC entity should apply for and secure a PEC before bids are let for a repair or construction project. This allows the entity alert contractors that materials for the project can be purchased tax exempt under a PEC. This is intended to reduce construction cost for the exempt entity.

The department encourages qualifying entities to secure a PEC for all of their projects that involve real property. There are a number of reasons for this recommendation. One is that an entity can never be certain who will actually do the work. For example, if a school routinely contacts with a contractor-retailer for repair services, the contractor-retailer may determine some of the repair requires the expertise of a specialty subcontractor. Without a PEC, the specialty subcontractor cannot claim exemption when it buys materials. Similarly, an emergency may require an exempt entity to hire a contractor to do the work, instead of than one of the contractor-retailers it normally hires. Again, without a PEC, the contractor cannot claim an exemption when it buys materials to do the work. These potential problems are avoided if a qualifying entity routinely secures a PEC whenever it needs to repair anything attached to real property.

This shows another reason that entities should routinely apply for a PEC when something attached to real property needs to be repaired or replaced. Beginning with a decision published in the nineteenth century, the Kansas Supreme Court has observed it is impossible under the law of fixtures for citizens to consistently distinguish between services performed to fixtures attached to real property and services performed to tangible personal property attached to real property that hasn't become a fixture. *See Kansas City Millwright Co., Inc. v. Kalb,* 221 Kan. 658, 562 P.2d 65 (1977). Securing a PEC eliminates the possibility of a contractor-retailer being assessed on parts or material withdrawn from its resale inventory.

The PEC application process is simple. This simplicity is intended to encourage qualifying entities to secure a PEC for every repair project they have, large or small. This helps to assure that the volunteers, employees, and board members of an exempt organization are aware of the PEC requirements, even when there is frequent turnover of the volunteer positions, employees, and board members. Routinely applying for a PEC for every small project helps organizations acquire institutional knowledge about PECs. This knowledge allow a qualifying entity to reduce its construction costs when it undertakes large construction projects, which may happen decades apart.

You also ask how Kansas sales tax applies to your client's sales, installation, and repairs of appliances. The sales tax treatment of appliances and fixtures is explained at length in EDU-28, *Sales Tax Guidelines for Businesses that Sell and Service Appliances and Electronic Products*. The only caveat here is that the list of appliances contained in EDU-28 is exclusive. If a fixture isn't listed in EDU-28 as an appliance, the fixture is treated as part of real property rather that as an appliance that taxed as TPP when sold, installed, or repaired. Not identifying which residential fixtures are treated as TPP and which ones are not, would have introduced the same due process shortcomings that resulted in an earlier imposition on labor services being declared unconstitutional. *See Kansas City Millwright Co., Inc. v. Kalb,* 221 Kan. 658, 562 P.2d 65 (1977).

The department of revenue has issued a number of publication that explain there is no sales tax imposition on excavating, drain and sewer auguring, and snow removal services. The one caveat is that these services must be billed as separate line-item charges and not lumped together with charges for taxable services. For example, if a plumber excavates a pipe and repairs it for a business, the entire amount is taxable unless the plumber bills its excavation charges as a separate line-item charge that can be distinguished from the separately stated line-item charge for taxable repairs to the pipe.

You ask what services need to be reported on a return and then backed out from the reported taxable sales by entering the same amount on the line provided on the return for "Other allowable deductions." Your question identifies an issue created by referring to two different type of services as "exempt services." The first type of "exempt service" is one that is taxable but for a statutory exemption. For example, sales to a political subdivision of the State of Kansas would be taxed except for the sales tax exemption extended to political subdivisions. The second type of "exempt service" is one that is not subject to sales tax because is it not listed or enumerated in the act's imposition section. Technically, these services cannot be "exempt" from sales tax because sales tax is not imposed on them in the first place. For example, it is more accurate to say charges for medical services are not subject to Kansas sales tax than to say medical services are "exempt" from tax.

Sales tax return issued were caused by this imprecise usage because there were times department associates advised businesses to report receipts from services not enumerated as taxable services and then back out those receipts on the line provided for "Other allowable deductions." At other times, associates advised businesses not to report receipts from any services not enumerated or listed in the act as a taxable service.

As a result, some service providers report large amounts of gross receipts and then back out most of those receipts as "Other allowable deductions." Other businesses that provide same services report relatively small amounts as gross receipts. For example, charges for hair cuts, permanents, and hair coloring are not subject to Kansas sales tax. Nevertheless, some beauty salons report their receipts from hair cuts, permanents, and hair coloring along with their sales of beauty products. They then back out their receipts from hair cuts, permanents, and hair coloring on the line provided for "Other allowable deduction." The result is these businesses correctly report sales tax on their taxable sales of beauty products, but also report and then subtract out their receipts from non-taxable charges for hair cuts, permanents, and hair coloring. As noted, other beauty salons that provide identical services only report their retail sales of beauty products.

The preferred reporting practice is to not report charges for services that are not "listed" or "enumerated" in the sales tax act. However, this is not a requirement because of the conflicting advice given by department associates over the years. Retailers that currently report receipts from nontaxable services are not required to change their accounting software so that these sales are not reported. Modifying or changing accounting software is expensive. The bottom line is that taxable sales must be accurately reported.

If you have any additional questions, please call me at 785-296-3081.

Sincerely,

Thomas E. Hatten
Attorney/Policy & Research

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