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2017 Joint Committee on Finance Paper #311

Sales Tax Treatment of Construction Contracts for Real Property Construction Activities (General Fund Taxes -- Sales and Excise Taxes)

[LFB 2017-19 Budget Summary: Page 191, #3]

CURRENT LAW

Wisconsin imposes a 5% general sales and use tax on the sales price or purchase price of taxable items and services sold in this state. Generally, the sales and use tax applies to all sales of tangible personal property unless specifically exempt. Services, on the other hand, are generally exempt unless specifically listed in statute. One such enumerated taxable service is the repair, service, alteration, fitting, cleaning, painting, coating, towing, inspection, or maintenance of personal property, except where installation or application of the tangible personal property will constitute an addition of or capital improvement of real property.

In determining what constitutes the addition or improvement of real property, certain items are identified as retaining their character as tangible personal property for purposes of repair and maintenance (such as air conditioners, dishwashers, furnaces, and various other appliances). However, sales tax does not apply to the original installation or the complete replacement of these items if that installation or replacement is a real property construction activity.

"Real property construction activity" means activities that occur at a site where tangible personal property, items, or goods are affixed to that real property, if the intent of the person who affixes the property, item, or good is to make a permanent accession to real property. Real property construction activities do not include affixing to real property tangible personal property that remains tangible personal property after it is affixed.

Based on the above, a contractor performing real property construction activities may not add tax to any charges for labor or material, since the sales price received from these activities is not taxable. Instead, the contractor is considered to be a consumer of property when providing services on real property (such as installing a window). Thus, a supplier's sales of building materials to contractors who incorporate the materials into real property in performing real property construction activities are subject to the sales and use tax. The tax which a contractor pays on its purchases of materials consumed in real property construction activities increases its cost of the materials and becomes a cost of doing business.

On the other hand, a contractor is treated as a retailer on the sale or transfer of tangible personal property to the customer in the installation, repair, or servicing of tangible personal property (such as selling parts related to repairing a customer's furnace). The contractor must report these sales on its return and is liable for sales tax based on the sales price charged to the customer unless an exemption applies. The contractor's purchases of taxable property, items, and services (products) are exempt so long as the contractor resells them. Further, a contractor's purchases of taxable products are exempt if the contractor resells them to a tax-exempt entity under a construction contract (such as a municipality).

Due to the nature of the work, construction contracts often require a contractor to sell both products, which are taxable, and real property construction activities, which are not taxable. For fixed price "lump sum" contracts (in which the contractor quotes the charges as one price, including where the individual components are itemized within that price), the sales tax treatment of the contractor depends on whether the products constitute less than 10% of the contract price.

Current law deems a contractor to be the consumer of all products used or sold as part of a lump sum contract for real property construction activities if the total sales price attributable to the taxable products is less than 10% of the total contract price. In such cases, the contractor will pay the sales and use tax imposed on all taxable products used or resold in the lump sum contract unless an exemption applies. In turn, the contractor's sales price to the customer under the lump sum contract is not subject to sales tax (lump sum contract exemption). As a result, the sales tax does not apply to the amount the contractor marked up the price of the products.

By contrast, if the total sales price attributable to the taxable products is 10% or more of the total lump sum contract price, then the contractor is required to charge the applicable sales tax on the taxable products unless an exemption applies. If the taxable products are separately itemized in the lump sum contract, then tax is due on the cost shown. If the lump sum contract states only a single price for all products and services, the contractor must charge and collect sales tax on that portion of the construction contract price which is allocated to the taxable sales unless an exemption applies. In either case, the contractor's purchases of taxable products are exempt so long as the contractor resells the products as part of the lump sum contract. However, the sales tax will apply to the amount the contractor marked up the price of the products.

GOVERNOR

The bill would expand the sales and use tax exemption for lump sum contracts to apply to all construction contracts and would pass through to subcontractors the exemption for sales to tax exempt entities. These changes are estimated to decrease tax revenue by $1,250,000 in 2017-18 and by $1,500,000 in 2018-19.

The bill would replace the definition of "lump sum contract" with the term "construction contract," which would be defined as a contract to perform real property construction activities and to provide products. As a result, the lump sum contract exemption would apply to all construction contracts and not merely lump sum contracts.

The bill would also clarify that similar treatment is provided for both prime contractors and subcontractors in regards to the exemption for construction contracts. Thus, a subcontractor would be deemed the consumer of all products used or sold as part of a contract for real property construction activities with the prime contractor or another subcontractor if: (a) the total sales price attributable to the taxable products is less than 10% of the total contract price; and (b) the products will be sold by the prime contractor as part of a construction contract. In such cases, the subcontractor would pay the sales and use tax imposed on all taxable products used or resold in the construction contract (unless an exemption applies). In turn, the subcontractor's sales price under the construction contract would not be subject to sales tax.

The bill would also define several terms. "Prime contractor" would be defined as a contractor which enters into a construction contract with the owner or lessee of real property to perform real property construction activities. "Subcontractor" would be defined as a contractor who enters into a construction contract with a prime contractor or another subcontractor. The bill would provide for similar treatment of prime contractors and subcontractors under a construction contract with a tax-exempt entity such that a subcontractor's purchases of taxable products would be exempt so long as the products are resold to either the prime contractor or to another subcontractor.

The effective date of these provisions would be the first day of the third month beginning after publication of the bill. The changes would first apply to contracts entered into or extended, modified, or renewed after that date.

Substantially similar provisions for expanding the lump-sum contract exemption have been included into separate legislation in 2017 Assembly Bill 340 and Senate Bill 273. Assembly Bill 340 was referred to the Committee on Ways and Means and Senate Bill 273 was referred to the Committee on Revenue, Financial Institutions, and Rural Issues. No action has yet been taken by either Committee.

DISCUSSION POINTS

1. Taxable products bundled with untaxable products in a single transaction are generally taxable on the entire amount of a non-itemized price unless the price attributable to nontaxable items can be determined. This rule does not apply to real property and services to real property, however. Prior to 2013 Act 20, the sale of tangible personal property and taxable services by contractors as part of a lump sum contract was dependent on the price of taxable products sold to a customer and whether the contractor provided a list price for the taxable products. If the contractor included taxable products that were less than 10% of the total contract price and no separate charge

was made in any document provided to the customer, then the cost to the contractor of the taxable products was used as the sales price subject to sales tax. If a separate charge was made for any of the taxable products, or the taxable products are more than 10% of the lump sum contract, then the separate charge to the customer was subject to the sales tax.

2. As provided in Act 20, current law provides an exemption for products sold as part of lump sum contracts regardless of whether the amounts charged for labor and services are listed separately from taxable products. For example, a contractor with a lump sum contract to construct a building (not taxable) that also includes improving the landscaping (taxable) is not required to break out the cost for landscaping and charge sales tax separately unless the taxable portion of the contract exceeds 10%. This means that a contractor does not have to break out the sales of minor pieces of personal property that are installed under a lump sum contract.

3. Act 20 did not provide a similar exemption for other types of construction contracts. For example, a "cost plus" contract refers to payment for the actual costs of construction plus a certain payment for overhead, management, and/or profit (with or without a guaranteed maximum price). Another example would be a time and materials contract where the buyer agrees to pay the contractor for the time spent performing the work and for the materials used (including the contractor's mark-up) no matter how much work is required to complete the contract. These sorts of contracts are useful where the project requirements and designs are likely to change during the course of construction or where it is difficult to estimate the costs beforehand.

4. The Committee could approve the Governor's recommendation and apply the exemption for lump sum contracts to all contracts to perform real property construction activities (Alternative 1). This would provide consistent tax treatment for all construction contracts, regardless of how payment is structured. The reduced revenue ($1,250,000 in 2017-18 and by $1,500,000 in 2018-19) would reflect that the sales tax would no longer apply to the contractor's markup when selling products to the customer where the value of the taxable products is less than 10% of the contract. Contractors would owe tax on their purchase of taxable items instead of customers paying sales tax on the contractor's final sales price.

5. Alternatively, the Committee could repeal the exemption for lump sum contracts effective October 1, 2017 (Alternative 2). Under this alternative, if a lump sum contract makes a separate charge for taxable products, or the taxable products are more than 10% of the lump sum contract, then the separate charge and markup to the customer would be subject to the sales tax. Compared to current law, it is estimated that this alternative would increase collections by $400,000 in 2017-18 and by $550,000 in 2018-19.

6. Finally, the Committee could find that it is not necessary to expand the lump sum exemption to other types of construction contracts and reject the Governor's proposal. This would prevent a reduction in revenues of $1,250,000 in 2017-18 and $1,500,000 in 2018-19.

ALTERNATIVES

1. Approve the Governor's recommendation.

ALT 1	**Change to**	
	Base	**Bill**
GPR-Tax	- $2,750,000	$0

2. Modify the Governor's recommendation to repeal the sales and use tax exemption for exemption for lump sum contracts.

ALT 2	**Change to**	
	Base	**Bill**
GPR-Tax	$950,000	$3,700,000

3. Delete provision.

ALT 3	**Change to**	
	Base	**Bill**
GPR-Tax	$0	$2,750,000

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