Construction Update: Navigating State and Local Tax Challenges

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About UHY

UHY is one of the nation's largest professional services firms providing audit, tax, consulting and advisory services to clients primarily in the dynamic middle market. We are trailblazers who bring our experience from working within numerous industries to our clients so that we can provide them a 360-degree view of their businesses. Together with our clients, UHY works collaboratively to develop flexible, innovative solutions that meet our clients' business challenges. As an independent member of UHY International, we are proud to be a part of a top 20 international network of independent accounting and consulting firms.

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- Manufacturing
- Oil and Gas
- Technology
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Paul Yoder is the Director of State and Local Taxes for UHY Advisors, located in the Houston office. Paul had over a decade of experience in sales and use tax, corporate income tax, and tax technology. Paul is focused on providing next level assistance to clients in resolving the myriad of state and local tax matters our clients face. Paul also has provided strategic and private equity buyers with state and local tax due diligence in over 350 sales/acquisitions.

Prior to joining UHY, Paul served in similar roles at two other top 10 public accounting firms. Paul has obtained experience with numerous industries and assisted clients operating in nearly every jurisdiction.

Agenda

- State Income, Franchise, Gross Receipts Taxes

- Sales and Use Taxes
  - Exemptions – Government, Non-profit and Manufacturing Customers
  - Purchases – Use Tax and Resale of Materials
  - Contract Form – Time/Material, Lump Sum, etc.

- Overview of "Unique" States –
  - Contractor's Excise Taxes
  - Taxable Services/Labor – Remodeling, Installation, etc.
    - KS, NM, TX, WA, etc.

- Payroll Tax Requirements on the Jobsite – Unemployment / Withholding

- Property Taxes

- Recap/Questions

State Income, Franchise and Gross Receipts Taxes

Entity Level Taxes

- State Income Taxes
  - Taxes based on net income
  - Taxes apply to corporations at the entity level and flow-through entities (partnerships, etc.) may also have entity level taxes and individual tax withholding requirements for non-resident individual partners
- State gross receipt and franchise taxes
  - Some may be reported on same form as income taxes
  - Others may be reported on separate form and imposed in addition to net income taxes
  - Others may be imposed in place of traditional net income taxes (Ohio CAT, Washington B&O, Texas Franchise Tax, etc.)
- Other Taxes
  - Business Licenses imposing tax on annual renewal
  - City payroll, gross receipts, and other taxes

When To File

- A state generally may impose its taxes on an entity to the extent a sufficient 'nexus,' or taxable connection exists.

- Examples of things that can create income tax nexus include:
  - owning or leasing property (real or personal, tangible or intangible) in a state;
  - having one employee (or one independent contractor / subcontractor) working in the state; or
  - deriving income from a single contract performed in the state.

- Tax filings may include more than just the in-state entity, 'Unitary combined' states may require a unitary group of corporations to file a combined return.

- Income for the entity/group generally apportioned between the 50 states and numerous local jurisdictions to determine taxes due in each.

Income Taxes - Apportionment

- There are two broad ways income is apportioned between the states—to wit, the "multi-factor" model and the "single-sales factor" model. The first of these models is the more traditional approach, and utilizes sales, payroll, and property ratios to produce an apportionment factor; this apportionment factor is then applied to all apportionable income earned by the company, and the tax rate is applied to the result.

- The "single-sales factor" has become much more widely accepted among the states in recent years. This approach apportions income to a state based solely on the number of receipts earned within that state as compared to nationwide.
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- The state apportionment approach used will affect information needed for tax filings. In a multi-factor state contractors will need to track not only revenue, but also payroll and property (owned and rented, inventory, etc.) by state.

Other Taxes

- Washington – Business and Occupation (B&O) Tax
  - Since the 1930s
- Texas – Franchise (Margin) Tax (2008)
- Ohio – Commercial Activity Tax (CAT) (2010)
- Nevada – Commerce Tax (2015)
- Other States – Oregon, Tennessee, etc.

Washington B&O

- Tax applies to all receipts (wholesale/subcontractor and retail/GC) derived within Washington.
  - Example GC contracts for $10,000,000 project in Washington
  - Subcontractor charges $3,000,000 for Electrical work
  - Subcontractor owes $14,520 in B&O tax at wholesale rate 0.484% on $3,000,000
  - GC owes $47,100 in B&O tax at retail rate 0.471% on entire $10,000,000 contract price

- This is entirely different from an income tax which is applied to the net income from business operations. There are no deductions for labor, materials, taxes or other costs of doing business. Each business (GC, Subs, etc.) owes the B&O tax on its own gross income.

Ohio Commercial activity Tax (CAT)

- Very similar to B&O
- Annual $1,000,000 exclusion from CAT (i.e., first $1M receipts not subject to tax rate).
- All receipts after $1M subject to 0.26% tax rate
- Generally,* all receipts subject to tax with no deductions

Ohio Commercial activity Tax (CAT) Continued

- In very specific circumstances, a GC may be able to deduct amounts attributable to subcontractor payments. In order for this to occur, an “agency relationship” must exist between the GC and Owner.
- Ohio provides that an agency relationship will be found where the following factors are present:
  - The general contractor is required to act in the owner’s best interest;
  - The general contractor, when bidding out the work, has an agreement in writing with the subcontractors that states that the general contractor is acting as the owner’s agent and not as an agent of the subcontractors; and
  - The general contractor acts as a conduit with respect to payments made to the subcontractors under the agreement.
- Contract must contain specific language that the GC is acting as an agent for the owner with respect to the subcontractors. The GC will still owe CAT on any markup, overhead, etc.

Texas Franchise (Margin) Tax

- Very similar to other state income tax regimes, uses a single sales factor apportionment.

- Texas Franchise Tax Base – Total Revenue less one of the following:
  - (1) COGS – Note* very different from Federal COGS
  - (2) Compensation
  - or (3) Total revenue multiplied by 70%

- For most business, payments to independent or subcontractors are not eligible to be included in COGS deduction.

- However, specifically related to real property construction, these payments may be deducted:
  - A contractor's payments to subcontractors for the construction, improvement, remodeling, repair or industrial maintenance of real property may be included in the computation of COGS (TTC Section 171.1012(i))

Nevada Commerce Tax

- The Nevada Commerce Tax, which became effective July 1, 2015, is imposed on the Nevada gross revenue of each business entity ("taxpayer") exceeding $4 million in a taxable year (determined on a July 1 – June 30 fiscal year basis)

- Tax is applied at various rates that depend on the industry in which the taxpayer is primarily engaged.

Sales and Use Taxes

Definitions

Sales Tax: A tax is imposed on each sale of a taxable item of tangible personal property.

- A sale is any transfer of title, possession, exchange, barter, lease or rental of tangible personal property or taxable service for consideration.

Use Tax: A tax is imposed on the storage, use or other consumption in this state of taxable items purchased from a retailer

- Use is to exercise a right of power or control over tangible personal property transported into the state
- Use tax is complimentary to the sales tax. A buyer must self-assess and remit use tax on taxable purchases when sales tax was not paid to the vendor, that do not otherwise qualify for an exemption.

As applied to Construction Industry

- In the vast majority of states – a construction contractor is NOT deemed to be selling materials as tangible personal property, but rather providing a service (often nontaxable service) of converting those materials into real property.

- When a contractor purchases materials, that they will incorporate into a building, they are converting these tangible items into real property, prior to conveying the improvement to the owner. As such, the contractor is deemed to be the final/end user and owes tax either as sales tax charged by the vendor or use tax paid directly by the contractor.

- Exceptions to this general rule will be discussed on the next slide, however important to note that in ALL states, tools/equipment used to provide construction services are subject to tax, and the contractor must pay tax at the time of purchase or accrue use tax on these items.

Exceptions – Materials/Fixtures

- Certain states impose sales tax on receipts from construction services. As such, materials can be purchased exempt for resale due to the fact that tax will be collected on the entire contract price.
    - Examples include Hawaii and New Mexico – sales tax to be collected on lump-sum contract price for construction

- Other states will allow for the purchase of materials exempt from tax under certain contractual arrangements (e.g. Time and Material vs. Lump-Sum)
    - E.g. Colorado, D.C., Indiana and other will allow a contractor to both sell materials (sales tax to be collected) and provide nontaxable construction services, when these are contracted for in a separated manner.

- States such as California separate between materials that lose their identity (lumber, concrete, etc.) and fixtures that are deemed to be accessories to the building (A/C units, lighting fixtures, prefabricated cabinets, etc.).
    - In California, contractor owes tax on purchases of "materials" but can resell "fixtures" and collect tax from building owner.

Exceptions – Labor

- As discussed previously, typically a contractor's services are viewed as a nontaxable service. There are however exceptions to this rule:
  - NY/NJ – "Capital Improvement" labor is viewed as exempt if a certificate of capital improvement is obtained from building owner. Otherwise, may be viewed as a repair and tax due on labor.
  - Arizona – MRRA vs. Prime Contracting
    - MRRA - Maintenance, Repair, Replacement and Alteration (less than $750k bid)
      - Follows typical scenario where no tax on charge to owner, contractor pays tax on materials
    - Prime Contracting – New Building, Road, etc.
      - Total receipts from owner subject to tax including labor under prime contracting classification.
  - Kansas – Residential vs. Commercial and "Original" Construction vs. Remodel
      - All residential construction labor is tax exempt in Kansas.
      - Original (new) construction is tax exempt in Kansas.
      - Commercial remodels are taxable in Kansas.

Exceptions – Labor (Continued)

- Texas – Similar to Kansas
  - Residential Construction Labor -Nontaxable (remodel and new construct)
  - Commercial New Construction Labor - Nontaxable
  - Commercial Repair and Remodeling Labor – Taxable

- Examples
  - Residential Construction
    - Charge Tax to homeowner on materials only if separated contract, pay use tax on materials if lump-sum
  - Commercial New Construction
    - Charge Tax to building owner on materials only if separated contract, pay use tax on materials if lump-sum.
    - NOTE* if working for an entity with potential exemptions (nonprofit, government, manufacturing) all contracts should be separated to allow for exemption to be claimed on eligible materials/equipment
  - Commercial Repair and Remodeling Labor
    - Entire contract subject to sales tax regardless of form

Customer Exemptions

- Working for a government, nonprofit or exempt manufacturer brings on numerous complexities

- Purchasing materials for incorporation into a building owned by an exempt entity – can an exemption be claimed by the contractor on these materials?
  - Depends on the state
  - May also depend on contract form and whether the contractor has been deemed to be an "agent" of the exempt organization
  - Certain states do NOT exempt government/nonprofit entities (e.g. CA, WA, etc.)

- Manufacturing entities may be able to claim exemptions on certain purchases, contract form may need to be separated in order for exemption to be claimed.

Other Tax Regimes

- A small handful of states have Contractor/Construction specific tax regimes:

- Mississippi
  - The Sales Tax Law levies a 3.5% contractor's tax on all non-residential construction activities when the total contract price or compensation received exceeds $10,000.00.
  - The 3.5% contractor's tax is imposed against the prime contractor and is due on all non-residential, commercial contracts regardless of whether or not the owner is a governmental, exempt, or non-profit entity.

- South Dakota
  - A 2% contractor’s excise tax is imposed on the gross receipts of all prime and subcontractors engaged in construction services or reality improvement projects.

Use Tax Best Practices

Use Tax Accrual

- What is Use Tax?
  - A non-recurring tax that is complementary to the sales tax and is imposed on the storage, use or other consumption of a taxable item in this state.

- Any taxable purchases on which sales tax was not charged by the vendor should be evaluated for use tax accruals.

- All non-taxed purchases should be reviewed to evaluate if a use tax accrual is necessary.

- Why would a vendor not charge sales tax, when sales tax is due?
  - Vendor lacks sufficient nexus with the State.
  - Vendor failed to charge sales tax in error.
  - Transaction is non-taxable.

Use Tax Best Practices

Accounts Payable – typically front line

- Review for over/under billed sales tax
  - Establish accrual review processes – timing, review method(s) and responsibilities
  - Have vendor contacts for sales tax
  - Ensure procurement has access to resale/exemption certificates & training

- P-Cards
  - Establish use policies
  - Required documentation for reimbursement
  - Record keeping method

Payroll and Property Taxes

Payroll related Taxes

- Personal income tax withholding
  - Employer withholds personal income tax on employee’s behalf

- State unemployment taxes (SUTA)

- Workers' compensation, FMLA, etc.

- Mobile Workforce State Income Tax Simplification Act?
  - Establishes federal 30-day de minimis exemption for non-resident employees
  - Does not apply to “notable individuals” – professional athletes, professional entertainers, public figures

Property Taxes

38 States plus DC impose some form of business personal property tax

1. Alabama
2. Alaska
3. Arizona
4. Arkansas
5. California
6. Colorado
7. Connecticut
8. District of Columbia
9. Florida
10. Georgia
11. Idaho
12. Indiana
13. Kansas
14. Kentucky
15. Louisiana
16. Maine
17. Maryland
18. Massachusetts
19. Michigan
20. Mississippi
21. Missouri
22. Montana
23. Nebraska
24. Nevada
25. New Mexico
26. North Carolina
27. Oklahoma
28. Oregon
29. Rhode Island
30. South Carolina
31. Tennessee
32. Texas
33. Utah
34. Vermont
35. Virginia
36. Washington
37. West Virginia
38. Wisconsin
39. Wyoming

Property Taxes

12 States include inventory (raw materials, etc.) in the tax base

1. Alaska
2. Arkansas
3. Georgia
4. Kentucky
5. Louisiana
6. Massachusetts
7. Mississippi
8. Oklahoma
9. Texas
10. Vermont
11. Virginia
12. West Virginia

Property Tax Challenges

- Value-based, not accounting-based
- Compliance requirements and deadlines vary by state
- Exemptions vary by state
- Valuation methodologies create a wide range of acceptable, reasonable basis for assessment
- Over 10,000 taxing jurisdictions across the U.S.
- Change of ownership can trigger reassessments, roll-back of taxes, loss of abatements, etc.

Questions?

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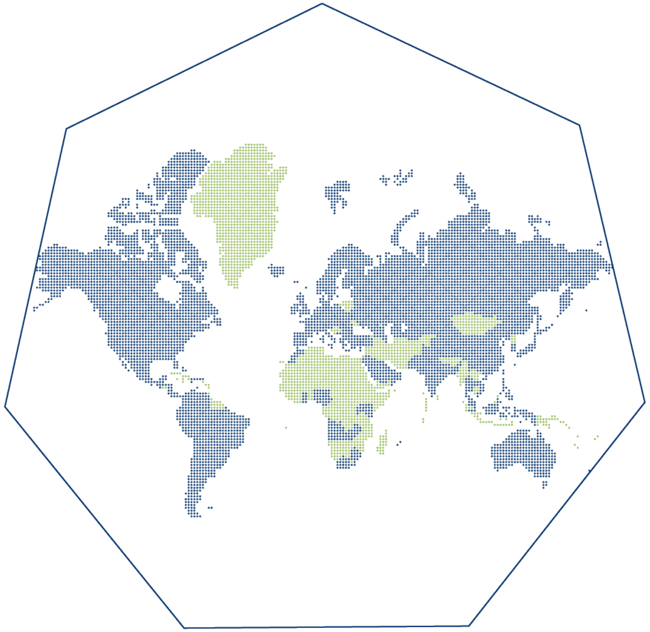

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