Simplification of Sales and Use Taxes: Is it Possible?

Identification and education are the keys to success in avoiding unexpected state and local sales and use tax liability.

BY ERICA HORN

IT IS NOT UNCOMMON FOR US TO RECEIVE A FRANTIC PHONE CALL FROM A STRUCTURAL STEEL FABRICATOR WHO HAS JUST BEEN NOTIFIED OF AN ASSESSMENT FOR STATE SALES OR USE TAX ON STEEL PROVIDED TO A JOB. Sometimes more than one state is attempting to assess the tax. Always we are told that this was entirely unexpected by the fabricator and that no contingency for the tax was included in the bid. Almost always these calls come in after the fact.

Why does this happen? What can be done about it?

Companies doing business in the structural steel industry wear many hats. The company may be a contractor, fabricator, manufacturer, retailer of building materials, or service provider. Complicating matters even more is the fact that many companies wear more than one hat on the same project. The company may fabricate steel to specifications prepared by the owner's structural engineer and then erect the fabricated steel pursuant to a separate subcontract with a construction manager. If that were not enough to make one's head hurt, what happens when the purchaser is a tax-exempt entity, such as a church or a governmental agency? The sales and use tax consequences of a particular transaction depend on the hat or hats being worn by a company and often the tax status of the purchaser, as well.

On top of all of this, 45 states and the District of Columbia impose tax on sales of tangible personal property and some services; an estimated 7,500 local jurisdictions (in states such as California, Texas, New York, Illinois, Florida, and Louisiana) impose their own sales- or use-type tax; and there is little, if any, uniformity in the laws among the jurisdictions. The problem is obvious: how does one navigate the minefield of state and local sales and use taxes? Is there any hope that the morass of laws and rules can be standardized?

Identification and Education

Identification and education are the keys to success in avoiding unexpected sales and use tax liability. As a first step, a company must identify the activities in which it is engaging (or the hat it is wearing) in a particular taxing jurisdiction and educate itself on that jurisdiction's treatment of such activities. Is the company fabricating steel (and doing nothing else) or is it also erecting the steel? In instances where the company's sole activity is the fabrication of steel, the company may be treated as a retailer that must collect and remit sales tax. If the company also engages in erection of the steel, then the company may be treated as a construction contractor and may have to pay use tax on its purchases of raw steel and supplies. So, what hats are you wearing—retailer, construction contractor, or something else?

As a general matter, sales tax is imposed upon the retail sale of tangible personal property. What constitutes a "retail sale" and who is a "retailer" is defined by each state's statute. Therefore, a fabricator must look at the statutes of the states (and ordinances or resolutions of the localities) in which it is doing business to determine whether the activities of the company are subject to sales or use tax. Interstate activities of companies, such as fabrication in one state and sales and erection in a different state, further complicate the application of sales and use tax.

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A state-by-state comparison of sales and use tax is far beyond the scope of this article. For the purpose of providing an example of how these taxes apply to structural steel fabricators, let's focus on a hypothetical state, which we will refer to as State A (though the reader is warned that all states vary in their treatment of these scenarios, and that is in fact part of the problem, as will be discussed later in the article).

Assume State A defines a "retail sale" to include fabrication, and the statute says that "retail sale" includes:

(a) The producing, fabricating, processing…of tangible personal property for a consideration for customers who furnish…the materials used in…

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the fabricating…; and

(b) A transfer for a consideration of the title or possession of tangible personal property which has been produced, processed, or fabricated…to the special order of the purchaser.

Therefore, in State A a fabricator is a "retailer" of tangible personal property and must collect and remit sales tax on its fabrication sales.

While the fabricator is a retailer in State A, the state also treats the fabricator as a "manufacturer" in some respects. For example, assume that State A allows the fabricator to purchase its raw materials, industrial supplies, and industrial tools exempt from sales tax. Allowing this exemption prevents the pyramiding of tax that will result if each component or input is subject to tax. The statute treats as exempt: "Gross receipts derived from the sale of, and the storage, use, or other consumption in this state of tangible personal property to be used in the manufacturing or industrial processing of tangible personal property which will be for sale."

"Industrial processing" is defined to include "fabricating," in which case the steel purchased by the fabricator could be purchased tax-exempt. The fabricator, however, must provide the seller with a "resale" certificate because the steel is purchased for resale after its fabrication. (A state's treatment of this situation may vary depending on the extent to which the raw steel is changed.)

The conclusions above—that the fabricator must collect and remit tax and that the company may enjoy the exemption for raw materials, tools, and supplies—are premised upon the assumption that the fabricator is not also the erector of the steel. Why is a different result reached when the company also engages in erecting the steel? Because there is now a question as to whether the "property" transferred is "tangible personal property," a prerequisite to the imposition of the sales tax.

As a result of the fabricated steel having been physically annexed or affixed to real property, has the steel lost its identity as "tangible personal property?" Should it be treated as a transfer of "real property" in which case no sales tax would apply? Generally, annexation of the fabricated steel to real property results in the company being treated as a construction contractor.

In our hypothetical State A, construction contractors are treated as the consumers of the raw materials and supplies they use in their businesses. Thus, they must pay sales or use tax on the raw materials and supplies used on a job. No "resale" exemption is provided in these circumstances. In other words, the contractor cannot give the seller of the materials a resale certificate and argue that the materials are resold via installation on the job.

This brief discussion of sales tax is the tip of the iceberg with respect to the questions and difficulties faced by today's structural steel businesses. Other questions include:

- When must use tax be paid as opposed to sales tax?
- When does a business have to collect and remit sales tax in a state other than the state in which its fabrication facilities are located?
- Does it make a difference if the steel was shipped from state A to state B on the fabricator's truck or by a common carrier?
- Is the free on board (FOB) job site or FOB fabricator's shipping dock controlling?
- What if the fabricator assumes the obligation to erect the steel and then subcontracts the actual, physical erection to a separate erecting company or chooses to provide oversight personnel and technical assistance to the company physically erecting the steel?
- What if the owner is a "tax-exempt" entity—does the fabricator or erector get the benefit of this status?

The myriad of endless questions leads to yet another question: Is there any hope for standardization or simplification?

In March 2000, state revenue personnel and other state government interests began discussing standardization or simplification of sales taxes. The impetus behind formalizing what had previously been informal discussions was the states' belief that remote (or electronic) retailers were depriving the states of millions of dollars in sales tax revenue. It was the states' hope that by streamlining and standardizing state sales and use taxes, a federal law would be enacted enabling the states to require remote sellers with no physical presence in a state to collect and remit sales or use tax. (The U.S. Supreme Court has held that a retailer must have a physical presence in a state before the state can require it to collect or pay sales and use tax.)

This standardization effort became known as the Streamlined Sales Tax Project (SSTP). The stated mission of the SSTP is to "develop measures to design, test, and implement a sales and use tax system that radically simplifies sales and use taxes." Currently, all states that impose or intend to impose a sales tax, except for Colorado and Idaho, are participating in the streamlined sales tax effort in some fashion.

The key features of the SSTP system are uniform definitions, rate simplification (one rate per state and one rate per locality), simplified exemption administration, and state-level tax administration of all state and local sales and use taxes. It is important to note that the SSTP does not require states to agree on the tax treatment of a particular transaction or entity. Instead, participating states are required to use uniform definitions set forth in the Streamlined Sales Tax Agreement.

The agreement is a fluid document, the most current version of which was adopted January 13, 2006. The agreement's "library of definitions" currently consists of 34 terms (not including those related exclusively to the telecommunications industry, which become effective January 1, 2008). Examples of the terms in the library include: "bundled transaction," "delivery charges," "lease or rental," "purchase price," "retail sale," "sales price," and "tangible personal property."

Businesses—including national retailers, trade associations, manufacturers, direct marketers, telecommunications companies, leasing companies, technology companies and others—have actively participated in the SSTP by offering expertise and input, reviewing proposals, suggesting language, and testifying at public hearings. Therefore, the SSTP presents an opportunity for companies with common interests to work together to advocate for uniformity and simplification in their business arena.

Additional information about the SSTP and how to become involved may be found at the SSTP's web site: **www.streamlinedsalestax.org**. MSC