

Construction Contractors

The application of the Michigan Sales Tax and the Michigan Use Tax to construction contractors has been a source of confusion for many years. The confusion is centered on the contractor/retailer issue and the proper tax base. In this chapter we will define a contractor and discuss the taxpaying options for the construction contractor. We will then discuss the exempt contracts and end with a discussion of the manufacturer/contractor.

Definition of Contractor

Neither the Sales Tax Act nor the Use Tax Act specifically defines a "contract" or a "contractor". However, indirectly it is defined in sections that provide exemptions. Contractors are "persons engaged in the business of constructing, altering, repairing or improving real estate for others when the material so purchased by such persons is affixed and made a structural part of the real estate or used and completely consumed in the fulfillment of a single contract ... (MCL 205.54c)

"Contractor" includes only prime, general, and subcontractors directly engaged in the business of constructing, altering, repairing, or improving real estate for others. Contractors are consumers of the materials used by them. All sales to or purchases by contractors of tangible personal property are taxable, except when affixed and made a structural part of real estate for a qualified exempt nonprofit hospital, a nonprofit housing entity qualified as exempt under the sales and use tax acts, a church sanctuary or a certified exempt pollution control facility. All materials consumed in the performance of such contracts and not affixed and made a structural part of real property are taxable. (Rule 205.71)

The key to the above definition is the taxpayer is "constructing or improving real estate for others". If the taxpayer is working on the tangible personal property of others then the taxpayer is not a construction contractor, but rather a servicer.

The type of contractors, who come under the contractor rule, can include a prime contractor, a general contractor or an independent contractor. It can also include the sub-contractor that has a contract with the prime or general contractor to do a certain portion of the work. The important part of the definition is, the contractor for purposes of the Michigan Sales and Use Tax is that person who actually affixes tangible personal property to the realty.

General Rule

Contractors are consumers of the materials used by them. All sales to or purchases by contractors of tangible personal property are taxable, except when affixed and made a structural part of real estate for a qualified exempt nonprofit hospital, a nonprofit housing entity qualified as exempt under the sales and use tax acts, a church sanctuary or a certified exempt pollution control facility. All materials consumed in the performance of such contracts and not affixed and made a structural part of real property are taxable. (Rule 205.71)

A general rule of taxation for Michigan Sales and Use Tax of the construction contractor is that the contractor is the consumer of all materials and supplies used or consumed in the performance of a construction contract. As such, the contractor is subject to tax on all purchases of tangible personal property to be used or consumed or to become affixed to real estate. A contractor has an option as to how to satisfy their Michigan Sales and/or Use Tax responsibilities. The options are two:

- a. First, the contractor has the option to pay the tax at the time of purchase. In this way, all items used or consumed on a construction contract are tax paid and the contractor would have no further liability.
- b. Second, the contractor can purchase all items tax-free and remit Michigan Use Tax when the materials or supplies are used or consumed in a construction contract. The contractor may use this latter method, which is less preferable, when large inventories of materials and supplies are maintained for future use on construction contracts or if the contractor works on exempt jobs. By use of the second method, the contractor defers the payment of the use tax until the materials or supplies are used or consumed on the construction contract.

Contractor - Retailer

Oftentimes the construction contractor may also become involved in making retail sales. A retail sale is defined as the transfer of tangible personal property for consideration in the ordinary course of the taxpayer's business to the final or ultimate consumer. For a contractor making a retail sale, it may be a minor part or it may be a major part of their business. The Michigan Sales Tax Act required that if a contractor makes retail sales, a sales tax license must be obtained. Furthermore, the Michigan sales tax must be paid to the state on all retail sales.

The Michigan contractor/retailer has two options as to how to satisfy the Michigan Sales and Use Tax liability when retail sales are involved.

1. Under the first option, the contractor/retailer could purchase all materials and supplies tax paid. When a retail sale is made the taxpayer could remit the 6% sales tax on the retail-selling price to the state of Michigan after taking a credit for the tax paid. The contractor/retailer would choose this method when the amount of retail sales is very small.

2. Under the second option, the contractor/ retailer would purchase all materials tax-free. The taxpayer would remit 6% sales tax computed on the total retail-selling price of the product to the state of Michigan on the monthly sales tax return. The taxpayer would also remit 6% use tax on all items used or consumed on construction contracts. This would also be submitted on the monthly use tax return. The taxpayer would choose the second method if retail sales were a very large and substantial part of the business. The entire inventory on hand would be tax-free. The tax would be paid at the time the material is sold in a retail sale or used on a construction contract.

Exempt Contracts

In Michigan, all construction contracts are taxable with the exception of nonprofit hospitals, nonprofit housing, church sanctuaries, and a qualified water pollution control facility or a qualified air pollution control facility. This means that where the taxpayer has a contract with a school or governmental entity for the construction or improvement of real estate, all materials and supplies used or consumed in completing the contract are taxable. When the contractor has a contract, for construction of or improvement of real estate for a nonprofit organization, all materials and supplies used or consumed in completing the contract are also taxable. When completing a contract for nonprofit hospitals, nonprofit housing, church sanctuaries, and a qualified water pollution control facility or a qualified air pollution control facility all materials and supplies used or consumed in completing that contract can be purchased tax-exempt. The construction contractor has the obligation to render a valid exemption certificate to the supplier of the materials and supplies. Furthermore, the construction contractor must maintain separate accounting records in order to properly segregate materials and supplies used or consumed on the exempt contracts as opposed to other materials and supplies used or consumed on taxable contracts.

The exemption includes only the materials and supplies used and consumed on the construction, improvement or alteration of the realty. All other tools and equipment used by the contractor are taxable if they do not remain with the realty.

Nonprofit Housing

Homes or dwelling places constructed by a nonprofit housing entity qualified as exempt pursuant to Section 15a of Act 346 of the Public Act of 1966, commonly referred to as the "Michigan State Housing Authority Act" are exempt contracts. The contractor is exempt on purchases of materials that are affixed to and become a part of the not-for-profit housing entity. The exemption does not extend to equipment or tools used on the construction of a nonprofit housing entity. In order to qualify for the exemption, the exempt organization must be operated by a governmental entity, church, or other nonprofit corporation. The entity must not be subject to local property taxes.

Nonprofit Hospitals

The exemption for nonprofit hospitals has been in the law for a number of years. However, there has been much controversy as to what is a “qualified nonprofit hospital”.

In *Canterbury Health Care v Department of Treasury*, 220 Mich App 23 (1996) the Michigan Court of Appeals established a four-part definition to qualify as exempt.

1. The hospital must be a separately organized institution or establishment,
2. The hospital must have as its primary purpose the provision of acute or intensive healthcare and nursing,
3. The hospital must provide these services to persons requiring them, and,
4. The hospital must not be operated for profit and no benefit from the real estate inures to individuals or private shareholders.

The four-prong test became the policy of the Department of Treasury and resulted in more confusion. In 1999 the Michigan legislature enacted into the law statutory definition of “nonprofit hospital”.

Public Act 116 (Sales Tax) and Public Act 117 (Use Tax) both put into statute a definition of nonprofit hospital. A long-standing exemption existed for materials and supplies used or consumed in the business of constructing realty for a nonprofit hospital. However, the law did not define a qualified nonprofit hospital. The new sales tax act section 4(w)(3), effective for taxes levied after June 30, 1999, provides as follows:

In subsection (a), a “nonprofit hospital” is defined to mean that portion of a building to which one of the following applies:

- A. Is owned and operated by an entity exempt under section 501(c)(3) of the internal revenue code that is licensed as a hospital under the public health code. (MCL 205.54w(3)(a)(i)(A))
- B. Is owned or operated by a governmental unit in which medical attention is provided. (MCL 205.54w(3)(a)(i)(B))
- C. Is owned or operated by an entity or entities exempt under section 501©(2) or (3) of the internal revenue code in which medical attention is provided. (MCL 205.54w(3)(a)(i)(C))

The statute exempts that portion of real property necessary and related to a building in which medical attention is provided and includes a county long term care facility built after December 31, 1995.

The law also provides that a “Nonprofit hospital” does not include:

- a. A freestanding building or other real property of a nursing home or skilled nursing facility licensed under the public health code. (MCL 205.54w(3)(b)(i))
- b. A hospice licensed under the public health code. (MCL 205.54w(3)(b)(ii))
- c. A home for the aged licensed under the public health code. (MCL 205.54w(3)(b)(iii))

The statute defines “Medical attention” to mean that level of medical care in which a physician provides acute care or active treatment of medical, surgical, obstetrical, psychiatric, chronic, or rehabilitative conditions, that require the observation, diagnosis, and daily treatment by a physician. (MCL 205.54w(3)(c))

Only the materials and supplies used or consumed and becoming an affixation to the real estate is exempt from tax. All material and supplies that do not become a part of the real estate are taxable. Tools and equipment are taxable.

Church Sanctuary

The exemption for materials and supplies to construct a church sanctuary was added to the Sales Tax Act (Act 274 of 1998) and the Use Tax Act (Act 275 of 1998) effective July 22, 1998. The problem with sales and use tax compliance was that churches and other houses of worship were exempt from sales and use taxes when purchasing goods and supplies for their use. This exemption allowed a church and the like to purchase all the materials needed tax-exempt and then turn around and have volunteers complete the construction. Whereas, when a contractor purchased the materials and supplies, they paid sales and use taxes on the same materials that could have been purchased tax-free by the church. Before passage of the two bills, HB 4163 and HB 4743, exemptions for such contractor purchases only existed for purchases made for nonprofit hospitals and nonprofit housing.

These bills (HB 4163 and HB 4743) resolved this issue for churches by exempting from the sales and use taxes the purchase of tangible personal property purchased by a person engaged in the business of constructing, altering, repairing, or improving real estate for others if the property is to be affixed to or made a structural part of a sanctuary. (MCL 205.54p(1))

Both bills define a “Sanctuary” means only that portion of a building that is owned and occupied by a regularly organized church or house of religious worship that is used predominantly and regularly for public worship. This language seems to be somewhat restrictive. The bills exempt only that portion of the structure used for public worship. Therefore, that portion of a structure used for classrooms, offices, gymnasiums, etc. would not be exempt from the tax. (MCL 205.54p(2)(b))

Contractors would be required to sign an affidavit attesting to the fact that the material purchased is to be affixed, or made a structural part of, a sanctuary. The affidavit, or exemption certificate, would be submitted to suppliers from whom such purchases are made. The contractor would be required to keep separate accounting records for the “public worship” portion of a job. Failure to do so would make the entire job taxable.

When a retailer makes an exempt sale to a construction contractor making a claim for exemption under not-for-profit hospitals, not-for-profit housing entities or church sanctuary, the retailer must obtain a properly executed exemption certificate. A contractor working on an exempt contract must obtain and retain documentary proof that the entity for which the contract is being completed is an exempt entity under the Michigan Statutes and the contractor must segregate purchases of materials and supplies used on the exempt contracts.

Pollution Control Facilities

Tangible personal property and qualified portions of real property used or consumed in building a certified Water Pollution Control Facility and/or Air Pollution Control Facility are exempt from tax. The State Tax Commission grants the exemption through issuance of a certificate for qualified water or air pollution control facilities. The exemption may include portions of real property as well as equipment and other items of tangible personal property. (MCL 205.54a(l))

The Department of Treasury will not allow the exemption until it has received a signed exemption certificate from the State Tax Commission. After a certificate is granted, refunds of tax paid can be authorized.

Manufacturer - Contractor

A contractor may also be a “manufacturer” if that person manufactures, fabricates, or assembles tangible personal property. (MCL 205.93(4)(c)) “Manufacture” means to convert or condition tangible personal property by changing the form, composition, quality, combination, or character of the property. (MCL 205.93(4)(b)) “Fabricate” means to modify or prepare tangible personal property for affixation or assembly. (MCL 205.93(4)(a)) If the taxpayer is primarily a manufacturer, all the materials and supplies that become a component part of the final product are purchased tax-free. These items are purchased tax-free for resale or for use in industrial processing. Properly executed exemption certificates must be rendered to the supplier.

When the manufacturer makes a sale of the final product to another for resale the sale is tax exempt. Sales tax is not collected until the product makes it’s final and end sale to the ultimate consumer at retail. If the manufacturer makes a sale of the final product to another for use or consumption, the sale is taxable based on the total gross

proceeds. The manufacturer would be required to obtain a sales tax license and to remit 6% sales tax on all retail sales.

To the extent that the final product is used or consumed in fulfillment of a construction contract, that is, the material is erected upon or becomes a part of a construction project. The tax is then due on the "finished goods inventory value". The "finished goods inventory value" includes direct material and cost of direct labor charges, a consideration for factory burden, general and administrative costs, distribution cost, shipping cost, and research and development cost. As a general rule, all costs that are reasonably traceable to the process of converting raw materials into the finished product are properly charged to finished good inventory value.

When a manufacturer/contractor pays Use Tax based on "finished goods inventory value", they would be entitled to the industrial processing exemption on all tangible personal property used or consumed in an industrial processing activity.

(f) For a manufacturer who affixes its product to real estate and maintains an inventory of its product that is available for sale to others by publication or price list, the direct production costs and indirect production costs of the product affixed to the real estate that are incident to and necessary for production or manufacturing operations or processes, as defined by the department. (MCL 205.93a(f))

A manufacturer/contractor who does not make available tangible personal property through a publication or price list and does not maintain inventory must pay sales and/or use tax on the property equal to the sum of the material cost and the cost of direct labor to manufacture, fabricate, or assemble the property. The statute specifically exempts from the tax base the cost of direct labor to cut, bend, assemble, or attach property at the job site. The cost of direct labor at the job site for mixing, combining or blending prior to affixation of property will be included in the use tax base. This manufacturer/contractor is not entitled to an industrial processing exemption to fabricate or assemble tangible personal property.

(f) For a manufacturer who affixes its product to real estate and maintains an inventory of its product that is available for sale to others by publication or price list, the direct production costs and indirect production costs of the product affixed to the real estate that are incident to and necessary for production or manufacturing operations or processes, as defined by the department. (MCL 205.93a(f))

It is very important for the manufacturer/ contractor claiming any type of exemption to keep good accurate records of the material and labor cost associated with the production of their product.

Tax Base

Once it has been determined that the taxpayer qualifies as a manufacturer and a contractor, it is necessary to determine the tax base to which the 6% use tax will apply. If the taxpayer acquires tangible personal property to be affixed to real estate, or to be withdrawn by a construction contractor from inventory available for sale to others, or made available to others by publication or price list as a finished product, then the tax base is "finished goods inventory value", the cost of material, labor and overhead.

If a construction contractor manufactures, fabricates, or assembles tangible personal property prior to affixing it to real estate (no finished goods inventory and no publication or price list) then, the tax base shall be equal to the sum of the material cost and cost of labor to manufacture, fabricate, or assemble tangible personal property but shall not include the cost of labor to cut, bend, assemble, or attach the property to the real estate at the site of affixation to real estate.

To make a proper determination as to which tax base applies, the taxpayer must determine whether tangible personal property is withdrawn from inventory available to others, or made available by publication or price list as a finished product. If inventory, publication, or price list exists, the tax base is a much higher "finished goods inventory value".

Inventory

If inventory is to cause the taxpayer to adopt a tax base based on finished goods inventory value, the inventory must be a finished good inventory and it must be inventory that is available for sale to others. Both of these requirements are necessary in order for the inventory, when it is withdrawn by a construction contractor, to be taxed at "finished goods inventory value". If the inventory is raw material inventory, or if it is not made available for sales to others, "finished goods inventory value" would not be the appropriate tax base.

Publication Or Price List

If the manufacturer/contractor does not withdraw tangible personal property from an inventory, they may still be subject to tax on "finished goods inventory value", if tangible personal property is made available by a manufacturer/contractor by "publication" or "price list" as a finished product. Again, neither Act 506, nor the Use Tax Act, defines "publication" or "price list".

Because the statute does not define "publication" or "price list" the Department of Treasury is using the old Rule 19 "Commercial Advertising" definitions of catalogs, price lists, sales pamphlets, or hand bills. If the "publication" or "price list" is of the type that would have qualified for the commercial advertising exemption, before repeal, the Department of Treasury is considering it a "publication" or "price list" for Act 506 purposes.

The following are the definitions from old Rule 19 for "Commercial Advertising".

1. "The term catalogs shall be defined as bound, stitched, sewed or stapled books or pamphlets, containing a list and description of goods, wares, merchandise or services with specific information, with or without price."
2. "The term sales price list shall be defined as numerical or alphabetical enumerations of goods, wares, merchandise items or services, quoting wholesale and/or retail prices and printed on cards or sheets of paper, presented in loose-leaf form, stapled, stitched or bound."
3. "The term "sales pamphlets" shall be defined as printed works concerning goods, wares, merchandise or services, consisting of two or more sheets of paper, stapled, sewed, or stitched with or without covers."
4. "The term sales hand bills (sometimes called circulars or dodgers) shall be defined as printed single sheets of paper intended to be circulated and concerning goods, wares, merchandise or services".

If the manufacturer/contractor makes available tangible personal property by use of any of the above listed items, the Department of Treasury will consider it a "publication" or "price list". In this case, the tax base will be "finished goods inventory value".

Different Business Activities

Oftentimes, a taxpayer may be engaged in more than one type of business activity. The same taxpayer may be a manufacturer/contractor on one job, and a retailer on another job. If the taxpayer is engaged in more than one type of business activity, Rule 4 "Imposition Of Tax" requires that separate books and records be maintained for each type of business activity. In the absence of such separate records, the entire proceeds from both businesses must be taxed. Therefore, it is imperative that if the taxpayer is engaged in more than one business activity, separate records be maintained for each business activity so as to make a proper and separate determination of tax for each business activity and each transaction consummated.

Finished Goods Inventory Value

If the tax base is determined to be "finished goods inventory value", the taxpayer must include, in addition to direct material and the cost of direct labor, a consideration for factory burden, general and administrative costs; distribution costs, shipping (freight in) costs and research and development costs. These additional costs will greatly enhance the tax base if applicable. Therefore, it is very important for taxpayers to carefully scrutinize their business operation and to make a determination as to what their tax base should be if Act 506 applies to the taxpayer's business.

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