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Texas Sales and Use Tax for the Construction Industry

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I. **Introduction**

Proper handling of Texas sales and use tax obligations is crucial to preserving profit margins and avoiding audit headaches within the construction industry. This paper addresses the most commonly taxable items in construction projects and how contract pricing dictates when and from whom Texas sales and use tax is due. Understanding contract pricing is key to minimizing adverse audit assessments, so awareness of variances between industry and Comptroller usage of common terms—like lump-sum and separated contracts—is essential. This paper then concludes with a discussion of common pitfalls that generate Texas sales and use tax audit assessments, including mistreatment of sales tax between the bid and contract phases, over-reliance on standardized industry forms that do not adequately address Texas sales and use tax matters, and incorporation of documents into a construction contract that impacts contract pricing.

II. **Texas Sales and Use Tax Principles Applicable to the Construction Industry**

Although several Texas taxes apply to the construction industry, this paper limits its discussion to Texas sales and use tax. Texas Tax Code Chapter 151 imposes sales and use tax on the sale, lease or rental of tangible personal property and on certain specified services.¹ Tangible personal property is property that is touchable or moveable, and does not include real property.² Texas' sales and use taxes are complementary, meaning that they do not overlap, but, rather, are intended to uniformly tax transactions once, whether the taxable transaction is consummated in or outside of Texas.³ The state sales and use tax rate is 6.25%, although various local jurisdictions

¹ See TEX. TAX CODE ANN. §§ 151.001–.801 (West 2015).

² See TEX. TAX CODE ANN. § 151.009 (West 2015).

³ *Combs v. Chapal Zenray, Inc.*, 357 S.W.3d 751, 757 (Tex. App.—Austin 2011, pet. denied) (“The use tax complements the state sales tax and is designed to tax transactions not reached by the sales tax. The use tax thus applies to use or consumption in this state of property purchased outside the state. The purpose of the use tax is ‘to more evenly distribute the tax burden among all consumers by imposing a tax on the fruits of an interstate purchase as well as on the sale of property in this State.’ The use tax serves to prevent ‘avoidance of a state's sales tax by the

may impose up to an additional 2% in local sales and use taxes.⁴ The maximum possible tax rate is 8.25%.

a. Sales Tax Versus Use Tax

Texas imposes *sales* tax on sales of taxable items in Texas.⁵ Thus, for example, if a construction company located in San Antonio purchases a diesel-powered backhoe from a supplier located in Houston, the construction company must pay *sales* tax on this purchase because the transaction is consummated in Texas.

In contrast, Texas imposes *use* tax when items are acquired out-of-state and brought into Texas for storage, use, or consumption.⁶ Without the use tax, persons could purchase items from an out-of-state retailer, use the items in Texas, and escape paying tax.⁷ The use tax prevents this abuse and places out-of-state vendors on an even playing field with Texas vendors because it removes a purchaser's incentive to shop outside of Texas to save on tax.⁸ Thus, if the same San Antonio construction company purchased a backhoe from a supplier located in Tulsa, Oklahoma, the construction company would owe Texas *use* tax on its purchase and must accrue and remit the Texas use tax to the Texas Comptroller. If *sales* tax was legally-owed and paid in Oklahoma, the construction company would be entitled to a tax credit for the Oklahoma *sales* tax paid against the Texas *use* tax due.

purchase of goods in another state, and to place retailers in the state upon equal footing with out-of-state competitors, who are not obligated to collect and remit sales tax.' In accordance with the complementary nature of the use and sales taxes, use tax is not applicable to a purchaser who has paid sales tax to a Texas retailer . . . and any exemption applicable to the sales tax applies to the use tax.") (internal citations omitted).

⁴ TEX. TAX CODE ANN. §§ 151.051(b), .101(b) (West 2015); 34 Tex. Admin. Code § 3.334(a)(22) (2015).

⁵ TEX. TAX CODE ANN. § 151.051(a) (West 2015).

⁶ *Id.*

⁷ *Combs v. Chapal Zenray, Inc.*, 357 S.W.3d 751, 757 (Tex. App.—Austin 2011, pet. denied).

⁸ *Id.*

b. Taxable Items in the Construction Context

As relevant to Texas sales and use tax, construction services include all forms of real property work, such as real property improvements; new construction; and repair, remodeling, restoration, and maintenance of both residential and non-residential properties. Construction companies' services and purchases may be subject to Texas sales and use tax. This paper limits its scope to the most common taxable items (tangible personal property and certain enumerated services) in the construction context, which include:

- **Materials Incorporated into Real Estate.** Sales of tangible personal property are taxable.⁹ For example, if a contractor purchases roofing material in Texas for a Texas project, the purchase is subject to the Texas sales tax.
- **Supplies Consumed at the Construction Site.** Sales of supplies to be consumed in the course of operating a business or while providing services (taxable or non-taxable) are taxable.¹⁰ For example, if a contractor purchases paint drop cloths in Texas for use at Texas projects, the purchase is subject to Texas sales tax.
- **Equipment Used to Provide Services.** Purchases of equipment and tools used to provide services (taxable or non-taxable) are taxable.¹¹ For example, if a contractor purchases a hammer in Texas to construct foundation forms at a Texas job site, the purchase is subject to Texas sales tax.

⁹ TEX. TAX CODE ANN. §§ 151.009, .010, .051 (West 2015).

¹⁰ *Id.*

¹¹ *Id.*

- **Leased Equipment (With and Without Operators).** Leases are taxable when the underlying property, if purchased outright, would be subject to Texas sales and use tax.¹² For example, a contractor owes Texas sales tax on the monthly lease payments for a generator used to power field lighting on a Texas project. However, when taxable items, like equipment, are leased with an operator, the application of the Texas sales and use tax rules become more complex because this transaction is presumed to be the performance of a service. A service is only taxable if it falls within the finite list of services stated in Texas Tax Code Section 151.0101.
- **Real Property Services.** Charges for certain types of real property services—such as surveying, grounds cleaning, weed control, and pest control—are taxable.¹³ For example, if a contractor purchases surveying services to determine Texas site boundaries, the purchase of this service is subject to Texas sales tax.
- **Non-residential (Commercial) Real Property Repairs and Remodeling.** Charges to repair or remodel non-residential (commercial) real property are taxable.¹⁴ For example, charges to remodel a Texas office building are subject to Texas sales tax.
- **Tangible Personal Property Repairs and Remodeling.** Charges to repair or remodel most tangible personal property are taxable.¹⁵ For example, charges to repair construction equipment are subject to Texas sales tax.

¹² TEX. TAX CODE ANN. §§ 151.005, .051 (West 2015).

¹³ TEX. TAX CODE ANN. §§ 151.0101(a)(11), .0048 (West 2015).

¹⁴ TEX. TAX CODE ANN. §§ 151.0101(a)(13), .0047 (West 2015).

¹⁵ TEX. TAX CODE ANN. §§ 151.0101(a)(5) (West 2015).

Notably, the above list of common taxable items does not include labor charges for new construction or residential repairs and remodeling. The Comptroller, by rule, defines new construction as “all new improvements to real property, including initial finish-out work to the interior or exterior of the improvement.”¹⁶ New construction also includes the addition of new, usable square footage to an existing structure.¹⁷ For example, adding a second floor to a one-story building without raising the roof of the first floor is new construction.¹⁸ Whether construction work constitutes new construction is only relevant for work performed on non-residential (commercial) structures because labor charges for residential work are not taxable, whether the work is performed on new or existing structures.

c. Properly Identifying Property Types

As demonstrated by the above list of taxable items, to properly handle their Texas sales and use tax obligations, contractors must be able to distinguish tangible personal property from real property, and residential real property from commercial real property.

i. Real Versus Tangible Property

Texas law defines real property as land, including structures and other improvements embedded in or permanently affixed to the land.¹⁹ Case law sets forth a three-factor test to distinguish real from tangible personal property: the mode and sufficiency of the annexation to realty, either real or constructive; the adaptation of the item to the use or purpose of the realty; and the intent of the party who annexed the personal property to the realty.²⁰ Comptroller auditors are

¹⁶ 34 TEX. ADMIN. CODE §§ 3.291(a)(9), 3.357(a)(8) (2002).

¹⁷ See 34 TEX. ADMIN. CODE §§ 3.291(a)(9), 3.357(a)(8) (2002).

¹⁸ See 34 TEX. ADMIN. CODE § 3.357(a)(8) (2002)

¹⁹ *Logan v. Mullis*, 686 S.W.2d 605, 607 (Tex. 1985); 34 TEX. ADMIN. CODE § 3.357(a)(10) (2002).

²⁰ *Logan v. Mullis*, 686 S.W.2d 605, 607 (Tex. 1985); *Hutchins v. Masterson & Street*, 46 Tex. 551 (1887).

trained to determine the parties' intent by reviewing contracts, authorizations for expenditures, annual reports, and other documentation.²¹

The following example illustrates the distinction between real and tangible personal property. If a property owner purchases a hot tub and installs it in a portable gazebo in his backyard, the portable nature of the gazebo may indicate an intent that the hot tub will be moved when the owner sells the house and, thus, support a characterization of the hot tub as tangible personal property. In contrast, if the property owner installs the hot tub in his bathroom during remodeling construction, the hot tub would most likely be characterized as real property due to the damage removal would cause (*e.g.*, tearing out one of the new walls).

ii. Residential Versus Commercial Property

The sales and use tax laws also require contractors to distinguish between residential and non-residential (commercial) real property. Residential real property is defined as property that is used as a family dwelling, multifamily apartment or housing complex, nursing home, condominium, or retirement home.²² The term includes homeowners-association-owned and apartment-owned swimming pools, laundry rooms, and other common areas designated for tenants' use.²³ Everything else is non-residential real property.²⁴ Examples include: hotels, motels, hospitals, prisons, rehabilitation centers, and recreational vehicle parks.²⁵ Understanding

²¹ TEXAS COMPTROLLER OF PUBLIC ACCOUNTS, AUDIT PROCEDURES FOR CONTRACTORS & REPAIRMEN, 1 (April 2017), *available at* <https://comptroller.texas.gov/taxes/audit/docs/contractor-manual.pdf>.

²² 34 TEX. ADMIN. CODE §§ 3.291(a)(12); 3.357(a)(13) (2002).

²³ *Id.*

²⁴ TEXAS COMPTROLLER OF PUBLIC ACCOUNTS, Pub. No. 94-157, HOMEBUILDERS AND REAL PROPERTY SERVICES (Mar. 1, 2001), *available at* <https://comptroller.texas.gov/taxes/publications/94-157.php>.

²⁵ *Id.*

the distinctions between residential and non-residential property is important because the charge for any type of residential construction labor (new construction or repair and remodeling) is not taxable.

d. The Most Commonly Applicable Exemption: Sale for Resale

A variety of Texas sales and use tax exemptions may apply to a construction project; however, this paper limits its discussion to the most commonly applicable one: the resale exemption. The sale of a taxable item for resale is exempt from Texas sales and use tax.²⁶ A sale for resale is generally defined as a sale of a taxable item to a purchaser who acquires the item for the purpose of reselling it, in the normal course of business either in the form or condition in which it is acquired, or as an attachment to, or integral part of, other taxable items.²⁷ The purpose of the resale exemption is to avoid duplicative taxation.²⁸

Both tangible personal property and taxable services may be purchased for resale.²⁹ The resale exemption is documented through a properly-completed resale certificate, which is a form promulgated by the Texas Comptroller.³⁰ A sale is exempt if the resale certificate is accepted in good faith and the seller lacks actual knowledge that the sale is not a sale for resale.³¹

²⁶ TEX. TAX CODE ANN. § 151.302(a) (West 2015).

²⁷ TEX. TAX CODE ANN. § 151.006(a)(1) (West 2015).

²⁸ *7-Eleven, Inc. v. Combs*, 311 S.W.3d 676, 684 (Tex. App.—Austin 2010, pet. denied) (“The purpose of the sale-for-resale exemption is to prevent double taxation.”).

²⁹ *See, e.g.*, TEX. TAX CODE ANN. § 151.006(a)(1) (West 2015).

³⁰ 34 TEX. ADMIN. CODE. § 3.287(h) (2018).

³¹ *See* 34 TEX. ADMIN. CODE § 3.285(c)(3)(B).

III. **Contract Pricing**

Contract pricing terms are crucial to determining contractors' Texas sales and use tax obligations because, when the labor component of a project is non-taxable (*e.g.*, new construction or residential repair and remodeling), contract pricing dictates who the consumer of taxable items used for the project is, and, thus, who either owes the tax or may claim the resale exemption.

a. **Lump-sum v. Separated**

For Texas sales and use tax purposes, contract pricing terms fall into one of two categories: lump-sum or separated. A lump-sum contract is one in which the agreed contract price is one lump-sum amount and in which the charges for incorporated materials are not separated from any charges for skill and labor.³² In contrast, a separated contract is one in which the agreed contract price is divided into a separately-stated price for incorporated materials and a separately-stated price for all skill and labor.³³ Labor includes fabrication, installation, and other labor that is performed by the contractor.³⁴ It is irrelevant if separately-stated prices for incorporated materials and labor are added together to state a sum total.³⁵

There is a document hierarchy for determining the nature of contract pricing.³⁶ A written contract is king. However, in the absence of a written contract, a written bid will control. If neither a written contract nor a written bid exists, a written invoice determines tax responsibilities. Generally,

³² 34 TEX. ADMIN. CODE § 3.291(a)(8) (2008).

³³ 34 TEX. ADMIN. CODE § 3.291(a)(13) (2008).

³⁴ 34 TEX. ADMIN. CODE § 3.291(a)(8), (13) (2008).

³⁵ 34 TEX. ADMIN. CODE § 3.291(a)(13) (2008).

³⁶ TEXAS COMPTROLLER OF PUBLIC ACCOUNTS, AUDIT PROCEDURES FOR CONTRACTORS & REPAIRMEN, 5 (April 2017), available at <https://comptroller.texas.gov/taxes/audit/docs/contractor-manual.pdf>.

the controlling document takes precedence over other documents that may be provided unless the controlling document incorporates or requires other documents utilizing a different contract pricing structure, as discussed further in the Pitfalls section below. Thus, for example, a contractor who issues separated invoices to his customer will not change a lump-sum contract into a separated one unless the terms of the contract itself require the issuance of invoices separately stating the charges for labor and materials or incorporates the invoices by reference.³⁷

A lump-sum contract is taxed as a service. Thus, the contractor's charge is either fully taxable or non-taxable, depending upon the nature of the labor provided.³⁸ For example, a lump-sum contractor building a new office building would not charge his customer Texas sales and use tax because new construction labor is not taxable and the lump-sum nature of the contract treats the contractor as providing a non-taxable new construction service. However, a separated contract treats a contractor as separately selling to his customer construction labor (which may or may not be taxable) and materials (which are taxable tangible personal property). So, if the same contractor uses, instead, a separated contract for a new construction project, the contractor would charge his customer Texas sales and use tax only on the materials charge because new construction labor is non-taxable.³⁹

The taxability of a contractor's charge, then, determines the availability of the resale exemption because the exemption may only be claimed on purchases of items that the contractor resells to the customer as a taxable item—*i.e.*, tangible personal property or a taxable service.

³⁷ See *e.g.* 34 TEX. ADMIN. CODE § 3.291(a)(8).

³⁸ 34 TEX. ADMIN. CODE § 3.291(b)(3)(A) (2008), 34 TEX. ADMIN. CODE § 3.357(b)(2) (2002).

³⁹ 34 TEX. ADMIN. CODE § 3.291(b)(4)(A) (2008).

Thus, contractors who provide lump-sum, taxable construction services (*e.g.*, commercial repair and remodeling) may purchase tax-free incorporated materials and taxable services that they resell to their customers through the provision of their own taxable service.⁴⁰ For example, the general contractor in a commercial remodeling project may purchase tax-free the services of a subcontractor to perform HVAC work because the subcontractor's taxable remodeling service will be resold and taxed through the general contractor's (marked-up) charge to the customer. In contrast, contractors who provide lump-sum, non-taxable construction services (*e.g.*, new construction and residential repair and remodeling) may not purchase taxable items tax-free because they do not resell them through the provision of a taxable service.⁴¹ Finally, separated contractors may purchase tax-free incorporated materials, regardless of the taxability of their labor, because their contract pricing terms establish the sale of taxable items to the customer.

b. Reimbursements

Contractors regularly incur business expenses that they then pass on to their customers to be reimbursed on a dollar-for-dollar basis. Contract pricing, the type of work performed, and the nature of reimbursement all impact whether a contractor must collect sales tax from its customer on reimbursement charges. The Comptroller has recently issued guidance addressing the taxability of reimbursements.⁴²

⁴⁰ See TEX. TAX CODE ANN. § 151.151 (West 2015); 34 TEX. ADMIN. CODE § 3.357(b)(2) (2002).

⁴¹ 34 TEX. ADMIN. CODE § 3.291(b)(3)(A) (2008).

⁴² See APPX. E.

IV. **Common Pitfalls to Avoid**

The following discussion of common pitfalls to avoid is based upon the authors' experience representing members of the construction industry during an audit or in litigation to challenge an adverse audit assessment.

a. **The Mixed Services Rule**

Contractors must be mindful of the consequences of stating a single charge for both taxable and non-taxable work. If a non-taxable service and a taxable service are purchased for a single charge, and the portion of the fee relating to the taxable service represents more than 5% of the total charge, then the entire charge is presumed taxable under the Comptroller's mixed services rule.⁴³ To prevent the entire charge from being treated as taxable, contractors should separately identify the charges for taxable and non-taxable work.⁴⁴

For example, if an office owner hires a contractor to construct a new wing for an existing building, the project will include laying a foundation for the new wing and building the wing itself. To provide access to the new wing, the contractor must knock down a wall in the existing building and replace it with an archway. While the work on the new wing is clearly non-taxable new construction, the work associated with demolishing the old wall and replacing it with an archway is considered taxable commercial repair and remodeling. The parties should apportion the total contract price between these two types of work to avoid the Comptroller's use of the mixed services rule to treat the entire project as taxable.

⁴³ See 34 TEX. ADMIN. CODE § 3.357(b)(9) (2002).

⁴⁴ 34 TEX. ADMIN. CODE § 3.357 (2002); 34 TEX. ADMIN. CODE § 3.291 (2008).

b. Assessments Arising from Tax Collected in Error

Failure to use the correct contract pricing terms may result in a contractor collecting tax in error from a customer. This can lead to audit issues, such as the following two examples. First, contractors should not include contract language purporting to charge Texas sales and use tax on a non-taxable project. Because the Texas sales and use tax is a trust fund tax, all tax purported to be collected must be remitted to the Comptroller regardless of whether the transaction is actually taxable.⁴⁵ For example, if a contractor who performs taxable and non-taxable work uses a contract containing tax-included language for both project types, but only remits to the Comptroller the tax on taxable projects, the Comptroller may assess the contractor for tax collected but not remitted on the non-taxable work. The contractor will be required to back the tax out of the non-taxable contract price, causing him to lose his profit margin, likely years after the work was completed, through a Comptroller assessment of up to 8.25% in tax, plus penalty and interest, on work that is not actually taxable.⁴⁶

Contract pricing errors may also lead to tax collected in error that cannot be used to offset the contractor's liability for tax due on purchases.⁴⁷ Say, for instance, a contractor believes he is performing new construction under a separated contract, so he claims the resale exemption on his purchase of incorporated materials and collects tax on the materials from the property owner. However, a Comptroller auditor determines that the project documents actually commingle some charges for labor and materials, so she treats the contract as lump-sum. Under a lump-sum contract

⁴⁵ See TEX. TAX CODE § 111.016 (West 2015).

⁴⁶ *Id.*

⁴⁷ TEXAS COMPTROLLER OF PUBLIC ACCOUNTS, AUDIT PROCEDURES FOR CONTRACTORS & REPAIRMEN, 4 (April 2017), available at <https://comptroller.texas.gov/taxes/audit/docs/contractor-manual.pdf>.

for new construction, the contractor should have paid tax on the materials at the time of purchase and not charged the property owner any tax. The auditor will issue an assessment to the contractor for Texas sales and use tax due on his materials purchases because he improperly claimed the sale for resale exemption. The contractor may not use the tax that the property owner paid on the materials to offset his audit liability because, generally, only the person who paid the tax collected in error is entitled to the refund.⁴⁸

c. Failure to Modify Standard Contracts

Many contractors use standardized industry contracts and billing forms, such as those promulgated by the American Institute of Architects, to govern their work. However, these documents are generally drafted for nationwide use and, thus, contractors should modify the sales and use tax provisions to properly document the Texas tax consequences of a given project. One contract size certainly does not fit all when it comes to Texas sales and use tax.

i. Tax-Included Contracts

Texas sales and use tax is a debt of the purchaser of taxable items.⁴⁹ The seller or service provider is responsible for collecting the tax from the purchaser and remitting it to the Texas Comptroller.⁵⁰ However, the Texas sales and use tax laws allow the Comptroller to pursue either the purchaser or the seller for unpaid tax.⁵¹ Therefore, as relevant to the construction industry, the Comptroller may pursue either the general contractor or his subcontractors for any tax due on the transactions between them.

⁴⁸ *Id.*

⁴⁹ 34 TEX. ADMIN. CODE § 3.286(d)(2)(A) (2018).

⁵⁰ 34 TEX. ADMIN. CODE § 3.286(d)(1)(A), (B) (2018).

⁵¹ *See* 34 TEX. ADMIN. CODE § 3.286(d)(2)(A) (2018).

To shift the sales tax liability solely to the seller, the parties' contract must include a properly drafted tax-included provision. Per Comptroller rule, the contract must state "the stated price includes sales or use tax."⁵² This provision means that the agreed price includes the sales and use tax as one of its components, even though the tax is not separately-stated. Comptroller decisions have stressed that, unless the taxpayer produces a written, controlling document with proper tax-included language, the presumption is that tax is not included in the sales price.⁵³ Contracts, bills or invoices stating that "all taxes" are included are not sufficiently specific to relieve either party to the transaction of sales and use tax responsibilities.

Parties must use the language recited above to create a tax-included contract, as illustrated by *Perry Homes v. Strayhorn*.⁵⁴ In *Perry Homes*, a residential home builder contracted to purchase taxable services in connection with its construction of new residential real estate.⁵⁵ The Comptroller assessed tax on the builder's purchases of subcontracting services.⁵⁶ The builder argued that its contracts with its subcontractors included sales tax in the contract price, pointing to contract language stating that its subcontractors would indemnify the builder for any taxes due, including sales tax.⁵⁷ The builder also offered evidence of letters that it wrote to its subcontractors,

⁵² 34 TEX. ADMIN. CODE § 3.286(d)(2)(B) (2018).

⁵³ Comptroller Hearing No. 40,433 (STAR No. 200508322H) (Aug. 26, 2005); Comptroller Hearing No. 44,143 (STAR No. 200407830H) (July 16, 2004); Comptroller Hearing No. 37,948 (STAR No. 200209562H) (Sept. 25, 2002).

⁵⁴ 108 S.W.3d 444 (Tex. App.—Austin 2003, no pet.).

⁵⁵ *Id.* at 445.

⁵⁶ *Id.*

⁵⁷ *Id.*

confirming that their fees satisfied all tax obligations.⁵⁸ The Third Court of Appeals held that the builder's subcontracts were not tax-included contracts because they did specify that "the stated price includes sales tax."⁵⁹ To the contrary, the contracts and the letters to the subcontractors merely sought to indemnify the builder from any tax due and did not shift the liability solely to the seller.⁶⁰ As *Perry Holmes* illustrates, private parties may not simply contract away Texas sales and use tax obligations.

It is important for contractors to understand when use of a tax-included contract provision is necessary. For example, a contractor who issues a bid that includes Texas sales and use tax should include a tax-included provision in the contract for that project. Otherwise, the Comptroller may assess the difference between the tax that the contractor backed out and the tax due on the entire contract price. More specifically, if the contractor uses a lump-sum contract for a \$100,000 commercial repair and remodeling job, the tax due, absent tax-included language is \$8,250. But if the contractor treated the contract as tax-included even though the contract lacked the necessary language, he would have remitted only \$7,621 in tax. The Comptroller may assess the contractor for the \$629 difference in tax, plus penalty and interest. These small underpayments add up across all jobs in the typical four-year audit period.

ii. Incorporation of Documents that Impact Contract Pricing

Contractors must be aware of the Texas sales and use tax ramifications of incorporating documents—like payment applications or invoices—by reference into their construction contracts because it may adversely impact the intended contract pricing structure. For example,

⁵⁸ *Id.* at 446.

⁵⁹ *Id.*

⁶⁰ *Id.* at 446-47.

incorporating by reference the terms of a prime contract may affect whether a subcontract is classified as lump-sum or separated.⁶¹ Similarly, a lump-sum contract that requires the use of separate invoices or incorporates by reference a schedule of values that separately states the charges for labor and materials may convert the contract into a separated one.⁶²

Converting the intended pricing structure of a construction contract can lead to audit issues. For example, a contractor who intends to perform new construction on a lump-sum basis but whose contract incorporates schedules of value separately stating the charges for labor and materials is at risk of an auditor reclassifying the contract as separated and creating an assessment of tax on the contractor's material charges. And, while the reclassification would mean that the contractor is entitled to a credit for tax paid in error to his vendors on materials purchases, the credit will not wipe out the higher tax assessment if he imposed a markup on the materials that is subject to tax. Therefore, contractors should include language in their contracts expressly stating that the parties do not intend for any incorporated documents to change the contract pricing structure for Texas sales and use tax purposes.

V. **Conclusion**

The Texas sales and use tax laws applicable to the construction industry are tricky, and auditors know that they can easily generate assessments against contractors. Therefore, contractors must have a firm grasp of the laws if they hope to minimize the chance of a substantial audit assessment and to preserve their profit margins.

⁶¹ 34 TEX. ADMIN. CODE § 3.291(a)(8) (2002).

⁶² Comptroller Hearing No. 40,445 (STAR No. 200205246H) (May 30, 2002).

Appendix A

201808031L [Tax Type: Sales] [Document Type: Letter/Memo]

The Comptroller of Public Accounts maintains the STAR system as a public service. STAR provides access to a variety of document types that may be useful in researching Texas tax law and tax policy. Documents which provide the Comptroller's interpretation of the tax laws are accurate for the time periods and facts presented in the documents. Letters on STAR can be the basis of a detrimental reliance claim only for the taxpayer to whom the letter was directly issued. Documents on STAR that no longer represent current policy may be completely or partially superseded, but there is no assurance that a document on STAR represents current policy even if it has not been marked as superseded.

Tax laws are complex and subject to change. Interpretations of the laws may be affected by administrative hearings, court opinions, attorney general opinions and similar authorities. STAR is a research tool, not a substitute for legal advice. If there is a conflict between the law and the information found on STAR, any decisions will be based on the law.

Texas Comptroller of Public Accounts STAR System

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**Tax Policy News
August 2018
Sales Tax**

Sales Tax

Contractors and Related Services

Part 1 - The Sales Tax ABCs for Contractors and Taxable Service Providers

In this month's issue, we introduce the first part of a four-part guide about contractors, taxable service providers and related services. Part 1 covers terminology and the taxability of real property improvements in Texas, and provides basic principles for determining the taxability of new construction and real property repair, remodeling and restoration.

Who are Contractors and Taxable Service Providers?

If you perform new construction; residential real property repair, remodeling, maintenance, restoration; or nonresidential real property scheduled and periodic maintenance, you are a contractor.

If you repair, remodel or restore nonresidential real property, you are a taxable service provider.

Am I Making a Real Property Improvement or Installing Tangible Personal Property?

The first step in understanding your tax responsibility is to determine whether an item is incorporated into the real property, a real property improvement, or remains tangible personal property (TPP) after you install it.

To determine if an item is incorporated into the real property, you must consider the following questions:

1. Is the item annexed (or connected) to the real property?
2. Is the item fitted or adapted to the real property?
3. Was the item intended to become a permanent part of the real property?

Note that the third question is considered the most important, with the first two being evidence to support it. Generally, if you would damage the real property, the item or both when removing the item after installation, the item has been incorporated into the real property.

If, in light of the three questions, the item is incorporated into the real property, then you are providing a real property improvement and are considered either a contractor or taxable service provider.

For example, creating a retaining wall is a real property improvement because the materials used in building the retaining wall are intended to remain in the wall permanently.

Examples of real property improvements include:

- toilets
- sinks
- faucets
- garage door openers
- kitchen cabinets
- building materials (such as wood, brick, concrete)
- ceiling fans
- flooring
- hardscaping (such as retaining walls, ponds, sprinkler systems, etc.)

If you are not incorporating TPP into the real property, then you are delivering or installing TPP and must collect sales and use tax on the total price (including installation labor, materials and all related charges) for the TPP.

For example, attaching a television to a wall mount in a residence is installing TPP because the television is not intended to be a permanent part of the real property. The owner is likely to remove the television and take it with them when selling the home.

Other examples of installing TPP are freestanding appliances (refrigerators, dishwashers, clothes washers and dryers), televisions, telephones and computers.

What Type of Property Am I Working On?

Once you have determined that you incorporate TPP into real property, you must determine what type of property the work is being performed on: residential or nonresidential.

Residential Property

Residential property is a building used as a residence, not as a business. Property next to and connected to those buildings is also residential property.

Residential property includes family homes, multifamily apartments or housing complexes (including homeowner and tenant common areas), condominiums, nursing homes and retirement homes.

Nonresidential Property

Nonresidential (commercial) property is property without facilities for people to live in. It includes buildings and other improvements built into, or affixed to, the land such as office buildings, shopping centers, industrial parks, bridges, hotels, motels, etc.

What Type of Contract Can I Use?

You must take into consideration the type of contract you use to determine your tax responsibilities. You can use either a lump-sum contract or a separated contract. Your tax responsibilities are different for each one.

Lump-Sum Contracts

Lump-sum contracts are also known as “one-fixed-price” or “turn-key” contracts. You bill your customer one amount for both labor and incorporated materials instead of separately stating them. Separated amounts on invoices issued to the customer will not change a lump-sum contract into a separated contract unless the terms of the contract require separated invoices.

Separated Contracts

Separated contracts are also known as “time and materials” contracts. You bill your customer by separately stating labor and incorporated material charges. As long as you state the charges for the incorporated materials and labor separately, it does not matter if the charges are added together and the total is provided. Cost-plus contracts are considered separated contracts if the cost of labor is separately stated from the cost for incorporated materials.

Your contract with your customer has priority over any bids or invoices you provide them. For example, if you have a lump-sum contract to perform residential repair work for your customer, separated bids or invoices will not change it to a separated contract. If there is no written contract, then the written bid determines the tax responsibilities. If there is no written contract or bid, then the written invoice determines tax responsibilities.

What are Incorporated Materials, Consumables and Equipment?

As a contractor or taxable service provider, you use incorporated materials, consumables, and equipment to complete your construction projects. Knowing how to classify the items you use will help you understand if you must pay sales tax.

Incorporated Materials

Incorporated materials are items that are incorporated into, and become a part of, any permanent real property improvement such as construction items (brick, drywall, mortar, lumber), central air conditioning units, lighting fixtures, electrical receptacles, flooring (tile, wood, carpet), paint and shingles.

Consumables

Consumables are non-reusable, single-use (nondurable) items used for construction projects such as non-reusable drop cloths, disposable latex gloves, barricade tape, electricity, natural gas, chalk or non-reusable concrete forms.

The following are not consumables: machinery, equipment, incorporated materials, durable items, office supplies or rented (or leased) items.

Equipment

Equipment is any item you use that is not an incorporated material or a consumable item. Equipment includes tools (screwdrivers, hammers), machinery (lathes, saws, drills) and accessories, or repair or replacement parts

for machinery.

What Type of Work Do I Perform?

The type of work you perform for your customer is a primary factor in determining your sales tax responsibilities. You can perform new construction, repair, remodeling, restoration or maintenance work on residential or nonresidential real property.

New Construction

New construction means building all new improvements to either residential or nonresidential property, and includes adding new usable square footage to a property or performing the initial finish-out of an existing building before its initial occupancy or use.

The initial finish-out refers to completion of the interior or exterior of an unfinished residential or nonresidential real property improvement so that it meets an owner's or lessor's requirements.

Some new construction examples are:

- constructing a new shopping mall
- building a new home
- building a new school
- performing the initial finish-out of a space (such as installing fixtures, drywall, cabinets, etc.) that has never been occupied in a strip mall
- adding new square footage (such as a new room) to an existing home or building
- installing a new sprinkler system in a lawn
- paving a new parking lot
- constructing a new commercial building
- building a new playground
- expanding an existing one-story building from 2,000 square feet to 3,000 square feet
- adding stories to an existing building
- completely demolishing an existing residential or commercial building down to the slab and constructing a new building in its place

Hardscaping is a real property improvement and the first installation of hardscaping (such as retaining walls, ponds, lawn sprinkler systems, etc.) is new construction.

Repairing, Remodeling or Restoring Property

Repairing property means mending or bringing the broken, damaged or defective real property back as near as possible to its original working order.

Remodeling or restoring property means rebuilding, replacing, altering, modifying or upgrading the existing real property.

Some examples of repairing, remodeling and restoration work are:

- partial demolition work
- any work done after the finish-out of an existing residential or commercial building
- fixing a leaking faucet
- fixing a fence
- unclogging a toilet
- remodeling a bathroom, kitchen or office
- replacing a roof
- replacing carpet or flooring
- replacing a central air conditioning unit
- replacing part of an existing parking lot
- repairing an existing retaining wall

Tax Responsibilities

Each of the following scenarios provides a summary from the contractor's or service provider's point of view and explains their tax responsibilities.

New Construction

The labor for new construction is not taxable. The incorporated materials are taxable. The person or entity responsible for paying the tax depends on the type of contract used.

As a contractor, you can bill your customers using either a lump-sum or a separated contract. Your tax responsibilities are different for each one. If your customer provides the materials, then you are providing labor only. You're not responsible for tax on the materials.

Lump-Sum Contracts

Under a lump-sum contract, you do not collect sales tax on materials or labor from your customer. You are the consumer of all items purchased to perform the work. You are not a seller.

Under a lump-sum contract, you must:

- pay sales or use tax on consumable supplies, tools and equipment used to do the work;
- pay sales or use tax to your suppliers on the incorporated materials at the time of purchase; and
- accrue and pay tax on materials bought tax free, either removed from your inventory or bought outside of Texas.

For items bought tax free, you must accrue state and local use tax based on:

- the jobsite location if the items are delivered directly to the jobsite from outside Texas; or
- the location where the items are first stored.

Use our Sales Tax Rate Locator to search for sales tax rates by address. In addition, for exempt contracts tax may not be due on incorporated materials, consumables and certain taxable services. See the "Contracts with

Exempt Organizations” section in this article.

Separated Contracts

Under a separated contract, you are the seller of the incorporated materials. You must collect tax on the incorporated materials billed to your customer, but there is no tax due on labor.

Under a separated contract, you must:

- pay tax on consumable supplies, tools and equipment used to do the work;
- give Form 01-339, Texas Sales and Use Tax Resale Certificate(PDF), to sellers instead of tax when buying:
 - incorporated materials and
 - subcontracted taxable services resold to the customer to complete the job; and
- collect from your customer:
 - tax on the incorporated materials;
 - Form 01-339 (back), Texas Sales and Use Tax Exemption Certificate(PDF), instead of sales tax on the incorporated materials, if an exemption applies; or
 - Form 01-339, Texas Sales and Use Tax Resale Certificate(PDF), on the incorporated materials, if you are performing a subcontract for a general contractor who is working under a separated contract.

You will collect local sales taxes based on the tax rate at the jobsite location. Use our Sales Tax Rate Locator to search for sales tax rates by address. In addition, for exempt contracts, tax might not be due on incorporated materials, consumables and certain taxable services. See the “Contracts with Exempt Organizations” section in this article.

Tax-Free Inventories

If you perform both lump-sum and separated contracts, and do not know at the time of purchase which type of contract you will use the incorporated materials under, you may purchase the materials tax-free for resale by issuing Form 01-339, Texas Sales and Use Tax Resale Certificate(PDF) and placing them in a tax-free inventory. You then must:

- charge sales tax on them, or accept a resale certificate if you subcontract to a general contractor working under a separated contract, if you are working under a separated contract; or
- accrue use tax on them when you remove them from inventory to perform a lump-sum contract.

Local taxes are due based on the jobsite if you remove the items to perform the work under a separated contract. Local taxes are due based on the location where your inventory is stored if you remove the materials to perform work under a lump-sum contract.

Residential Repair, Remodeling, Restoration and Maintenance

Labor to repair, remodel, restore or maintain residential real property is not taxable. Materials incorporated into the real property are taxable. The individual or entity responsible for paying the tax depends on the type

of contract used. The taxing responsibilities for residential repair, remodeling and restoration are identical to those for new construction. See the “New Construction” section in this article.

Nonresidential Repair, Remodeling and Restoration

When you repair, remodel or restore nonresidential real property, you are a taxable service provider. Any restoration, repair or remodeling work done after the initial finish-out of an existing nonresidential (commercial) building is taxable.

The total charge for both labor and materials used to repair, remodel or restore nonresidential real property is taxable. It makes no difference whether you use a lump-sum or separated contract to bill your customer.

If your customer provides the incorporated materials, then you are providing labor only, which is taxable. You are not responsible for the tax on incorporated materials, your customer is.

Tax is due on the entire charge to your customer, and you must:

- pay tax on consumable supplies, tools and equipment used to do the work;
- give Form 01-339, Texas Sales and Use Tax Resale Certificate(PDF), to vendors when buying incorporated materials and subcontracted taxable services resold to the customer; and
- collect from your customer:
 - tax on the total charge;
 - Form 01-339, Texas Sales and Use Tax Resale Certificate(PDF), if you are performing a subcontract for another service provider; or
 - Form 01-339 (back), Texas Sales and Use Tax Exemption Certificate(PDF), instead of sales tax if an exemption applies.

The tax you collect is based on the tax rate at the jobsite location. Use our Sales Tax Rate Locator to search for sales tax rates by address. In addition, for exempt contracts, tax may not be due on incorporated materials, consumables, and certain services. See the “Contracts with Exempt Organizations” section below.

Contracts With Exempt Organizations

An exempt organization is an entity that is either exempt under state or federal law or approved by our office to be exempt from Texas sales and use tax. Be aware, though, that some exemptions only apply to specific types of exempt entities.

Federal, state and local governments are automatically exempt from Texas taxes.

Many non-profit organizations have been granted Section 501(c) exemption status by the Internal Revenue Service (IRS), which is a federal entity. This Section 501(c) status does not automatically grant the organization tax exemption in Texas.

To be recognized as exempt from Texas sales and use tax, these organizations must apply to the Comptroller’s office for exemption on purchases necessary for an organization’s exempt purpose. You can verify an organization’s exempt status using our Texas Tax-Exempt Entity Search.

Be aware that certain exemptions are available for projects performed for certain Section 501(c) and other nongovernmental exempt organizations. The work you perform, though, must be related to the exempt

organization's primary purpose. If the job is unrelated to that purpose, then the associated exemptions are invalid.

When you do work for an exempt organization, you must get proof showing the contract is exempt. For a qualifying nongovernmental exempt organization, this is a Form 01-339 (back), Texas Sales and Use Tax Exemption Certificate(PDF). For a governmental entity, a written contract or purchase order is also acceptable documentation.

When your contract is with an exempt organization, and you have received proof of exemption from the entity, you can give your suppliers your own exemption certificate referencing the exempt contract and listing yourself as the purchaser instead of paying sales tax on:

- incorporated materials;
- consumables that are essential to the job and completely used up or destroyed after one use at the job site; and
- taxable services performed at the job site that are integral to completing the job and specifically required by the contract.

For example, a city hires you to repair a city road. You can give an exemption certificate instead of paying tax for taxable items incorporated into the road (such as concrete, asphalt, etc.) and on certain types of consumable items you use to complete the job (such as barricade tape).

If your customer provides the materials, then you are providing labor only. You are not responsible for the tax on the materials.

You must pay tax on items you use to provide your services such as machinery, equipment, accessories or repair and replacement parts for your equipment and machinery used at the job site, office supplies, furniture and computers.

Note, your machinery and equipment are specifically excluded from the exemption discussed above. For example, if you need to rent a backhoe to complete the road job, you owe tax on the backhoe rental. This is true even if the exempt entity reimburses you for the tax.

Conclusion

In conclusion, to properly apply and collect or pay the appropriate taxes, contractors and services providers should analyze their transaction by answering five key questions:

1. Am I installing tangible personal property or improving real property?
2. What type of property am I working on?
3. What type of work am I performing?
4. What type of contract do I have with my customer?
5. Is my customer exempt from sales and use taxes?

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Appendix B

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Texas Comptroller of Public Accounts STAR System

201809024L

Tax Policy News
September 2018
Sales Tax

Sales and Use Tax

Contractors and Related Services

In this month's issue, we continue our series (Part 1 @ 201808031L) that takes a close look at the sales tax treatment for specific contractors, repairmen and other service providers.

Part 2 - Breaking Down Demolition Services

Demolition involves tearing down buildings and other man-made structures by implosion or using non-explosive methods such as a wrecking ball.

The complete demolition of a real property improvement (such as a building or parking lot) is not taxable. Any partial demolition is considered real property remodeling and the taxability depends on whether the work performed is on residential or nonresidential property.

Complete demolition of a real property improvement means to destroy the improvement down to the slab or bare ground. Total demolition of a building means the entire structure is removed except for the slab. Note that parking lots are separate real property improvements from buildings.

For example, the complete demolition of a parking lot means to demolish the lot down to the dirt. Retaining any portion of the previous real property improvement such as a sidewall, steel columns or joists, or a section of the parking lot, etc., is partial demolition and considered remodeling.

If a company only performs complete demolition services, it is not required to have a sales tax permit or collect tax on this nontaxable service. If, however, the company performs partial demolition or other services (such as debris removal, new construction or remodeling services, etc.), then it may be required to have a sales tax permit and collect tax.

A provider of a demolition service owes tax on all materials and equipment bought, leased or rented to provide the service.

Waste Removal (Real Property Services)

Waste removal services are taxable real property services. Real property service providers must collect tax on their services and pay tax on all materials and equipment bought, leased or rented for use in providing the waste removal services.

If a company bills its customer separately stated charges for both complete demolition and waste removal services, it only collects tax on the taxable waste removal services.

For example, a company charges its customer \$40,000 for its services: \$27,000 for complete demolition and \$13,000 for debris removal services. The assumed sales tax rate is 8.25 percent.

Separated Contract

Item	Amount
Complete Demolition	\$ 27,000
Waste Removal	\$ 13,000
State and Local Sales Tax (8.25% x \$13,000)	\$ 1,072.50
Total	\$ 41,072.50

If the company bills its customer a lump-sum charge for both the complete demolition and waste removal services, and the waste removal charges are more than 5 percent of the entire bill, then it must collect tax on the entire charge to its customer.

Using the same charges from the previous example:

Lump-Sum Contract

Item	Amount
Complete Demolition and Waste Removal	\$ 40,000*
State and Local Sales Tax (8.25% x \$40,000)	\$ 3,300
Total	\$ 43,300

*A single charge for complete demolition and waste removal services, when the waste removal services are more than 5 percent of the single charge, is taxable. If the service provider separately states the charges, they only need to collect tax on the taxable waste removal services.

Real Property Improvements After Demolition Services

Complete Demolition

Making new real property improvements following complete demolition services is new construction. A company performing new construction is considered a contractor.

For example, if a company destroys an entire parking lot down to the dirt, the new parking lot it builds is new construction. Likewise, for the construction of a building on an existing site to qualify as new construction, a company would need to demolish the existing building to its slab or foundation, with no remaining walls or ceilings above the ground floor slab or foundation.

For new construction, the construction labor and demolition services are not taxable, but the incorporated materials and waste removal services are taxable. The party responsible for paying the tax on the incorporated materials and the waste removal services depends on the type of contract used.

Contractors performing new construction contracts under a lump-sum contract (a lump-sum amount that does not separate the charges for incorporated materials or labor) are consumers of all materials, consumable items and equipment used or incorporated into a customer's property.

As a consumer, a lump-sum contractor must pay tax to suppliers when buying the materials. If the materials are purchased from an out-of-state seller, a contractor must accrue and remit use tax on the materials, unless Texas use tax was collected by the out-of-state seller. A contractor must not collect tax from a customer on a lump-sum charge or on any portion of the charge.

Contractors performing separated contracts (the charges for incorporated materials and labor are separately stated) are the retailers of all materials physically incorporated into the real property improvement. As a retailer, a contractor may issue a resale certificate and must collect tax from the customer based on the agreed contract price of the incorporated materials and other taxable services provided.

Here are some examples of how the type of contract affects tax collection and payment responsibilities. In these examples, a company charges its customer \$340,000 for its services: \$27,000 for the complete demolition, \$13,000 for waste removal and \$300,000 for the new construction. The assumed sales tax rate is 8.25 percent.

Lump-Sum Contract

Item	Amount
Complete Demolition, Waste Removal, and New Construction	\$ 340,000**
State and Local Sales Tax (8.25% x \$340,000)	\$ 28,050
Total	\$ 368,050

**Again, because the waste removal service exceeds 5 percent of the single charge (i.e., is not separately stated), the entire service is presumed to be for taxable waste removal services. However, the service provider may separate the charges under Rule 3.356(i)(2) and charge tax only on the \$13,000 charge for waste removal services.

Separated Contract

Item	Amount
Complete Demolition	\$ 27,000
New Construction (Incorporated Materials)	\$ 110,000
New Construction (Labor)	\$ 190,000
Waste Removal	\$ 13,000
State and Local Sales Tax (8.25% x \$123,000)***	\$ 10,147.50
Total	\$350,147.50

***\$110,000 for incorporated materials + \$13,000 for waste removal

Partial Demolition

Partial demolition of existing realty and any real property improvements made following partial demolition services is remodeling. The taxability of remodeling depends on the type of property (residential or nonresidential).

If you perform residential remodeling, you are a contractor. For residential remodeling, the remodeling labor and demolition services are not taxable, but the incorporated materials and waste removal services are taxable. The party responsible for paying the tax on the incorporated materials and waste removal services depends on the type of contract used.

If you perform nonresidential remodeling, you are a taxable service provider. For nonresidential remodeling, the taxable service provider must collect tax on the total charge (including the demolition services). It makes no difference what type of contract is used.

Looking Ahead

In the next part of our series, we will revisit topics from a previous Tax Policy News article, “Caught in the Middle - Contracts With Exempt Entities: Purchases of Taxable Services, Supplies and Rental Equipment by the ‘Middleman.’”

More Information

- Rule 3.291 - Contractors
- Rule 3.356 - Real Property Service
- Rule 3.357 - Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance

Qualifying Exempt Organizations and Real Property Improvements: Understanding When Incorporated Materials Can Be Purchased Tax Free

This article will provide guidance on the exemption for incorporated materials used in performing real property improvements for a governmental entity or qualified religious, educational and public service nonprofit organization.

Buying Incorporated Materials

Certain incorporated materials can be purchased tax free when performing a real property improvement for governmental entities (under Section 151.309) or qualifying religious, educational and public service nonprofit organizations (under Section 151.310). This exemption applies even when the contract is between a nonexempt entity (such as a subcontractor) and a contractor if the contract is an “exempt contract.”

An exempt contract is a contract to improve real property for an exempt organization’s primary use and benefit as long as the improvements relate to the organization’s purpose. When the job’s primary use and benefit does not fulfill the exempt entity’s primary purpose, the exemption is lost.

Exempt Example

A Texas public university, which is an exempt governmental entity, decides to lease property to a for-profit entity to build a dormitory for its students. The for-profit entity will purchase the construction materials under a construction contract with a contractor. The university will have control over the dormitory. Because the dormitory enhances the university’s educational operations, the dormitory fulfills the university’s exempt purpose. The for-profit entity may issue a properly completed exemption certificate to the contractor building the dormitory. The contractor can then provide an exemption certificate to their vendor instead of paying sales tax on the incorporated materials, qualifying consumables and qualifying taxable services.

Taxable Example

A Texas private university that qualifies as an exempt organization decides to lease property to a for-profit entity to build retail space to lease to other businesses. The for-profit entity will purchase the construction materials under a construction contract with a contractor. The private university will have limited control over the property for the duration of the lease. The for-profit entity allows any patrons to shop at the retail space, and the businesses are able to use the retail space for their own general business needs such as rental revenue or selling items or services. Because the university will not primarily benefit from the retail space’s operation, the retail space is not for the primary use and benefit of the private university. The for-profit entity cannot give an exemption certificate to the contractor.

Leases

An exempt organization is not required to own the real property improvement, and the exemption can apply when the exempt organization leases the real property. If a taxable entity owns an improvement, such as a building, which is leased to an exempt entity, the exemption applies if the life of the lease equals or exceeds the expected useful life of the real property improvement.

If the life of the lease is less than the expected useful life of the real property improvement, then the exemption does not apply. If a lease between the owner and the exempt entity is for a specific period and the exempt entity has the option, but is not contractually obligated to renew the lease, the option is not considered when determining if the exemption applies.

For example, a Texas tax-exempt educational organization decides to lease an entire campus from a nonexempt entity. Under the lease, the property owner (lessor) acquires a site, constructs new facilities and

leases the campus for 25 years. The planned improvements have an expected useful life of 22 years.

Because the lease is greater than the real property improvement's expected useful life, the contract is making a real property improvement for the exempt entity and qualifies as an exempt contract. The educational organization can issue a properly completed exemption certificate to the contractor building the campus. The contractor can then provide an exemption certificate (PDF) to their vendor instead of paying sales tax on the incorporated materials, qualifying consumables and qualifying taxable services.

More Information

- STAR Accession No. 200910694H
- STAR Accession No. 200310283H
- STAR Accession No. 201405903L
- STAR Accession No. 200108598L
- Texas Tax Code Section 151.309 – Governmental Entities
- Texas Tax Code Section 151.310 – Religious, Educational, and Public Service Organizations
- Texas Tax Code Section 151.311 – Taxable Items Incorporated Into or Used for Improvement of Realty of an Exempt Entity
- Rule 3.291 – Contractors

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Appendix C

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Texas Comptroller of Public Accounts STAR System

201810029L

**Tax Policy News
October 2018
Sales Tax**

Sales Tax

Contractors and Related Services

Part 3: "Caught in the Middle"- Revisited *(Note: the issues in this article were previously addressed in STAR 200904585L.)*

In this month's issue, we are continuing with our contractor series and looking at agency agreements.

In our August Tax Policy News article, "The Sales Tax ABCs for Contractors and Taxable Service Providers," (*STAR 201808031L*) we discussed the applicability and responsibility for sales and use taxes on taxable items bought, leased or rented to complete projects for exempt organizations. In summary, a contractor can buy incorporated materials, consumables and certain qualifying taxable services tax free for an exempt contract.

The contractor, however, must pay tax on equipment used in completing their work. They cannot give the seller a resale or exemption certificate for equipment they use in their work because they are the end user of the equipment.

The equipment is not re-rented to the exempt organization, and the exempt organization's exempt status does not flow through to the contractor. The contractor can, however, ask for an equipment and tax reimbursement from the exempt entity. The exempt entity is simply paying an expense (including the tax paid by the contractor) for a cost incurred in completing the contract. The exempt entity is not paying sales tax to the contractor on a purchase for the entity's use that the entity could claim as an exempt purchase.

Agency Agreements

An exempt organization can enter into an agency agreement with a contractor. This agreement authorizes the contractor to buy items and services tax free on the exempt organization's behalf.

Three elements are necessary to demonstrate that an agency relationship exists:

- one person (the agent) is acting for another (the principal);
- both parties consent to the arrangement; and
- the agent is under the principal's control.

Although an agency agreement might be implied from the parties' conduct, and it might be determined that one exists based on that conduct alone, Comptroller authorities require a written agreement to confirm such a relationship. That is, a written agreement is the only way to verify an agency agreement.

Note: agency agreements apply only to materials incorporated into the job.

Documentation Requirements

When buying items or services on the exempt organization's behalf, the contractor must disclose that they are acting as the exempt organization's agent. The contractor can give a properly completed exemption certificate (PDF) to the seller for taxable items.

When acting as an agent, the contractor cannot mark up the item's purchase price. Charges to the exempt organization must show the actual amount paid to suppliers. Any charges identified as a collection of tax, however, must be remitted to the Comptroller's office.

The contractor must maintain accounting records and invoices proving that the charges to their clients are identical to what was paid.

Refunds

If the contractor pays sales tax in error, they are due a refund and can:

- take a credit in the amount of the refund on a future sales tax return;
- amend the return to take a credit in the amount of the refund for the period in which the sales tax was paid; or
- request a refund from the Comptroller's office.

For more information, see Sales Tax Refunds.

More Information

- Rule 3.281 – Records Required; Information Required
- Rule 3.291 – Contractors
- Rule 3.325 – Refunds and Payments Under Protest
- STAR documents 201604754L, 8910L0965E11, 200405686H, 201103048H and 200904585L

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Texas Comptroller of Public Accounts STAR System

201812016L

**Tax Policy News
December 2018
Sales Tax**

Sales Tax

Contractors and Related Services

Part 4 – Pipe Works: Understanding New Construction vs. Repair, Remodeling and Restoration for Pipelines

In this month's issue, we are concluding the contractor series with a look at the tax treatment for pipeline construction. This article summarizes the tax treatment of new construction work and real property repair, remodeling and restoration work and examines the tax application to pipeline construction work.

Contractors perform new construction. Taxable service providers perform nonresidential real property repair, remodeling and restoration.

When performing pipeline construction work, tax responsibilities depend on the type of:

- work being done (new construction, repair, remodeling, restoring or maintenance); and
- contract being used (lump-sum or separated).

As previously discussed in the August Tax Policy News article (STAR 201808031L), The Sales Tax ABCs for Contractors and Taxable Service Providers, in a lump sum contract you charge one amount for both labor and incorporated materials. In a separated contract, you separately state your labor and materials.

See Rule 3.291, Contractors, and Rule 3.357, Nonresidential Real Property Repair, Remodeling, and Restoration.

New Construction

A contract to build an addition to an existing nonresidential structure or to build a new structure is a real property improvement and taxed as “new construction.” The person making the improvements is a contractor. Note that the labor to “tie in” a new to an existing structure is taxable remodeling labor (see information below on repair, remodeling and restoration work). If this labor is included in the new construction contract and the charge for remodeling is less than 5 percent of the total job, it can be excluded from tax. If the charge is 5 percent or more, the charge for remodeling must be separately stated and taxed or the total contract will be subject to tax.

Contractors performing new construction under lump-sum contracts are consumers of all materials, consumable items and equipment used or incorporated into customers’ properties. As consumers, contractors must pay tax to suppliers when buying the materials. If the materials are purchased from out-of-state sellers, contractors must accrue and remit use tax on the materials, unless Texas use tax was collected by the out-of-state sellers. Contractors do not collect tax from customers on lump-sum charges or on any portion of the charges.

Contractors performing separated contracts are the retailers of all materials physically incorporated into the real property improvements. As retailers, contractors collect tax from customers based on the agreed contract price of the incorporated materials.

Repair, Remodeling and Restoration Work

Nonresidential repair, remodeling and restoration services are taxable. A person repairing, remodeling or restoring nonresidential real property is a taxable service provider, rather than a contractor.

All taxable service providers who repair, restore or remodel nonresidential real property either collect tax on the total sales price to their customers, or accept a valid Form 01-339 (front), Texas Sales and Use Tax Resale Certificate(PDF); Form 01-339 (back), Texas Sales and Use Tax Exemption Certificate(PDF); or Form 01-919, Texas Direct Payment Exemption Certification Limited Sales, Excise and Use Tax Certificate(PDF), instead of tax. When the work is for nonresidential real property repair, remodeling or restoration, there is no distinction between a lump sum or a separated contract.

Pipeline Construction Work

Last year, in a private letter ruling, the Tax Policy Division outlined the sales tax treatment of different pipeline construction and remodeling services.

For construction services, installing a new pipeline in a new trench is new construction, and the labor is not taxable. The new pipeline’s location in relation to an existing pipeline does not affect the tax treatment.

Additionally, removing an existing pipeline and installing a new pipeline at a lower or greater depth is new construction and the labor is not taxable if the pipeline’s depth changes substantially (the new pipeline’s depth must be at least one-third deeper or shallower than the existing pipeline’s depth). This excavation work to remove the existing pipeline and install the new deeper or shallower pipeline is complete demolition and new construction work, respectively. The labor is not taxable.

In all instances, connecting the new pipeline to an existing pipeline is nonresidential real property repair or remodeling and is taxable. Likewise, replacing the existing pipeline with a new pipeline at the same depth is taxable nonresidential real property repair or remodeling work.

For abandoning the pipeline, filling an existing pipeline with concrete is not taxable because it is complete pipeline demolition. If, however, the service provider caps the ends of an existing pipeline in order to abandon the pipeline in place, the labor is taxable nonresidential real property repair or remodeling.

Services

Unless connected to the sale of a taxable item or service, inspection and testing services are not taxable.

To be nontaxable, stand-alone inspection and testing charges must not be related to any taxable equipment or nonresidential real property repairs, restoration or remodeling.

Mixed Contracts

When nontaxable unrelated services and taxable services are sold or purchased for a single charge and the portion relating to taxable services represents more than 5 percent of the total charge, the total charge is presumed to be taxable. The service provider may later establish the percentage of the total charge that relates to nontaxable services. To do so, the service provider's books must support the apportionment between taxable and nontaxable services.

If a service provider separately states the nontaxable unrelated services from the taxable services, they only charge tax on the taxable services.

More Information

- Rule 3.291 – Contractors
- Rule 3.357 – Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance
- State Tax Automated Research (STAR) System letter 201706007L
- Tax Policy Webinar – Mixed Transactions

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Texas Comptroller of Public Accounts STAR System

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Tax Policy News

November 2019

Sales and Use Tax

[Reimbursements for Contractors and Taxable Service Providers](#)

As a [contractor](#) or [taxable service provider](#), you may incur some business expenses that you wish to be reimbursed for on a dollar-for-dollar basis (i.e., a reimbursement). A reimbursement is a sum paid to cover money that has been spent or lost. Depending on the contract, type of work, and reimbursement type, you may be required to collect sales tax on your charges.

As a reminder, contractors perform new construction; residential real property repair, remodeling, maintenance, and restoration; or nonresidential real property scheduled and periodic maintenance.

In contrast, taxable service providers repair, remodel, or restore nonresidential real property.

For more information on contractors and taxable service providers, see our [August 2018 Tax Policy News](#) article, “*The Sales Tax ABCs for Contractors and Taxable Service Providers*.”

What is “Sales Price”?

The [sales price](#) is the total cost the customer pays for tangible personal property or a taxable service, including any delivery fees or other expenses included in the cost (such as labor), even if separately stated.

When performing a nontaxable service (such as new construction or residential real property repair, remodeling, and restoration), the related charges (such as inspection charges, permit fee and other reimbursements) are component costs of the service regardless of the contract type (lump-sum total charge or separately stated) with the customer.

Tax Responsibilities

Depending on the contract used, your tax responsibilities as a contractor or service provider will vary.

Contractor – Lump Sum v. Separated

Under a *lump-sum contract*, you are the consumer of all items purchased (or removed from a tax-free inventory) to perform the work. The reimbursement charges incorporated into your lump-sum contract are not taxable, and you do not collect sales tax from your customer on materials, labor, or reimbursements that are part of that charge.

For example, Robert (under a lump-sum contract) completes a kitchen-remodeling project for an existing home in Austin, Texas. He invoices his customer:

- ***Kitchen Remodeling: \$45,000***
- Includes:
 - Materials
 - Labor
 - Meal Reimbursements
 - Fuel Reimbursements
- Total Price: \$45,000

In this instance, Robert does not need to collect any sales tax from his customer.

Under a *separated contract*, you are the seller of the incorporated materials. You can provide a properly completed resale certificate to your supply vendor instead of paying tax on the incorporated materials and must collect tax on the incorporated materials billed to your customer, but there is no tax due on labor. Reimbursements related to the incorporated materials charge, such as fuel reimbursements for material pickup and delivery, are taxable. Reimbursement charges directly connected to the labor component, such as wait time, per diem, lodging, etc., are not taxable.

Using a similar example, Robert now invoices his customer using a separated contract:

- ***Kitchen Remodeling:***
 - Materials: \$25,000*
 - Labor: \$19,000
 - Meal Reimbursements: \$500
 - Fuel Reimbursement (Material Pick Up): \$300*
 - Wait Time: \$200
- Subtotal: \$45,000
- Sales Tax (8.25 percent): \$2,087.25

- Total: \$47,087.25

(*) – denotes taxable charges

In this example, Robert must collect sales tax on the taxable portions of the separated contact (i.e., materials and fuel reimbursements). The total sales tax he should collect is \$2,087.25, which is $(\$25,300 \times .0825)$.

Contractor - Reimbursements for Equipment and Consumables

Both lump-sum and separated contractors improving real property must pay tax on equipment purchased or rented to complete the job. Additionally, the contractor owes tax on consumables used at the job site of nonexempt customers at the time of purchase. The contractor should not charge tax to the customer for reimbursement of either of these charges.

A separated contractor may bill the customer for reimbursement of expenses incurred on the purchase or rental of equipment and purchases of consumables used on the job. Sales tax on the purchase or rental of these items is an expense to the separated contractor. The contractor must clearly label these items as a reimbursement.

For example, Robert needs to rent an excavator and purchase various consumables to complete a new irrigation system installation for his nonexempt customer. He invoices his customer:

- ***Irrigation Installation:***
 - Materials: \$20,000*
 - Labor: \$15,000
 - Consumables Reimbursement: \$1,000
 - Equipment Reimbursement: \$5,000
- Subtotal: \$41,000
- Sales Tax (8.25 percent): \$1,650
- Total: \$42,650

(*) – denotes taxable charges

In this instance, Robert has indicated the tax-paid consumables and equipment reimbursements on the invoice and does not need to collect tax on these charges. He must still collect tax on the incorporated materials charges (\$20,000).

If you do not properly represent the reimbursement of your expenses to purchase or rent equipment or your purchase of the consumables, including the tax you paid, you must remit any charge represented as sales or use tax on your customer's invoice to the Comptroller's office. Documenting these charges as expense reimbursements avoids the customer's perceiving you are collecting taxes.

Reimbursements for Taxable Service Providers

If you repair, remodel, or restore nonresidential real property, you are a [taxable service provider](#). You owe tax when purchasing or renting equipment and consumables you use to complete your projects for nonexempt entities. You are not reselling these items to your customer.

A taxable service provider must collect tax on all charges billed to the customer for the taxable service, regardless of the contract type (lump-sum or separately stated). A service provider must charge tax on a lump-sum charge, including any reimbursements included in that lump-sum charge. For example, Robert renovates an employee breakroom for an existing business office in Houston, Texas. He invoices his customer:

- ***Breakroom Remodeling: \$152,000****

- Includes:
 - Materials
 - Labor
 - Meal Reimbursements
 - Fuel Reimbursements
 - Wait Time
- Subtotal: \$152,000
- Sales Tax (8.25 percent): \$12,540
- Total: \$164,540

(*) – denotes taxable charges

Likewise, a taxable service provider must collect tax on all charges made for the service when the charges are separated, including any reimbursement charges. For example, Robert instead invoices his customer using a separated contract:

- ***Breakroom Remodeling:***

- Materials: \$100,000*
- Labor: \$50,000*
- Meal Reimbursements: \$1,000*
- Fuel Reimbursement (Material Pick Up): \$500*
- Wait Time: \$500*
- Subtotal: \$152,000
- Sales Tax (8.25 percent): \$12,540
- Total: \$164,540

(*) – denotes taxable charges

More Information

- [Texas Tax Code Section 151.007, "Sales Price" Or "Receipts"](#)
- [Rule 3.291, Contractors](#)
- [Rule 3.357, Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance](#)

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