APPLICATION OF SALES AND USE TAX LAWS TO CONTRACTORS

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I. INTRODUCTION

For purposes of a state sales and use tax, a contractor is, for most purposes, treated as the consumer of materials or services that might be utilized in a given contractor's trade or business. Accordingly, if a contractor procures materials for incorporation of these materials into an immovable, the contractor would normally be taxed on the purchases of these items. This would be prevalent, especially when an individual contractor may be in the process of manufacturing a building for either commercial or residential purposes. Ordinarily, in such circumstances, the cost of labor is not taxed when materials are incorporated into immovable property. See Bill Roberts, Inc. v. McNamara, 539 So.2d 1226 (La. 1989).

On the other hand, contractors who perform and fabricate component parts of a bigger project may in fact give rise to sales and use taxes not only on the materials utilized, but also on the labor involved. When the component parts are incorporated into a larger project, and the individual contractor is responsible for only a portion of the overall project, then, and in that event, the project owner might be responsible for the labor associated with the contractor who assembles only one of the many component parts; and then tenders the finished component part to the project owner for further incorporation into the overall project. Under such circumstances, the labor costs of fabrication might be included.

As such, the analysis to be utilized for purposes of determining whether sales and use taxes apply to a given tax event, depends on the character of the transaction itself. Accordingly, it is very important when contracts are drafted, that they be tailored in such a way as to hopefully preclude the taxation of labor costs, which, under many circumstances, could result in cost overruns, which would be prohibitive. Piecemeal fabrication by subcontractors to a contractor might be very costly. The structure of the transaction becomes paramount to determine whether or not a sales and use tax is owed.

When one considers the position of a contractor in any given transaction, the characterization of the contractor as the purchaser or the buyer becomes important for purposes of determining the responsibilities and obligations of the contractor in a given transaction. Normally speaking, any and all retail sales of materials or services would qualify for purposes of a taxable event for sales and use tax purposes. However, there are many exceptions which must be known for analytical purposes, to determine whether there has in fact been a taxable transaction.

II. THE CONTRACTOR AS A PURCHASER

As specified above, a contractor is one who is the ultimate consumer of materials which may be incorporated into an immovable or into tangible personal property. An analysis of a given transaction will many times determine whether the events in question result in sales and use tax. Accordingly, the activity which surrounds either the purchase of materials or services will help the individual determine whether there is a sales and use tax owed.

A. THE CONTRACTOR, AS A PURCHASER OF MATERIALS AND EQUIPMENT FROM SUPPLIERS

When a business entity purchases material or equipment from one of its suppliers, it is the obligation of the supplier to collect and turn over sales and use taxes resulting from the purchase of materials and equipment. Under the pertinent State Statutes, a "dealer" is very broadly defined, and includes "every person who sells at retail, or who offers for sale at retail, or who has in his possession for sale at retail, or for use, or consumption, or distribution, or storage to be used or consumed in this State, tangible personal property . . ." LSA R.S. 47:301(4)(b). Since a supplier is a "dealer," within the meaning of the Statute, he is obligated to collect all sales and use taxes levied on the purchaser or the consumer at the time of the sale. If the supplier fails to collect all appropriate sales taxes levied under this State statute, he is liable not only for the paying of the tax itself, but also is subject to a fine or imprisonment, or both. Accordingly, the State, as indicated earlier, should proceed against the supplier for its failure to collect and turn over such taxes.

Unfortunately, the purchaser also falls within the definition of a "dealer." This definition is broad enough to permit the State to collect such delinquent taxes from the

business entity. Under LSA R.S. 47:301(4)(c), a "dealer" is further defined as "any person who has sold at retail, or used, or consumed, or distributed, or stored for use or consumption in this State, tangible personal property and who cannot prove that the tax levied by this chapter has been paid on the sale at retail, the use, consumption, the distribution, or the storage of said tangible personal property." Accordingly, the business entity would thus qualify as a dealer under the secondary definition of this term, unless it could prove that tax levied on materials and equipment were procured by the business entity had been paid. As a consequence, it can be argued that a dual obligation exists whereby the State may collect delinquent sales and use taxes from either the business entity or the supplier. Legally, this appears to be true even though the business entity may have previously paid such taxes to the supplier.

The concept of dual obligation which may require the purchaser to pay sales and use taxes to the State due to the failure of the supplier to turn over such taxes, is improper. This is not to say that such a dual obligation could not exist under law. Yet, it can, and should be argued vigorously, that it is improper for the State to proceed against a business entity until such time that it has proceeded first against the supplier who was initially obligated to collect and turn over such sales and use taxes pursuant to LSA R.S. 47:304.

Business entities do not have continuing, ongoing, problems both with the State and local subdivisions who impose a sales and use tax due to the failure of "dealers," as agents of the State or political subdivision, to properly collect and/or turn over the proceeds of sales and use taxes. Accordingly, it is in the best interest of a contractor who purchases supplies or materials to make certain, or at least determine, whether or not a sales and use tax is being collected by the supplier of materials and services, and to what taxing jurisdiction these taxes are allegedly owed.

B. PURCHASE OF SERVICES FROM SUPPLIERS

When a business entity procures services, such as welding or electrical services from one of its many suppliers, a sales and use tax is imposed by the State of Louisiana. Under LSA R.S. 47:302(c), a sales tax is levied upon all sales of services within the State. "Sales of services" is defined in LSA R.S. 47:301(14), as including the furnishing of repairs to

tangible personal property. Thus, when a contractor purchases services in the form of repairs on a pre-existing piece of tangible personal property, these services constitute a taxable transaction. To this extent, the imposition of a sales tax on services such as welding and electrical services is justified.

Although repair work, as an example, clearly falls within the purview of the State statute, it is less clear whether such services would in fact result in a taxable transaction during the construction or assembly of a given piece of tangible personal property. For example, if an oil rig was being fabricated, one must look to the actual activities surrounding the providing of such services, like electrical and welding, to determine whether or not, in fact, a taxable transaction has occurred. If one looks to the definition of "sales and services," it is clear that the initial construction or assembly of something such as a rig would not constitute a repair, and as such, should not be subject to State sales and use taxes under LSA R.S. 47:301(14).

Unfortunately, LSA R.S. 47:301(14) defines a "sale" as:

> " . . . any transfer of title or possession, or both, exchange, barter, conditional or otherwise, in any manner, or by any means whatsoever, of tangible personal property, for a consideration, includes the fabrication of tangible personal property from consumers who furnish, either directly or indirectly, materials used in fabrication work, and the furnishing, preparing and servicing, for a consideration, of any tangible, personal property, consumed on the premises of the person furnishing, preparing or serving such tangible personal property . . . "

Hence, the fabrication of tangible personal property qualifies as a "sale" under this statute.

Such services as electrical and welding, which are performed by outside suppliers during the initial assembly of an oil rig, for instance, would result in the justifiable imposition of sales taxes. However, if the fabrication of the property is <u>not</u> done by outside third parties, but by the seller of the finished product which, in turn, will be offered for sale, no taxable event has occurred. Therefore, as a general rule, a sales tax is properly imposed by the State when tangible personal property is constructed, or when repairs are needed to place such an oil rig back in service. In any event, if suppliers fail to collect legitimate sales and use taxes

on services provided to fabricators, the definition of a dealer is sufficiently broad, at the present time, to permit the State to collect such delinquent taxes from the purchaser of such services.

C. EXCEPTIONS

Except for exemptions and exclusions, all retail sales, except those for resale, are intended to be taxed. The best indication of when a tax event occurs is when the title changes hands by and between the purchaser and the seller. See LSA R.S. 47:301(10)(a). Wholesale purchases or sales would not necessarily fall within the ambient of the sales and use tax statutes found within the State of Louisiana. As mentioned above, there are many nuances and qualifications, when one tries to determine whether a taxing event has occurred. Examples of these particular qualifications vary widely. Examples follow:

When a contractor purchases materials in Louisiana for fabrication in another state, these materials, and the sales taxes associated with their purchase, could be exempt as sales in Interstate Commerce. Further, these might be considered as foreign sales. See Potashnick Construction Company v. Louisiana Department of Revenue, 64 Sup.Ct. 1023 (1944). Further, materials purchased for further processing are expressly excluded from taxes. See LSA R.S. 47:301(10). In fact, repairs which would be a taxable event have exceptions as well. Services and repairs by cable television affiliates are not taxable. Repairs made in Louisiana to tangible personal property, but delivered to a purchaser in a different state, is also beyond the ambient of the taxing legislation. Accordingly, to the extent that certain transactions are excluded, and are beyond the ambient of the Louisiana statutes imposing the sales and use tax, all transactions should be closely scrutinized to determine whether this alleged taxable event falls within those which are subject to this State's sales and use tax authority.

III. THE CONTRACTOR AS SELLER

As a general proposition, the seller of services and/or materials is a "dealer" under the Revised Statutes for purposes of collecting and turning over sales and use taxes to the appropriate governmental entity. However, these obligations vary, depending upon circumstances. In analyzing this situation, the contractor who is acting as a seller should look

to determine his potential obligations and liabilities associated with his business conduct. As specified above, a seller of services is defined under LSA R.S. 47:301(14) and does result in a taxable event for repairs or other such services provided to tangible personal property. Yet, again, one must look to determine whether a retail transaction has occurred, and whether the transaction itself is within the purview of the State jurisdiction.

When a contractor sells services such as the rental of equipment, to a third party, a sales tax usually is imposed upon the gross proceeds derived from the lease or rental of such tangible personal property. The imposition of this tax is limited, however, to those transactions which fall within the meaning of the term "lease or rental." LSA R.S. 47:301 defines "lease or rental" as "the leasing or renting of tangible personal property and possession or use thereof by the lessee or rentee, for a consideration, without transfer of the title of such property." Under this definition, any lease or rental transaction would appear to fall within the ambient of the taxing transactions under this State's sales and use tax statute.

Yet, there exists an express exclusion in LSA R.S. 47:301(7). This exclusion states that the term "lease or rental" shall not mean or include "lease or rental made for the purposes of re-lease or re-rental of casing tools and pipe, drill pipe, tubing, compressors, tanks, pumps, power units, other drilling or related equipment used in connection with the operating, drilling, completion or re-working of oil, gas, sulphur or other mineral wells." Therefore, when a business entity in the oil and gas industry rents equipment to another oil and gas company, and the company, in turn, rents this same equipment to a third party, no sales tax would be due from the original transaction, since it is expressly excluded under the definition of "lease or rental" under LSA R.S. 47:301(7). The definitions found in the Revised Statutes should be revisited frequently to determine if any given transaction qualifies as a taxable event.

A. THE TAX EXEMPT STATUS OF A PURCHASER

Another consideration which should be considered is whether any given customer of a seller has tax exempt status. For instance, the United States government is exempt from sales and use taxes imposed by the State under the Supremacy Clause of the United States Constitution. The State of Louisiana is exempt from sales and use taxes, pursuant to LSA

R.S. 47:305.29. This is equally true with municipalities within the State of Louisiana. In such cases, the sale of materials to a project owner, let's say in the situation of the fabrication of certain tangible personal property, might result in no taxable event if the purchaser of said materials was, in fact, an exempt entity. In other words, if the incorporation of materials into a movable were to occur pursuant to a contract given to a seller by a governmental entity, then the obligation of the seller to collect and turn over sales and use tax would not exist. Again, this should be considered for purposes of analysis in determine whether a taxable event has occurred.

B. AFFILIATED ENTITIES

Another problem exists, in how a given transaction is perceived when a seller of services or materials provides these materials or services to an affiliated business entity. Just like many other analyses that have been used for purposes of determining whether a taxable event has occurred, the Step Transaction Doctrine, better known in income tax circles, is an important consideration to be utilized for purposes of sales and use tax analysis. The Step Transaction Doctrine usually mandates that the form of a transaction shall not overshadow the substance of a transaction when determining whether a taxable event has occurred. At least under Federal jurisprudence, the substance of a transaction is paramount in determining whether or not a tax liability has been incurred. See Gregory v. Helvering, 293 U.S. 465 (1935).

However, on the State level, when dealing with sales and use taxes, it appears that at least initially, the State had taken a position that was contrary to this long-standing doctrine. Accordingly, when two legally established entities, although related, be it is subsidiary of a parent or some other legally distinguishable entity, enters into a transaction with a third party, be it related or not, a taxable event may in fact occur. Under Federal jurisprudence, the fact that two parties to a transaction were related might result in looking through the form of the transaction to determine whether this was an arms-length transaction. However, State sales and use tax jurisprudence, at least at the present time, indicates that no such relief may be expected by a taxpayer, when dealing with related entities. See Hilton Hotel Corporation v. Triagle, 360 So.2d 245 (La. App. 1st Cir. 1978). Therefore, if independent and legally

recognizable, but related, business entities procure materials or services from a parent corporation or business, it is more than probable that a taxing event has occurred. However, if the so-called "third party" is nothing other than an extension of the seller, and does not exist but for the continued benevolence of the provider of services and/or materials, then, in that event, it is more probable that this is an in-house transaction resulting in no tax liability.

C. THE SELLER OF RENTAL EQUIPMENT AND/OR PROVIDER OF SERVICES

When a business entity purchases equipment for resale, such a transaction is not subject to sales or use tax imposed by the State. See LSA R.S. 47:301(10). When a business entity purchases equipment for rental, this transaction is a retail sale, and as such, is subject to tax. A business entity is therefore required to pay a sales tax when they procure equipment in a rental property, and then is subsequently sold, two separate tax transactions have occurred. A business entity would thus be required to pay sales tax on the purchase of the original equipment and to collect sales taxes from a customer at the time they sold this equipment to a third party. This seller would also have to collect sales taxes from a customer upon the rental of such equipment.

A distinction must be made as to whether the equipment was originally bought for resale or for rental. Tax consequences flow from this determination. If one intends to purchase equipment for resale, the equipment should not be intended to be rented out or leased by a seller to a third party prior to such an event. Otherwise, again, the characterization of the transaction changes.

In a like manner, equipment which is rented to a third party, who in turn, ships such equipment offshore for use in international waters, would, under most circumstances, not be required to pay a sales tax. The question that has to be posed is: when do the obligations of a transaction become complete so as to give rise to a taxing event? The answer to this question stems from the manner in which this equipment is utilized. Normally, the rental or leasing of equipment is a taxable transaction. Thus, the State would be justified in imposing a sales tax on such transactions. However, when equipment is used exclusively outside the territorial waters of the State of Louisiana, the State sales and use tax statute expressly

provides that no sales tax is incurred in such an instance. See LSA R.S. 47:305.1(c). In essence, it should be understood that transactions which actually commence outside the territorial limits of the State of Louisiana are outside the ambient of the State statute imposing sales and use taxes.[1] Therefore, unless the equipment at issue is dedicated solely for the purpose of offshore drilling outside the territorial waters of the State, this entity cannot avoid paying such sales taxes. Consequently, if there is any kind of hybrid utilization of equipment, it is best that the seller of "rentals" or leased equipment collect sales and use taxes from the purchaser of such services, so as to preclude the State or local subdivision from claiming that the seller, as a "dealer," has not lived up to its obligations under the State statutes.

IV. EXCLUSIONS

When considering a given transaction for purposes of determining whether a sales and use tax is warranted, there are two separate and distinct considerations that must be addressed once the transaction has been initially characterized. First, as mentioned above, there are many exclusions provided for in this State's sales and use tax statutes. An exclusion, in essence, is defined as an event or a transactions that falls outside the ambient of the taxing statutes themselves. On the other hand, the Revised Statute of this State expressly provides for certain exemptions from what would otherwise be taxable transactions. These exemptions are, therefore, taxable transactions which are subsequently exempted from tax for some policy reason. Exclusions are in essence something beyond the ambient of the State statutes. Accordingly, a tax statute is normally construed narrowly, and in favor of taxpayers when courts consider whether a given set of circumstances fall within the parameters of the intent of the Legislature at the time they drafted a given law. See St. Charles Parish School Board v. Louisiana Power & Light Company, 465 So.2d 93 (La. App. 5th Cir. 1985). Equally certain is the fact that exemptions, or express exclusions from what would otherwise be taxing events, are strictly construed to limit the application of such exemptions. McNamara v. Arkansas Louisiana Gas Company, 441 So.2d 446 (La. App. 2nd Cir. 1983). With this in

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[1] This may no longer be true since LSA R.S. 47:305.1(C) was revised by Act 41 of the 2002 Louisiana Regular Legislative Session. See also LSA R.S. 47:305(I).

mind, there are certain exclusions which are important to remember when analyzing a given business transaction.

A. SALE FOR RESALE

Only retail sales are taxable in the State of Louisiana. LSA R.S. 47:302(A). Theoretically, there should be no tax when a purchaser procures tangible personal property with the intent to resell this property to third party. The problem is interpretative. A given transaction, and the facts surrounding such events, are always found in the eyes of the beholder. A taxing jurisdiction usually will interpret events to serve their best interest. As such, a manifest intent to resell an item at the time of purchase is the best defense to a claim that this transaction would otherwise result in a legitimate sales tax. If one purchases something for resale, and stores it for a long period of time, it is almost certain that a taxing entity will assume that these are two separate and distinct transactions, thus resulting in a sales and use tax at the time of the original purchase.

B. CASUAL SALES

Sales and use taxes can only apply to those transactions involving taxpayers that are in the business of making sales of services or materials. An isolated or an occasional sale of tangible personal property is not taxable, since the taxpayer is not engaged in the business of selling such items on an ongoing basis. Accordingly, a non-vendor is not responsible for sales and use taxes, simply because it is an isolated transaction.

C. PURCHASER OF MATERIALS FOR FUTURE PROCESSING

Under LSA R.S. 47:301(10), if raw materials are ultimately incorporated into an end product for sale, which in turn would result in the generation of sales taxes, such a purchase of raw materials would not be taxable. Accordingly, a seller of finished goods, who utilizes raw materials in producing an end product for sale should not, under the ambient of this particular provision, be held accountable for a sales tax, simply because these are utilized in producing a finished good, which, in turn, will generate future sales taxes.

D. INTERSTATE SALES

Under LSA R.S. 47:305(E), transactions involving a bonafide Interstate Commerce transaction are not subject to tax. This simply results from the fact that there can be no

impediments on Interstate Commerce as specified in the United States Constitution. Accordingly, the seller of services or products from one state to another would be excluded from collecting sales and use taxes for the State of Louisiana or its political subdivisions.

E. THE REPLACEMENT OF DAMAGED OR DESTROYED EQUIPMENT AND/OR LOST EQUIPMENT

In some instances, the seller of services, or the lessor of rental equipment to third parties finds himself in a unique position, due to the needed replacement of damaged or lost equipment. Under such circumstances, a business entity would customarily bill a customer for the damage, or the replacement cost of such equipment. In both instances, the mere billing of a customer for damage, or for the replacement cost of a particular piece of equipment, would not, in my opinion, result in a taxable transaction. The monies received by such a business entity in such a situation is merely a reimbursement for a loss sustained by the seller or lessor. This is not to say that taxable transactions will not result from the repair of such damaged equipment. The acquisition or repair of such equipment would normally be a taxable event. Yet, a business entity is not obligated to either repair or procure additional equipment at the time they receive a payment for damaged or destroyed equipment. Until such time that they actually acquire equipment, or contract for the repair of equipment that was damaged or destroyed, no taxable event would necessarily have occurred.

It should be noted that upon the acquisition of equipment, or the contract for the repair of such equipment, a taxable transaction does occur. However, for sales tax purposes, the taxing statute requires that there be a consideration. LSA R.S. 47:301(12). The word consideration here is analogous to that of profit. Thus, because the business entity would not make a profit from funds received for damaged or destroyed equipment, such a transaction would not be taxable.

V. EXEMPTIONS

As specified above, exemptions are different from exclusions, in the fact that there are taxable transactions but for the Legislature providing an exemption, which precludes the imposition of a tax. Normally, exemptions result in the issuance of certificates by the Department of Revenue and are furnished to a dealer, i.e., a seller, at the time that the

transaction occurs. Other exemptions from the statute are done for policy reasons, including, but not limited to, the giving of a competitive edge to certain businesses within the State so as to help them compete with businesses in other states. The exemption of certain activities from taxation is simply within the discretion of the Legislature. Specifically, some of the exemptions found in the Louisiana Revised Statutes of this State include:

A. Shipbuilding

Shipbuilding is normally exempt from sales and use taxes. This was done by the Legislature for purposes of helping shipbuilders compete with other surrounding industries in adjacent states. In order for the exemption under LSA R.S. 47:305.1 to apply, the shipbuilder must be fabricating ships, vessels or barges of fifty tons load displacement, or greater. Under these circumstances, these activities are exempt from sales and use tax considerations.

B. Component Parts

Sales of materials, equipment and machinery which become a part of vessels, ships or barges, are likewise exempt under LSA R.S. 47:305.1(A).

C. Repairs and Ship Supplies

Again, the Legislature made a determination that for other reasons, the repairs made to ships or ship supplies made to vessels or ships operating exclusively in Foreign or Interstate Commerce are exempt from sales and use tax. LSA R.S. 47:305.1(B). The determination made here depends on the use of the vessel so repaired and supplied.

D. Foreign and Interstate Commerce

One of the most simplistic exemptions found in the State, from a theoretical point of view, has resulted in the largest amount of litigation to interpret what would otherwise seem obvious on its face. Normally speaking, transactions involving the sale of materials or services between a party in one state is not subject to a sales and use tax. Likewise, transactions between a party in this State and that of the United States, would be exempt from sales and use taxes. When one considers the totality of the transaction, the geographical location of such an event should be considered for

purposes of determining whether the State sales and use tax provisions extend to these transactions. See Sales Tax District No. 1 of the Parish of Lafourche v. Express Boat, Inc., 486 So.2d 947 (La. App. 1st Cir. 1986), affirmed in part, 500 So.2d 364 (La. 1987); McNamara v. John E. Chance & Associates, Inc., 491 So.2d 154 (La. App. 3rd Cir. 1986).

E. Vessels Leased for Use in the Production of Minerals

An exemption is also furnished for vessels leased for use in the production of oil and gas and other mineral production, provided that the services of those so engaged in such activity, are exempt from State and local sales taxes. If vessels are leased for use in territorial waters outside of that of the State of Louisiana and the United States, this exemption should apply. See LSA R.S. 47:305.19.

F. Property Purchased for First Use Outside of Louisiana

Again, an exemption is provided when property is purchased with the expressed intention of its first use being somewhere outside of the territorial limits of the State of Louisiana. Accordingly, something imported into this State, or purchased within the State, which is intended for use in another state, or in an area beyond the territorial limits of the State of Louisiana, should be exempt under the provisions of LSA R.S. 47:305.10.

However, there are certain limitations. In order for this particular exemption to apply, the purchaser of the otherwise taxable materials must be registered for sales and use taxes within the State of Louisiana. Further, this particular purchaser must regularly report and pay sales and use taxes for sales where the property is ultimately destined to be used, (i.e., that other state). Finally, if this exemption is to apply, there must be a reciprocal exemption. The State of ultimate destination for the material must provide equivalent treatment for similar transactions initiated in that foreign jurisdiction and ultimately destined for Louisiana.

G. Fabrication or Repairs to Property Utilized Beyond the Territorial Limits of the State of Louisiana

The repair or modification, or further fabrication of property originally utilized outside the State of Louisiana in waters extending beyond the territorial limits of th State, are exempt from sales and use tax purposes when such equipment is brought into the jurisdiction of the State of Louisiana for repair, modification or further fabrication; if and when that same equipment is to be returned beyond the territorial limits of the State of Louisiana for further use in an ongoing business operation.

H. Fungible Goods

Fungible goods are such materials which intermingle among themselves, or are incapable of being separated at a given time and place, for purposes of what would potentially be utilized within the territorial waters of the State of Louisiana, and that which would be delivered beyond the territorial limits of the State of Louisiana. A good example of fungible goods would be diesel fuels to be delivered offshore in international waters. These fuels may partially be consumed in being transported from the territorial waters of the State to its offshore location. Hypothetically, fungible goods such as diesel fuel should not be taxed if in fact they ultimately are destined to be utilized beyond the territories of the State. However, there can be no denying that at least part of the fungible goods transported through the territorial waters of the State are consumed in performing this function. Accordingly, an exemption does exist under LSA R.S. 47:305.10(G). This exemption for all practical purposes has been limited to a percentage of the fungible goods which actually are delivered offshore. Although this may not be an appropriate application of the true spirit of this exemption, pragmatically, this is the force and effect that has been given to this exemption by the State for sales tax purposes.

There are multiple miscellaneous exemptions which exist under the Louisiana Revised Statutes. Referral to the Revised Statutes will specify additional types of transactions, which the Legislation felt did not warrant the imposition of tax due to other policy reasons.