

FREQUENTLY ASKED QUESTIONS (F.A.Q.)

Regarding

Taxation

by Seth Millstein



1. What are the three construction categories for tax purposes?

Businesses perform construction activities as prime contractors, subcontractors, or speculative builders. For state tax purposes, the difference between a prime contractor and a subcontractor is only significant on custom contracting jobs. Otherwise, a prime and subcontractor are treated the same for tax purposes. To determine how to properly report your taxes, you must determine which category of construction activities you perform.

Custom Construction Prime Contractors. Generally, custom construction involves residential and commercial construction performed for others. Custom prime contracting is when a contractor is hired by a landowner to complete an entire construction project. The income from custom prime contracting (without deduction for any amounts paid to subcontractors) is reported under the "retailing" B&O tax classification, and is subject to retail sales tax unless a specific exemption applies. The prime contractor is considered to be a consumer of all items that are not incorporated into the final project (such as tools, equipment, and supplies). As a consumer, the contractor must pay retail sales tax or use tax on such items.

Custom Construction Subcontractors. Custom subcontracting is when a contractor is hired by a custom prime contractor to provide a portion of the services necessary to complete the project. Income from custom subcontracting is reported under the "wholesaling" B&O classification.

Speculative Builders. Speculative building is when a builder makes improvements on land he/she owns. Spec-builders are not subject to B&O tax or retail sales tax on the sale of the real estate. They are, however, subject to the real estate excise tax. If the spec-builder hires a contractor to work on the project, the contractor, for tax purposes, is treated like a custom prime contractor as opposed to a subcontractor. Hence, any contractor performing services for a spec-builder must charge sales tax on the total contract price. A spec-builder can never use a resale certificate.

2. I'm a spec-builder. What are the tax consequences of pre-sales agreements and the sale of a spec-home during the course of construction?

For tax purposes, a prospective buyer does not become the owner of land by merely executing a purchase and sale agreement or pre-sale agreement with the contractor (even if a substantial amount of money is paid). Rather, the key date is closing, because that is the date that the transfer of ownership rights and liabilities occurs. When a speculative builder sells

or contracts to sell property upon which there is a building under construction, all construction completed subsequent to the date of such sale or contract constitutes custom prime contracting. The "retail sale" does not take place until the purchasers have the "right of possession" to the real property on which construction takes place. Typically, the right to possession is transferred on the date of closing the property conveyance. Therefore, retail construction on what was originally a speculative house does not occur until after closing.

3. For tax purposes, is there a difference between acting as a traditional general contractor as opposed to merely providing consulting services to the landowner?

Yes. For B&O and for sales tax purposes, the Department of Revenue distinguishes between companies providing professional services (such as engineering, architectural, surveying, etc.) and companies acting as traditional general contractors. The key question to ask is whether the company is responsible for the completed construction without regard to who actually performs the construction, or whether the company merely reviews the work related to the construction but does not supervise or direct the work.

4. What is a resale certificate, who can use it, and how do I get one?

A resale certificate is a standard business form that is used by registered businesses making purchases of goods and certain services which they intend to resell in the normal course of business without intervening use. The use of a resale certificate allows for purchases without paying sales tax.

A buyer purchasing a good from a wholesaler does not have to pay sales tax on the good if the buyer presents the wholesaler with a resale certificate. A sample certificate that can be duplicated may be requested from the Department of Revenue. Certificates may also be purchased at stationery supply stores. See WAC 458-20-102.

5. How are resale certificates used in the construction industry?

There are two common situations in which a custom contractor uses retail certificates. The first situation occurs when the contractor purchases materials for resale, i.e., materials that become part of the project. For example, a contractor can avoid paying sales tax on lumber by simply presenting a valid resale certificate to the lumber seller when the lumber is purchased. Caveat: A prime contractor may not use a resale certificate to purchase items that are consumed in performing construction. Examples of such purchases are equipment, equipment rentals, tools, form lumber or visqueen not incorporated into the structure, duplex nails, and other supplies used in performing the construction. The rationale for this exception is that the Department of Revenue considers the contractor to be the consumer of these items.

The second situation in which a contractor uses a resale certificate is when the contractor purchases services for resale.

6. What happens if the Department of Revenue catches a business improperly using resale certificates to evade paying sales tax?

Contractors who use resale certificates to purchase items or services they use as consumers will be assessed a misuse penalty of 50% of the tax due on the improperly purchased item or service (see RCW 82.32.291). This is in addition to all other taxes, penalties, and interest due.

7. Is labor subject to sales tax?

Yes. Generally, whenever tangible goods are repaired, altered, cleaned, improved, modified, or installed for the consumer, the activities are subject to retail sales tax. This includes plumbers, TV repairpersons, electricians, general handiwork, etc., even when no parts or materials are sold. See WAC 458-20-173.

8. What is the business and occupation (B&O) tax and who is subject to it?

Business and Occupation (B&O) tax is a gross receipts tax levied on a business for the privilege of doing business in Washington. Almost all businesses located or doing business in the state of Washington are subject to the state B&O tax. It is an out-of-pocket cost for engaging in business activities.

The B&O tax has many different rates which depend on the business activity. For example, common business activities that get taxed at different rates are wholesaling, service, and retailing activities. Businesses performing more than one activity may be subject to tax under one or more B&O tax classifications.

The B&O tax is based on gross, rather than net, income. The term "gross income" refers to the total amount of income earned by the business for products sold or services rendered. Retail sales tax you charge should not be included in the gross income figure you report. There are no deductions allowed for costs of doing business, materials used, labor or delivery expenses, or taxes. See RCW 82.04.080. Since the B&O tax is a tax based on gross income, no deductions are allowed for costs or expenses incurred in the process of earning the income.

9. Does it make a difference if I do not include sales tax in my bid, proposal, or contract?

Yes. For purposes of determining the amount of sales tax due, the Department of Revenue presumes that a selling price quoted in any agreement does not include the retail sales tax unless that tax is separately itemized. See RCW 82.08.050. This is true even if the contractor and the customer agreed that the price quoted includes sales tax. The words "tax included" are not sufficient; the amount of the sales tax must be separately itemized.

10. Now that I know that the amount of the sales tax must be separately itemized, must the sales tax be separately itemized in just the original bid/proposal/contract, or the invoices, or both?

If the bid/proposal/contract states the amount of the total sales tax to be charged, then sales tax does not have to be listed in the individual invoices. Note that if sales tax is specifically listed in the invoices, it does not have to be stated in the bid/proposal/contract.

11. *I'm a building contractor. Do I need to pay sales tax on the equipment I rent to use on a job? I'm already charging my customer sales tax.*

Yes, you must pay the sales tax on equipment you rent, even though you charge your customer sales tax on the contract. Why? Because you are using the equipment to perform the job you were hired to do, much like the purchase and use of a hammer or other tools. You are not re-renting or re-selling the equipment to your customer, the equipment does not become a part of the finished product, and you will not leave the equipment with your customer when you have completed the job. You are the consumer of the rented equipment. As the consumer, you owe the sales tax.

The sales tax you pay should be included in the contract price charged to your customer as a cost of doing business, just like the cost of the rental. See WAC 458-20-211.

12. *I'm selling various supplies to a governmental entity (local, county, state, or federal). Should I charge my client sales tax?*

Generally, sales to state, county, or local government agencies, school districts, or fire districts are subject to retail sales tax. See WAC 458-20-189. However, the federal government, its agencies, and instrumentalities are exempt from state taxation. See WAC 458-20-190.

13. *Does setting up a corporation or LLC protect me from failure to collect sales tax?*

No. Collected retail sales taxes are considered trust funds. If a corporation or LLC closes, leaving collected retail sales taxes unpaid to the Department of Revenue, the individuals responsible for making the financial decisions for the business may be held personally liable for payment of the unpaid sales tax. This is considered "trust fund accountability". The individuals liable may include corporate officers, bookkeepers, accountants, or any other person who made the decision to not pay the collected sales tax to the Department.

14. *What is use tax? What are some common situations in which use tax is owed?*

Use tax is a compensating tax owed when retail sales tax was due, but was not paid at the time of purchase. See WAC 458-20-178. Washington's use tax is due on items used by a business or individual when sales tax has not been paid (except inventory held for sale). The following list provides examples of purchases on which you may owe the use tax:

- Goods are purchased in a state with no sales tax or a lower sales tax rate
- Goods are purchased from someone who is not authorized to collect sales tax
- Goods are purchased from a mail order catalog company, or over the Internet from an out-of-state retailer (e.g. office supplies, magazine subscriptions)
- Personal property is acquired with the purchase of real property

The local tax rate for use tax is determined by the location where the goods are used. See WAC 458-20-178.

15. As a contractor doing business in Washington, what kind of records should I maintain to be prepared in the event that my business is audited by either the Department of Revenue or the Internal Revenue Service?

- Excise tax returns and any work papers used to prepare them
- Federal income tax returns for the business
- Summary accounting records and source journals, such as check registers, the general ledger, sales journal, general journal, cash receipts journal, and any other records you use to record income and expenses
- Sales invoices
- Purchase invoices (i.e., accounts payable, receipts)
- Depreciation schedules listing all assets acquired during the audit period, along with purchase invoices for those assets
- Resale certificates for any wholesale sales made
- Supporting documentation for all deductions and exemptions

16. What happens after an audit?

After the auditor's review, you will be told of any tax differences (either debit or credit). The auditor will explain each adjustment clearly to you or your representative before finalizing the audit. If you believe the auditor has made a mistake, or if you have further information the auditor hasn't considered, it is important to contact him or her immediately. If you agree with the adjustments, the audit will be processed and a copy of all applicable schedules, laws, and rules will be mailed to you. Usually, it takes four to six weeks for the final copy to reach you.

If the audit results in additional taxes owed, you have 30 days from the date the audit was mailed to pay the tax and interest in full. The due date will be clearly noted on the audit bill. See WAC 458-20-100.

17. What happens if after the audit I don't respond or make satisfactory payment arrangements?

The Department of Revenue may issue an assessment and then a tax warrant covering all unpaid tax, penalty, and interest. If a tax warrant is not paid within 10 days after the issue date, it is filed with the Superior Court where you own real or personal property.

A filed tax warrant establishes a lien against real and personal property. It also enables the Department of Revenue to seize property (bank accounts, wages, personal property) to pay the debt. If a filed tax warrant remains unpaid after 30 days, a hearing to revoke your business's tax registration endorsement may be held.