

HOW THE NEW SALES AND USE TAX CHANGES AFFECT RESIDENTIAL CONSTRUCTION PARTICULARLY REGARDING REPAIR, MAINTENANCE AND INSTALLATION SERVICES

By J. Michael Carpenter, NCHBA General Counsel*

These changes do NOT impose the sales tax on ALL construction labor as some have claimed. Rather, the sales tax is extended to labor performed only under certain LIMITED circumstances.

BACKGROUND

Effective March 1, 2016, the 4.75% general State sales tax, and the applicable local sales tax (either 2.00% or 2.25%, depending on the county, and, in a few counties, the .50% transit sales tax: see ** below for list), will apply to the sales price (or the gross receipts) derived from repair, maintenance, and installation services with respect to tangible personal property. This change expands the sales tax to certain services that were previously not subject to it. In addition, effective March 1, 2016, a second change relates to the sales price of tangible personal property where the retailer makes a separate charge for labor for installation. Where the sales tax is now due on labor for installation (see below), it does not matter that the installation charge is or is not stated separately.

HOW THE CHANGES APPLY TO RESIDENTIAL CONSTRUCTION FROM A BUILDER'S PERSPECTIVE

I. NO SALES AND USE TAX CHANGE IN THE LAW AND NO SALES AND USE TAX DUE ON LABOR

For many, if not most, residential construction activities, there is no change in the law and no sales and use tax on labor will be owed.

1. There is no change in the law for a builder (general contractor, subcontractor or remodeler) who purchases tangible personal property and installs it (either personally or by using the person's own employees) in a new home under construction or in an existing home being remodeled. Sales or use tax has been, and will continue to be, due on the materials that go into a house. However, no sales or use tax has been, nor will continue to be, due on the builder's labor. The law preserves the "real property contractor" exclusion and the builder who acts as a "real property contractor" is, thus, specifically exempted from paying sales tax on his services. (GS 105-164.3 (33a) defines "real property contractor" as a person "that contracts to perform construction, reconstruction, installation, repair, or any other service with respect to real property and to furnish tangible personal property to be installed or applied to real property in connection with the contract and the labor to install or apply the tangible personal property that

***The opinions and analysis expressed herein are those of the author and should not be a substitute for consultation with your attorney, CPA or the NC Department of Revenue.**

**Items subject to the general 4.75% State rate are also subject to the 2% (2.25% in Alexander, Anson, Ashe, Buncombe, Cabarrus, Catawba, Cumberland, Davidson, Duplin, Durham, Edgecombe, Greene, Halifax, Harnett, Haywood, Hertford, Lee, Martin, Montgomery, New Hanover, Onslow, Orange, Pitt, Randolph, Robeson, Rowan, Sampson, Surry, and Wilkes Counties) local sales and use tax rate. Mecklenburg County has an additional 0.50% transit county tax for public transportation in addition to the 2% local sales and use tax rate. Durham and Orange Counties have an additional 0.50% transit county tax for public transportation in addition to the 2.25% local sales and use tax rate.

becomes part of the real property. The term includes a general contractor, a subcontractor or a builder for the purposes of GS 105-164.4H. The term does not include a person engaged in retail trade.”)

2. If a builder contracts with a subcontractor who solely operates as a “real property contractor” to provide and install tangible personal property to real property, there will continue to be no tax on the labor (but there will continue to be sales or use tax due on the tangible personal property by the subcontractor on the purchase of the tangible personal property). *An example cited by the Department of Revenue is that of a business that installs wall-to-wall carpet. “This person agrees to provide the carpet, padding, and other tangible property and the labor to complete the work per the contract. The person does not sell carpet at retail from any location or establishment inside or outside the State. Rather, the person purchases the necessary carpet, padding and other tangible property on an as needed basis from sellers and pays tax at the time or purchase on such items.”* The law defines “person” as “an individual...a firm...a partnership, a limited liability company, a corporation...”
3. A builder who contracts with a person whose **only business activity** is providing repair, maintenance and installation services where the person’s activities do not otherwise meet the definition of “retail trade”, such person is not a retailer and, as such, charges by the person to the builder are not retail sales and no sales and use tax will be due on that person’s labor charges to the builder. *An example cited by the Department of Revenue is a person engaged in business as a carpet installer and who does not receive income from any other source. “The person only installs carpet purchased by others and does not ever provide the carpet or other tangible personal property to complete an install. As the only business income is from providing installation services, the person does not meet the definition of ‘retail trade’ and is not a retailer required to collect tax on the installation charges to the customer.”*
4. Labor for framing, and other similar subcontractor services, where the subcontractor has no retail component to his or her business, will not be subject to the sales tax.

II. SALES TAX MAY BE DUE ON LABOR IF RETAIL TRADE IS MAJORITY OF SUBCONTRACTOR’S REVENUE

If a builder uses a subcontractor who sells and installs good or services (e.g., flooring contractor, HVAC contractor, etc.) directly to the public, the builder should conduct an inquiry of that subcontractor to determine if sales and use tax will be due on that subcontractor’s services with respect to the particular project subject to that real property subcontract.

If the subcontractor is engaged in sales to the public whether the sales tax is due on that subcontractor’s labor will turn on whether the business derives a “majority of revenue from retailing tangible personal property, digital property, or services to consumers.” If so, the subcontractor is a “retailer” and tax will be due on the retailer’s charges (sales price) to the builder for materials and installation for that subcontract. However, if a builder uses a subcontractor who makes retail sales but the “majority of revenue” is not “from retailing tangible personal property, digital property, or services to consumers”, such person is a “retailer-contractor” (defined under GS 105-164.3 (35a) as “[a] person that acts as a retailer when it sells tangible personal property and as a real property contractor when it performs real property contracts.”) and the sales tax on labor will not apply to the subcontractor’s services which the subcontractor provides to the builder pursuant to the subcontract for the real property contract.

Just because a business has a retail component doesn't automatically make the business subject to the sales or use tax imposed on a retailer on repair, maintenance and installation services or receipts from a real property contract. The Department of Revenue states: "A person who meets the definition of a 'retailer-contractor' prior to March 1, 2016, must consider the definition of 'retail trade' effective March 1, 2016, and determine whether the majority of the revenue in the State is derived from retail sales or from real property contracts for purposes of the Sales and Use Tax Act for sales transactions on or after March 1, 2016 in the State." The Department cites two examples to illustrate:

- a. *"For the 2015 calendar year, a person who sells septic tank components at retail locations solely in the State and installs septic tanks in real property solely in the State received total revenue of \$5,000,000. Of the \$5,000,000 in total revenue, \$4,000,000 was from the retail sale of septic tank components in the State and \$1,000,000 was from installation of septic tanks. Based on the 2015 calendar year, the person's revenue is comprised 80%...from retail sales of component parts. Effective March 1, 2016, the person is deemed to be in 'retail trade'; therefore, the person is a retailer and must treat all sales transactions as retail sales on or after March 1, 2016, no matter that prior [to that date] the business was permitted to operate as a retailer-contractor. The total sales price of installed septic tanks on or after March 1, 2016, is subject to sales tax in the same manner as the sale of any components sold at retail."*
- b. *"For the past three tax years, a person engaged in business in North Carolina sold kitchen cabinets at retail in the State to consumers and also performed kitchen remodeling contracts that primarily included the removal of existing cabinets, site preparation, installing new cabinets, plumbing, fixtures, and countertops at customers' locations in the State. The cumulative revenue for three years from sales in the State totaled \$2,000,000; consisting of \$1,500,000 from kitchen remodeling contracts and \$500,000 from retail sales of kitchen cabinets. Based on the three prior tax years, the person received 75% of its revenue from remodeling contracts for real property. The person does not meet the definition of 'retail trade' since only 25% of its revenue is from the retail sales of kitchen cabinets. This person is a "retailer-contractor" since the majority of the revenue is from remodeling contracts." See above for definition of "retailer-contractor".*

The "look back period" to determine "majority of revenue" is not specifically set forth in the new law. The Department of Revenue advised the author that it expects the General Assembly to address this omission during the upcoming 2016 Session. In fact, the Department of Revenue advised that it specifically chose different time periods in its examples set forth in its Directive (SD-16-1) to illustrate that no particular "look back" period is favored over another one. Those examples cite the following calculation periods: "for the past three tax years", "for March, April and May of 2016", and "for the 2015 calendar year". Until the General Assembly supplies a definite time period, any good faith calculation period would appear to be acceptable.

HOW ABOUT CONTRACTS ENTERED INTO PRIOR TO MARCH 1, 2016?

A contract entered into prior to March 1, 2016, which did not include sales tax on labor which would be due for a transaction on or after March 1, 2016, will be honored provided the builder files the necessary form set forth below. The Department of Revenue states: "A contractor (subcontractor, if applicable) that purchases an item to fulfill a lump-sum or unit-price contract where such contract was entered into, awarded, or entered into or awarded pursuant to a bid made prior to March 1, 2016, may purchase such

an item without payment of the sales or use tax on installation charges provided the retailer can separately identify the installation charges on the invoice or similar document given to the purchaser at the time of sale. To purchase such qualifying items without payment of sales or use tax on the portion of the sales price for installation charges, Form E-589J, Affidavit to Exempt from Sales and Use Tax Installation Charges for Certain Purchases of Tangible Personal Property by Contractors to Fulfill a Lump-Sum or Unit-Price Contract, must be fully completed by a contractor (subcontractor, if applicable) and submitted to a retailer. The Department notes that this form is available on its website, www.dorn.com. Form E-589J will be amended for use to purchase taxable repair, maintenance, and installation services on or after March 1, 2016 without payment of tax where such are to fulfill a lump-sum or unit-price contract where such contract was entered into, awarded, or entered into or awarded pursuant to a bid made prior to March 1, 2016

WHAT POSITION DID NCHBA TAKE ON THIS LEGISLATION WHEN IT WAS BEING CONSIDERED?

In the 2013 Session of the General Assembly, NCHBA successfully opposed legislation which would have extended the sales tax to all labor performed in connection with residential construction as a part of a sweeping proposal to substantially expand the sales tax base to almost 200 services which was opposed by many other groups. This proposal to expand the sales tax base to include repair, maintenance and installation services arose very late in the 2015 Session. It was proposed, along with other revenue changes, to resolve a longstanding disagreement between the Senate and House on the issue of reallocation of sales tax proceeds which had prevented an agreement on the budget for months. When it appeared that the proposal would be included in the final budget conference report, our strategy turned to work on the language to limit the scope of the change. Our first priority was to preserve the “real property contractor” exemption which was achieved. We also successfully worked to limit expansion of the definition of “retailer” to preserve the “retailer-contractor” exemption. While we would have preferred no change in the law, the results were considerably more favorable than originally proposed.

FOR MORE INFORMATION

The North Carolina Department of Revenue has published information that more fully discusses these changes and these documents can be accessed via the following links:

<http://www.dorn.com/practitioner/sales/directives/SD-16-1.pdf>

<http://www.dorn.com/practitioner/sales/directives/SD-16-2.pdf>

http://www.dorn.com/taxes/sales/repeal_of_installation_charges_exemption.pdf

ASSOCIATE MEMBERS WHO OFFER SERVICE CONTRACTS

Some associate members who sell service contracts to retail customers will now be responsible for paying sales tax even though the property covered in the service contract becomes a part of or is affixed to real property. See link below for more information:

http://www.dorn.com/taxes/sales/impnotice020216_servicecontract.pdf