

APPLICATION OF SALES AND USE TAX TO PURCHASES MADE BY A CONTRACTOR ON BEHALF OF AN EXEMPT ENTITY - BACKGROUND MEMORANDUM

Section 1 of 2015 House Bill No. 1401 directs the Legislative Management to study the application of sales and use taxes to purchases made by a contractor on behalf of an exempt entity. As introduced, House Bill No. 1401 would have created a sales and use tax exemption for materials, supplies, or equipment acquired by a contractor, subcontractor, or builder on behalf of an exempt entity. The bill would have required the purchaser to obtain a purchasing agent authorization letter and an exemption certificate or number from the exempt entity and would have required that any items exempt from sales or use tax be installed or completely consumed in the performance of the contract. The fiscal note for the bill, as introduced, indicated a combined reduction in state general fund and state aid distribution fund revenues of an estimated \$56 million for the 2015-17 biennium. The bill was later amended in the House to remove the substantive provisions and to provide for this study.

SALES AND USE TAX APPLICATION AND EXEMPTIONS

The application of sales and use tax is governed by North Dakota Century Code Chapters 57-39.2 and 57-40.2. Sales tax is imposed at a rate of 5 percent on the gross receipts from taxable retail sales of tangible personal property and services. The tax is paid by the purchaser and collected and remitted by the retailer. Use tax, which is also imposed at a rate of 5 percent, is applied to tangible personal property purchased at retail for storage, use, or consumption in this state or tangible personal property purchased outside this state but later brought into this state. Use tax is applied to the purchase price of an item at the time of purchase, or to the fair market value of the item at the time it is brought into this state.

Pursuant to Sections 57-39.2-04 and 57-40.2-04, a wide range of products, services, and activities are exempt from the imposition of sales and use tax. Exempt products range from small items, such as the ink used to print newspapers, to larger items, such as durable medical equipment. In addition to the exemptions available for individual items, various groups and entities are also exempt from paying sales and use tax on some, or all, of their purchases. Groups and entities exempt from payment of sales and use tax on purchases include:

- Private nonprofit schools, on purchases of textbooks, yearbooks, and school supplies, pursuant to Section 57-39.2-04(5);
- Public schools, on all purchases made using a school district check or warrant, pursuant to Section 57-39.2-04(6);
- The federal government, including federal corporations, on all purchases made by the United States government or its agencies, departments, or instrumentalities, pursuant to Section 57-39.2-04(1);
- State and local governments, on all purchases made by any state or any state's subdivisions, departments, agencies, or institutions so long as a political subdivision of the other state would treat a sale to a North Dakota political subdivision as an exempt sale in that state, pursuant to Section 57-39.2-04(6);
- Indian tribes, on all purchases made by a tribal government agency, instrumentality, or political subdivision that performs essential government functions, pursuant to Section 57-39.2-04(6);
- Hospitals, skilled nursing facilities, intermediate care facilities, basic care facilities and emergency medical services providers licensed by the State Department of Health, and assisted living facilities licensed by the Department of Human Services, on all purchases made for the use or benefit of the provider's patients or occupants, pursuant to Section 57-39.2-04(24);
- Nonprofit voluntary health associations and nonprofit medical research institutes, exempt from federal income tax under section 501(c)(3) of the United States Internal Revenue Code [26 U.S.C. 501(c)(3)], on all purchases, pursuant to Sections 57-39.2-04(32) and 57-39.2-04(43);
- Commerce authorities, on purchases integrated into the infrastructure of a commerce authority to directly serve the commerce authority's infrastructure needs, pursuant to Section 57-39.2-04(48);
- Special fuel businesses, on purchases of equipment to enable a facility to sell diesel fuel containing at least 2 percent biodiesel or green diesel fuel, pursuant to Section 57-39.2-04(51); and
- Montana residents and businesses, on all purchases exceeding \$50 for use outside of this state, pursuant to Section 57-39.2-04(12).

PAYMENT OF SALES AND USE TAX BY CONTRACTORS

A contractor or subcontractor is deemed to be the final user or consumer of any tangible personal property used in the performance of a contract with another party. As the final user, a contractor is required to remit sales or use tax on any tangible personal property used in the performance of a contract, subject to limited exemptions. The amount of tax due will be determined by applying the applicable tax rate to either the purchase price of the property or to the fair market value of the property, whichever is greater. A contractor may take various approaches in remitting the required amount of sales or use tax.

A contractor may remit sales tax on all purchases of tangible personal property at the time of purchase or a contractor may present a certificate of resale or a contractor's certificate to avoid payment of sales tax at the time of purchase. If a contractor presents a contractor's certificate and elects not to pay sales tax at the time of purchase, the contractor will be required to remit use tax on those items in the reporting period in which the purchases were made. If a contractor presents a certificate of resale and elects not to pay sales tax at the time of purchase, the contractor will be required to remit use tax on those items once they are used in the performance of a contract. In both instances, the contractor may build in the cost of the tax paid into the contract but may not explicitly designate the charge as relating to sales tax on the customer's invoice as the contractor is always deemed to be the final user of tangible personal property and the party ultimately responsible for remitting sales or use tax on those items.

A contractor's responsibility to remit sales or use tax on items used in the performance of a contract is not extinguished by the fact that some of the items may have been purchased by an entity that is exempt from paying sales and use tax. A contractor must still remit use tax on any items used in the performance of a contract on which sales or use tax was not remitted by a previous purchaser, subject to limited exceptions.

Items that may be purchased by an individual or entity without the payment of sales or use tax and later installed by a contractor without payment of use tax include:

- Medical equipment purchased by a long-term care facility and later installed into the hospital or facility making the exempt purchase, pursuant to Section 57-40.2-03.3(3);
- Production equipment and other tangible personal property used for repowering, environmental upgrades, or power plant construction, pursuant to Sections 57-39.2-04.2 and 57-40.2-03.3(4);
- Machinery, equipment, or other tangible personal property used to construct an agricultural commodity processing facility, pursuant to Sections 57-39.2-04.3 or 57-39.2-04.4 and 57-40.2-03.3(4);
- Tangible personal property used to construct or expand a system used to compress, process, gather, or refine gas recovered from an oil or gas well in this state or used to expand or build a gas processing facility, pursuant to Sections 57-39.2-04.5 and 57-40.2-03.3(4);
- Tangible personal property used to construct or expand a qualifying oil refinery, pursuant to Sections 57-39.2-04.6 and 57-40.2-03.3(4);
- Tangible personal property used to construct or expand a processing facility to produce liquefied natural gas, pursuant to Sections 57-39.2-04.10 and 57-40.2-03.3(4);
- Tangible personal property used to construct or expand a facility for coal gasification byproducts, pursuant to Sections 57-39.2-04.11 and 57-40.2-03.3(4);
- Tangible personal property used to construct or expand telecommunications service infrastructure that is capable of providing telecommunication service, pursuant to Sections 57-39.2-04.9 and 57-40.2-03.3(4);
- Materials used in compressing, gathering, collecting, storing, transporting, or injecting carbon dioxide for use in enhanced recovery of oil or natural gas, pursuant to Sections 57-39.2-04.14 and 57-40.2-03.3(4); and
- Tangible personal property used to construct a qualifying fertilizer or chemical processing facility, pursuant to Sections 57-39.2-04.15 and 57-40.2-03.3(4).

If any of these items are purchased or installed on behalf of an exempt entity or individual by a contractor who remits sales or use tax on the items, the individual or entity qualifying for the exemption may apply to the Tax Commissioner for a refund of the difference between the amount of tax paid and the exemption imposed or allowed.

RECENT SALES AND USE TAX LEGISLATION PERTAINING TO CONTRACTORS

The provisions of 2015 House Bill No. 1401, as introduced, are not the first to be considered by the Legislative Assembly in modifying the application of sales and use tax for purchases made by contractors on behalf of an exempt entity. Since 2007, three bills have been introduced in the Legislative Assembly on this topic, all of which were ultimately defeated.

Senate Bill No. 2253 (2007) would have allowed an individual or organization to apply for a refund of the amount of sales or use tax paid by a contractor for tangible personal property delivered or installed by a contractor for that individual or organization if sales or use tax would not have applied had the individual or organization purchased or installed those items directly. Testimony provided during the committee hearings on the bill indicated the bill originally arose due to concerns expressed by a medical center. The example provided during testimony on the bill illustrated a scenario in which a large medical center, that could afford to have maintenance staff on its payroll, could purchase a piece of equipment and have it installed by the facility's maintenance staff without incurring any sales or use tax liability. This scenario was contrasted with a situation in which a smaller medical center would make the same purchase, but hire a contractor to install the item as the facility did not employ its own maintenance staff. The contractor hired by the smaller facility would be required to pay use tax when installing the item purchased by the medical center as sales tax was not remitted at the time the item was purchased. The contractor in this situation would presumably pass on the cost of remitting use tax on that item to the facility in which the contractor executed the installation contract. During further discussion of the bill, testimony indicated that the language provided in the bill may have broader application reaching beyond just medical centers. The fiscal note for the bill indicated an anticipated reduction in state general fund and state aid distribution fund revenues of \$15.4 million for the 2007-09 biennium.

Following the defeat of 2007 Senate Bill No. 2253, 2009 Senate Bill No. 2186 and 2011 Senate Bill No. 2159 were also introduced to allow a sales and use tax exemption for purchases made by a contractor on behalf of an exempt entity. The provisions in these bills ultimately prompted the same discussion regarding scope of application and potential revenue impacts as the provisions contained in 2007 Senate Bill No. 2253. As similar discussion arose during the testimony received on 2015 House Bill No. 1401, as introduced, the House Finance and Taxation Committee voted to amend the provisions of the bill into a study and advance the bill forward with a do pass recommendation. Repeated introduction of the bill's concepts over the last several sessions suggests that further study may be required to adequately address the topic and determine if further legislation should be considered.