



PROACTIVELY ADDRESSING

The best offense is a good defense. The author says that creating and maintaining a separate, proactive sales and use tax “examination-ready” file for each specific job or construction project can turn the tables on any sales and use tax examiner.

SALES AND USE TAXATION

JAMES E. HELMUS

It is well known that state and local taxing jurisdictions across the nation are scrambling for desperately needed revenues to fill unprecedented budget gaps. The lag in the current economy and with federal funding shrinking, state and local governments have been forced to come up with new sources of revenue to balance their budgets while proposing widespread spending cuts that have left the taxpayer community reeling.

This has had a dramatic effect on the tax enforcement sections of state and local governments across the country. Taxpayer audit activity by state and local governments is reaching a record level, not only in terms of the sheer growing number of taxpayers being subjected to an examination, but in the depth and scope of such audits, which have increased dramatically in these recent economic times. This has resulted in the entire audit examination process across the nation taking on an alarmingly newer and longer life.

There is no question that the construction industry is among those most affected by this new trend. Although this

activity is not necessarily a strategically planned and targeted attack against the industry by state and local governments, it may be a function of the complexity and dynamics of construction projects which present a significant challenge in making accurate sales and use tax determinations. Eyeing the significant dollar amounts that generally accompany such projects, examiners are digging deeper into construction documents than ever before, looking for specific items to question and scrutinize. Their goal is simply to catch taxpayers off guard, both from a documentation standpoint and a sales and use taxability-decision standpoint. Given the jurisdictionally varying state and local sales and use tax rules across the country and the diverse application of such rules by each jurisdiction, the exact same project could be taxed completely differently from one jurisdiction to the next. Since the nature of each project and the specific parties to such projects can also vary from project to project, construction businesses are continually required to make complex sales and use taxability decisions. This drives state and local sales and use tax examiners to

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scrutinize such decisions relentlessly to maximize opportunities to challenge wherever they can. With regard to the documentation issue, the fact that state and local sales and use tax examinations can usually go back as far as three to four years (depending on the jurisdiction) creates a very real and practical issue for the construction industry since such businesses often do not maintain the sufficient level of documentation to satisfy a tax examiner scrutinizing a specific project that was finished and completed years before the examiner walked in the door.

Go on the attack

How can you be better prepared in an environment where the odds are stacked against you? As the saying goes, the best offense is a good defense.

Creating and maintaining a separate, proactive sales and use tax “examination-ready” file for each specific job or construction project is the solution to this problem and can turn the tables on any sales and use tax examiner. It has been this author’s opinion that no matter which state or local taxing jurisdiction across the country is involved, having an effective, proactive system and approach in place from the very beginning of a project will consistently result in a minimal amount of unanticipated sales and use liability under future examination.

Setting up an effective system and approach

The most important aspect in maximizing the effectiveness of a proactive sales and use tax system is to address the relevant issues during the job proposal process. Taking a solid, hard look at the sales and use tax consequences of a project during the proposal process can lead to the up-front identification of significant liability issues that could affect the pricing and budgeting of the project. All too often, hidden liability issues identified by a sales and use tax examiner subsequent to a project’s completion result in a contractor being liable for taxes that could have been passed

through to the customer in the proposal, resulting in a hit to the overall job profitability.

Another benefit of focusing on sales and use tax during the proposal process is that it provides the flexibility to ensure proactively that the proposal and contract language is presented in the most advantageous fashion from a sales and use tax perspective. Gearing language to specifically address a particular state and local sales and use taxing jurisdiction’s capital improvement exemption, for example, can lead to a smoother future examination process with less scrutiny from an examiner. On the flip side, this process also ensures that the proposal or contract contains no language that could lead to unnecessary scrutiny by an examiner upon future audit. This process provides one the opportunity to cleanse the documents of language that can cause ambiguity with respect to a project’s taxability, in whole or in part. Lastly, if it is determined that a particular customer proposal or contract contains a combination of taxable and nontaxable services, the opportunity is provided up front to make a proactive allocation to determine the most favorable and supportable sales and use amount due with respect to the taxable aspect of the project. This, in effect, turns the tables and places the burden on the examiner to rebut the allocation and associated tax. Attempting to address this allocation years after a project’s completion and not having all of the relevant information readily available (or not at all) usually makes the negotiation process very advantageous to the examiner.

Implementing an effective system and approach can lead to the detection of hidden benefits as well, such as available economic development and enterprise zone sales and use tax exemptions. Surprisingly, these particular exemptions are often missed in a vast array of available areas across the country and rarely fully recouped if discovered after a project’s completion. Another up-front benefit to this process is in the area of projects on behalf of tax-exempt organizations. There are specific strategies in particular state and local taxing jurisdictions

around the country that can be used when structuring the acquisition of materials and equipment for a project on behalf of such organizations that can yield significant monetary benefits to the contractor by reducing the overall sales and use tax costs related to the project. This can have a significant favorable impact on a project's overall profitability. Once the transactions have been structured and completed, it is virtually impossible to go back and undo what was done and thus the available benefits are lost.

Documentation issue

The single largest issue facing a construction business undergoing a sales and use tax examination is documentation. As previously stated, if not prepared it is often a very difficult task to obtain complete files of project documents years after their completion. This is exacerbated by the recent trend of examiners demanding an even greater level of detail than ever before. Businesses that have experienced previous sales and use tax examinations and believe they have adequate records and files for a future audit are facing a new world of burdensome, detailed documentation requests from examiners that are extremely difficult to accommodate. Much of the required subcontractor information is difficult to obtain because subcontractors do not maintain the same level of recordkeeping as contractors. This leaves contractors vulnerable to significant unanticipated liabilities upon future examination if the issue is not addressed up front with a clear and specific documentation requirement and retention system and approach.

Creating a separate sales and use tax project file

A common mistake made by the business community is failure to create specific and separate sales and use tax job files. The new age of electronic documents has greatly benefitted the document retention process, not only from a protection standpoint, but from a duplica-

tive standpoint as well. Having an electronic document system in place affords a business the opportunity to create a parallel file specifically intended for a future sales and use tax examination, to be handed over to an examiner without hesitation, review, or cleansing. The typical file would contain not only all of the standard documentation that is typically required with a sales and use tax examination (contracts, proposals, relevant sales and use tax returns, etc.), but also additional detail that proactively addresses and supports the sales and use tax determinations made during the course of the entire project. Such additional detail includes relevant documented written and oral representations pertaining to the project from a number of sources, including subcontractors, architects, engineers, and in-house and outside counsel. Other supporting documentation would include architectural blueprints, designs, and technical schematics, all change-order information and detail, relevant project vendor invoices, relevant sales and use tax technical memorandums, supporting statutes, case law, informal rulings, and other published guidance regarding the relevant jurisdiction.

The above-discussed files can be further enhanced by the creation of an organized spreadsheet system that tracks and inventories all of the documents related to the project and sets forth all of the transactions contained within the draw summaries, along with the corresponding state and local sales and use tax consequences. This approach has a proven track record of success in project organization and adds significant credibility to the project sales and use tax taxability determinations from an examiner's perspective.

Classification issues

Another significant challenge facing construction businesses is the area of classification: whether a particular project, or a particular aspect of a project, is subject to a jurisdiction's sales and use tax (as a qualified capital improvement). As previously stated, the sales and use tax

rules vary from jurisdiction to jurisdiction around the country and customer jobs often have their own specifics and parameters. This makes it a challenge to continually monitor, understand, and apply accurately the rules of the jurisdiction in which a particular job or project is occurring. It is important to note that much of the information that is useful in making such determinations is, in most cases, not generally contained within the relevant statutes, rules, and regulations of a particular state or local taxing jurisdiction. The specific answers and relevant guidance are usually found within a particular jurisdiction's issued policy statements, publications, published formal and informal rulings, and judicial court decisions.

Using a proactive approach, accurate sales and use tax determinations can be made and documented during the proposal and contract process when all relevant information is readily available. More importantly, by reviewing all relevant case law and other guidance and information in advance of the project, any additional and necessary detailed information in support of the determination can be obtained and made part of the project sales and use tax file.

Added benefits of being proactive

It is well known that state and local sales and use tax examiners in most cases do not identify areas of overpayment that may have occurred during the life span of a construction project. What is not commonly known is that there are lurking sales and use tax overpayments with regard to such projects that

often go undetected. Given the burden and complexity of monitoring all of the sales and use tax aspects of a significant construction project, it is reasonable to assume that errors will be made. For example, a subcontractor may be erroneously charging tax on an otherwise nontaxable project, or a vendor may be mistakenly charging a higher rate of tax than a particular jurisdiction requires. Whatever the reason, such mistakes are common, but having an organized and proactive system will help detect such occurrences and also provide the opportunity to immediately recover the erroneously paid sales tax directly from whoever charged the tax. If such error is discovered in the future, a formal refund claim may be required to be filed directly with a state and/or local jurisdiction in order to recover the overpaid tax.

Conclusion

If you have ever experienced a sales and use tax examination in any jurisdiction across the country, then you understand the importance of preparedness and documentation availability. If you have also ever been assessed sales tax upon an examination that should have been charged to a customer and paid by such customer, then you understand the importance of proactively addressing the sales and use taxation in advance of a project's commencement.

Developing and implementing the sales and use tax system discussed herein will yield your organization significant benefits and place you on the offensive in the battle being waged across the country in the sales and use tax arena. ■