STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**02/19/10**	Bill No:	**SB 1373**
Tax:	**Sales and Use**	Author:	**Leno**
Related Bills:			

BILL SUMMARY

This bill provides that construction contractors who manufacture the materials which they furnish and install in the performance of paving construction contracts, as defined, are deemed to be retailers, rather than consumers, of such materials.

ANALYSIS

CURRENT LAW

Current law imposes a sales or use tax on the gross receipts from the sale of, or the storage, use, or other consumption of, tangible personal property, unless specifically excluded or exempted by statute.

The Board of Equalization's (BOE) Sales and Use Tax Regulation 1521, *Construction Contractors*, interprets and makes specific the sales and use tax law as it applies to construction contracts. Contractors are persons who erect, construct, alter, or repair any building or other structure, project, development, or other improvement on or to real property. In general, construction contractors are consumers of the materials and retailers of the fixtures they furnish and install in the performance of a construction contract. As consumers, contractors are generally required to pay either sales tax or use tax with respect to their purchase of the materials used in the course of the project. With respect to fixtures, contractors are regarded as retailers, and tax applies to their sales of the fixtures.

"Materials" means construction materials and components, and other tangible personal property incorporated into, attached to, or affixed to, real property by contractors in the performance of a construction contract and which, when combined with other tangible personal property, loses its identity to become an integral and inseparable part of the real property. Typical items regarded as materials include asphalt, cement, gravel, oil, doors, ducts, glass, insulation, linoleum, paint, stucco, wallboard, and windows.

"Fixtures" means items that are accessories to a building or other structure and do not lose their identity as accessories when installed. Items such as air conditioning units, lighting, burglar and fire alarms, prefabricated cabinets, prefabricated counters, elevators, electric generators, and plumbing hardware are typically regarded as fixtures.

Generally, a construction contractor who simply furnishes and installs materials is not required to obtain a seller's permit with the BOE. Contractors that are generally regarded as consumers include, among others, concrete, asphalt or linoleum layers, painters, wallpaper hangers, and window installers. These contractors are generally regarded as consumers of the materials they purchase. If the contractor is liable for use tax on the purchase of the materials, its tax liability is limited to the tax on the purchase price of the materials used in the performance of the contract. If the materials are

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purchased from a supplier who is responsible for collecting sales tax on the transaction, the contractor may be charged for sales tax reimbursement on the purchase price of the materials.

When contractors fabricate or produce the materials they install, only the actual cost of materials are subject to tax.

With regard to construction contractors that install fixtures, the contractors' responsibilities are different. Contractors engaged in the business of furnishing and installing fixtures, such as ceiling fans, are the retailers of fixtures and tax applies to their sales. These contractors are generally required to hold a seller's permit, file sales and use tax returns, and remit tax based on their selling price of the fixtures they install. The BOE's regulation provides that if the contract states the sale price of the fixture, tax applies to that price. However, if the contract does not state the sale price, such as in the case of a lump-sum contract, the regulation provides that the sale price shall be deemed to be the contractor's cost price of the fixture.

Contractors that are also the manufacturer of the fixture, however, are required to report tax in another manner. Under the Board's regulation, in such cases where the contractor is also the manufacturer of the fixture, the manufacturer/contractor is required to report tax on its "cost price." The "cost price" is deemed to be the price at which similar fixtures in similar quantities ready for installation are sold by it to other contractors. If similar fixtures are not sold to other contractors ready for installation, then the cost price shall be deemed to be the amount stated in the price lists, bid sheets or other records of the contractor. If such a price cannot be established, then the "cost price" upon which tax is required to be paid by such manufacturers/contractors is the aggregate of the following:

- Cost of materials, including such items as freight-in and import duties,
- Direct labor, including fringe benefits and payroll taxes,
- Specific factory costs attributable to the fixture,
- Any manufacturer's excise tax,
- Pro rata share of all overhead attributable to the manufacture of the fixture, and
- Reasonable profit from the manufacturing operations, which, in the absence of evidence to the contrary, shall be deemed to be 5 percent of the sum of the preceding factors.

With regard to construction contracts performed for the United States Government, contractors are considered the consumers of materials and fixtures which they furnish and install in the performance of these contracts. Either the sales tax or the use tax applies with respect to sales of such property to U.S. construction contractors. There is no distinction between the application of tax to materials and fixtures. Only the cost of the materials and fixtures is subject to tax.

PROPOSED LAW

This bill would add Revenue and Taxation Code Section 6007.7 to the Sales and Use Tax Law to provide that contractors who fabricate, manufacture, process, or produce materials that they furnish and install in the performance of a paving construction contractor shall be deemed the retailer of those materials. The gross receipts from the

retail sale of the materials shall be included in the measure of tax. For purposes of this section, gross receipts shall be determined as follows:

(1) The price at which the contractor sells similar materials in similar quantities ready for installation to other contractors.

(2) If the contractor does not sell similar materials in similar quantities ready for installation to other contractors, the price shall be deemed to be the amount stated in the price lists, bid sheets, or other records of the contractor.

This bill would define "paving construction contract" as a construction contract to erect, construct, alter, or repair streets, highways, sidewalks, driveways, curbs, gutters, parking lots, or other similar structures.

As a tax levy, the bill would become effective immediately upon enactment.

IN GENERAL

For contractors who manufacture the materials they install, only the contractor's actual cost of materials is subject to tax. Any labor to fabricate, process, or assemble materials is not subject to tax. However, where the contractor sublets fabrication or processing of materials to an outside business, such fabrication is considered part of the cost of materials subject to tax to the contractor. The company performing the taxable fabrication labor is required to report and pay tax to the BOE measured by its charges and may collect sales tax reimbursement from the contractor.

For contractors who acquire materials by excavating them (e.g., rock, sand, and gravel) from their own real property, there is no sales or use tax due. In this instance, the contractor is not *purchasing* the rock, sand, and gravel when it produces these materials by excavating its own real property. In such cases, tax does not apply to the contractor's use of its own rock, sand, and gravel when the contractor subsequently consumes these materials in the performance of a construction contract. In addition, tax does not apply to amounts related to crushing of rock or processing of materials to produce the finished product (e.g., asphalt concrete). The contractor would, however, owe tax on the asphalt cement (also known as asphalt binder or petroleum asphalt) or other additives that are purchased and combined with the aggregate materials to produce the final product.

COMMENTS

1. **Sponsor and Purpose.** This bill is sponsored by the author in an effort to address a sales tax inequity that exists between large contractors that manufacture their own construction materials over small contractors that do not. According to the author's office, Regulation 1521 requires contractors that purchase materials for roads and other projects to pay taxes on the materials, but does not require the same from contractors that produce the materials themselves. When a large contractor self-manufactures materials, only the contractor's purchased material cost is subject to sales tax. When the small contractor purchases the same materials from a supplier, the small contractor pays tax on the retail sales price of the materials. They contend this sales tax inequity puts small contractors at a great competitive disadvantage in bidding on state contracts and depletes the State of California of billions in lost revenues.

2. **Tax Liability Issue.** The sales and use tax liability can be greater on a construction contract for a nonmanufacturing contractor who purchases materials from a supplier than the tax liability of a manufacturing contractor who produces its own materials. Since Regulation 1521 treats contractors as consumers of materials which they furnish and install in the performance of a construction contract, the contractor is required to pay tax on its purchase price of the materials used. However, to the extent the contractor utilizes sand, gravel or rock extracted from its own quarry, no tax is due on those materials. Any labor incurred by the contractor to manufacture the materials would not be subject to tax. The manufacturing contractor would, however, owe tax on any materials it *purchased* that are combined with the sand, gravel, and rock to make the finished product (asphalt cement). The manufacturing contractor would also owe tax on any consumable materials and supplies, small tools, and equipment used in producing the aggregate and asphalt concrete (see comment 6).

   Thus, there can be a difference between the measure of tax of a nonmanufacturing contractor that purchases materials from a supplier and installs those materials and a manufacturing contractor that performs a construction contract with materials it extracts from its own quarry.

3. **What is the effect of this bill?** This bill would treat construction contractors that manufacture materials which they furnish and install in the performance of a paving construction contract similarly to construction contractors that furnish and install fixtures. They would be the retailers, rather than consumers, of materials and sales tax would apply to their gross receipts from the sale of the materials. This would apply whether the construction contract is structured as a lump-sum or time and material contract.

   As retailers, these contractors would be required to report and pay sales tax measured by the price at which they sell similar materials in similar quantities to other contractors. If they do not sell similar materials to other contractors, then these contractors would be required to report and pay tax based on the retail price stated in their price lists, bid sheets or other records of the contractor.

   The contractors affected by this bill manufacture or produce aggregates, asphalt cement, asphalt concrete, or other construction materials and use these materials in the performance of a paving construction contract would be retailers of those materials. Aggregate plants, concrete batch plants, hot mix asphalt facilities, ready mix facilities, quarries, other processing operations that also perform construction contracts to construct or repair streets, highways, sidewalks, driveways, curbs, parking lots and similar structures would be retailers of the materials.

4. **Concerns regarding consistency among the construction industry**. This bill would treat manufacturing/contractors of paving construction contracts differently than all other contractors that self-manufacture materials. Many contractors perform some fabrication or processing work of materials which they furnish and install. For example, construction contractors that fabricate and install solar panels often install solar panels that, depending upon the degree of attachment, are regarded as materials. Solar panel manufacturers/contractors purchase completed components which they then assemble into a finished panel. While solar panel manufacturers/contractors assembly labor is less extensive than paving manufacturers/contractors, they still are only liable for tax on the cost of materials to

assemble the panel. Their labor to manufacture the panel is not subject to tax. There are other types of manufacturing/installing contractors whose manufacturing labor is more substantial. For example, manufacturers of cultured marble products manufacture certain products such as bathroom vanity tops which are considered materials under Regulation 1521. These products consist of a blend of raw materials which are mixed together and placed into open molds. Some of these manufacturers also perform their own installation. These manufacturer/contractors' tax liability is based on their actual cost of the materials to produce the cultured marble product.

5. **This bill would create a reporting burden for affected contractors.** In general, it is easier for taxpayers to report their sales and use tax liability as a consumer, rather than a retailer. As a consumer, taxpayers are liable for sales or use tax on their purchases. For contractors that furnish and install materials, tax applies to the sale of the materials to the contractor or to the use of the materials by the contractor. It is our understanding that most paving construction contracts are performed on a lump-sum basis. Thus, the discussion in this comment is related to materials installed on lump-sum contracts.

   Manufacturers/contractors who acquire rock and aggregate by mining their own quarry do not currently owe tax on these materials. Thus, there is no reporting requirement. In the case of asphalt concrete, if the contractor utilizes aggregate extracted from its own quarry, no tax is due on the aggregate. The manufacturer contractor, however, does owe tax on its *purchases* of asphalt cement used to bind the aggregate together. Where the contractor purchases the asphalt cement on a tax paid basis, no further reporting is necessary. Where the contractor purchases the asphalt cement without tax, the contractor needs to determine the amount of the asphalt cement used in the paving project. Contractors may establish formulas to determine the quantity of cement to quantity of aggregate installed on a project and report their tax liability using such methods.

   Under this bill, manufacturers/contractors would now be retailers and would owe tax on the gross receipts from their sales of materials. Where the contractor regularly sells these materials in similar quantities ready for installation, the contractor would report and pay tax on that price. For smaller construction jobs involving mainly reconstruction and maintenance, a manufacturing contractor may sell similar materials to other contractors. In this instance, it may not be difficult for a manufacturing contractor to report and pay its tax liability based on its regular selling price. However, for a large complex road and highway project the contractor may not sell similar materials to other contractors. These are custom projects involving specialized engineering design work. In this case, the contractor would have to determine a fair retail selling price for the materials, instead of computing and reporting and paying tax on the amount of asphalt cement used on a project. The contractor would have to determine a fair retail value of the excavated materials, including the cost to produce the aggregate or asphalt concrete, plus any related overhead costs, plus a markup.

6. **Manufacturing contractors pay taxes and fees that nonmanufacturing contractors do not pay.** Manufacturing contractors pay sales and use tax on their equipment and supplies to produce the materials (e.g., aggregate, asphalt concrete, ready-mix concrete) including cranes, crushers, compaction equipment, crawler excavators, dozers, drilling machines, haulers, loaders, tractors, trucks, and

vehicles, and a variety of other equipment and parts for equipment, tools, and supplies used in producing the aggregate and other materials. Additionally, the contractor must pay payroll taxes for employees to produce the aggregate. They may also pay property tax on the value of the real property from which the material is excavated. And they pay fuel taxes on the high transportation costs of the aggregate, including fuel taxes to operate the diesel-powered equipment. Thus, to do a side-by-side comparison of only the sales tax liability due on construction contracts may unfairly skew the complete picture of the total taxes and fees paid by these contractors.

7. **Where a contractor purchases materials, rather than manufactures or produces its own materials, the contractor would continue to report and pay tax on a consumer basis.** Depending on the location of a construction project and the availability of materials, manufacturing contractors may choose to purchase the materials from a supplier, instead of manufacturing or producing their own materials. In this instance, the contractor would continue to report and pay tax as a consumer.

8. **BOE staff has the following administrative concerns with the current language.**

   Definition of paving construction contract. The bill defines a paving construction contract as a construction contract to erect, construct, alter, or repair streets, highways, sidewalks, driveways, curbs, gutters, parking lots, or other similar structures. Would the construction and improvement to streets and highways include the construction or repair of bridges and tunnels? Would the new application of tax apply to airport infrastructure improvements such as runways, taxiways, and parking facilities? The bill's provisions include parking lots. Would this include multi-level parking garages? Manufacturing contractors who would be subject to the proposed change in law perform various construction projects and services ranging from construction of golf courses to construction of rapid transit facilities. In order for BOE staff to effectively administer the new application of tax, the bill should clarify which projects are subject to the new application of tax. BOE staff will work with the author's office to address these concerns.

   Fixed Price Contract. Should the proposed change in law apply to fixed price contracts entered into prior to the effective date of this bill? Contractors who manufacture materials, which they furnish and install pursuant to a paving construction contract, would now be required to report and pay tax on the gross receipts from their sales of materials. As previously stated, under current law, these contractors are considered consumers of the materials and they are required to pay tax on any materials they purchase. The proposed change in law could increase their tax liability due on a contract. Under a "fixed price" contract, the contract price cannot be increased for any reason. The contractor bears the risk of performing all the work, including any cost variation in materials, for the specified amount. If the cost exceeds the contract price, the difference comes out of the contractor's pocket. Without an exemption for fixed price contracts, for existing contracts entered into before the effective date of this bill, a contractor will be liable for any increases in tax due and payable on his or her contracts. However, due to the nature of a fixed price contract, the contractor may not be permitted to reimburse himself for the increase in the contract price.

BOE staff will work with the author's office to address this concern as the bill progresses through the legislative process.

Delayed Operative Date. As a tax levy, the provisions of the bill would become effective immediately. However, since taxpayers generally rely on receiving the "official notice" of tax law changes from the BOE before implementing a law change, it is recommended that a delayed operative date be incorporated into the bill in order for the BOE to give proper advance notice. In addition, affected contractors need sufficient lead time to modify recordkeeping and reporting procedures, program computers, and train staff. The following language is suggested to be added to proposed Section 2 of the bill:

> However, the provisions of this act shall become operative on the first day of the first calendar quarter commencing more than 90 days after the effective date of this act.

COST ESTIMATE

The Board would incur costs to administer this bill. These costs would be attributable to notifying affected contractors, revising the BOE's regulation, revising publications, and answering inquiries from contractors and the public. An estimate of these costs is pending.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

Some large highway and street construction companies mine their own sand, gravel, and rock rather than purchase these materials. We do not know which specific California highway and street construction firms furnish their own materials. People familiar with the industry generally believe that larger firms are much more likely to furnish their own materials than smaller firms. For revenue estimation purposes, we will assume that all highway and street construction firms with more than 1,000 employees (defined as "large" firms) mine all of their own sand, gravel, and rock.

The U.S. Census Bureau surveys businesses every five years, in years ending in "2" or "7." Selected data from the 2007 census are now available, but the complete survey dataset has yet to be released. Our revenue estimates use more than one figure from these economic censuses. We use data from either the 2002 or the 2007 census, whichever is the most recent.

Data from the *2007 Economic Census* of the U.S. Census Bureau indicate that the costs of materials, components and supplies used by California highway, street and bridge construction firms [North American Industry Classification System (NAICS) Code 237310] were $3.5 billion in 2007. At a 9.10 percent average statewide state and local sales and use tax rate, the tax on these materials would be about $322 million.

Data from the *2002 Economic Census* (the latest available) indicate that U.S. firms with more than 1,000 employees accounted for 10.4 percent of the total costs of materials in NAICS Code Industry 237, Heavy and Civil Engineering Construction. (This is a broader industry classification than 237310, and it includes construction of utilities, pipelines, power lines and land subdivision developments.) If we assume this percentage approximates the value of work done by large highway and street

construction firms in California, this implies that about $33.5 million in state and local sales taxes were paid on materials by such large firms.

Since 2007 the housing industry has declined precipitously, and so has related highway and street construction. We have no data for California costs or revenues since 2007. The data available that we believe most closely depicts changes in highway street and bridge construction revenues and costs since 2007 are employment numbers. Data from the California Employment Development Department indicate a 23.2 percent drop in employment numbers in NAICS Industry 2373 (Highway, Street and Bridge Construction) from 2007 to 2009. If we adjust the 2007 sales and use tax revenues for this employment loss percentage, they decline from $33.5 million to $25.7 million.

The large firms that mine their own sand, gravel and rock make their own paving materials by adding petroleum distillates as a binder. These firms would be expected to pay less in sales taxes on their paving materials since sand, gravel and rock account for much of the total value of paving materials. The main component on which they would pay sales taxes would be the bituminous binder. According to a 2009 article in the *Sacramento Business Journal,* large highway and street construction firms pay about 50 percent of the sales taxes of smaller firms.[1] The 50 percent reduction in taxes paid results from the value of sand, gravel and rock that is mined and supplied by large firms without a taxable transaction taking place since they mined the materials themselves. If we take 50 percent of $25.7 million, the result is about $12.9 million. This figure is our estimate of calendar-year 2009 sales and use tax revenues related to highway and street construction contracts that would become subject to sales and use taxes under this bill at the current average statewide rate of 9.10 percent.

We believe, along with many analysts, that the construction industry will recover over the next several years. Therefore, we adjusted the $12.9 million in revenues for 2009 proportional to the increase in California the value of total building permits forecast from 2010 to 2012 in the *2010-11 Governor's Budget*.

We adjusted growth by fiscal year, starting in January 2010 using a two-step process. First we adjusted the calendar year 2009 data for fiscal year 2009-10 by the half-year growth rate in construction value of January through June of 2010 compared to the same period of 2009. Then we estimated fiscal year 2010-11 revenues using growth in total building construction permit valuations from 2009-10 to 2010-11. Over this 18-month forecast period, from calendar year 2009 through fiscal year 2010-11, the *Governor's Budget* forecast is for a 30 percent increase in building permit valuations, which would raise the $12.9 million revenue figure to $16.7 million. The *Governor's Budget* forecasts an additional 18 percent growth in building permit valuations from fiscal years 2010-11 to 2011-12. However, the one percent additional state sales and use tax rate ends June 30, 2011, which reduces the growth rate of total state and local tax revenues. While the effective date of this bill is uncertain (as a tax levy, this bill would take effect immediately), for revenue estimation purposes, we will assume an effective date of January 1, 2011. Thus, if this measure takes effect January 1, 2011, fiscal year 2010-11 revenues would be only reflect six months of the impacts of the proposed law change.

[1] "Contractors seek level playing field," *Sacramento Business Journal,* October 2, 2009.

REVENUE SUMMARY

We estimate that state and local sales and use tax revenues would increase by about $8.3 million in fiscal year 2010-11. The first complete year under the bill would be in fiscal year 2011-12, and revenues are expected to increase by $17.5 million in that year. This figure reflects both the change in the temporary tax rate effective July 1, 2011 as well as expected growth in the construction industry. Details of these revenue estimates are as follows:

	Fiscal Year 2010-11	**Fiscal Year 2011-12**
	(Millions of Dollars)	
State	$5.7	$11.4
General Fund (6.00% in FY 2010-11; 5.00% in FY 2011-12)	5.5	10.8
Fiscal Recovery Fund (0.25%)	0.2	0.5
Local (2.00%)	1.8	4.3
Transit (0.85%)	0.8	1.8
Total State and Local (9.10% in FY 2010-11); (8.10% in FY 2011-12)	**$8.3**	**$17.5**

Qualifying Remarks. These revenue estimates are preliminary and subject to change, pending more recent data releases or the discovery of more accurate information sources.

Profits earned by large firms would decline by the amounts of increased sales and use taxes they would now be paying. The California corporate profits tax is 8.84 percent. Assuming that large firms are earning profits, a comprehensive view of state revenues implies that the state sales and use tax revenue figures would be reduced by 8.84 percent of the state and local sales and use tax revenues estimated for these proposals.

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