Audit Manual

Chapter 12

Construction Contractors

Business Tax and Fee Department
California State
Board of Equalization

This is an advisory publication providing direction to staff administering the Sales and Use Tax Law and Regulations. Although this material is revised periodically, the most current material may be contained in other resources including Operations Memoranda and Policy Memoranda.
Please contact any Board of Equalization office if there are concerns regarding any section of this publication.

Table of Contents

CONSTRUCTION CONTRACTORS 1200.00

INTRODUCTION 1201.00
General 1201.05
Types of Construction Contracts 1201.10
When Property Is Not Installed 1201.15
When Property Installed Is "Machinery and Equipment" 1201.20
Construction Contract Procedure 1201.25

RECORDS OF GENERAL CONTRACTORS 1202.00
General Ledger 1202.05
Books of Original Entry 1202.10
Subsidiary Records 1202.15
Supporting Documents 1202.20

HOW TAX APPLIES TO CONSTRUCTION CONTRACTORS 1203.00
Construction Contractors Generally (Other Than U.S. Contractors) 1203.05
United States Construction Contractors 1203.10

AUDIT PROCEDURE — BASIC CONCEPT 1204.00
General 1204.05
Audit Planning 1204.10

FUNDAMENTAL VERIFICATION GUIDELINES 1205.00
Total Sales 1205.05
Taxable Basis of Contractor 1205.10
Accounting for Costs 1205.12
Expense and Supply Items Included in Costs 1205.15
Allowance For Waste and Breakage For Glass Contractors 1205.20
Fixed Assets & Expense Items 1205.25

EXCLUSIONS, EXEMPTIONS AND DEDUCTIONS 1206.00
Resales 1206.05
Use of Resale Certificates by Construction Contractors 1206.10
Interstate and Foreign Commerce 1206.15
Materials and Fixtures Used Outside of California 1206.20
Tax-Paid Purchases Resold 1206.25
Bad Debts 1206.30

SPECIAL PROVISIONS APPLICABLE TO CONTRACTORS 1207.00
Application of Regulation 1700, Reimbursement For Sales Tax 1207.05
Job Reporting Basis — Jobs in Process 1207.10
Transportation Charges 1207.15
"Last Act" Test 1207.20
Local Tax 1207.25
Transactions and Use Taxes 1207.30
Fixed-Price Contracts 1207.35
Liability by Type of Contract 1207.40
Listing of Materials, Fixtures, and Machinery and Equipment 1207.45

TABLE OF CONTENTS (CONT.)

PARTICULAR APPLICATIONS 1208.00
Draperies and Drapery Hardware 1208.10
Prefabricated Cabinets 1208.15
Prefabricated Buildings 1208.20
Factory-Built School Buildings 1208.25
Factory-Built Housing 1208.30
On-Premise Electric Signs 1208.35
Modular Furniture 1208.40
Solar Energy Systems 1208.50
Construction Contractors Purchasing Qualified
Farm Equipment and Machinery 1208.60
Partial Exemption for Manufacturing and
Research & Development Equipment 1208.65

CONSTRUCTION CONTRACTORS 1200.00

INTRODUCTION 1201.00

GENERAL 1201.05

This chapter is a guide for determining the sales and use tax liability of construction contractors. The chapter does not cover all phases of auditing problems that may be involved as they are too numerous and complex. In all cases, the auditor should refer to provisions of the Sales and Use Tax Law as supported by Regulation 1521 — *Construction Contractors*, and pertinent Annotations.

The term "contractor," as used herein, includes both general contractors and subcontractors, whether licensed or unlicensed, who perform contracts for erecting, remodeling, or repairing a building or other structure on land. The essential factor is that for the contractor to fall within the specific taxing provisions applicable to "construction contractors," the contractor must install the property in a manner by which it is incorporated into the realty. Thus broadly speaking, a construction contractor is a person who makes improvements on or to real property.

TYPES OF CONSTRUCTION CONTRACTS 1201.10

Contracts for improvements on or to real property are principally of three general types:

a) *Lump-Sum*

A contract which fixes the amount to be paid to the contractor as a single amount.

b) *Cost-Plus*

A contract which itemizes the cost of tangible personal property, which may include tax, labor, overhead and other costs, plus a certain fee or percentage in addition to cost.

c) *Time and Material*

A contract which specifies material and fixtures at retail or at some other agreed price plus labor, etc., at an agreed price.

NOTE: *It is important to remember that the primary document of concern when auditing construction contractors is the actual contract and not necessarily the billing documents. When a contractor has a written contract, application of tax is controlled by the terms of the contract, not the billing documents. However, if a contract is only verbal, billing documents should be considered the equivalent of the contract, unless the contractor provides documentation supporting some alternative method of contracting. Clear, complete, and concise comments should be made regarding the verification and types of construction contracts and billing documents.*

During a construction project, the contractor and client may agree on changes to the original contract. These changes are generally recorded on change orders and may or may not involve additional charges to the client. For purposes of the sales and use tax, change orders are regarded as separate contracts. Application of tax to charges on change orders will depend on the specific terms of the change order. For example, if a change order separately states the sales price of materials or fixtures, tax is due on that separately stated price even if the original contract is lump-sum.

WHEN PROPERTY IS NOT INSTALLED 1201.15

Frequently a contractor, because of union regulation or other contract stipulation, may merely deliver a portion of the materials or fixtures to the "jobsite — not installed." Even though the entire contract may be lump sum, where any such property is delivered to the job and not installed by the contractor, a sale of tangible personal property has been made, and the transaction is not an improvement to realty. Sales tax should accordingly be computed upon the retail selling price of such items. The auditor should verify from the taxpayer's cost records, contracts, etc. if installation was made by the taxpayer or other installer hired by him/her. For example, when a subcontractor delivers fabricated materials or fixtures to a prime contractor who will make the installation, there is a sale of tangible personal property rather than a subcontract to improve real property.

WHEN PROPERTY INSTALLED IS "MACHINERY AND EQUIPMENT" 1201.20

This is considered a sale and installation of tangible personal property rather than an improvement to realty since "machinery and equipment" is not accessory to the building and does not serve a function of the building itself.

CONSTRUCTION CONTRACT PROCEDURE 1201.25

A sequence of events that may occur in a construction contract follows:

a) Examination by the contractor of the plans and specifications and the invitation to bid.

b) Preparation of a bill of materials and an estimation of the cost of materials plus tax thereon, labor, overhead and profit.

c) Submission of a bid to the owner or general contractor.

d) Signing of a contract and obtaining of a building permit.

e) Stages of construction with inspection, progress billings, retention.

f) Completion, completion notice and final billing.

g) Changes, additions and deletions at an agreed price. These may come through as various change order numbers on large jobs or simple oral agreements on smaller jobs.

RECORDS OF GENERAL CONTRACTORS 1202.00

GENERAL LEDGER 1202.05

This may include several accounts peculiar to contractors who wish to set up as a liability the contracts which the contractor is obligated to perform, and the discharge of that liability as the job progresses and progress billings are made. Examples include accounts for progress billings or billing retention.

BOOKS OF ORIGINAL ENTRY 1202.10

These may be similar to those of a retailer or manufacturer. The purchase journal and/or cash disbursements journal may show material purchases charged to inventory or directly to specific construction job numbers. A sales journal may reflect progress billings on lump-sum contracts, over-the-counter sales and time and material contracts with separate columns for labor, material or fixture sales price and sales tax reimbursement charged.

SUBSIDIARY RECORDS 1202.15

Subsidiary records may include the following:

a) Contract register with columns for contract number, owner's name, job location, brief description of job, type of contract, total amount of contract and date completed.

b) Contract job cost journal showing in columns such items as material cost, labor, overhead, subcontracts, etc., for the various jobs in process and a total for all jobs in process to date for a particular accounting period. Subtracting the totals of the previous period shows the cost for the current accounting period. Job cost ledger cards also may be kept.

c) Requisition journal recording materials and fixtures withdrawn from inventory through requisitions.

SUPPORTING DOCUMENTS 1202.20

Supporting documents may include the following:

a) Billings, both progress and final.

b) Job cost folders:

   1) Plans and specifications
   2) Estimate of costs
   3) Copy of contract
   4) Copy of purchase invoices for direct charges to job
   5) Copy of requisitions for material withdrawn from inventory
   6) Time cards for both in-plant labor and labor at jobsite

c) Files of paid purchase invoices.

HOW TAX APPLIES TO CONSTRUCTION CONTRACTORS 1203.00

CONSTRUCTION CONTRACTORS GENERALLY (OTHER THAN U.S. CONTRACTORS) 1203.05

Tax applies to construction contractors generally as follows:

(a) MATERIALS — Contractors are consumers of materials that they furnish and install in the performance of construction contracts. Either sales tax or use tax applies with respect to the sale of materials to or the use of the materials by the construction contractor. Examples of the types of property that qualify as "materials" are given in Regulation 1521, section 1207.45 and in the Annotations in the section *Construction Contractors*.

A construction contractor may contract to sell materials and also to install the materials sold. If the contract explicitly provides for the transfer of title to the materials prior to the time the materials are installed and separately states the sale price of the materials, exclusive of the charge for installation, the contractor will be deemed to be the retailer of the materials.

In the case of a time and material contract, if the contractor bills the customer an amount for "sales tax" computed upon the marked up billing for materials, it will be assumed, in the absence of convincing evidence to the contrary, that the contractor is the retailer of the materials.

If such a time and material sales contract with sales tax reimbursement added occurs in this state, the sales tax applies to the contractor's (retailer's) gross receipts from the sale of the materials. If the sale occurs prior to the time the property is brought into this state, the contractor's (retailer's) customer is the consumer, and his or her use (unless otherwise exempt) is subject to use tax measured by the sales price. The contractor must collect the use tax and pay it to this state.

In situations where the contractor is the consumer of materials and the contractor fabricates or processes material prior to installation, no tax is due on such processing costs; only the contractor's actual material cost is subject to the tax. Where the contractor sublets fabrication or processing of material to an outside firm, such fabrication is considered part of the taxable cost of materials.

(b) FIXTURES — Construction contractors are the retailers of fixtures that they furnish and install in the performance of construction contracts, and tax applies to their sales of the fixtures. Examples of the types of property that qualify as "fixtures" are given in Regulation 1521, section 1207.45 and in the Annotations in the section *Construction Contractors*.

If the contract states the selling price at which the fixture is sold, tax applies to that price. If the contract does not state the sale price of the fixture, the sale price shall be deemed to be the cost price of the fixture to the contractor.

If the contractor purchases the fixtures in a completed condition, the cost price is deemed to be the sale price of the fixture to the contractor and shall include any manufacturer's excise tax or import duty imposed with respect to the fixture prior to the sale by the contractor.

If the contractor is the manufacturer of the fixture, the cost price is deemed to be the price at which similar fixtures in similar quantities ready for installation are sold by him/her 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 the sale price cannot be established in the above manner and the fixture is manufactured by the contractor, the cost price shall be deemed to be the aggregate of the following:

1) Cost of materials, including such items as freight-in, import duties, and charges for outside fabrication labor
2) Direct labor, including fringe benefits and payroll taxes,
3) Specific factory costs attributable to the fixture,
4) Any manufacturer's excise tax,
5) Prorata share of all overhead attributable to the manufacture of the fixture, and
6) 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.

Jobsite fabrication labor and its prorated share of manufacturing overhead must be included in the sale price of the fixture. Jobsite fabrication labor includes assembly labor performed prior to attachment of a component or a fixture to a structure or other real property.

UNITED STATES CONSTRUCTION CONTRACTORS 1203.10

Tax applies to United States (U.S.) construction contractors as follows:

a) MATERIALS AND FIXTURES — U.S. construction contractors are the consumers of materials and fixtures, which they furnish and install in the performance of construction contracts with the United States (federal) government. 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 materials and the cost of fixtures to the U.S. construction contractor are subject to tax. If the fixture is self-manufactured, the cost of the fixture that is subject to tax is the cost to the manufacturer of the property that becomes a component part of the fixture and any outside fabrication costs. Examples of the types of property that qualify as "materials" or "fixtures" are given in Regulation 1521, section 1207.45 and in the Annotations in the section *Construction Contractors*.

b) MACHINERY AND EQUIPMENT — U.S. construction contractors are retailers of machinery and equipment furnished in connection with the performance of a construction contract with the federal government. Tax does not apply to sales of machinery and equipment to U.S. construction contractors or subcontractors, provided title to the property passes to the federal government before the contractor makes any use of it. In this case, the contractor may issue a resale certificate. However, if the contractor uses the machinery or equipment before passage of title to the federal government, then the contractor is the consumer of the machinery or equipment and either sales tax or use tax applies to the sale to or the use by the contractor of the machinery and equipment. Examples of the types of property that qualify as "machinery and equipment" are given in Regulation 1521, section 1207.45 and in the Annotations in the section *Construction Contractors*.

c) PURCHASES AS AGENT OF THE UNITED STATES — Several court cases have established the principle that a construction contractor is not immune from state tax unless the contractor "stands in the Government's shoes." That is, the contractor is so closely connected with the federal government that it cannot be viewed as a separate entity. Most U. S. construction contractors who are authorized to act as "agent of the United States" maintain their separate identity and are not "agents" as that term is normally understood. Consequently, purchases by these contractors are generally subject to the sales tax or use tax under the rules discussed above in a) and b).

d) PROPERTY PURCHASED OUTSIDE OF CALIFORNIA — When a United States construction contractor acquires property outside of California and title is transferred to the United States government before the property enters the State of California, the property is owned by the United States before it enters California and the contractor has not made a taxable consumption of the property in this state. Since the contractor never owns the property in California, the application of tax is the same as if the property was furnished by the United States and installed by the contractor.

AUDIT PROCEDURE — BASIC CONCEPT 1204.00

GENERAL 1204.05

Procedures for auditing a construction contractor generally vary substantially from those of a regular retailer because contractors are generally responsible for tax only on their cost, rather than their billed price. Thus, in most cases, an audit of a construction contractor is completed on a taxable measure basis, and in a manner accounting for not only retail sales, but *all material costs*.

It is apparent that in this industry the type of business, size of operation, accounting practices, and reporting methods vary greatly Consequently, it is neither possible nor desirable to prescribe an inflexible audit program to be followed in all cases. The auditor must assume the responsibility for planning and performing verifications appropriate for each particular set of circumstances encountered. Auditors should be in a position to do this after they:

a) Have a thorough understanding of the application of tax to construction contractors,

b) Are thoroughly familiar with the various special provisions of the law and regulations applicable to contractors,

c) Have knowledge of the fundamental verification guidelines, and

d) Have performed the analysis and planning procedures outlined below.

AUDIT PLANNING 1204.10

Certainly the best foundation to sound audit planning is a complete understanding of the facts. Auditors should, prior to planning their verification programs, determine:

a) THE SCOPE OF ACTIVITIES — In what type of contracting is the taxpayer engaged? Does it involve materials, fixtures, or both, and is the contractor also engaged in making retail sales? Are contracts performed for the United States Government?

b) HOW THE TAXPAYER CONTRACTS AND BILLS — Although the taxpayer's method of billing is important, the real concern of the auditor is how the taxpayer contracts with his/her customers, i.e., lump-sum, time and material or cost plus. Do any contracts qualify as fixed price contracts? (See section 1207.35 for a discussion of fixed price contracts.)

c) HOW THE TAXPAYER PURCHASES — Does the taxpayer purchase materials and fixtures on an ex-tax, tax-paid, or mixed status basis? Are fixed asset or supply items included with material purchases?

d) HOW THE TAXPAYER RECORDS AND REPORTS — This is the vital key to effective audit planning, for not only must the auditor be aware of the taxpayer's methods, the auditor generally can make use of data already accumulated by the taxpayer.

NOTE: *Essential information about all of the above areas should always be covered in the audit verification comments.*

FUNDAMENTAL VERIFICATION GUIDELINES 1205.00

TOTAL SALES 1205.05

Liability for contracting operations normally should be verified on a taxable measure basis. Verification of gross sales generally should be confined to examination and control of revenue and other general ledger accounts to ensure accounting for all classes of transactions.

Typical examples of other than normal operations might be rentals, joint venture operations, dispositions of fixed assets, etc.

TAXABLE BASIS OF CONTRACTOR 1205.10

a) CONTRACTOR ON TAX-PAID BASIS — Some contractors responsible only for tax on cost may elect to pay tax at source and/or report all ex-tax purchases from out-of-state vendors as "Purchases Subject to Use Tax;" thus placing them on a tax-paid basis. In such instances, the auditor should verify that taxpayers are actually responsible only for tax on the purchase cost and that all purchases are properly tax paid or reported. It should also be verified that opening inventory is made up of tax-paid purchases or purchases previously reported as taxable.

b) CONTRACTOR NOT ON TAX-PAID BASIS — The actual source of fixtures, materials, and supplies used on jobs are generally:

   l) Direct purchases for specific jobs

   2) Withdrawals from inventory

   Some contractors maintain detailed and complete job cost records and are able to report directly from job cost folders, which normally contain details of purchases made directly for specific jobs, and stock requisitions for inventory withdrawals. Some contractors report estimated costs.

   Unless the contractor is on a tax-paid basis, the auditor as standard procedure should prepare a reconciliation accounting schedule (cost accountability test/examination) for all costs. A cost accountability test assists the auditor in determining whether the contractor's tax liability was correctly paid on all costs available for sales or use.

ACCOUNTING FOR COSTS 1205.12

It is preferable that a cost accountability test/examination be performed for the entire audit period. (See Exhibits 1 and 2). If accurate inventories are maintained, the cost accountability may be made for individual years with separate errors for each year. If the results indicate under/over-reported costs, the potential debits/credits should be investigated thoroughly and detailed comments made in the audit working papers.

Care must be taken to ensure costs posted in a contractor's records are for ex-tax purchases of materials and fixtures. Contractors may post tax-paid purchases to these accounts or other costs that are associated with the cost of materials or contracts. Examples of such costs are transportation charges for delivery of materials by common carriers or the cost of subcontracts. All recorded costs must be carefully reviewed. Costs that are not for the purchase of materials or fixtures and the cost of any tax-paid purchases must be removed from the recorded total purchases before completing the cost accountability test.

EXAMPLES OF ACCOUNTING FOR COSTS

Example #1 — CONTRACTING OPERATIONS ONLY — TAXPAYER RESPONSIBLE FOR COST ONLY:

(Lump-sum and Cost-plus Jobs)		
Beginning inventory		$ 15,000
*Purchases, audit period		400,000
Total		$415,000
Less ending inventory		25,000
Total costs to be accounted for		$390,000
Less: Tax-paid purchases		50,000
Net costs to be accounted for		$340,000
Taxable measure reported	$360,000	
Less fixed assets, supplies, etc.	40,000	
Total reported on contracts		320,000
Indicated understatement		$ 20,000

*Should be adjusted for accounts payable at beginning and end of audit period, if on a cash basis.

Example #2 — CONTRACTING OPERATIONS — TAXPAYER RESPONSIBLE FOR COST OF INSTALLED MATERIALS AND SELLING PRICE OF OVER-THE-COUNTER SALES:

Beginning inventory		$ 15,000
Purchases, audit period (ex-tax)		350,000
Total		$365,000
Less ending inventory		25,000
Total costs to be accounted for		$340,000
*Less cost of over-the-counter sales:		
Sales	$30,000	
Average M/U ratio	50%	
Cost of o/c sales ($30,000 / 150%)		20,000
Total cost to be accounted for by jobs		$320,000
Total taxable measure reported on contract		s 320,000
Indicated understatement of contract costs		NONE

*Make similar adjustments for resales and other non-installed sales.

Example #3 — CONTRACTOR OPERATIONS — TAXPAYER RESPONSIBLE FOR COST OF MATERIALS AND BILLED PRICE FOR FIXTURES (Time and Material Jobs — No tax charged):

Total costs to be accounted for		$340,000
Add markup on fixtures billed:		
Fixture purchases	$150,000	
Average M/U ratio	10%	
Estimated markup ($150,000 x 10%)		15,000
Taxable measure to be accounted for on contracts		$355,000
Reported taxable for contracts		320,000
Indicated understatement		$ 35,000

When a markup is used to establish costs for a portion of the sales, as is the case in Examples #2 and #3, the auditor must verify the markup used. For examples of more complex accountability tests, see Exhibits 1 through 3. These Exhibits include three different approaches involving situations where accountability tests are used in accounting for taxable costs and sales in audits of construction contractors.

COPIES OF RESALE CERTIFICATES

When a cost accountability test discloses an ex-tax purchase from a California seller that is subject to tax, in order to document that the applicable tax is the liability of the contractor/purchaser as opposed to the liability of the seller, the auditor must obtain a copy of the resale certificate for each such purchase made from a California seller for which the contractor is the consumer; that is, for purchases of materials and for purchases of fixtures for U.S. Government contracts. (See AM Chapter 4, section 0409.63, *Tax Assessed on Purchaser).*

AM section 0409.63, provides, "When contacting the seller, the auditor may not inform the seller that the auditor's reviewing the purchaser's records. Instead, the auditor is only allowed to inform the seller that he or she is verifying whether the seller has a copy of the purchaser's resale certificate on file, and if so, to request a copy of the certificate."

Resale certificates should be saved in the *Supporting Audit Documents* subfolder in the audit case folder. See AM section 0409.63 for additional information.

EXPENSE AND SUPPLY ITEMS INCLUDED IN COSTS 1205.15

The auditor in making the above cost analyses should exercise care to verify that tax-paid supply and expense items are charged to expense accounts rather than being included in material purchases. If a contractor includes expense and/or supply items in material costs attributed to construction contracts, auditors must exclude these items from costs of materials in order to accurately account for materials.

ALLOWANCE FOR WASTE AND BREAKAGE FOR GLASS CONTRACTORS 1205.20

When performing a cost accountability test on a contractor/retailer of glass and/or mirrors, consideration should be given to both storage breakage and wastage attributed to retail. Such allowances should be identified separately within the cost accountability test.

A loss/breakage amount established on over-the-counter sales is exempt from tax and should be clearly identified in the contractor's cost accountability test. However, once property is allocated to a construction contract, it cannot be included in the loss/breakage amount.

When performing a cost accountability test, the auditor should allow a percentage or tolerance for breakage of glass while in storage prior to being allocated to contracts or over-the-counter sales (Storage Breakage). If the glass is purchased for a specific construction contract, then no storage breakage percentage or tolerance is allowed for such glass. In determining the cost of retail sales, the cost factor should include a wastage factor for unusable pieces of glass (Retail Wastage). However, if the glass retailer accounts for wastage by charging for the additional glass that is left from the cutting of the glass, then a retail breakage factor would not apply. For example, if a customer requests a 20x20 piece of glass and the retailer cuts this glass from a 20x24 piece of glass and the retailer charges for the larger piece of glass, then the retail breakage percentage would not apply.

In determining appropriate percentages or tolerances, the auditor must consider the type of glass (i.e., shower doors, mirrors, plate glass, sliding doors, etc.), the size of the shop, the procedures in place for handling and storing the glass, and the employee's experience in handling the glass. The auditor must provide comments in the working papers regarding the taxpayer's method of accounting for breakage.

Since the handling of glass varies from operation to operation, it would be impossible to establish an equitable statewide allowance. Accordingly, each case should be handled on its own merits. A statewide survey was conducted to help determine reasonable allowances. However, the survey disclosed that the percentages varied greatly. In the most extreme case, the storage breakage was as high as five percent and the retail breakage over twenty percent. Whether or not a percentage or tolerance is allowed, the auditor must support his/her recommendation in the working papers. In addition, in the case of recommending an allowance, the auditor must fully explain how he or she arrived at the percentage.

It is important for auditors to understand that these types of allowances may also be used for other types of contractors when waste and breakage should be accounted for in the audit.

FIXED ASSETS & EXPENSE ITEMS 1205.25

Fixed asset acquisitions and expense items should be verified. A key item to watch for in a construction contractor audit is the "self order" job involving withdrawals of materials from inventory for own use. Frequently, such withdrawals are recorded only by journal entries, or perhaps only in memo form. Purchase invoices should be examined for small tools and supplies being included on invoices also listing materials and fixtures. It is fairly common for a contractor to purchase these from the same vendors. A blanket resale certificate or a specific or itemized listing may have been issued to the vendor.

EXCLUSIONS, EXEMPTIONS AND DEDUCTIONS 1206.00

RESALES 1206.05

The auditor should verify that exclusions for resale represent sales of tangible personal property, rather than contracts involving improvement to realty.

Regulation 1521 provides that a subcontractor may not avoid liability for sales or use tax on materials or fixtures furnished and installed by the subcontractor by taking a resale certificate from the prime contractor. A subcontractor who furnishes and installs materials or fixtures is liable for tax on such transactions even though the subcontractor may have a resale certificate from the prime contractor, and the prime contractor has collected tax from his/her customer. The tax so collected by the prime contractor is excess tax reimbursement and should be refunded to the customer. If it is not refunded to the customer, the prime contractor may be liable to the state for the amount of the excess tax reimbursement. Regulation 1700 also provides that the excess tax reimbursement may be used as an offset of the tax liability of the subcontractor. (Refer to Section 1207.05)

A subcontractor or contractor may accept a resale certificate for fixtures which he/she installs only if the fixtures will be leased in place as tangible personal property by a lessor who is other than the lessor of the realty to which the fixtures are attached, and who will pay tax measured by rental receipts.

USE OF RESALE CERTIFICATES BY CONSTRUCTION CONTRACTORS 1206.10

Contractors holding valid seller's permits may purchase fixtures, machinery and equipment for resale by issuing resale certificates to their suppliers. They may not purchase materials for resale unless they are also in the business of selling materials. Contractors should not purchase supplies and tools for resale unless they are actually engaged in the business of selling such property without previously using it.

Under Regulation 1521, a construction contractor generally is the consumer of materials that he/she furnishes and installs in the performance of a construction contract to improve real property. However, if the contract (other than a U.S. government contract) explicitly provides for transfer of title to the materials prior to installation, and the sale price of the materials is separately stated in the contract, the contractor will be deemed to be selling the materials. In addition, if a contractor bills the customer an amount for "sales tax" computed upon a marked up billing for materials under a time and material contract, it will be assumed, in the absence of convincing evidence to the contrary, that the contractor is selling the materials. When the contractor is deemed to be the seller of materials, the contractor may issue a resale certificate for the purchase of materials.

A construction contractor who does not make sales of materials is a consumer and may not purchase materials for resale. Tax is due at the time of purchase, not at the point at which the materials are withdrawn from inventory for use by the contractor. If a contractor purchases materials ex-tax from an out-of-state vendor, the materials are subject to tax when they enter the state. If a contractor is making substantial retail sales of materials used on construction contracts, he or she may make purchases for resale. Items removed from inventory by the contractor for use rather than retail sale must be reported for tax at the point at which they are transferred for use.

When a construction contractor is the seller of materials that he/she installs, the sale of the materials is a retail sale. Consequently, there are no circumstances under which a construction contractor may accept a resale certificate from a prime contractor, interior decorator, department store, or others for materials, which the contractor furnishes and installs. Also, a prime contractor may not issue a resale certificate for materials that are purchased and delivered to the jobsite and are subsequently installed by the subcontractor, as the prime contractor is regarded as the consumer of the "materials" (Annotation 190.0980).

Construction contractors (other than U.S. construction contractors) are also generally regarded as retailers of fixtures, which they furnish and install and, under most circumstances, construction contractors may not accept a resale certificate from a prime contractor, interior decorator, department store, or others for fixtures, which they furnish and install. However, a construction contractor may furnish and install a fixture for a person, other than the owner or lessor of the realty, who intends to lease the fixture in place as tangible personal property and pay tax measured by rental receipts. In this case, the contractor may take a resale certificate from the lessor at the time of the transaction, and the sale to the lessor will be considered a sale for resale. Under no other circumstances, may construction contractors accept a resale certificate for fixtures that they furnish and install.

It should be noted that under no circumstances are contractors, who perform construction contracts for the United States government, to be regarded as retailers of materials or fixtures they furnish and install on such contracts.

INTERSTATE AND FOREIGN COMMERCE 1206.15

Sales of buildings without installation or erection are exempt from the tax *when the contract of sale provides that the seller shall deliver the buildings to the purchaser at an out-of-state point.* This condition of the contract may be fulfilled by shipping the building to a point outside the state by means of:

1) facilities that are operated by the retailer,
2) delivery by the retailer to a carrier for shipment to a consignee at such point,
3) delivery by the retailer to a custom's broker or forwarding agent for shipment outside this State.

Sales of buildings or other tangible personal property are also exempt if they are sold to foreign purchasers for shipment abroad and delivered to a conveyance furnished by the purchaser for the purpose of carrying and taking the property abroad that demonstrates an irrevocable commitment of the property into the exportation process. Proof must be retained that the property was carried to the foreign destination. (See Regulation 1620.)

MATERIALS AND FIXTURES USED OUTSIDE OF CALIFORNIA 1206.20

Where contractors have a contract to improve real property outside of California, their use of materials and their sales of fixtures are not subject to the tax provided they fulfill certain conditions. The sales of fixtures, which occur upon installation, are sales outside of California and tax does not apply to the sale by virtue of the fact that title passes at the out-of-state point. The purchases of materials in California are not subject to the tax under the conditions specified in Sales and Use Tax Law Section 6386. Those conditions are:

1) The purchaser must hold a valid seller's permit,
2) The property purchased must be used in performance of a contract to improve real property that is located outside of California, and
3) The purchaser must certify in writing to the seller at the time of purchase that the conditions specified above are met.

This exemption is available only if at the time of the purchase the contractor certifies in writing to the seller that he/she holds a valid California seller's permit (giving the number of that permit and identifying the property purchased) and states that the property will be used in the performance of a contract to improve real property located outside of California. The certificate must be signed by the contractor or an authorized employee. Such certificate may appear in the body of a purchase order that bears the signature of the purchaser. Any certificate given subsequent to the time of purchase will not be recognized.

If the property purchased under a certificate is used by the contractor in any other manner or for any other purpose than that stated on the certificate, the contractor shall be liable for the sales tax as if he/she were the retailer making a retail sale of the property at the time of such use, and the sale price of the property to the contractor shall be deemed the gross receipts from the sale.

TAX-PAID PURCHASES RESOLD 1206.25

If materials or fixtures are purchased tax paid or reported on Line 2, the contractor may claim credit for the cost of tax-paid materials or fixtures sold over-the-counter or reported on time and material contracts or retail sales. If the contractor sells short ends or pieces which are not used other than in severing them from larger units purchased by the contractor and on which he/she has paid sales tax reimbursement or use tax, the contractor may claim the deduction for tax-paid purchases resold, but the amount of the deduction may not exceed the price at which he/she sells such short ends or pieces.

BAD DEBTS 1206.30

When a contractor, other than a United States contractor, is considered to be the retailer of materials which the contractor installs, or the retailer of fixtures, or makes over-the-counter sales, the contractor is entitled to a bad debt deduction in accordance with the provisions of Regulation 1642. On contracts where the contractor is considered to be a consumer, a bad debt deduction is not allowable.

Contractors may claim a deduction for bad debts found to be uncollectible and charged off for income tax purposes. If the uncollectible amounts include exempt items, such as installation labor, as well as taxable items, a bad debt deduction may be claimed only in respect to the unpaid amount upon which the tax has been paid. In determining this amount, all payments and credits to the accounts must be apportioned to the taxable and nontaxable elements that make up the amount the purchaser agreed to pay.

- If any accounts found worthless and charged off for income tax purposes are subsequently collected in full or in part, the amount collected must be included in the first return filed after receiving the funds.No deduction is allowable for expenses the contractor incurred in attempting to collect the bad account.
- No deduction is allowable for that portion of the debt recovered and retained by or paid to a third party as compensation for collecting the account.

SPECIAL PROVISIONS APPLICABLE TO CONTRACTORS 1207.00

APPLICATION OF REGULATION 1700, REIMBURSEMENT FOR SALES TAX 1207.05

The auditor should check billings for tax reimbursement procedures, and in all cases reconcile sales tax accruals for the audit period. The auditor should also be aware of situations regarding excess tax reimbursement. When an amount represented by a contractor to a customer as constituting reimbursement for sales tax is computed upon an amount that is not taxable or is in excess of the taxable amount and is actually paid by the customer to the contractor, the amount so paid is excess tax reimbursement. Generally, in excess tax reimbursement situations, the seller is required to refund the excess tax reimbursement to the customer or remit the excess tax reimbursement to the State. However, the auditor should be aware of certain offset provisions discussed below.

If a person who has collected excess tax reimbursement on a transaction fails or refuses to refund it to the customer from whom it was collected, the excess tax reimbursement shall be offset against any tax liability of the taxpayer on the same transaction. The "same transaction" means all activities involved in the acquisition and disposition of the same property. The same transaction may involve several persons, such as a vendor, a subcontractor, a prime contractor, and the final customer. Any excess tax reimbursement remaining after the offset must be refunded to the customer or paid to the State. An offset of a taxpayer's own tax liability against tax reimbursement collected from a customer can be made only with respect to transactions in which possession of the property upon which the taxpayer's liability is based is transferred, either permanently or temporarily, to the customer. Thus, an offset of excess tax reimbursement is not allowed for consumable supplies purchased without tax or tax reimbursement paid by the contractor because the consumable supplies were not installed.

The following examples illustrate the application of tax to certain transactions:

- A contractor furnishes and installs materials under a lump-sum construction contract for the improvement of real property, and collects tax reimbursement on the total contract price. The contractor must pay use tax, or sales tax reimbursement to the vendor, on the purchase price of the materials consumed in performing the contract. This tax or tax reimbursement may be offset against the tax reimbursement collected from the contractor's customer. The balance of the tax reimbursement collected from the customer must be returned to the customer or paid to the State.
- A subcontractor furnishes and installs ex-tax materials under a lump-sum contract to improve real property. The prime contractor collects tax reimbursement from the prime contractor's customer on the total contract price and pays all the tax reimbursement collected to the State. The subcontractor's use tax liability on the materials consumed in performing the contract will be offset against the tax reimbursement paid to the State by the prime contractor, and the subcontractor has no further tax liability on the transaction. The tax reimbursement paid to the State by the prime contractor in excess of the use tax liability of the subcontractor will be refunded to the prime contractor only if it is returned to the customer.

A subcontractor who claims that their tax liability on a transaction should be offset against tax reimbursement paid to the State by the prime contractor has the burden of proving that tax reimbursement was in fact paid to the State on the same transaction by the prime contractor. In the absence of such proof, no offset will be allowed.

In audits of the prime contractor, the prime contractor should be given an opportunity to choose among the following options:

1. Refund excess tax reimbursement to the customer. Under this alternative, the subcontractor would owe tax on the cost of the materials and no offset would be available.
2. Take no further action. Under this alternative, the subcontractor may offset its use tax liability against the tax reimbursement paid to the State by the prime contractor.
3. Refund to the customer the difference between what the prime contractor collected as tax reimbursement and the subcontractor's use tax liability. However, in order to choose this option the prime contractor must establish the subcontractor's tax cost for each transaction. Under this alternative, the subcontractor may offset its use tax liability against the tax reimbursement paid to the State by the prime contractor to the extent that such amounts have not previously been refunded.

In situations where an offset is allowed, the subcontractor should be informed that the item in question is being accepted because the prime contractor has paid the tax and not because a resale certificate was accepted by the subcontractor. As part of the verification of an offset, the auditor should obtain a statement from the prime contractor that the tax was paid to the State and that no refund will be claimed for the excess tax reimbursement used to offset the subcontractor's tax liability. An appropriate audit memo (BOE–1164) should be prepared for placement in the prime contractor's file.

JOB REPORTING BASIS — JOBS IN PROCESS 1207.10

Contractors who may legitimately purchase materials for resale become liable for use tax on materials, and should report tax thereon, in the reporting period in which the material is withdrawn from stock for use in performing a construction contract. Fixtures, however, should be included in the reporting period in which installation is made. Thus, where the auditor encounters an audit where the contractor is reporting construction jobs at the time of completion rather than as outlined above, the auditor should establish as additional measure of tax in the audit any materials and fixtures on all jobs in process as of the end of the audit period.

Contractors who do not make retail sales should not be purchasing materials for resale. If they erroneously purchase materials for resale, they are liable for tax on their purchases at the time of the purchase. See the guidelines for the application of tax provided in Section 1206.10.

TRANSPORTATION CHARGES 1207.15

It should be noted that, particularly in the construction material industry, delivery of such items as lumber, concrete, structural steel, etc., is generally made by facilities of the retailer. Thus, the freight charges by the seller to the contractor may or may not be subject to tax, depending upon the conditions of the sale. The same principles that apply to freight charges on the purchase of tangible personal property also apply to the sale of tangible personal property by the contractor. For example, where a sale is made of a prefabricated fixture without installation, no tax will apply to separately stated freight charges made for the shipment of the fixture by independent contract or common carrier. Where tangible personal property is shipped in the seller's own truck or facility, separately stated charges for such delivery are subject to tax unless the sales agreement specifically provides that title to the goods passes at the seller's place of business. Frequently it will be found, however, that such transportation charges will be charged to "Transportation Expense" or "Freight In" rather than to "Purchases." Thus, the auditor should exercise care to verify that the taxpayer has included such taxable transportation charges in recording and reporting ex-tax material cost.

Construction contractors who bill their customers for sales tax on materials used on time and material contracts are assumed to be "retailers" of the materials in the absence of convincing evidence to the contrary. Quite often, contractors will deliver materials to jobsites by use of their own transportation facilities and make a separate charge to the customer for such delivery. Normally, unless otherwise stipulated by the contract, title to the materials passes at the time of delivery to the jobsite. Under such circumstances, when delivery is by the facilities of the contractor/retailer, the sales of materials and such separately stated delivery charges are subject to sales tax. However, separately stated delivery charges may be exempt from the tax if title to the materials explicitly passes to the customer prior to delivery. See Regulation 1628, Transportation Charges.

"LAST ACT" TEST 1207.20

Dumping of rock, concrete, road oil, etc., may be either an improvement to realty, or a sale of tangible personal property, dependent upon whether the dumping by the seller or contractor constitutes the "last act." If the material must be spread, tamped, smoothed, or otherwise later set in place to real property by another person, it constitutes a sale of tangible personal property.

Examples of the "last act" test are as follows:

> Persons who agree to furnish and apply asphalt or other similar products on a lump-sum basis are considered construction contractors and consumers of such materials, provided such application constitutes improvement of real property. The materials must be applied in such a manner as to convert them to real property upon application.
>
> A person who sells and delivers liquid asphalt to an area *other than a roadway* where it is mixed with dry material and subsequently used for road surfacing is a retailer of the liquid asphalt. A person who furnishes and spreads liquid asphalt in its final resting place upon a roadway is a construction contractor and the consumer of the liquid asphalt. A person who sells and delivers liquid asphalt to the roadway is the retailer of the asphalt if the person is not responsible for subsequent mixing, spreading, and compacting of the material.

Regulation 1806, Construction Contractors, defines the basis upon which the state administered local sales and use taxes are applied to construction contractors. As noted therein, the jobsite is considered the place of sale of fixtures and the place of use of materials.

For purposes of allocating local sales and use tax from construction contracts, the following classification and procedures have been provided:

a) If the contractor reports $600 or less a year in local tax, the account is identified as an SR account and is assigned a countywide area code ending in "99" for the county where the place of business is located. No allocation is required for reporting by such a taxpayer.

b) A contractor reporting more than $600 per year local tax is identified as an SR S account and requires a special local tax allocation by county of jobsite. Over-the-counter sales, however, are allocated to the specific location of the taxpayer's place of business.

Effective January 1, 1995, local tax from construction contractors may be allocated to the local jurisdiction of the specific construction jobsite. This is accomplished by a contractor, or subcontractor, electing to obtain a sub-permit for the jobsite. The contracts, or subcontracts, that are for $5,000,000 (5 million dollars) or more are eligible for this election. This qualifying contract price applies to each contract or subcontract for work performed at the jobsite, and not to the total value of the prime contract.

Construction contractors may elect to allocate local tax to a specific jurisdiction on Schedule C by obtaining a sub-permit for a specific jobsite. If this election is not made, local tax will be allocated in the usual manner by using Schedule B.

Conditions of the Sub-Permit

(a) The estimated completion date of the contract is to be obtained at the time of registration. The sub-permit shall be closed-out by the district office immediately after the sub-permit is registered using a close-out date of the estimated completion date of the contract, plus six months.

(b) The contractor's election to obtain a sub-permit for a jobsite is irrevocable and the sub-permit may not be cancelled or closed-out for the life of the contract.

(c) The sub-permit is subject to revocation action as provided by the Sales and Use Tax Law.

(d) Permits should not be issued to contractors who only install materials purchased in-state and are not normally retailers of materials. The resolution does not allow contractors to purchase tangible personal property for resale, including materials, which they will consume at the jobsite.

(e) Contractors may not purchase machinery and equipment to be used on the construction job without payment of sales tax in order to allocate the use tax to the specific jobsite.

(f) Regarding machinery and equipment sold by the contractor as part of the contract, local tax should continue to be allocated to the contractor's permanent place of business where the principal negotiations take place in accordance with Regulation 1802.

(g) Per Regulation 1806, local tax must still be allocated countywide for jobsites which have contracts of $5,000,000 or more where the contractor has elected not to obtain a sub-permit. However, if the election is made, no local tax will be reallocated for periods prior to the reporting period for the start date of the sub-permit.

(h) No documentation of the $5,000,000 contract price or value of work remaining is required to issue a sub-permit for a jobsite unless the value of the work appears to be substantially less than $5,000,000.

Also see "Decision Tables" in Chapter 2 (Exhibits 19 and 20).

TRANSACTIONS AND USE TAXES 1207.30

The jobsite is regarded as a place of business of a contractor and is the place of sale of "fixtures" furnished and installed by a contractor. The place of use of "materials" is the jobsite. Accordingly, if the jobsite is in a district (or districts) having state-administered transactions (sales) and use taxes, the transactions (sales) tax applies to the sale of fixtures, and the use tax applies to the use of the materials. If the jobsite is not in a district with a state-administered tax, state-administered transactions (sales) tax will not apply to the sale of the fixtures even though the contractor's principal place of business is in a district with such a tax.

The contractor is entitled to a credit against use tax liability for transactions tax reimbursement paid to the retailer of the materials in a district, under the conditions specified in paragraph (b)(1)(E) of Regulation 1823 (18 CCR 1823), Application of Transactions (Sales) Tax and Use Tax. If fixtures are purchased by a contractor tax paid in a district having state-administered transactions (sales) and use taxes, the contractor, upon installing the fixtures in a county without such a tax, is entitled to a credit for the tax of the district of purchase. If the contractor installs the fixtures in a district (or districts) imposing transactions and use taxes at a rate (or combined rate) greater than the district in which the contractor purchased the fixtures tax paid, the contractor is also entitled to a credit for the tax of the district of purchase, but is liable for the transactions tax (or taxes) of the district (or districts) where the fixtures are installed.

FIXED-PRICE CONTRACTS 1207.35

A "fixed-price contract" is a contract that obligates both the buyer and seller to the specified terms. The buyer must be obligated to purchase and the seller must be obligated to sell a determinable quantity of tangible personal property identified by the contract. In addition, if either party has the right to terminate the contract, conditioned only upon notice, whether or not such right is exercised, it is not a "fixed-price contract." Also, if the contract is contingent on the occurrence of an act or an event, it is not a "fixed-price contract."

"Fixed-price" means that the contract price cannot be increased for any reason. In addition, the tax amount or rate must be specifically stated in the contract. A contract for a "fixed-price" includes:

- A unit price contract under which each unit price is a fixed dollar amount which may not be increased or decreased by reason of any changes in tax rates, cost of materials, and so forth.
- A guaranteed maximum contract under which the guaranteed maximum amount cannot be increased by reason of changes in tax rates, cost of materials, and so forth.

The ordinances imposing the Transactions (Sales) and Use Tax contain provisions that state the tax does not apply to the gross receipts from the sales or purchases of tangible personal property in the district, if the seller is obligated to furnish and the buyer is obligated to purchase the property for a *fixed price* pursuant to a contract *entered into prior to the operative date of the ordinance.*

This exemption applies to the fixed-price contract between the contractor and his/her customer only. The construction contractor may not file an exemption certificate with his/her suppliers for the purpose of obtaining a refund of new transactions taxes enacted during the period of a contract. The contractor must be a party to a fixed-price contract directly with his/her supplier to be entitled to this exemption.

LIABILITY BY TYPE OF CONTRACT 1207.40

Contractors in General and United States Construction Contractors					
Kind of Item	How Acquired	Lump-Sum or Cost-Plus	Time and Material	Time and Material with Sales Tax Added to Billed Price of Materials	United States Construction Contractors
MATERIALS	Purchased ex-tax	Cost	Cost	Billed price	Cost
	Purchased tax paid	None	None	Excess of billed price over cost	None
	By conversion of realty[1]	None	None	Billed price	None
FIXTURES	Purchased ex-tax	Cost	Billed price	Billed price	Cost
	Purchased tax paid	None	Excess of billed price over cost	Excess of billed price over cost	None
	Manufactured from ex-tax material by installing contractor	Prevailing price to contractors or, if that cannot be established, the amount stated in price lists, bid sheets or other records or manufactured cost, including profit, to contractor-manufacturer	Billed price	Billed price	Cost
	Manufactured from tax paid material by installing contractor	Excess of prevailing price, or manufactured cost,[2] including profit, over tax paid cost of materials	Excess of billed price over tax paid material cost	Excess of billed price over tax paid material cost	None[3]

1. Rock or dirt taken from contractor's own property.
2. See section 1203.05 for the definition of "manufactured cost."
3. Although the cost of the contractor's own labor is not subject to tax, tax does apply to the cost of outside fabrication labor.

LISTING OF MATERIALS, FIXTURES, AND MACHINERY AND EQUIPMENT 1207.45

The following listings of specific items of materials and fixtures should be helpful in conducting audits. The method of attachment to the realty or the use of the item may result in a change of classification.

Items usually regarded as *materials*:

- Asphalt
- Bricks
- Builders' hardware
- Caulking material
- Cement
- Conduit
- Doors
- Ducts
- Electric wiring and connections
- Flooring
- Glass
- Gravel
- Insulation
- Lath
- Lead
- Lime
- Linoleum
- Lumber
- Macadam
- Millwork
- Mortar
- Oil
- Paint
- Paper
- Piping, valves, and pipe fittings
- Plaster
- Power poles, towers, and lines
- Putty
- Reinforcing mesh
- Roofing
- Sand
- Sheetmetal
- Steel
- Stone
- Stucco
- Tile
- Wall coping
- Wallboard
- Wallpaper
- Wall-to-wall carpeting (When affixed to the floor)
- Weather stripping
- Windows
- Window screens
- Wire netting and screen
- Wood preserver

Items usually regarded as *fixtures*:

- Air conditioning units
- Awnings
- Burglar alarm and fire alarm fixtures
- Cabinets, counters, and lockers (prefabricated)
- Electric generators (affixed to and accessory to a building, structure or fixed works)
- Elevators, hoists, and conveying units
- Furnaces, boilers, and heating units
- Lighting fixtures
- Plumbing fixtures
- Refrigeration units
- Signs
- Telephone switchboards and instruments
- Television antennas
- Transformers and switchgear
- Vault doors and equipment
- Venetian blinds

Machinery and Equipment

- Drill presses
- Electric generators (unaffixed, or, if affixed, which meet the requirements of Regulation 1521, subparagraph (a)(l)(B)(6)
- Lathes
- Machine tools
- Moving parts of cranes
- Printing presses

Not Machinery or Equipment

Lists of items which are usually:

- Fixtures and materials as defined in Regulation 1521
- Wiring, piping, etc., used as a source of power, water, etc., for machinery and equipment
- Radio transmission antennas
- Large tanks (i.e., over 500-barrel capacity)
- Fire alarm systems
- Street light standards
- Cooling towers other than small prefabricated cooling units

Note: Please refer to Regulation 1521 and Sales and Use Tax Annotations on construction contractors (numbered 190.0000) for a further listing of specific property defined as materials or fixtures.

PARTICULAR APPLICATIONS 1208.00

DRAPERIES AND DRAPERY HARDWARE 1208.10

Persons who contract to sell and install draperies including drapery hardware, such as brackets, rods, tracks, etc. are retailers of the items which they furnish and install.

Tax applies to the entire contract price exclusive of the charge for installation, which charge should be separately stated. Installers who furnish drapery hardware or other tangible personal property may accept resale certificates from department stores or other sellers to furnish and install the draperies and drapery hardware.

The department stores or other sellers furnishing resale certificates are required to pay the tax to the state upon their selling price of the draperies and drapery hardware, exclusive of installation charges. The installer should segregate his or her installation charge in order for the department store or other seller to properly segregate its charge attributable to installation for purposes of determining its taxable gross receipts.

PREFABRICATED CABINETS 1208.15

A cabinet will be considered to be "prefabricated" and a "fixture" when 90 percent of the total direct cost of labor and material in fabricating and installing the cabinet is incurred prior to affixation to the realty. In determining this 90 percent, the total direct cost of all labor and materials in fabricating the cabinet to the point of installation will be compared to the total direct cost of all labor and materials in completely fabricating and installing the cabinet. If more than one cabinet is fabricated and installed under the contract, each cabinet will be considered separately in determining whether the cabinet is prefabricated.

PREFABRICATED BUILDINGS 1208.20

Prefabricated units such as commercial coaches, house trailers, etc., registered with the Department of Motor Vehicles or the Department of Housing and Community Development, are tangible personal property even though they may be connected to plumbing and utilities. A mobilehome that meets or is modified to meet all applicable building codes and regulations and that is permanently affixed to realty is an improvement to realty and is not personal property. A contract to furnish and install a prefabricated or modular building that is not a factory-built school building (relocatable classroom) is a construction contract whether the building rests in place by its own weight or is physically attached to realty. It is immaterial whether the building is erected upon or affixed to land owned by the owner of the building or is leased to the landowner or lessee of the land.

Generally, a contract to furnish and install a small prefabricated building, such as a shed or kiosk, that is movable as a unit from its site of installation is a construction contract only if the building is required to be physically attached to real property by the seller upon a concrete foundation or otherwise. The sale of such a unit to rest in place by its own weight, whether upon the ground, a concrete slab, or sills or piers, is not a construction contract even though the seller may deliver the unit to its site of use.

Prefabricated or modular buildings which are "factory-built housing" where permanently affixed to the realty are improvements to realty. The manufacturer of factory-built housing who contracts to furnish and install the factory-built housing manufactured by him or her is the consumer of the materials used in building and installing the factory-built housing and the retailer of the fixtures.

FACTORY-BUILT SCHOOL BUILDINGS 1208.25

A contract to furnish and install a factory-built school building is not a construction contract but rather is a sale of tangible personal property.

The term "factory-built school building" (relocatable classroom) means and includes:

- **Effective September 13, 1990:** Any building which is designed or intended for use as a school building and is wholly or substantially manufactured at an offsite location for the purpose of being assembled, erected, or installed on a site owned or leased by a school district or a community college district. A factory-built school building must be designed and manufactured in accordance with building standards adopted and approved pursuant to Chapter 4 (commencing with Section 18935) of Part 2.5 of Division 13 of the Health and Safety Code and must be approved by the structural safety section in the office of the State Architect.

The term does not include buildings licensed by either the Department of Motor Vehicles or the Department of Housing and Community Development. The term also does not include prefabricated or modular buildings which are similar in size to, but which are not, "factory-built school buildings." It is immaterial whether the building is erected upon or affixed to land owned by the owner of the building or is leased to the landowner or lessee of the land.

The term "consumer" means and includes:

- **Effective September 13, 1990:** Either (1) a school district or a community college district or (2) a contractor who purchases a factory-built school building for the purpose of fulfilling the requirements of an existing contract with a school district or a community college district to furnish and install such building.

The term "place of sale" means and includes:

- The place of sale or purchase of a factory-built school building is the place of business of the retailer regardless of whether the sale of the building includes installation or whether the building is placed upon a permanent foundation (it is not the jobsite location).

Tax applies to 40 percent of the sales price at which the factory-built school building is sold to the consumer, excluding on-site installation labor. Exhibit 4 provides an example of the exemption certificate to be completed by the purchaser and retained by the retailer in order for the retailer to exclude 60 percent of the gross receipts from the measure of tax. See Regulation 1521 for further details.

FACTORY-BUILT HOUSING 1208.30

Factory-built housing (defined in Regulation 1521.4) includes only those units approved by the Department of Housing and Community Development or by the local building authority under contract with the Department. State insignias are issued by the Department of Housing and Community Development and attached to each unit at the factory before shipment.

Factory-built housing includes a residential building, dwelling unit, or an individual dwelling room or combination of rooms thereof, or building component, assembly, or system, so manufactured that all of its parts cannot be inspected prior to affixation to realty without disassembly, damage, or destruction, including units designed for use as part of an institution for resident or patient care, which is either wholly manufactured or is in substantial part manufactured at an offsite location to be wholly or partially assembled onsite in accordance with regulations adopted by the Commissioner of Housing and Community Development of the State of California or in accordance with applicable local building requirements if such factory-built housing is inspected and approved by the local enforcement agency at the place and time of manufacture pursuant to Section 19990 of the Health and Safety Code.

Factory-built housing also includes "modular housing," "sectionalized housing," "modular," " utility," or "wet cores;" and "materials and fixtures" as defined in Regulation 1521 which are sold or purchased as a part of the factory-built housing package and installed in the resulting structure.

Factory-built housing does not include a "mobilehome," "precut housing packages" where more than 50 percent of the package consists of precut lumber only, "panelized construction" which will not form a complete housing structure, materials, fixtures, or other components which are not sold or purchased as a part of the factory-built housing package, "freestanding appliances," and any other furnishings (except wall-to-wall carpet).

Tax applies to 40 percent of the sales price of the factory-built housing sold directly to a consumer for use in erecting or remodeling a building on land to be used for residential dwellings or as an institution for resident or patient care. A retailer who makes retail sales of "factory-built housing" that claims to be subject to tax measured by 40 percent of the purchase price must obtain from the consumer a signed "60 percent exclusion certificate." The retailer must retain this certificate to support such sales. See Regulation 1521.4 for certificate.

If any other use is made of the factory-built housing, tax applies to the full selling price or to 60 percent of the sales price if purchased tax-paid with tax measured by 40 percent of the sales price.

Where a manufacturer contracts to furnish and install factory-built housing, the manufacturer is the consumer of the materials used and the retailer of the fixtures. Tax applies to the manufacturer in this situation in accordance with Regulation 1521 rather than 1521.4.

ON-PREMISE ELECTRIC SIGNS 1208.35

Operative October 1, 2000, subdivision 1521(c)(12) allows contractors who furnish and install on-premise electric signs to report tax on 33% of the total contract price of a job. Total contract price includes all charges for materials, fabrication labor, installation labor, overhead, profit, and any other charges associated with the sale and installation of the sign. Auditors should review contracts to determine if the contractor has reported tax on 33% of the total contract price, as defined. Auditors should also perform an accountability test to ensure that this reporting method has adequately accounted for all materials used in the production of on-premise electric signs.

MODULAR FURNITURE 1208.40

Effective December 1, 1999, Regulation 1583, *Modular Systems Furniture*, provides guidelines for sales of modular systems furniture. The regulation specifically states that a contract to sell and install modular systems furniture is a contract for the retail sale of the tangible personal property and not a construction contract. For contracts to sell and install modular systems entered into on or after October 1, 1999, the regulation allows persons selling and installing the modular systems to claim 10 percent of the total contract price, net of charges attributable to free-standing furniture, as the charge for installation labor. When auditing sellers of modular systems furniture, auditors should use the provisions of Regulation 1583 to determine the proper application of tax, not the provisions of Regulation 1521.

SOLAR ENERGY SYSTEMS 1208.50

Regulation 1521 defines a solar energy system as any solar collector or other energy device that provides for the collection and distribution of solar energy and, where applicable, the storage of solar energy. A construction contract to furnish and install a solar energy system generally involves furnishing and installing both materials and fixtures. Refer to Regulation 1521 for a list of items in a solar energy system that are classified as materials or fixtures. At times, contractors installing rack mounted solar panels will affix the solar panels to the rack on the ground, lift a grouping of solar panels (solar array) to the roof, and then bolt the mounting brackets to the roof. A labor charge to affix solar panels purchased in a completed condition to a mounting system is not subject to tax. Thus, when solar panels are purchased in a completed condition, it is immaterial that the labor takes place on the ground rather than the rooftop. The labor to affix those panels to the mounting system is not subject to tax.

CONSTRUCTION CONTRACTORS PURCHASING QUALIFIED FARM EQUIPMENT AND MACHINERY 1208.60

Revenue and Taxation Code section 6356.5 (See also Regulation 1533.1, *Farm Equipment and Machinery*), provides a partial exemption for the sale of qualifying farm equipment and machinery to qualified persons for use primarily in producing and harvesting agricultural products. A qualified person who purchases or leases qualifying property from a California retailer, or registered out-of-state retailer required to collect use tax, must provide the retailer with a partial exemption certificate in order to claim the partial exemption. To be relieved from the liability for sales tax subject to the partial exemption or the duty of collecting use tax subject to the partial exemption, the retailer must timely, and in good faith, accept a partial exemption certificate from the qualified person. The retailer must maintain the partial exemption certificate in his or her records.

Construction contractors are generally not regarded as qualified persons as defined in Regulation 1533.1. Regulation 1521, *Construction Contractors*, specifies that construction contractors are regarded as retailers of fixtures, machinery and equipment and other tangible personal property which they furnish and install in the performance of a construction contract. Under certain circumstances, a construction contractor may also be the retailer of materials they furnish and install. As retailers, construction contractors are required to maintain a seller's permit. A construction contractor holding a valid seller's permit may issue a proper resale certificate to purchase fixtures, machinery and equipment, and other tangible personal property including qualifying farm equipment and machinery, for resale to a qualified person. As a retailer, a construction contractor must timely, and in good faith, accept a partial exemption certificate from the qualified person in order to be relieved from the liability of tax subject to the partial exemption.

California retailers, and registered out-of-state retailers required to collect use tax, may not accept a partial exemption certificate from a construction contractor for purchases of qualifying farm equipment and machinery for resale to a qualified person. Retailers may only accept partial exemption certificates from qualified persons purchasing qualifying property. However, retailers may timely accept a valid *resale certificate* in good faith from a construction contractor holding a seller's permit who purchases qualifying farm equipment and machinery, or any other property, for resale. In such a case, the sale by the retailer to the construction contractor would be non-taxable.

In an audit of a retailer selling qualified farm equipment and machinery, staff should accept claimed sales for resale made to construction contractors, who purchase qualifying farm machinery and equipment that will be incorporated into the real property, when the retailer timely takes, in good faith, a valid resale certificate from the construction contractors. In absence of evidence to the contrary, staff should accept such resale certificates as having been taken in good faith by the retailer. See Regulation 1668, *Sales for Resale*, subdivision (c).

See AM section 0422.15, *Solar Power Facility*, for information on construction contracts of solar power facilities that may qualify for the farm equipment and machinery partial exemption as provided in Regulation 1533.1.

PARTIAL EXEMPTION FOR MANUFACTURING AND RESEARCH & DEVELOPMENT EQUIPMENT 1208.65

As relevant to construction contracts, Revenue and Taxation Code (RTC) section 6377.1 (see also Regulation 1525.4, *Manufacturing and Research & Development Equipment)* provides a partial sales and use tax exemption for the sale or purchase of (1) qualified tangible personal property; (2) purchased for use by a contractor purchasing that property for use in the performance of a qualified construction contract for a qualified person; (3) who will use the improvement on or to real property or the special purpose building and foundation as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or as a research or storage facility for use in connection with those processes.

The partial exemption applies to qualifying sales and purchases made on or after July 1, 2014 and before July 1, 2022. The legislation limits the allowable exemption to $200 million in qualifying purchases each calendar year for each qualified person.

When performing qualifying construction contracts for qualified persons, construction contractors should obtain a BOE-230-M, *Partial Exemption Certificate for Manufacturing, Research and Development Equipment,* from the qualified person. If a construction contractor takes a certificate in good faith from a qualified person, and the qualifying person is later found to not qualify for the partial exemption, the qualifying person who issued that certificate will be liable for the payment of tax.

Construction contractors who purchase qualified tangible personal property for use in the performance of a construction contract for a qualified person, who will use that property in a qualifying manner, must issue a partial exemption certificate to the retailer in order for the retailer to claim the partial exemption. The construction contractor may use form BOE-230-MC, *Construction Contracts—Partial Exemption Certificate for Manufacturing, Research and Development Equipment*. If a contractor issues a certificate to its vendor to purchase tangible person property for use in a construction contract for a qualified person subject to the partial exemption, and instead uses those materials for another purpose, the contractor will be liable for the tax.

A construction contractor can also be a "qualified person" if they manufacture tangible personal property provided they meet the criteria in Regulation 1525.4(b)(8)(A). When a construction contractor is a qualified person, the contractor is subject to the $200 million yearly limitation provisions separate from the limitation provisions that apply to the contractor's customers. As a qualified person, the contractor may issue a BOE-230-M partial exemption certificate to their retailer and purchase qualified tangible personal property subject to the partial exemption, provided all other requirements are met.

Equipment used by a construction contractor in the performance of a construction contract for a qualified person does *not* qualify for the partial exemption. *For example,* the lease of a crane used in the construction of a special purpose building does not qualify.

Issuance of a partial exemption certificate certifies in writing that the tangible personal property purchased will be used in a manner entitling the seller to regard the gross receipts from the sale as partially exempt from the sales tax. Purchasers are responsible for tracking their purchases to ensure they do not exceed the $200 million annual cap. If a purchaser exceeds the $200 million limitation, or if within one year from the date of purchase, removes the property from California, converts the property for use in a manner not qualifying for the exemption, or uses that property in a manner not qualifying for the exemption, the purchaser is liable for payment of the sales tax, with applicable interest as if the purchaser was a retailer making a retail sale.

See AM Chapter 4, section 0422.25 for audit procedures.

Table of Exhibits

Accountability Test (Based on Taxable Cost of Construction Contracts) ..... Exhibit 1
Accountability Test (Based on Taxable Measure of Construction Contract) ..... Exhibit 2
Reconciliation of Taxable Measure (Construction Contracts and Sales) ..... Exhibit 3
Exemption Certificate — Factory-built School Buildings ..... Exhibit 4
Standard Material Accountability Test for Construction Contractors ..... Exhibit 5

Accountability Test (Based on Taxable Cost of Construction Contracts)

Exhibit 1

Accountability Test for Period 1/1/xx to 12/31/xx Based on Taxable Cost of Construction Contracts	12A - 1
	SR GH 98-000000
	S. M.
	3/13/2000

	A	B	C	D	E	F
REF						
1		Beginning Inventories (1/1/xx)				
2	<P J>	Goods in Warehouse				$ 8,540
3	<P J>	Materials in Jobs in Process				1,504
4	<P J>	Purchases				488,612
5	(L2+L3+L4)	Cost of Goods Available for Sale or Use				$ 498,656
6		Less: Ending Inventories (12/31/xx)				
7	<P J>	Goods in Warehouse				15,980
8	(L5 - L7)	Costs To Be Accounted For:				$ 482,676
9		Less: Costs of Sales	Cost of Retail Sales	Cost of T & M Contract Fixtures	Cost of Resales	
10	<S J>	Sales	$ 27,153	$ 57,623	$ 6,211	
11	<12A-2>	Audited Markup Factor (per test)	133.37%	164.21%	140.00%	
12	(L10 / L11)	Cost of Sales	$ 20,359	$ 35,091	$ 4,436	59,886
13	(L8 - L12)	subtotal				$ 422,790
14	<P J>	Less: Tax Paid Purchases				18,481
15	(L13 - L14)	Audited Ex-Tax Costs of Construction Contracts (Lump Sum)				$ 404,309
16	<P J>	Recorded Ex-Tax Costs of Construction Contracts (Lump Sum)				$ 312,838
17	(L15 - L16)	Understatement				$ 91,471
18						
19		Analysis of Understatement				
20	<P J>	Ending Inventory - Materials in Jobs in Process				$ 4,315
21	(L17 - L20)	Other Errors in Contracts				$ 87,156
22	(L21 / L16)	Percentage of Recurring Errors				27.86%
23						
24						
25						
26						
27						
28						
29						
30						

— Adjusted for Accounts Payable if on a cash basis

Note: This schedule illustrates an Accountability Test based on construction contract costs. The materials were reported on a job-completed basis. No fixtures were manufactured by the contractor. Some fixtures were contracted and billed on a lump-sum basis, while others were billed on a time-and-materials basis. Tax was added to the billed price of fixtures on time and material jobs. Since inventories were found accurate, separate accountability tests were made for each fiscal year of the audit period.

WORKSHEET=12A-1
WORKBOOK=chap-12_exhibits.xls

Accountability Test (Based on Taxable Measure of Construction Contract)

Exhibit 2

Accountability Test for Period
1/1/xx to 12/31/xx
Based on Taxable Measure of
Construction Contracts

12A - 1
SR GH 98-000000
S. M.
3/13/2000

	A	B	C	D	E
REF					
1	<P J>	Beginning Goods in Warehouse Inventory (1/1/xx)			$ 8,100
2	<P J>	Purchases			482,562
3	(L1 + L2)	Cost of Goods Available for Sale or Use			$ 490,662
4	<P J>	Less: Ending Inventory - Goods in Warehouse (12/31/xx)			14,258
5	(L3-L4)	Costs to be Accounted For			$ 476,404
6		Add: Markup on Fixtures Billed T & M			
7	<S J>	Sales of Fixtures		54,704	
8	<12A-2>	Audited Markup Factor (per test)		164.00%	
9	(L7 / L8)	Cost of Fixtures		33,356	
10	(L7 - L9)	Markup			21,348
11	(L5 + L10)	Subtotal			$ 497,752
12		Less: Computed Costs of Sales	Retail Sales	Resales	
13	<S J>	Sales	$ 55,121	$ 41,210	
14		Audited Markup Factor (per test)	133%	140%	
15	(L13 / L14)	Costs of Sales	41,444	29,436	70,880
16	(L11 - L15)	Subtotal			$ 426,872
17	<P J>	Less: Tax Paid Purchases			2,510
18	(L16 - L17)	Audited Taxable Measure of Contracts			$ 424,362
19	<P J>	Recorded Taxable Measure of Contracts			$ 371,215
20	L18 - L19)	Understatement			$ 53,147
21					
22					
23					
24					
25					
26					
27					
28					
29					
30					

— Adjusted for Accounts Payable if on a cash basis

Note: This schedule illustrates a 12-month Accountability Test based on taxable measure of contracts. The materials were reported when withdrawn from inventory for use in a contract and were billed lump sum. All fixtures were billed time and material with no tax added. Inventories were found accurate. Therefore, separate accountability tests were made for each fiscal year.

WORKSHEET=12A-1
WORKBOOK=chap-12_exhibits.xls

Reconciliation of Taxable Measure (Construction Contracts and Sales)

Exhibit 3

Reconciliation of taxable Measure
for Period 1/1/xx to 12/31/xx
Construction Contracts and Sales

12A - 1
SR GH 98-000000
S. M.
3/13/2000

	A	B	C	D	E	F
REF						
1		Beginning Inventories (1/1/xx)				
2	<P J>		Goods in Warehouse			$ 30,000
3	<P J>		Materials in Jobs in Process			30,000
4	<P J>		Purchases			355,000
5	<P J>		Accounts Payable (12/31/xx)			25,200
6	(L2+L3+L4+L5)		subtotal			$ 440,200
7		Less: Ending Inventories (12/31/xx)				
8	<P J>		Goods in Warehouse		$ 50,000	
9	<P J>		Accounts Payable (1/1/xx)		5,200	
10	<P J>		Tax Paid Supplies included in Purchases		2,000	57,200
11	(L6 - L10)	Total Costs to be Accounted for				$ 383,000
12		Less: Tax Paid Purchases Resold				
13	<P J>		Costs of Sales for Resale			3,000
14	<S J>		Sales		$ 11,000	
15	<12A-2>		Audited Markup Factor		110%	
16	(L14 / L15)					10,000
17	(L11-L13-L16)		subtotal			$ 370,000
18		Add Markups		T & M (Tax Added)	Over the Counter	
19	<S J>		Sales	45,000	80,000	
20	<12A-3>		Audited Markup Factor per test	150.00%	160.00%	
21	(L19 / L20)		Cost of Sales	30,000	50,000	
22	(L19 - L21)		Markup	15,000	30,000	45,000
23	(L17 + L22)	Audited Taxable Measure				$ 415,000
24	<414>	Reported Taxable Measure				$ 261,000
25	(L23 - L24)	Understatement				$ 154,000
26		Analysis of Understatement				
27	<P J>	Materials in Jobs in Process (12/31/xx)				40,000
28	(L25 - L27)	Unidentified Differences				$ 114,000
29						
30						

Note: This schedule illustrates a three-year reconciliation of taxable costs and sales from the records to reported taxable measure for a construction contractor who had no fixtures (i.e. a flooring contractor). Tax was reported on materials on a job completion basis. Some construction contracts were billed lump sum, remainder were billed time and materials Tax was charged on billed price of T&M jobs.

WORKSHEET=12A-1
WORKBOOK=chap-12_exhibits.xls

Claim for 60% Exclusion from Tax on Purchase of Factory-Built School Buildings

(Section 6012.6, Revenue and Taxation Code)

I hereby certify that the factory-built school building that I

_____
(Name of Purchaser - Consumer)

am purchasing under the authority of this certificate from

_____
(Name of Retailer)

will be used as a school building as defined in Sales and Use Tax Regulation 1521. My seller's permit number, if any, is _____.

I further certify that I understand and agree that if the property purchased under the authority of this certificate is used by the purchaser for any purpose other than indicated above, the purchaser shall be liable for payment of tax to the State Board of Equalization at the time of such use measured by 60% of the sales price of the factory-built school building.

Signed by: _____
(Name of Purchaser)

As: _____
(Owner, Partner, Purchasing Agent, etc.)

Date: _____

STANDARD MATERIAL ACCOUNTABILITY TEST FOR CONSTRUCTION CONTRACTORS

Chapter 12
EXHIBIT 5

MATERIAL ACCOUNTABILITY TEST FOR
CONSTRUCTION CONTRACTORS
Period:_____to_____

12A-1
SRGH 98-000000
S.M
03/01/00

REF	A	B	C	D	E
1	COST OF MERCHANDISE SOLD AND/OR CONSUMED ON CONTRACTS				$
2	Less: Cost of Retail Sales		Selling Price	Cost	
3	Retail Sales (ex-tax)				
4	Cost: Divided by markup of_____% plus 100%				
5	Less: Cost of Sales for Resale				
6	Cost: Divided by markup of_____% plus 100%				
7	Less: Cost of Sales in Interstate Commerce				
8	Cost: Divided by markup of_____% plus 100%				
9	Less: Cost of Sales to U. S. Government				
10	Cost: Divided by markup of_____% plus 100%				
11	Other:				
12					
13	TOTAL COST OF MERCHANDISE SOLD	(Col D, L4+…12)			$
14	TOTAL COST OF MERCHANDISE AVAILABLE FOR USE ON CONTRACTS	(L1-13)			
15	LESS: COST OF MERCHANDISE ON WHICH TAX WAS PAID				
16	TOTAL EX-TAX COST OF MERCHANDISE AVAILABLE FOR CONTRACTS	(L14-15)			
17	ADD: OVER-THE COUNTER SALES				
18	TOTAL RETAIL SALES AND CONTRACT MATERIAL	(L16+17)			$
19	TOTAL REPORTED TAXABLE SALES	<414>			$
20	UNDER/OVER-STATEMENT	(L18-19)			$
21	PERCENTAGE OF ERROR	(L20/19)			%

Copy to Taxpayer
Date:_____