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USE TAX: CONTRACTORS

Senate Bill 996 as passed by the Senate
First Analysis (12-7-88)

Sponsor: Sen. Norman D. Shinkle
Senate Committee: Finance
House Committee: Taxation

THE APPARENT PROBLEM:

Under the Use Tax Act, taxpayers are liable to pay a use tax equal to four percent of the price of a property or a service that is purchased out of state and brought into Michigan. A construction contractor who affixes personal property to real estate for others is considered to use or consume the personal property for purposes of the tax. For instance, a homeowner who contracts to remodel his or her house does not pay use tax on the value of the finished product; however, the contractor must pay the use tax on materials used in the construction. The applicability of the use tax to contractors, particularly contractors who purchase raw materials and alter those materials before affixing them to real estate, has been in question for many years and has been the subject of continuing litigation. Specifically, the Department of Treasury has maintained that the use tax applies to the value of personal property affixed to real estate, while some contractors have maintained that the use tax applies only to the value of the raw materials used.

In 1979, the Department of Treasury attempted to assess Honeywell, Inc. for use tax based upon the value of thermostats the company was installing. Honeywell contended that the use tax applied only to the raw materials used in making the thermostats. The case was not decided by the Tax Tribunal until 1985. The Michigan Court of Appeals in 1988 upheld the tribunal's ruling that the department had a right to assess use tax on the price of the property as affixed to the real property (Honeywell, Inc. v. Department of Treasury, Docket No. 88934).

During the litigation process, a 1982 amendment to the act addressed the issue of construction contractors, which the act had not specifically mentioned before the amendment. This amendment, which is still current law, says that the price of personal property subject to the use tax, for a construction contractor who is also a manufacturer, fabricator, or assembler of property for affixation to real estate, is the price that any other person would have to pay if the other person acquired the property from the manufacturer, fabricator, or assembler. This means that a contractor who is also a manufacturer cannot attempt to reduce use tax liability by selling itself property at a price lower than it would charge anyone else. Some contractors feel that the department's application of the 1982 amendment has been too broad and aggressive. Contractors have complained that the department has, in effect, attempted to make them into manufacturers by applying the tax to the value of the personal property as it is attached to the real property rather than the value of the materials as purchased by the contractor. (Reportedly, for example, there is a question over whether the tax should apply to sheet metal purchased to build duct work, or, as the department contends, to the finished duct work.) This has resulted in numerous other disputes between contractors and the department and left many contractors' tax audits unfinished. Contractors claim that for many years they have not known how to factor use tax costs into contracts because, 1) the 1982 language is ambiguous and, 2) the department has been inconsistent in its application of the language. The department has stated that its position is that the price of material upon which the use tax is applied is not the price of raw material but of the finished product. It has been suggested that a solution to the dispute would be to allow the department's view, in general, to prevail for contracts written after 1988, but to allow contractors to settle existing use tax disagreements based upon the act prior to the 1982 amendment.

THE CONTENT OF THE BILL:

The bill would amend the Use Tax Act to provide the following as regards the application of the use tax to construction contractors:

The price of tangible personal property, for affixation to real estate, withdrawn by a contractor from inventory available for sale to others or made available by publication or price list as a finished product for others would be the finished goods inventory value of the property. For contracts entered into after March 31, 1989, if a contractor manufactures, fabricates, or assembles tangible personal property prior to affixing it to real estate, the price of the property (for use tax purposes) would be equal to the sum of the materials cost of the property and the cost of labor to manufacture, fabricate, or assemble the property, not including the cost of labor to cut, bend, assemble, or attach property at the site of affixation to real estate. The materials cost referred to, for property withdrawn by a contractor from inventory available for sale to others or made available by publication or price list as a finished product for others, means the finished goods inventory value of the property.

MCL 205.92

BACKGROUND INFORMATION:

As the Michigan Court of Appeals explained in Honeywell, "The use tax is a complement to the sales tax and is designed to cover those transactions not covered by the General Sales Tax Act . . . While the General Sales Tax Act levies a tax on the person making a 'sale at retail,' as the conduit or means of collecting a sales tax from customers, the use tax provides for a more direct collection of the tax from the consumer where the purchase is made out of state . . . The use tax is a tax for the privilege of using, storing and consuming tangible property brought from out of the state after it has come to rest."

FISCAL IMPLICATIONS:

The Senate Fiscal Agency has said that the bill would have an indeterminate fiscal impact. The net revenue increase or decrease depends on the interpretation of current law.

OVER

For a discussion, see Senate Fiscal Agency memorandum dated November 15, 1988.

ARGUMENTS:

For:

The bill represents a compromise acceptable to the construction industry and the treasury department. Contractors find themselves in a difficult position as a result of the confusion and disagreement over the application of the use tax. If nothing is done, contractors and the department will likely continue to conduct lengthy and expensive court battles over assessments and audits, a situation beneficial to neither the contractors nor the state. Contractors, however, have a more urgent need to settle the disputes because they are uncertain of how to bid new contracts; that is, how to factor in the use tax as it applies to a job. Contractors desperately need an equitable solution to the dispute over the interpretation of the use tax since the 1982 amendment. If the department's view, (which has been affirmed by the Court of Appeals) that the use tax applies to the value of material as affixed, prevails, then some contractors will have enormous unanticipated tax bills on contracts long since completed. Contractors, in that case, will be left with huge tax levies that can be paid only by raising the cost of future contracts. One likely result is that such contractors will be driven out of business. The bill offers a compromise to the problem by adopting the department's interpretation, with modifications, for contracts written after 1988, and allowing past disputes to be settled based upon the contractors' interpretation of the act prior to the 1982 amendment.

POSITIONS:

The Department of Treasury supports the bill. (12-6-88)

A representative from the Great Lakes Fabricators and Erectors Association testified on behalf of the construction industry in support of the bill before the House Taxation Committee. (12-6-88)