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BILL ANALYSIS

Senate Fiscal Agency

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Senate Bill 996 (Substitute S-2 as reported)**Sponsor: Senator Norman D. Shinkle****Committee: Finance****Date Completed: 11-29-88****RATIONALE**

Under the Use Tax Act, taxpayers are liable to pay a use tax equal to 4% 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 into contracts use tax costs 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.

CONTENT

The bill would amend the Use Tax Act to provide that, regarding the application of the use tax to construction contractors, language inserted into the Act by Public Act 479 of 1982 would not apply to contracts entered into before January 1, 1989. Currently, under the Act as amended by Public Act 479 of 1982, the price of property or a service subject to the use tax, for a construction contractor who is also a manufacturer, fabricator, or assembler of personal property for affixation to real estate, is equal to the purchase price or amount of consideration that any other person would have to pay if the person acquired the personal property from the manufacturer, fabricator, or assembler for affixation to real estate. The bill states that this provision would apply to contracts entered into after December 31, 1988. The bill further provides that cutting, bending, or modifying the personal property, or attaching any material to the personal property, would not constitute manufacturing, fabricating, or assembling unless the contractor offered the modified personal property for sale at retail and maintained that personal property in inventory.

MCL 205.92

BACKGROUND

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."

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FISCAL IMPACT

The bill would have an indeterminate fiscal impact. The net revenue increase or decrease depends on the interpretation of current law. For a discussion, see Senate Fiscal Agency memorandum dated November 15, 1988.

ARGUMENTS

Supporting Argument

Because of the confusion and disagreement regarding the applicability of the use tax to construction contractors that exists between the Department and contractors, contractors find themselves in a difficult position. If nothing is done, contractors and the Department will likely continue to conduct lengthy and expensive court battles over assessments and audits, a situation that is 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. Further, contractors desperately need an equitable solution to the problem of interpretation of the use tax since 1982; that is, if the Department's view, as 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 tax bills on contracts long since completed that did not contain provisions to pay the use tax in this manner. Contractors, in that case, will be left with huge tax levies that can be paid only by raising the cost of future contracts. The 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.

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