

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of	)	
	)	DOCKET NO. 21384
[Redacted],,	)	
	)	DECISION
Petitioner.	)	
_____	)	

On June 16, 2008, the Sales, Use, and Miscellaneous Tax Audit Bureau (Bureau) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (Notice) to [Redacted]. The Notice proposed additional sales tax, use tax, and interest in the total amount of \$33,395 for the period January 1, 2005, through December 31, 2007. The taxpayer filed a timely appeal and petition for redetermination on August 14, 2008.

The taxpayer requested an informal conference, which was held on January 15, 2009. Following a review of the audit file, and considering the information obtained at the informal conference and from additional paperwork provided by the taxpayer, the Commission eliminated the liability of some audited transactions and upheld the remaining audit findings. The following discusses the reasons for this decision.

**Background and Applicable Tax Law**

The taxpayer is a [Redacted] contractor, as well as a retailer of [Redacted] materials. It has retail locations in Idaho and builds [Redacted] for in-state customers. Bureau staff conducted a sales and use tax audit of the taxpayer for compliance with the Idaho Sales Tax Act (Idaho Code § 63-3601 *et seq.*).

In Idaho, the sale of tangible personal property is subject to tax (Idaho Code § 63-3612) unless the buyer qualifies for exemptions that are enumerated in the Sales Tax Act. The Idaho Sales Tax Act distinguishes between retail sales of tangible personal property and improvements

to real property. Improvements to real property which include, but are not limited to, the installation of permanent [Redacted] are not included in the definition of sales subject to tax:

All persons engaged in constructing, altering, repairing or improving real estate, are consumers of the material used by them; all sales to or use by such persons of tangible personal property are taxable whether or not such persons intend resale of the improved property (Idaho Code § 63-3609(a)).

Thus, a business like the taxpayer must collect sales tax from its customers when it makes sales of tangible personal property, but must either pay a sales tax to its vendor or use tax (to the state) on the value of materials it uses in performing a real property improvement. To illustrate, a retailer's invoice to a customer will separately state the sales tax it charges on the sales price of [Redacted] material. A [Redacted] will owe a tax on the value (generally the purchase price) of materials used on the job. The invoiced price to the customer will include material and labor. Overhead, including sales tax paid to vendors or use tax accrued and owed to the state, will be incorporated into the contracted and billed price. No sales tax will be charged.

### **Audit Findings**

In the case at issue, the taxpayer considered itself solely as a retailer of tangible personal property. The auditor determined that the taxpayer collected sales tax from most of its customers on the value it assigned to the materials it used installing [Redacted]. Thus, it treated improvements to real property as if those transactions were retail sales subject to sales tax.

The typical customer invoice for the installation of [Redacted] by this taxpayer shows a list of materials used at both their unit (e.g., section or dimension) and extended price. Interspersed with listed materials on the invoice are installation charges. The bottom of the invoice shows a subtotal, followed by a sales tax line with a tax rate and an amount. Observation reveals that the tax was calculated on the material total. The auditor determined that the taxpayer

remitted this tax to the state, as it did with the tax billed on all of its retail sales of [Redacted] materials.

For reasons that will be discussed later, the auditor accepted sales tax collected from a customer in lieu of a use tax that should have been accrued and paid by the taxpayer on the value of materials it used on behalf of that customer. Idaho Code § 63-3621 imposes a use tax on the storage, use, or other consumption of tangible personal property in Idaho. Use tax is a complementary tax to the sales tax. The use tax rate is the same as the sales tax and is imposed on the value of the property. When property is stored, used, or consumed in Idaho, the user owes use tax unless he has paid sales tax on the purchase of the property or an exemption applies. All states with a sales tax have a complementary use tax.

The taxpayer's incorrect tax treatment of real property improvements had some unintended consequences.

It was noted earlier that all retail sales of tangible personal property are taxable unless an exemption applies. The legislature has granted sales tax exemptions to various entities, including Idaho's political subdivisions, not-for-profit hospitals, certain educational institutions and others. A full listing is found in Idaho Code § 63-3622O.

The taxpayer installed [Redacted] for an Idaho city and did not charge tax. A few of the taxpayer's other customers refused to pay sales tax on the value of materials used in real property improvements. Additionally, a considerably large [Redacted] company, a [Redacted], requested and received from the Commission a refund for tax erroneously charged by and paid to the taxpayer for real property improvements. Having no sales tax on these transactions to offset the use tax rightly owed by the taxpayer, the Bureau, through its auditor, asserted use tax against the taxpayer.

## **The Protest**

The taxpayer states that in a sales and use tax audit conducted by the Commission in 1998, the auditor “was agreeable to the method” used by the taxpayer to charge and collect sales tax on its invoices and that “no adjustments, recommendations or requirements” were made with respect to its billing of sales tax for real property improvements. It further states that an audit in 2005 failed to find fault and made no requirement for the taxpayer to change its practices. (Petition for Redetermination, letter dated August 14, 2008.)

The taxpayer continues in its letter, cited above, that it paid significantly more tax to the state by its billing practices than it would have by accruing use tax. (Note: By Idaho Code § 63-3621, the taxpayer owed use tax on the value (i.e., purchase price) of the material it used in real property improvements. On those invoices, it charged customers a tax based on the materials’ marked-up “sales price” as it would do on retail sales invoices.)

## **Analysis**

As described beforehand, the auditor accepted sales tax collected from customers in lieu of use tax owed by the taxpayer improving real property. This acceptance, however, was on an individual invoice basis and not on an aggregate basis. That is, if use tax legally due from the contractor was \$100, the auditor accepted \$110 in sales tax collected from the contractor’s customer as sufficient. However, the auditor did not allow the additional \$10 to satisfy the use tax due on unrelated contracts where no use tax was accrued by the taxpayer and no sales tax was collected.

The taxpayer asks that it be allowed to credit its liability regarding some customers with this “excess tax” collected from other customers. As noted, however, the legal incidence of tax

falls on the consumer of tangible personal property in a real property contract. In retail sales, despite the obligation of the retailer to collect sales tax, the incidence is on the purchaser.

For administrative convenience, the Commission has allowed an offsetting of use tax liability with sales tax collected erroneously on real property contracts on a contract-by-contract basis. The Commission sees no reason to do so in the aggregate, however. As noted in this decision, some taxpayers have rightly sought refunds from the Commission for sales tax paid in error. There is nothing inherently fair about rewarding the taxpayer's improper billing practices with tax it collected in error from others on transactions that bear no relation to the liability.

The taxpayer says that an auditor in 1998 was agreeable to its practices but did not provide anything in writing from that auditor to substantiate this. There is no Commission record to suggest that any auditor told the taxpayer or similarly situated taxpayers that it was statutorily correct to charge sales tax on real property improvement transactions. The Commission contends that the taxpayer mistakenly believes that since prior audits did not result in a liability on this issue, the Commission approved methods that this decision finds at fault.

The Commission has accepted the audit approach described in this decision until a recent change. As the taxpayer notes in its protest letter previously cited, the Commission advised real property contractors that for transactions occurring October 1, 2008, and later, the Commission would no longer accept the sales tax collected from a customer as a substitute for the tax the contractor owes on the purchase or use of contract materials (Tax Update, Vol. 20, No. 1, June 2008, Page 2. Mailed to all sales and use tax permit holders). Cognizant of the future cost for not complying, the taxpayer has agreed to prospectively change its accounting and billing practices.

In making this policy change, the Commission realized that auditors who advised contractors in the proper tax treatment of real property improvements were often unsuccessful in their attempts at obtaining compliance. Auditors of real property contractors who misunderstand the law routinely advise these taxpayers to align their billing and accounting practices with sales tax law, but there has been no requirement that this advice be in writing, nor has there been a liability imposed for non-compliance when the offset provision discussed in this decision was available.

The results of this audit reveal how a real property contractor's non-compliance with the tax law at issue can be problematic. Customers can rightly refuse to pay a sales tax that is erroneously charged. Once paid erroneously, a taxpayer can obtain a refund within an allowed statutory period. Sales tax-exempt entities, such as political subdivisions of the state, generally refuse to pay sales tax charged on purchase invoices. All of these issues are present in the audit discussed here.

### **Other Protested Issues**

During the period under audit, the taxpayer provided material and built [Redacted] for [Redacted]. [Redacted]has "direct pay authorization":

01. In General. Direct Pay Authorization is issued to certain taxpayers where it is to the mutual convenience of the Tax Commission, the taxpayer, and the taxpayer's vendors to have the sales and use tax liability upon the taxpayer's purchases determined by the taxpayer and reported directly to the state in the form of a use tax. This allows vendors to sell all items of tangible personal property to the particular taxpayer without charging any sales tax. The only effect of this arrangement is to shift the reporting responsibility to the taxpayer holding the direct pay authority

03. Documentation. To make a purchase without paying sales tax to the vendor, the taxpayer holding the direct pay authorization must furnish to each of his vendors a copy of the letter from the

Commission granting the direct pay authority (IDAPA 35.01.02.112.01 and .03.)

The taxpayer states that it received a direct pay authorization letter from [Redacted]and, therefore, is not liable for use tax on the cost of materials it incorporated into real estate for that company. It believes that [Redacted] would be responsible for that burden. However, [Redacted] is presumed to be aware of the following:

07. Valid Only on Purchases of Tangible Personal Property. The direct pay authority is valid only on purchases of tangible personal property. The holder may not use their direct pay authority when engaging contractors involved in improving real property. Special rules apply to contractors. (IDAPA 35.01.02.112.07.)

Nevertheless, for the period in question, the Commission affords the same consideration with respect to this transaction as it has with all others: if tax was remitted specifically for this transaction by a party other than the taxpayer, it will in this instance be acceptable to relieve the taxpayer of its liability.

Since the taxpayer did not bill sales tax, the question is whether [Redacted] accrued use tax. Although the taxpayer says in its protest letter and in correspondence dated March 3, 2009, that [Redacted] did so, the Commission has asked for sufficient written evidence. In a letter dated May 13, 2009, the Commission requested that the taxpayer provide detailed information from [Redacted]on this transaction. To date, the Commission has not received a response.

The taxpayer provided a purchase invoice for a leased vehicle that was unavailable during the audit field work. Since this invoice shows tax, the Commission adjusted the workpapers and resulting liability accordingly in the taxpayer's favor. As the transaction was part of a sample record exam, and the error in the sample was extrapolated to the whole, that extrapolation has been adjusted as well.

The taxpayer provided proof that it paid use tax on the purchase of a [Redacted] and accessories. The Commission removed this taxable amount from the schedules and made the appropriate adjustment to the liability.

Finally, the Commission reviewed transactions with invoice prices in excess of \$20,000 for the calendar year 2005 and found no errors. It therefore removed liability from the workpapers for this period that was originally based on errors found in other audit time periods for which records were available during the audit field work.

WHEREFORE, the Notice of Deficiency Determination dated June 16, 2008, is hereby MODIFIED, and as so modified is APPROVED, AFFIRMED and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer pay the following tax and interest:

<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
\$24,867	\$4,660	\$29,527

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the taxpayer's right to appeal this decision is enclosed.

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 2009.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_, 2009, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[REDACTED]  
[REDACTED]

Receipt No.

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