

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 25848
[Redacted],)	
)	
Petitioner.)	DECISION
_____)	

On May 10, 2013, the staff of 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] (taxpayer), proposing sales tax, use tax, penalty, and interest for the period September 1, 2011, through September 30, 2011, in the total amount of \$39,724.

On June 11, 2013, the taxpayer filed a timely appeal and petition for redetermination of the Notice. At the taxpayer’s request, the Commission held an informal hearing on December 4, 2013. Present at the hearing were Commissioner [Redacted], Deputy Attorney General [Redacted], and Tax Policy Specialists [Redacted] and [Redacted]. The Commission is fully advised of the contents of the audit file, as well as information obtained at the hearing and thereafter, and hereby issues its decision to cancel the Notice.

Background and Audit Findings

The Bureau performed a routine review of the contracts related to the construction of the [Redacted] and [Redacted]. Records reviewed showed that the prime contract to supply and install the [Redacted] and [Redacted] was awarded to [Redacted] by the Idaho Transportation Department. [Redacted] then contracted with the taxpayer to supply and install the fabricated [Redacted] components. Finally, the taxpayer hired [Redacted] to install those components.

Sales tax was paid by the taxpayer on the materials that were used to build the [Redacted] components.

The Bureau agrees that if the taxpayer had contracted to fabricate and install [Redacted] components, and [Redacted] had not been involved in the installation work, then the amount subject to tax would be the cost of materials only, regardless of whether the taxpayer hired a subcontractor to install the components. In such a case, the taxpayer would have paid the correct amount of tax.

However, the Bureau takes issue with the fact that the taxpayer hired [Redacted] to do the installation, the very same party that awarded the contract to the taxpayer to fabricate and install the [Redacted] components. If the taxpayer were acting as a supplier, sales tax would be due on the fully fabricated value of the [Redacted] components.

The Bureau argues that this arrangement was an attempt to avoid sales or use tax on fabrication labor and markup on the [Redacted] components and holds that, regardless of how [Redacted] and the taxpayer set up their contracts, the substance of the transaction is that the taxpayer acted as a retailer who made a retail sale of the [Redacted] components to the general contractor. The general contractor then installed these [Redacted] components into real property, which would make those materials subject to sales or use tax on the fully fabricated value. The Bureau contends that the substance of this transaction should prevail over the form of the transaction.

Summary of the Taxpayer's Protest

The taxpayer protested the Bureau's determination, stating that it contracted to fabricate and erect the [Redacted] components for the [Redacted]. It claims to have acted as a subcontractor improving real property and argues that it has already paid the full amount of tax due.

The taxpayer states that its contracts fall into three general categories: (1) contracts to supply and deliver fabricated [Redacted] components as a final product, without any obligation for the erection, (2) contracts to supply and install fabricated [Redacted] components, hiring a third party subcontractor to complete the erection, and (3) contracts to supply and install fabricated [Redacted] components, hiring the prime contractor to complete the erection.

The taxpayer maintains that if the Commission respects the plain language and obligations of the first two contracts, it should respect the third. The taxpayer states that nothing in Idaho law prevents it from hiring another subcontractor, including the prime contractor, to assist them in meeting their contractual obligations.

Applicable Tax Law and Analysis

In Idaho, the sale, purchase, and use of tangible personal property is subject to tax unless an exemption applies. If sales tax is not paid to the vendor, the buyer owes a use tax to the state. Payment of use tax extinguishes the sales tax obligation (Idaho Code §§ 63-3612 and 63-3621).

For sales and use tax purposes, a contractor improving real property is the consumer of any materials that become part of the realty and owes a sales or use tax on such materials:

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)).

Based on the above, if a contractor has used materials in the construction of real property, the contractor will owe sales or use tax. The term “use” as utilized here is a specially defined term for purposes of the use tax:

The term “use” includes the exercise of any right or power over tangible personal property incident to the ownership or the leasing of that property or the exercise of any right or power over tangible personal property by any person in the performance of a contract, or to fulfill contract or subcontract obligations, whether the title of such property be in the subcontractor, contractor, contractee, subcontractee, or any other person, or whether the titleholder of such property would be subject to the sales or use tax....(Idaho Code § 63-3615(b) emphasis added).

With respect to a contract to fabricate building materials and sell those materials to construction contractors without any requirement to install the materials, this is a sale of tangible personal property, and as such, is subject to the collection of sales tax from the customer on the fully fabricated sales price of the materials.

With respect to a contract to fabricate and install building materials, regardless of whether a subcontractor is hired to do the installation, this is a contract to improve real property:

When a contractor fabricates and installs tangible personal property into Idaho real property, the value is the cost of materials and parts he uses. If a contractor, with a contract to furnish and install goods, fabricates the goods and hires a subcontractor to do the installation, the amount subject to tax is the cost of material to the contractor who fabricated the goods. (IDAPA 35.01.02.12.09.a).

Currently, neither Idaho law nor administrative rule make a distinction as to whether the identity of the subcontractor that installs goods into real property makes a difference in the application of IDAPA 35.01.02.12.09.a referenced above. IDAPA 35.01.02.12.11 merely indicates that a subcontractor is treated the same as a general contractor:

In general, a subcontractor is treated the same as a general contractor. Whether his contract is with the owner or the general contractor, the subcontractor pays tax on materials he buys to improve real property. Like any contractor, the subcontractor could be employed to work on or with material purchased by the general contractor or the owner, with one or the other paying tax on the material

purchased. These services rendered by the subcontractor are not taxable. His relationship with the owner or general contractor is no different than the relationship between the contractor and owner. However, the provisions of Subsection 011.10 of this rule apply equally to a subcontractor. (IDAPA 35.01.02.12.11)

The argument made by the Bureau directs the Commission to look at the substance of the transaction rather than the form. Gregory v. Helvering, 293 U.S. 465, 55 S. Ct. 266, (1935), was a landmark decision by the United State Supreme Court concerned with US income tax law. The case is cited as part of the basis for two legal doctrines: the business purpose doctrine and the doctrine of substance over form. Please note that these are income tax doctrines, not commonly used in conjunction with the Sale Tax Act.

The business purpose, doctrine essentially states that where a transaction has no substantial business purpose other than the avoidance or reduction of [Redacted]income tax, the law will not regard the transaction. Relevant to this case, the Bureau argues that this doctrine applies to the creation of a contract to fabricate and install [Redacted] components into real property when the taxpayer does not intend nor have the ability to install the [Redacted] components itself, and ultimately hires [Redacted] to do the installation work, the very work that [Redacted] had hired the taxpayer to do in the first place. This would also reduce the sales tax due for the fabricated [Redacted] components, thereby reducing the bid to the contractor, increasing the likelihood that the taxpayer would be awarded the contract. With that in mind, the Commission acknowledges that it is likely that the taxpayer has arranged its affairs in an effort to reduce the amount of sales tax due by contracting to fabricate and install the [Redacted] components, but cannot find fault with this approach when it is allowed by the Tax Commission's own rules. It is also not apparent that this particular contract, or that these facts,

are contrary to accepted industry practices. The US Supreme Court also spoke to this very issue in the case cited previously:

Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. *Helvering vs. Gregory*, 69 F. 2d 809, 810 (2d Cir. 1934).

Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands.

The legal right of the taxpayer to decrease the amount of what otherwise would be taxes, or altogether avoid them, by means which the law permits, cannot be doubted. U.S. Supreme Court: *Gregory vs. Helvering*, 293 U.S. 465 (1935).

The substance over form doctrine essentially states that, for [Redacted] tax purposes, a taxpayer is bound by the economic substance of a transaction where the economic substance varies from its legal form. The step transaction doctrine is a variation on the substance over form doctrine, designed to ensure that transactions are taxed according to their substance, regardless of their form. *C.I.R. v. Clark*, 1989-2 C.B. 68, 489 U.S. 726, 109 S. Ct. 1455, 103 L. Ed. 2d 753, 89-1 U.S. Tax Cas. (CCH) P 9230, 63 A.F.T.R.2d 89-860 (1989). By thus linking together all interdependent steps with legal or business significance, rather than taking them in isolation, the tax liability may be based on a realistic view of the entire transaction. In this case, the different levels of contracts found result in [Redacted] being hired as a subcontractor to assist with the contractual obligations its own subcontractor. The Bureau argues the realistic view of what really happened was [Redacted] hired the taxpayer to fabricate [Redacted] components, even though the contracts appear to burden both [Redacted] and the taxpayer to do the installation work and with the liability for the installation work. The contract(s) between [Redacted] and taxpayer meet the requirements of IDAPA 35.01.02.12.01.c., because the taxpayer

delivered the materials to the job site with a contractual requirement that they install the tangible personal property. See, Louisiana Paving Co., Inc. v. St. Charles Parish Public Schools, 604 So.2d 593 (LA 5th Cir. Ct.App. 1992) (where the Court looked to the contractual responsibility to install in determining the tax liability).

The Commission does have reservations about the way that these contracts have been set up, but cannot ignore the fact that, because of the contract to fabricate and install, Idaho law recognizes the taxpayer as a contractor improving real property, regardless of whether a third party was hired to do the installation. If the taxpayer had hired any other third party to do the installation, the Bureau would fully recognize the contract and not attempt to question its substance or attempt to rearrange the parties to reflect its desired tax liability. Idaho law does allow that for a real property improvement, a prime contractor can be hired as a subcontractor, because the Tax Commission's own rule specifies that a subcontractor should be treated the same as a general contractor. The Commission cannot uphold this Notice with the current rules.

THEREFORE, the Notice of Deficiency Determination dated May 10, 2013, is hereby CANCELLED.

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

DATED this _____ day of _____ 2014.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2014, 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]

Receipt No.
