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**LEGAL BRIEFING**  
**HOT TOPICS IN GEORGIA**  
**SALES AND USE TAX APPLICATION 2006**

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**1. Sales & Use Tax - Application Of Public Entity Tax Exemption As Applied To “Owner Furnished” Equipment And Materials On Public Works Construction Projects** [Statutory Amendment to Ga Stat 48-8-63 (HB 306, GA LEGIS 83 (2005)].

Georgia taxes the ultimate sale of tangible personal property theoretically at the point of sale to the ultimate user or consumer. This is most frequently in the form of a “sales tax” imposed on the retail sale purchase price, but where the tangible property is not “purchased” per se or is processed before its incorporation into a construction project the a “use tax” (essentially analogous to the “sales tax”) is imposed on the fair market value of the personal property before it is consumed or incorporated into the construction project. Certain transactions have been carved out as exempted from such “sale and use” tax, including its purchases by a public entity of tangible personal property. It has been clearly settled that this “exemption” cannot be transferred to or used by the independent contractor engaged by the public entity to perform the construction work, leaving the contractor’s own purchases as taxable transactions.

However, what if the public entity itself actually purchases the materials and equipment for installation in the construction work and then furnishes such to the construction contractor – viola! A tax free transaction??? Well, yes and no – tax free for the public entity’s “purchase” but taxable under the “use tax” side of the process to the contractor to whom it is furnished for installation. Under existing Georgia law, a contractor (and its subcontractors) assumes the ultimate liability and responsibility to assure payment of “sales and use” tax for equipment or material purchased and furnished to the contractor by a public entity (e.g., a school board), even if such entity itself is tax exempt and not subject to “sales” tax on such purchase, where the contractor receives such material or equipment and actually installs it (i.e. uses and consumes it) in a public works project. See ESI Companies, Inc. v. Fulton County, 609 S.E.2d 126 (Ga. App. 2004). In such case, the installing contractor is deemed the “consumer” of the goods in question and thus subject to the “use” side of this tax liability based on the “fair market value” of such owner furnished material or equipment. O.C.G.A § 48-8-63(a) and (b) and Georgia Administrative Code Section 560-12-2-.26.

While this law has been only infrequently enforced and policed over the years, the recent budgetary problems of the State of Georgia awakened the state taxing authorities to this potentially fertile area of untapped tax revenues. This “use” tax was recently being aggressively pursued with audits of and assessments against contractors and subcontractors throughout the state for such tax liabilities that had never been contemplated and were not included in the contract pricing. In response to several egregious examples of such after-the-fact tax assessment, this operative statute was amended last session.

This amendment made several important, and beneficial, modifications in this sales and use tax scheme but does not cure all of its risk for unwary contractors and subcontractors. The changes include:

(a) Clarification that sales or use tax liability for the contractor shall not arise with respect to the “*use of tangible personal property owned by the [state or local governmental entity]. . . in the performance of contracts with such entities when the property is **not actually used up and consumed in the performance of the contract.***” Thus, public owner furnished equipment would not create a use tax liability for the contractor if such equipment is not “used up and consumed” in the performance of the construction work and not **physically incorporated** into the structure.

(b) BUT: “*Tangible personal property **incorporated into real property construction which loses its identity as tangible personal property shall be deemed to be used up and consumed within the meaning of this subsection***” and thus subject to the “use” tax obligation to the contractor that “consumes” it, even if it was purchased by the public owner under its tax exemption and furnished to the contractor for such installation as part of the contract responsibility!

(c) However, it is further provided that “any governmental entity which furnishes tangible personal property to a contractor for incorporation into a construction, renovation, or repair project conducted pursuant to a contract with such governmental entity “*shall issue **advance written notice to such contractor of the amount of tax owed for such tangible personal property. The failure of the governmental entity to issue such advance written notice to the contractor of such tax liability shall render such governmental entity liable for such tax.***”

While these changes add some clarification to this obscure law, there are still ambiguities and traps for the unwary contractor. First, the newly added language does not specify when such “advance written notice” of tax liability shall be issued; although, in order to level the playing field for all bidding or proposing contractors and allow inclusion of the cost of such tax liability in their estimates and bid/proposal pricing, such notice would logically seem to be required prior to the bid or proposal date. Thus, on any public works project for which the public owner is to furnish materials or equipment, pre-bid or proposal clarification should be sought if no such notice has yet been given.

Also, the public owner’s determination of the “amount of tax owed” on such owner furnished equipment or materials would not be binding on the Georgia Department of Revenue (“DOR”). Therefore, it would also be prudent for the bidding contractor liable, or potentially liable, for such tax, to seek pre-bid or proposal clarification as to the basis of the owner’s determination of the “amount of tax” that may be due. Any such clarifications would be

generally issued by pre-bid addendum to all competing contractors so that all would be pricing based on the same basis.

Further, tax liability now turns on whether the public owner furnished material or equipment is “physically incorporated” into the construction thereby losing “its identity”– and thus “used” and “consumed” in the performance. This creates many gray areas – for example, where owner furnished “laboratory casework” is to be installed, including physical affixation to the structure and MEP connections, it may later be deemed by the DOR to have been “physically incorporated” and become a “fixture” deemed part of the improved real estate even if the public owner originally indicated to the contrary. The public owner’s misclassification of this equipment as not resulting in a tax liability to the contractor would not be binding upon the DOR which may still assess “use” tax on the contractor after the fact if it were to disagree.

Finally, if there is any possibility that “use tax” may be later assessed by the DOR after tender and acceptance of final payment” – an event which usually results in a full waiver and release of any other claims, such right to statutory indemnity for later imposed “use” tax liability should be expressly and specifically reserved in the application for final payment.

Thus, if there is any doubt about “use” tax liability for public owner furnished materials or equipment, the bidding contractor proceeds at its own risk in failing to include an amount to cover such potential liability in its estimate, bid and contract price unless there is a clear contractual right of indemnity or reimbursement to the contractor if tax liability is later imposed in excess of the amounts previously indicated. The new “statutory” indemnity provision only applies where the owner totally fails to give “written notice,” not to any error in computation of such tax liability. And if such statutory right to indemnity does arise, it will often be after completion of the project, and close out of the applicable contract, which will at the least require a separate legal claim assertion and prosecution and potentially result in arguments over whether such claims were contractually waived or expressly waived or released by the contractor in its acceptance of “final payment.”

## **2. Sales & Use Tax – Withholding Requirements – and Modifications to Eliminate Withholding re “Resident” Contractors. [Statutory Amendment to Ga Stat 48-8-63 (HB 111, GA LEGIS 447 (2006)].**

Previously, the prime contractor had been required to withhold 4% of the subcontract amount for every subcontract unless and until (1) the subcontractor had posted with the tax commissioner a “sales and use” tax bond or (2) the subcontractor had obtained a “certification” from the tax commissioner attesting to satisfaction of all such tax liabilities relative to its work under the subcontract. Now this requirement only applies to large amount subcontracts with “nonresident” subcontractors.

After languishing for more than a year after its introduction, this bill was substantially modified at the very last minute and rushed through the legislative process with, apparently the assistance of legislator “friends in high places” to modify the practice and requirements for general contractor “withholding” of payments otherwise due to a subcontractor to assure full

satisfaction of all “sales and use” tax obligations relative to the subcontractor’s work. Now, under this modification, this withholding requirement only applies where the “total amount” of the subcontract or subcontracts between the prime or general contractor and a particular subcontractor on any one project exceeds \$250,000.00, and where the subcontractor is a “nonresident” of Georgia. For purposes of this statute, a “nonresident subcontractor” is defined a person “who does not have a bona fide place of business in Georgia through the maintaining of a permanent domicile or business facility engaged in contracting real property” including lower tier subcontractors. Of course, any such withholdings will still be subject to the bonding and certification requirements that previously had applied to all subcontractors.

But general contractors no longer need – or are required or allowed - to withhold the 4% sales and use tax from subcontract monies due a “resident” subcontractor. Under this new law, the messy and complicated administrative process is no longer applicable to subcontracts with subcontractors who are Georgia “residents.”

### **3. Sales & Use Tax - Application of the “Dual Operator” Rule to Construction Activities to Require Collection (and Remission) By An Installing Contractor From Customer Of Full Sales Tax on the Material Portion of a “T & M” Service or Repair Type Activity (non-fixed contract price).**

A contractor that, pursuant to a construction contract, incorporates and installs materials and equipment as part of the overall contract performance, normally pays “sales” tax at the point of its purchase of such materials and equipment at the price of sale when it purchased them. The contractor may then incorporate such materials and equipment into the work without having to assess additional sales or use tax as part of the price to the project owner, such materials and equipment ceasing to be taxable “personal property” when they are installed, incorporated or consumed in the construction process. The contractor has no further liability for additional sales or use tax for such materials and equipment consumed in the construction process and becoming part of the whole project and need not assess any additional “sales” tax on the owner relative to such materials or equipment (although the purchase price of the materials and equipment bought by the contractor (or its subcontractors), including the cost incurred in paying the sales tax on such purchase, would be included in the cost base of the construction contract costs.

However, a recent Georgia Department of Revenue investigation and audit process of a particular contractor suggest that where a contractor is not proceeding pursuant to a construction contract fully defining the scope and price of the integrated and fully constructed work, but rather is performing service or repair work, on a “T & M” pricing basis, in which it employs materials and equipment it has previously purchased and paid sales tax on, the tax considerations, consequences and obligations may be quite different. The more this type of transaction looks like a “retail” sale to an ultimate customer/consumer for whom the service or maintenance works is done, the more the circumstances may drift from the “contractor” model to a “dealer” model in which additional sales or use tax liability may arise relative to the “sale” of the materials or equipment to the ultimate customer, even if it was attended by installation labor

charges and irrespective of whether they taken from inventory or purchased specifically for the job. This is particularly true where a “sales tax” charge is specifically included against the “materials” portion of the pricing to the ultimate customer. While the lines are bright or clear, contractors engaging both in conventional construction contract work and in service and maintenance work must be quite careful in structuring and implementing their “sales and use tax” handling.

The risk is being characterized as a “dual operator” in which case they may end up paying sales tax twice and even subject the contractor side of their activities to potential double exposure, first to “sales” tax on material purchase and then to “use” tax on the consumption of the materials in the construction process. Under the “dual operator” concept employed by the Georgia Department of Revenue, a contractor may be obligated and liable to collect the full sales or use tax from its customer and to remit the full amount collected to the DOR as “sales” tax. And, of course, any “sales” tax so collected upon retail sales, once collected, may be considered “trust funds” held for the benefit of the state, for which not only the company, but its officers could be held personally liable.

While there is no “statutory” recognition of “dual operator” or statutory definition of that term, the DOR Regulations provide in pertinent part that

**“560-12-1-17 - Dual Operator. Amended.**

(1) The term “dual operator” means a dealer in the business of selling tangible personal property who, in addition to selling at retail, withdraws tangible personal property from inventory for use in performing contracts.

(2) When a dual operator makes purchases of tangible personal property, a part of which he will sell at retail and part of which he will convert to his own use in performing a contract, such operator should furnish his supplier with a properly executed Certificate of Exemption.

(3) The dual operator must collect and remit the tax on the sales price of the tangible personal property sold at retail, and pay the tax on the fair market value of the tangible personal property used by him in performing a contract.

(4) For the purpose of this regulation “fair market value” means the fabricated cost of the article at the time of its first use in performing a contract. (Emphasis added)

**[Authority Ga.L.1937-38. Extra Sess., pp.77, et seq., as amended (Ga. Code Ann., Secs. 92-8405, 8406, 8409, 8427); Ga.L.1951, pp. 360, 385 (Ga. Code Ann., Sec. 92-3438a). Administrative History, Original Rule entitled “Exceptional or Special Reporting” was filed and effective on June 30, 1965. Amended rule repealed and a new Rule entitled “Dual Operator” adopted, filed August 16, 1974; effective September 15.]**

The classic example of such a “dual operator” doing business in the construction industry is where the taxpayer, a steel fabricator, “purchases raw material (sheet steel). . . which it fabricates and uses in two ways. Part of the fabricated steel is sold by the taxpayer to independent contractors [for installation and construction by them in construction projects]. The taxpayer also uses some of the steel it fabricates in performing its own erection contracts. A person who engages in these operations is known as a ‘dual operator.’” *Ingalls Iron Works Co., v. Chilivas*, 237 Ga. 479, 228 S. E. 2d 866. (1976). There the “dual operator” was determined to

be responsible for “sales” tax calculated and assessed against the sale of the fabricated materials to third parties and a “use” tax on the fair market value of the fabricated materials that it incorporated itself as a contractor into construction projects.

The “dual operator” is considered both a “dealer” and a “contractor” for sales and use tax purposes. A “dealer” is generally engaged in the business of buying raw materials or inventory and then reselling the materials purchased, often after they were further processed or fabricated, to others on a retail basis as tangible personal property on which sale or use tax has not yet been paid. When a “dealer” purchases of tangible personal property which is intended for resale on a retail basis, he may furnish his supplier with a dealer’s certificate of exemption and avoid payment of sales tax on his purchases of his raw materials, since the “dealer” will be paying the full sales tax upon its sale to the ultimate consumer, which sale price will reflect the “fair market value” for such goods, even to the extent that they have been further processed and fabricated by the dealer (e.g. the steel fabricator discussed above). On the other hand, a “contractor” is a person who contracts to construct or repair real property and in the process to procure and furnish tangible personal property, materials and equipment into the construction project and, thus, is deemed to be the consumer of such tangible personal property. The contractor must therefore pay either the sales tax on the purchase price of the materials, i.e. tangible personal property - at the time of its purchase, or if it is furnished by others (see Article No. 1, above), pay a “use” tax on its fair market value when it was received.

A “dual operator”, in this construction industry context as designated by the DOR, is one who acts both as a “dealer” in the business of selling tangible personal property at retail, and also as a “contractor” in the business of purchasing or withdrawing such tangible personal property from inventory for use in performing construction contracts itself in which it installs such personal property in the project. This analysis may or may not apply to particular contractor operations. However, if it were applicable, in its “dealer” capacity, the purchase of its raw materials or inventory would be exempted from sales and use, since the tax would typically be paid on the resale. Operating as a “dealer”, the business must collect and remit the tax on the sales price of the tangible personal property sold at retail. However, in its predominant “contractor” capacity, it is likely that such a business is, in fact, paying sales tax on the purchase of all of its materials and equipment, whether to be used in construction or for “resale”, at the point of such purchase, leaving it further liable for the sales tax on the ultimate resale for at least in the amount of any increase in value after its purchase and perhaps for sales tax on the full sale value. On the other hand, regarding the predominant “contractor” side of its business, the business, even though the business already paid the sales tax on all of its purchased construction materials and equipment at the point of purchase, if found to be a “dual operator” it may also be required to pay the tax on the fair market value of the tangible personal property it used and consumed in performing a contract.

There is very little judicial interpretation of this concept, the last being almost 20 years ago, and those dealt primarily with steel fabricator/constructor and asphalt producer/appliator situations where the “contractor” itself purchased raw materials, and then processed and fabricated them into structural steel components and asphaltic paving materials, and then used most of that in their own contracting business but sold the remainder to other contractors. Whether this situation can be readily applied to other types of contracting business has not been readily predicted or determined. However, if it were to be so applied, this could conceivably

render a contractor found to be a dual operator, essentially engaging in both a “retail” and a “contracting” business liable for payment of tax twice, once as a sales tax on the purchase of the raw materials, and then as either sales tax again on the retail sales or use tax on the materials consumed in its contract work performance. Not a good deal!! This type of business model needs to be very carefully structured and its business practices very carefully implemented in order to minimize or avoid such liability or challenge by the Department of Revenue.