

Construction and Non-Construction Contractors Chapter Index

Purpose

This chapter is a guide for determining sales and use tax liability of construction contractors, real estate developers, and their suppliers. It does not cover all phases of auditing problems that may be involved with these types of taxpayers, but it provides guidelines on common situations an auditor may encounter.

Disclaimer

This audit manual is designed for internal staff-use only and is intended to provide general information on selected topics to assist Illinois Department of Revenue (“Department” or “IDOR”) auditors in the completion of their audits. The contents of this audit manual must not be relied upon for decision making or as a substitute for the official text of statutes, administrative rules, and case law. This manual does not carry the weight or effect of law and is only informational in nature. Auditors must conduct audits in accordance with the pertinent statutes, administrative rules, and case law.

Citations to statutes, regulations, or case law are included to assist the auditors in locating the relevant legal authority as a basis for conducting audits. The manual may be amended at any time without notice by the Department. Nothing in this manual shall contradict the official text of statutes, administrative rules, or case law. In case of any unintended inconsistency, the official text of statutes, administrative rules, and case law controls and must be followed. The Department’s Director, General Counsel, and Legal Services Bureau do not sanction any deviation by the Department staff from the official text of statutes, administrative rules, or case law in the performance of job functions.

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The following sections of the Illinois Administrative Code should be referred to when auditing contractors:

- a) 130.1940 - Construction Contractors & Real Estate Developers
- b) 130.2075 - Sales to Construction Contractors, Real Estate Developers, and Speculative Builders
- c) 130.1949 - Sales of Building Materials Incorporated into the South Suburban Airport
- d) 130.1950 - Sales of Building Materials Incorporated into the Illiana Expressway
- e) 130.1951 – Sales of Building Materials to Enterprise Zones
- f) 130.1952 – Sales of Building Materials to a High Impact Business
- g) 130.1953 - Sales of Building Materials to be Incorporated into a Redevelopment Project Area within an Intermodal Terminal Facility Area
- h) 130.1954 - Sales of Building Materials Incorporated into Real Estate within River Edge Redevelopment Zones
- i) 130.1957 - Tangible Personal Property Used in the Construction or Operation of Data Centers
- j) 130.1965 - Florists and Nurseries
- k) 130.2101 – Sellers of Floor Coverings
- l) 130.2140 - Vendors of Curtains, Slipcovers, Floor Covering and other Similar Items Made to Order
- m) 130.2155 – Tax Liability of Sign Vendors

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13.2.1 COMMON DEFINITIONS USED IN THE REGULATIONS AND INDUSTRY

Where an item is defined by regulation, the applicable regulation is cited. If the item is not defined by regulation, the definition comes from Merriam Webster Dictionary.

CONSTRUCTION CONTRACTOR - includes general contractors, subcontractors, and specialized contractors such as landscape contractors. Reference 86 Ill. Adm. Code Section 130.1940(a)(1)

CONTRACTOR - any person who is engaged in the occupation of entering and performing construction contracts for owners. Reference 86 Ill. Adm. Code 130.1940(a)(1).

REAL ESTATE DEVELOPER - any person engaged in the business of transferring title (legal or equitable) of real estate to others. The term does not include an isolated or occasional sale of real estate by a person not engaged in the business of selling real estate, and the term does not include a person who acts merely as an agent for a commission to bring sellers and buyers of real estate together without ever actually taking either the legal or the equitable title to real estate. Reference 86 Ill. Adm. Code 130.1940(a)(7).

CONSTRUCTION CONTRACT - a contract, written or oral, to "construct" (i.e., build, erect, install, plant, repair, renovate, or remodel) a "structure" (i.e., building, house, edifice, tunnel, sewer, highway, road, bridge or any other type of structure, or any part thereof such as any system of plumbing, heating, ventilating, or air conditioning). Reference 86 Ill. Adm. Code 130.1940(a)(3), (a)(4), and (a)(6).

FIXTURE – something that is fixed or attached (as to a building) as a permanent appendage or as a structural part.

GENERAL CONTRACTOR – a person or business entity that contracts to oversee a building project usually involving the use of subcontractors.

SUBCONTRACTOR – an individual or business firm contracting to perform part or all of another's contract.

MATERIALS - all the tangible personal property, including fixtures, which enter a structure or otherwise become incorporated into real estate. Reference 86 Ill. Adm. Code 130.1940(a)(5).

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Contracts for improvements to real property are principally of three general types:

- (a) Lump Sum - A contract which fixes the amount to be paid to the contractor as a single amount.

A lump-sum contract is one in which the agreed contract price is one lump-sum amount and in which the charges for incorporated materials are not separate from the charges for skill and labor. Separated invoices issued to the customer will not change a lump-sum contract into a separated contract unless the terms of the contract require separated invoices. Under a lump-sum contract, the contractor is considered the ultimate consumer. The contractor owes tax on the purchases of incorporated materials, equipment, consumable items, and taxable services.

- (b) Cost Plus - A contract which itemizes the cost of tangible personal property, which may include tax, labor, overhead and other costs, plus a certain fee or percentage in addition to cost.

Cost-plus a fee contract is generally regarded as a separated contract. A separated contract is one in which the agreed contract price is divided into a separately stated agreed contract price for incorporated materials and a separately stated agreed contract price for skill and labor.

- (c) Time and Material - A contract that specifies material and fixtures at retail or at some other agreed price plus labor, etc., at an agreed price.

Arrangement in which a contractor is paid on the basis of: (1) actual cost of direct labor, usually at specified hourly rates, (2) actual cost of materials and equipment usage, and (3) agreed upon fixed add-on to cover the contractor's overheads and profit (income).

A sequence of events that may occur in a construction contract follows:

- (a) Examination of the plans, specifications, and the invitation to bid by the contractor.
- (b) Preparing a bill of materials and estimating cost of materials plus tax, labor, overhead and profit.
- (c) Submission of a bid to the owner or general contractor.
- (d) Signing of contract and obtaining a building permit.
- (e) Stages of construction with inspection, progress billings, retention.
- (f) Changes, additions, and deletions at an agreed price. These may come through as various change orders on large jobs or simple oral agreements on home construction.
- (g) Completion, completion notice and final billing.

13.4.1 WHEN PROPERTY IS NOT INSTALLED

Frequently a contractor, because of union regulation or other contract stipulation, may merely deliver a portion of the materials or fixtures to the "jobsite - not installed." Even though the entire contract may be lump sum, where any such property is delivered to the job and not installed by the contractor (or a subcontractor hired by the seller), a sale of tangible personal property has been made and the transaction is not a construction contract. Also, contractors occasionally sell tangible personal property which does not become part of the real estate in conjunction with real estate contracts. In these cases, tax should be computed upon the retail selling price of such items. If the "retail selling price" is not separately stated in the contract, the tax will be based on no less than the contractor's cost. Auditors must verify from the taxpayer's cost records, contracts, etc., that the taxpayer made the installation, or other installer(s) hired by the taxpayer made the installation. The contractor, or subcontractor, must be under contract to have the property installed for the transaction to be considered a construction contract.

For example, should a subcontractor merely deliver fabricated materials or fixtures to a prime contractor who will make the installation, there has been a sale of tangible personal property from the subcontractor to the prime contractor rather than a subcontract to improve real property.

13.4.2 WHEN PROPERTY INSTALLED IS MACHINERY AND EQUIPMENT

Generally, when machinery and equipment are installed, this is considered a sale and installation of tangible personal property rather than an improvement to realty since "machinery and equipment" is not permanently affixed to the building. Reference COMMONWEALTH EDISON CO. (See Chapter 15, Manufacturing and Assembling Exemption) regarding machinery and equipment determined to be real property.

13.5.1 Overview

General Ledger – This may include several accounts particular to contractors. Contractors may set up contracts they are obligated to perform as liabilities and discharge the liabilities as the jobs progress and progress billings are made.

Books of Original Entry – These may be similar to those of a retailer or manufacturer. The purchase journal and/or cash disbursements journal may show material purchases charged to inventory or directly to specific job numbers or job cost expense accounts. The sales journal may reflect various entries such as: (1) progress billings on lump sum contracts, (2) over-the-counter sales, and (3) time and material contracts. The journal will normally have separate columns for labor, material and tax charged.

Subsidiary Records – These records reflect a detailed breakdown and may be the source of amounts recorded on the books of original entry. These records may include the following:

- (a) Contract register showing contract number, owner's name, job location, brief description of job, type of contract, total amount of contract and date completed.
- (b) Contract job cost journal showing such items as material cost, labor, overhead, subcontracts, etc., for the various jobs in process and a total for all jobs for a particular accounting period. Job cost ledger cards may also be kept.
- (c) Requisition journal, recording materials and fixtures withdrawn from inventory.

Supporting Documents - These documents may include the following:

- (a) Billings, both progress and final
- (b) Job cost folders:
 - (1) Plans and specifications
 - (2) Estimate of costs
 - (3) Copy of contract
 - (4) Copy of purchase invoices for direct charges to job
 - (5) Copy of requisitions for material withdrawn from inventory
 - (6) Timecards for both in-plant labor and labor at job site
- (c) File(s) of paid purchase invoices.

13.6.1 Overview

Generally, other than contractors performing contracts for exempt organizations, tax applies to construction contractors as follows:

- (a) **Materials** - Contractors are consumers of material which they furnish and convert into real property in the performance of construction contracts. Tax applies to the cost of materials to the construction contractor. Construction contractors are deemed end users of tangible personal property purchased for incorporation into real property. As end users of such tangible personal property, contractors incur Use Tax liability for such purchases based upon the cost price of the tangible personal property. If Contractors buy all materials from Illinois registered retailers, they may simply pay the tax to their suppliers. If they purchase materials from out of state retailers, they need to verify that any tax collected is Illinois tax. If the retailer from which they are purchasing is not collecting Illinois tax, the Contractor must register with the Department and self-assess Use Tax. Section 3-55 of the Use Tax Act states: "d) The use, in this State, of tangible personal property that is acquired outside this State and caused to be brought into this State by a person who has already paid a tax in another State in respect to the sale, purchase, or use of that property, to the extent of the amount of the tax properly due and paid in the other State."

A construction contractor is not required to separately bill materials and installation labor. If the contract explicitly provides for the materials to be converted into realty and separately states the sale price of the materials, the contractor still owes tax only on the cost of the materials.

Many contractors purchase "Special Order Structural Steel." To qualify as "Special Order", the seller must design or contribute substantially to the designing of the structural steel. The contractor is considered the end user of the special-order structural steel in the form of tangible personal property. Therefore, the Service Occupation Tax and Service Use Tax rules should be applied accordingly. Refer to 86 Ill. Adm. Code 130.2115 Sellers of Machinery, Tools, and Special-Order Items

When a contractor fabricates or processes material prior to its conversion into realty, no tax is due on such processing costs. Only the contractor's actual material cost is subject to the tax. Where the contractor sublets fabrication or processing of material to an outside firm which also supplies the material, such fabrication is considered part of the taxable cost of materials.

- (b) **Fixtures** - Contractors are not retailers of fixtures which they furnish and convert into realty. If the contractor purchases a manufactured fixture, the tax base is the cost price, i.e., the contractor's purchase price of the fixture. However, if the contractor manufactures the fixture, the taxable measure is the actual cost of material becoming part of the manufactured item.
- (c) **US Government Contracts** - 86 Ill. Adm. Code 130.2075(d)(1) states that material incorporated into real estate owned by governmental bodies, is exempt from tax. However, 86 Ill. Adm. Code 130.2075(d)(3) states that "sales of tools, fuel, lumber for forms and other end use or consumption items to construction contractors who do not incorporate these items into real estate are taxable sales regardless of who the contractor's customers may be, and this has been true since the beginning of the Act." However, in some circumstances, "contractor use items"

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may be exempt sales for resale to the governmental entity. Refer to 86 Ill. Adm. Code 130.2076 Sales to Purchasers Performing Contracts with Governmental Bodies.

- (d) **Tax Rate Information for Contractors** - For most sales of tangible personal property, the date of delivery is the key in determining the tax rate applicable in the event of a tax rate increase. However, in the case of sales of building materials to construction contractors for use in performing a binding construction contract which was entered into before the effective date of a tax rate increase, the applicable tax rate will be the rate which was in effect when the contract was entered into. If delivery occurred after the date of the tax rate increase and the contractors are legally unable to shift the burden of the tax rate increase to their customers, the applicable tax rate will be the rate which was in effect before the effective date of the rate increase. Construction contractors must give their suppliers a written, signed certification stating that specifically described materials are being purchased for use in performing a binding contract which was entered into before the effective date of the tax rate increase. See 86 Ill. Adm. Code 150.115(b).

13.7.1 Overview

Procedures for auditing construction contractors generally vary substantially from those for a regular retailer in that contractors are generally responsible for tax on their cost. Thus, in most cases, audits of construction contractors are completed by examining purchases in a manner where all material costs are accounted for.

In this industry, the methods and size of operation, accounting, and reporting methods vary greatly. It is impossible to prescribe an inflexible audit program to be followed in all cases, nor is it desirable. An auditor must assume the responsibility for planning an audit technique appropriate for each particular set of circumstances encountered. To accomplish this, an auditor must:

- (a) have a thorough understanding of the application of tax to construction contractors;
- (b) be thoroughly familiar with the various special provisions of the law and regulations applicable to contractors;
- (c) have knowledge of the audit planning procedure and fundamental verification guidelines as outlined below.

13.7.2 AUDIT PLANNING

Certainly, the best foundation to sound audit planning is a complete understanding of the facts. Prior to planning the audit program, determine the following:

- (a) **The Scope of Activities** - In what type of contracting is the taxpayer engaged? Does it involve materials, fixtures, or both? Is the taxpayer also engaged in making retail sales? Are contracts performed for the United States Government, other governmental units, or exclusively religious, charitable, or educational organizations?
- (b) **How the Taxpayer Bills** - Does the taxpayer bill on lump sum, cost plus, time and material basis, or varied methods? Does the taxpayer charge tax to customers as a separate item?
- (c) **How the Taxpayer Purchases** – Does the taxpayer purchase materials and fixtures on tax-exempt, tax-paid, or mixed-status basis? Does the taxpayer purchase material for specific jobs, or do purchases get charged to central inventory, or both?
- (d) **How the Taxpayer Records and Reports** - This is a vital key to effective audit planning. An auditor must be aware of the taxpayer's methods and make use of data already accumulated by the taxpayer. Does the taxpayer record materials purchased against specific jobs, or to central inventory, or both? How is material removed from central inventory recorded? Are year-end adjustments made? When and how does the taxpayer report tax on these materials to the Department?

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13.8.1 TOTAL SALES

Verification of gross sales generally should be confined to examination and control of revenue and other general ledger accounts to insure accounting for all classes of transactions. Typical examples of other than normal operations might be rentals, joint venture operations, dispositions of fixed assets, etc. In cases where a taxpayer operates as a retailer and a contractor or whenever over-the-counter sales are substantial, gross sales should be verified.

13.8.2 TAXABLE BASIS OF CONTRACT

Some contractors maintain detailed and complete job cost records and can report directly from job cost folders. These normally contain details of purchases made directly for specific jobs, and stock requisitions for inventory withdrawals.

Some contractors maintain very poor cost records and frequently report estimated costs. Furthermore, omissions are frequent even where adequate cost records are maintained.

Auditors must exercise care to verify that tax-paid supply and expense items are charged to expense accounts rather than being included in material purchase accounts. When a markup is used to establish costs of a portion of the sales, auditors will verify the markup utilized.

13.8.2.1 CONTRACTOR ON TAX-PAID BASIS

Construction contractors are considered the end users for tangible personal property that is incorporated into real property and owe use tax on the cost of the tangible personal property. This means they pay tax to the vendor at the time of purchase. If purchases are made from unregistered sellers who did not collect any Illinois Use tax, the construction contractor must register with the Department to report and pay the tax due by self-assessment on their ST-1 return on all materials other than those that will go into exempt jobs. Auditors will verify that the contractors are paying tax on the cost of materials only. If tax was not paid on any purchases of materials, verification of if they were used on exempt jobs is required before listing as exceptions.

In addition, minimum load charges on delivered sales of ready-mix concrete are taxable sales at retail even if the charge is separately contracted for and stated. In addition to delivery charges being a cost of doing business, wait time/ hold time/idle time or over time charges are also deemed to be a cost of doing business and are not deductible from gross receipts. Please refer to 86 Ill. Adm. Code 130.410 for more information.

Some concrete mixing businesses have "batch plants" which can qualify as a manufacturing facility because it combines ingredients to form concrete. This will affect whether the equipment used is taxable or not. It should also be noted that if the concrete produced by these pieces of equipment is for use in construction contract jobs primarily then the equipment will also not qualify as manufacturing equipment.

13.8.2.2 CONTRACTOR NOT ON TAX-PAID BASIS

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A contractor owes tax when the contractor commits materials to a specific job, either by delivery, charges to a job in cost records, withdrawals from inventory, etc., or in the month the contractor paid the supplier for the materials if the contractor is on a "receipts basis". This situation occurs when the contractor certifies that they will assume accountability for the tax liability. The contractor needs to be registered with the Department to make purchases using a resale certificate. 86 Ill. Adm. Code 130.2075(b) provides details on how the contractor is to report the tax liability. The auditor must verify that the contractor is properly reporting sales and paying the State Retailers' Occupation Tax along with any other applicable local Retailers' Occupation Taxes. See section 13.7.5 below.

The auditor will need to review purchase invoices for direct purchases for specific jobs, withdrawals from inventory for specific jobs, actual job cost records and any general ledger or accounting records the taxpayer maintains.

13.8.2.3 DEPOSIT OR PREPAYMENT ON PURCHASES OF MATERIALS NOT YET MANUFACTURED OR DELIVERED

Prepayments do not constitute taxable gross receipts until delivery of the merchandise is made to the customer or until the merchandise is specifically identified to the sales contract.

86 Ill. Adm. Code 130.430, Deposit or Prepayment on Purchase Price, states:

If a buyer in a sale at retail makes a binding commitment to purchase, and the tangible personal property which is the subject of the binding commitment has been identified to the contract, any payment on the purchase price must, at the time of such payment, be included in the measure of the seller's tax liability.

In the Illinois Appellate Court case of UNITED TECHNICAL CORPORATION V. THE DEPARTMENT OF REVENUE, 107 Ill. App. 3d 1062 (1st Dist. 1982), an exception to this rule is discussed. Equipment that is prepaid, prior to being manufactured or delivered (title has not passed to the purchaser) is not subject to the use tax until such time as title passes to the purchaser. This case refers to equipment sold to a purchaser (other than a contractor). However, there would be no distinction between this, and material and fixtures sold to a contractor for subsequent incorporation into real estate.

13.8.3 FIXED ASSETS AND EXPENSE ITEMS

Verifying fixed asset acquisitions and expense items should be completed as in any normal audit. A significant item is the "self-order" job involving withdrawals of materials from inventory for the contractor's own use. Frequently, such withdrawals are recorded only by journal entries, or perhaps only in memo records.

Machinery and equipment used by construction contractors is taxable because construction contractors are the consumers of the material incorporated into real estate. Construction contractors are not retailers of the materials incorporated into real estate. See 86 Ill. Adm. Code 130.2075.

13.8.4 RESALE

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The auditor should verify that deductions of items purchased for resale represent sales of tangible personal property.

The Administrative Code provides that a subcontractor may not avoid liability for Retailers' Occupation Tax or Use Tax on materials or fixtures furnished and installed by taking a resale certificate from the prime contractor. A subcontractor who furnishes and installs materials or fixtures is liable for tax on such transactions, even though the subcontractor may have a resale certificate from the prime contractor, and the prime contractor has collected tax from the customer. In such a transaction, any separately stated tax collected by the prime contractor from the customer is excess tax (to the extent that it exceeds tax on cost) and must be paid to the Department if it is not refunded. However, the Board of Appeals has granted relief in some over-collection situations. 86 Ill. Adm. Code 140.108(a)(3)

13.8.5 USE OF RESALE CERTIFICATES BY CONTRACTORS

Contractors holding valid registration numbers may purchase materials for resale by issuing resale certificates to their suppliers if they do not know how the materials will be sold or used. They may not purchase materials for resale unless they are also in the business of selling materials at retail. Contractors should not purchase consumable supplies and tools for resale unless they are engaged in the business of selling such property. This is true even if the contractor is otherwise registered and gives the supplier a resale certificate. Auditors should inform the contractor that this is an improper use of the certificate.

When dual retailers/contractors furnish resale certificates to suppliers for materials which will be subsequently converted into real estate, they will be liable for reporting and paying tax to the Department in the same form as if they had paid the tax to their suppliers (i.e., Retailers' Occupation Tax plus local and transit taxes if applicable). Reference 86 Ill. Adm. Code 130.2075(b)(3). When the dual retailer/contractor assumes the liability thereby relieving the supplier that would otherwise have collected local taxes, the local taxes due are based on the contractor's location, not the supplier's location.

Since the dual contractor/retailer is liable for Retailers' Occupation Tax in this situation, the provisions of the Retailers' Occupation Tax regulations, including the discount, would apply. 86 Ill. Adm. Code 130.501(b)(4)(A) allows the taxpayer a reimbursement of 1.75% of the tax due for the expenses incurred in keeping records, preparing, and filing returns, remitting the tax and supplying the data to the Department on request. This discount is only allowed if the taxpayer timely files the return and pays the tax. Additionally, retailers required to file returns electronically pursuant to the Act who fail to file their returns electronically may not take the discount.

A dual retailer/contractor should generally report all over-the-counter receipts and gross receipts from construction contracts on Line 1 of the ST-1. Since contractors, when performing construction contracts, only owe tax on the cost of material, they may take a miscellaneous deduction for their labor and will generally describe it as "excess of construction contracts over material costs." This would typically also include any markup they charged their customer on the materials. However, a dual retailer/contractor may not report receipts from construction contracts on Line 1 of the ST-1 when they utilize materials purchased from out-of-state suppliers. They only owe Use tax on purchases from out-

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of-state suppliers and must instead pay Use tax on such purchases on Line 12a of the ST-1, under Step 5: Tax on Purchases.

Contractors who are not also retailers cannot give their suppliers resale certificates to avoid local and transit taxes. If this is found in audit, the auditor must inform the contractor that this is an improper use of the certificate.

Under 86 Ill. Adm. Code 130.2075, construction contractors are the consumers of materials, which they furnish and convert into realty in the performance of a construction contract. Consequently, there are no circumstances under which construction contractors may accept a resale certificate from a prime contractor, interior decorator, department store, or others for materials, which they furnish and convert into realty.

13.8.6 TAX-PAID PURCHASES RESOLD

If materials or fixtures are purchased tax-paid or reported on the contractor's ST-1 return, they may claim credit for the cost of tax-paid materials or fixtures, which are subsequently sold over the counter at retail. The authority for this credit is explained in 35 ILCS 120/6.

13.8.7 BAD DEBTS

A bad debt deduction is not allowable for contractors because the legal obligation for the tax is on the contractor since the contractor is the consumer of the building materials. A contractor's purchase of tangible personal property is the last transfer of tangible personal property in a retail situation per *G. S. LYONS & SONS* where the court declared that the builder buys materials to use, and not to resell as personal property. This is true whether the real estate belongs to the builder or a third party. In either case, the material, in the process of use, becomes real estate and is no longer the object of a tax on the privilege of selling. Also, the Retailer's Occupation Tax is a tax upon the retailer and not upon the purchaser (contractor). There is no section within the Retailer's Occupation Tax Act and there is nothing within 86 Ill. Adm. Code 130.1960(d) which authorizes a credit for bad debts to be given to a non-retailer.

13.8.8 EXEMPT SALES

Contractors can claim exemption from tax on jobs for exclusively charitable, religious, or educational institutions, and governmental bodies. All invoices must designate the name of the exempt job. They can present the exempt organization's exemption number along with a certification that their purchases are for conversion into real estate under a contract with the exempt organization.

The exemption also applies to material sold to construction contractors for incorporation into public improvements, which are required to be transferred to a unit of local government upon completion. In this situation, to claim the exemption, contractors must also submit as part of the exemption letter the active registration number issued by the Department to the governmental unit to which the public improvements will be transferred upon completion. Refer to 86 Ill. Adm. Code 130.2076 Sales to Purchasers Performing Contracts with Governmental Bodies.

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Consumable supplies, which are sometimes referred to as “overhead materials” or “contractor use items” that are used in fulfilling a contract with a governmental entity and which are transferred to the governmental entity are exempt sales for resale if the following conditions are met:

1. Title to the overhead materials is transferred to the governmental entity.
2. The contract must specify that the materials or supplies are transferred to the government. The contract does not have to be item specific. For example, a statement that title to all property purchased shall pass and vest in the government will be sufficient. It also does not matter if title transfers immediately or after the completion of the contract.

Consumable supplies include fuel that a purchaser uses to fulfill its contract with the governmental entity.

When contractors purchase materials for use rather than for incorporation into real estate on an exempt job, an exemption cannot be claimed. An example of this would be lumber purchased for making forms to be used in laying out public streets. Contractors cannot claim an exemption for material shipped to a construction job of an exempt organization if that organization is merely going to lease that property from a non-exempt organization.

MANUFACTURING ILLINOIS CHIPS FOR REAL OPPORTUNITY (MICRO) ACT

Beginning April 19, 2022, building materials used in the construction of a qualifying facility that manufactures microchips or semiconductors (or their parts) are exempt from any State or local Use Tax or Retailers’ Occupation Tax. The project must be certified by the Department of Commerce and Economic Opportunity (DCEO) as qualified under the MICRO Program. See 35 ILCS 120/5m and 35 ILCS 45/110-105 for more information.

REIMAGINING ELECTRIC VEHICLES (REV) IN ILLINOIS ACT

Beginning October 16, 2021, building materials used in the construction of a qualifying facility directly related to the manufacturing of electric vehicles are exempt from any State or local Use Tax or Retailers’ Occupation Tax. The project must be certified by the DCEO as a REV Illinois Project. See 35 ILCS 120/5n and 20 ILCS 686/105 for more information.

13.8.9 TEMPORARY STORAGE

Per 86 Ill. Adm. Code 150.310(a)(5), tax does not apply to the temporary storage of building materials in Illinois purchased from inside and outside Illinois by an Illinois registered combination retailer and construction contractor who incorporates the building material into realty outside Illinois. Non-retailer contractors may only claim the temporary storage exemption on items acquired outside Illinois. See 86 Ill. Adm. Code 150.310(a)(4) for more information.

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13.9.1 OVERCOLLECTION OF TAX

An auditor should check billings for tax reimbursement procedures, and, where applicable, reconcile sales tax accruals or records of tax collections for the audit period.

When contractors collect tax from customers as a separate item with respect to materials which they have incorporated into realty, the amount the contractor collects is an overcollection of tax. Any such overcollection of tax must be refunded by contractors to their customers or paid to the Department. The discount on tax overcollections is not allowable. Interest does not accrue on overcollection of tax.

A taxpayer cannot reimburse himself for his use tax liability by showing it as a tax amount on the invoice. The taxpayer should rephrase it on the invoice to show the tax as a reimbursement for taxes paid or include it in the selling price. Construction contractors owe use tax on the cost of tangible personal property converted to real estate. Therefore, any tax separately stated on the invoice simply as a tax is technically an overcollection of tax.

BOARD OF APPEALS GENERAL ORDER 03-3001 – for all contractors

On April 28, 2003, the Board of Appeals entered General Order 03-3001 to provide relief for taxpayers who misunderstood their Illinois tax obligations as found in 86 Ill. Adm. Code Sections 130.1940 and 130.2075. Taxpayers (e.g., contractors and subcontractors) under these regulations incur Illinois Use Tax on the cost price of materials converted into real estate.

They are allowed to reimburse themselves for their Use Tax liability by (1) building it into the charge for the item or (2) stating a charge on the invoice as “Reimbursement for Use Tax Incurred.”

Some taxpayers attempt to reimburse themselves for their own Use Tax obligation without properly identifying this charge as a reimbursement. Others improperly collect the Illinois Retailers’ Occupation Tax on the selling price in a transaction subject to Use Tax on the contractor’s cost price. As a result of this activity, the State of Illinois receives tax amounts significantly greater than what would be due if the transaction had been completed correctly.

Therefore, the Board of Appeals has authorized the granting of relief against the unpaid Illinois Use Tax liability resulting from the taxpayer’s improper collection and remittance of the Illinois Retailers’ Occupation Tax to the Department of Revenue. This relief is granted because the Use Tax and the Retailers’ Occupation Tax collected and remitted are for the same transactions, and that the Retailers’ Occupation Tax is equal to or greater than the amount of Use Tax owed on the same transaction.

The conditions that must be met to qualify for relief are:

1. The taxpayer must remit payment for the remaining final tax liability owed regarding this issue.
2. The taxpayer cannot, later, file a claim for credit for any money refunded to customers who have requested a refund from the taxpayer.

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3. After relief is granted under the Order, any taxpayer that challenges its Illinois tax liability regarding this issue for the period of which the relief has been granted, whether through a claim for refund or by any other means, voids the relief. All liability waived by the Order shall become immediately due and owing.
4. The taxpayer must immediately come into compliance regarding the proper filing and collection of its Illinois Retailers' Occupation and Use Tax liability.

Only the Sales and Miscellaneous Tax Division Manager and Audit Bureau Manager are authorized to grant this relief. If this issue is encountered, auditors should contact their supervisor for proper channeling of the request for approval of this relief.

This Order remains in effect until such time as the Board takes further action regarding this matter.

13.9.2 JOB REPORTING BASIS - JOBS IN PROCESS

Contractors should report tax when materials are withdrawn from stock, when materials are paid for, or when materials are delivered to the job for use in performing a construction contract. When an auditor encounters contractors who are reporting tax on construction jobs at the time of completion rather than as outlined above, they should assess tax on any materials on jobs in process at the end of the audit period. For an exception, see 13.8.2 Taxable Basis Of Contract.

13.9.2.1 DELIVERY CHARGES

It should be noted that, particularly in the construction material industry, delivery of such items as lumber, concrete, structural steel, etc., is generally made by the retailer. Generally, tax will not apply to such separately stated delivery charges. Refer to 86 Ill. Adm. Code 130.415 Transportation and Delivery Charges

However, delivery charges for ready-mix concrete are part of the purchase price since the customers do not have the option of arranging for delivery themselves. Minimum load charges on delivered sales of ready-mix concrete are taxable sales at retail even if the charge is separately contracted for and stated. See Section 130.415 for more information on delivery charges.

13.9.3 OUT-OF-STATE CONTRACTORS

Even though property is delivered in this State, an exemption is provided for all tangible personal property to be incorporated into real estate outside of Illinois. According to 86 Ill. Adm. Code 150.110, contractors bringing equipment into Illinois for use (bulldozers, etc.) are subject to Use Tax on depreciated cost less tax properly paid to another state. Depreciation should be computed using the straight-line method.

13.9.4 "LAST ACT" TEST

Dumping of rock, concrete, road oil, etc., may be either an improvement to realty or a sale of tangible personal property, dependent upon whether the dumping by the seller or contractor constitutes the "last

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act." If the material must be spread, tamped, smoothed, or otherwise later set in place by another person, it constitutes a sale of tangible personal property.

13.9.5 LOCAL TAX

86 Ill. Adm. Code 130.2075 defines the basis upon which the local taxes are applied to dual business taxpayers (retailers/contractors). The place where the dual retailer/contractor maintains its business is considered the place of use of materials. Retailers' Occupation Tax plus local taxes, if applicable, would be due based upon the location of the taxpayer's business for untaxed purchases from ILLINOIS SUPPLIERS when the contractor presented a resale certificate.

When a dual Illinois retailer/contractor furnishes resale certificates to Illinois suppliers for materials that the contractor will subsequently incorporate into real estate, the dual retailer/contractor will be liable for reporting and paying tax to the Department on the cost price of those materials in the same form as if it had paid the tax to its suppliers (i.e., Retailers' Occupation Tax plus local taxes if applicable). Reference 86 Ill. Adm. Code 130.2075(b)(3). When the dual retailer/contractor assumes the liability thereby relieving the supplier that would otherwise have collected local taxes, the local taxes due are based on the contractor's location, not the supplier's location (e.g., Springfield contractor = Springfield ROT rate).

When a dual Illinois retailer/contractor furnishes resale certificates to an out-of-state supplier for materials that the contractor will subsequently incorporate into real estate, the tax liability of the dual retailer/contractor for those materials depends on whether the dual retailer/contractor's out-of-state supplier has nexus with Illinois. If the supplier does not have physical presence nexus with Illinois but has met a tax remittance threshold (economic presence nexus), the contractor would need to report and remit Retailers' Occupation Tax and local taxes on the cost price of the materials based either upon the Illinois location to which the tangible property is shipped or delivered or at which possession is taken by the purchaser ("destination sourcing"). If a tax remittance threshold has not been met (no economic presence nexus) by the out-of-state supplier who does not have physical presence nexus with Illinois, the retailer/contractor would owe Use Tax on the tangible personal property used on a job. If the out-of-state supplier has physical presence nexus with Illinois, Use Tax would be owed by the contractor.

An out-of-state contractor who has no "Illinois Place of Business" owes Use Tax only on untaxed purchases of building materials, which are incorporated into real estate in Illinois from both ILLINOIS SUPPLIERS and out-of-state suppliers.

13.9.6 JOB-SITE DELIVERY

When material that is to be incorporated into the real estate is delivered to the job site, contractors will be liable to the supplier for tax on the materials. If tax is not paid to the supplier, the contractor must remit it directly to the Department.

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13.10.1 Overview

No formula exists as to when an item remains tangible personal property and when it is converted to real estate. However, there are a few questions to consider in attempting to answer this question:

- 1) What did the parties intend?
- 2) Will removing the item damage the real estate or the item being removed?
- 3) Integrated Industrial Plant Doctrine Test - If the item is necessary to the operation of the plant and is affixed to real property, the item could be considered real property. Reference COMMONWEALTH EDISON CO. case regarding machinery and equipment ruled to be real property.

Whenever a utility company purchases items used in providing their service, the taxability may depend on where the items are installed:

- 1) If a utility installs an item on an easement on or above ground, the item can be either tangible personal property or real estate depending on whether the intent was for the item to remain indefinitely.
- 2) If a utility installs an item below ground on an easement, it is converted to real estate.
- 3) If a utility installs an item on property it owns, whether it is above or below ground, the item is converted to real estate.

13.10.2 VOICE, DATA, VIDEO, SECURITY, AND ALL TELECOMMUNICATION SYSTEMS

Public Act 88-420, effective August 20, 1993, exempted from Retailers' Occupation Tax, construction contracts for the improvement of real estate consisting of engineering, installation, and maintenance of voice, data, video, security, and all telecommunication systems. These do not constitute engaging in a business of selling tangible personal property at retail within the meaning of the Retailers' Occupation Tax Act if they are sold at one specified contract price. 86 Ill. Adm. Code 130.1940 (c)(3) was amended as follows:

Construction contractors who contract for the improvement of real estate consisting of engineering, installation, and maintenance of voice, data, video, security, and all telecommunication systems incur Use Tax, rather than Retailers' Occupation Tax, liability on those items if they are sold at one specified contract price. This provision applies to all of the items in this subsection (c)(3) even if they are not incorporated into real estate.

EXAMPLE:

A contractor installs security and telecommunication systems. The contractor also provides remodeling, repair, and service/maintenance assistance on the systems. All systems are installed (hard-wired) into the customer's realty. The contractor does not sell any mobile equipment or make any over-the-counter sales.

As a result of the statutory and regulatory language, installers of security systems and telecommunications described in subsection (c)(3) of Section 130.1940 are authorized to pay Use Tax

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to their providers on all equipment and supplies they purchase related to the security systems they sell and install, even if some of those supplies are not technically incorporated into real estate, such as the telephones, cameras, computers, and monitors. This provision applies only if the sale and installation of the security systems are packaged for one specified contract price.

13.11.1 Overview

Suppliers of construction contractors are retailers. They are vendors who sell tangible personal property that is converted into real estate. Some suppliers are also in other businesses (e.g., selling end use items to contractors such as tools, fuel, forms, etc.) and act as construction contractors.

Audits of suppliers are conducted much the same as audits of any other retailer. Suppliers of construction contractors can, on occasion, also be subject to the Service Occupation Tax when acting as a serviceperson (repairing tangible personal property or fabricating "Special Order Structural Steel").

Suppliers can range from a retailer of all types of material used in construction (including tools) to suppliers of specific materials, such as sheet metal, lumber, electrical, plumbing, etc.

When auditing suppliers of contractors, properly completed resale certificates provided by the contractor to the supplier will be accepted even if the job site is identified on the sales invoice or the purchase order. This is the result of court decisions that give no consideration to the Department's past practice of disallowing sales claimed for resale on job site deliveries. Auditors should consider making an audit referral of contractors who have given suppliers resale certificates for materials delivered to a job site.

The complexities surrounding suppliers of contractors can be simply stated by using a common 2x4 piece of lumber.

The SUPPLIER might:

- (a) sell it OVER THE COUNTER to a carpenter or to a person not in the carpentry trade and incur Retailers' Occupation Tax (State, local and transit if applicable) on the selling price;
- (b) sell it over the counter to a serviceperson (i.e., for use in repairing tangible personal property) and incur Retailers' Occupation Tax (State, local and transit if applicable) on the selling price.
- (c) take it out of stock and use it for their own purposes (i.e., constructing a building on their own real estate or making forms, etc.) and incur Use Tax;
- (d) take it out of stock and construct a structure for others thereby incurring Retailers' Occupation Tax (State, local and transit if applicable) on cost, or Use Tax on cost depending upon whether the 2x4 was purchased in or out-of-state; or
- (e) take it out of stock and use it to repair a mobile home (tangible personal property) and thereby incur Service Occupation Tax on the selling price, Service Occupation Tax on cost price or Use Tax on cost depending on whether their cost is over the 35% cost/receipts threshold.

13.11.2 DEDUCTIONS CLAIMED BY SUPPLIERS OF CONTRACTORS

Suppliers of contractors generally will have deductions in the following categories depending upon the size of the business and scope of operations:

- (a) Resale, Sales to Other Dealers, and "Registered" Contractors - The latter group should be scrutinized.

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- (b) Cash Discounts and Cash Refunds - These should be checked to ensure they were allowed on taxable transactions which have been reported.
- (c) Service Charges (Interest, Carrying Charges) - Verify these have been included in Line 1 of the ST-1 return.
- (d) Production Labor – When suppliers of construction contractors sell certain manufactured products to construction contractors, they are NOT allowed to take a deduction for production labor (also referred to as fabrication labor).

For example, a sheet metal shop (supplier) fabricates a piece of ductwork for a furnace/air conditioning system. They sell (over the counter) the ductwork to a heating contractor who will incorporate it into real estate on a taxable job. The entire selling price of the ductwork is taxable. Some sheet metal shops (suppliers) will charge tax on the price of the materials (sheet metal, rivets, screws, insulation, etc.) but not on the amount charged for their labor. This labor, sometimes referred to as production labor or fabrication labor, is NOT an allowable deduction.

- (e) Church, Charity, School, Government - These may be direct sales to exempt organizations and users, or they may be to contractors claiming to have contracts with such organizations involving real estate owned by the exempt organization. Care should be taken to ensure the organization is exempt by evidence of a proper exemption number. Valid contracts must exist. When verifying an exemption for materials purchased by contractors for public improvements that will be transferred to a governmental unit, auditors must make sure that the supplier has obtained the registration number of the local governmental unit. If there is doubt as to the authenticity of a particular project, an auditor may require the supplier to obtain the following documentation before allowing the exemption.
 - (1) A copy of the local governmental ordinance in effect at the time of the development and applicable to the development. The ordinance must require that title to the public improvements be transferred to the local governmental unit upon completion.
 - (2) A copy of any pre-development agreement between the governmental unit and the developer, which requires that title to the public improvements be transferred to the governmental unit upon completion.
- (f) Manufacturing Machinery and Equipment - Contractors who make purchases of manufacturing machinery and equipment, which will be installed into real estate on behalf of a manufacturer, may claim the manufacturing machinery and equipment exemption. To claim the exemption, the contractors may present to their supplier the certification (Form ST-587) provided for in 86 Ill. Adm. Code 130.330(j)(4) that the machinery or equipment will be transferred to a manufacturer as manufacturing machinery or equipment in the performance of a construction contract for the manufacturer. The purchasing contractor should include the manufacturer's name and registration number on the certification when claiming the exemption. However, if the contractor has an active registration or resale number, the contractor can submit his registration or resale number to his suppliers in lieu of the prescribed certificate per 86 Ill. Adm. Code 130.330(j)(2).

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(g) Enterprise Zones - These sales should be verified as discussed in the following paragraph.

13.11.3 ENTERPRISE ZONES

Sales of building materials that will be incorporated into realty in an Enterprise Zone may be exempt. To qualify for the deduction; the materials being purchased must be building materials that are purchased for physical incorporation into real estate within an enterprise zone.

Before July 1, 2013, "qualified sale" means a sale of building materials that will be incorporated into real estate as part of a building project for which a Certificate of Eligibility for Sales Tax Exemption has been issued by the administrator of the enterprise zone in which the building project is located. Beginning July 1, 2013, "qualified sale" means a sale of building materials that will be incorporated into real estate as part of a building project for which an Enterprise Zone Building Materials Exemption Certificate has been issued to the purchaser by the Department of Revenue. **A construction contractor or other entity shall not make tax-free purchases unless it has an active Exemption Certificate issued by the Department at the time of the purchase.**

Before July 1, 2013, the retailer had to obtain from the purchaser a copy of the Certificate of Eligibility for Sales Tax Exemption issued by the administrator of the enterprise zone into which the building materials will be incorporated to document the exemption.

On and after July 1, 2013, to document the exemption, the retailer must obtain from the purchaser the required certification which must contain the Enterprise Zone Building Materials Exemption Certificate number issued to the purchaser by the Department of Revenue. Upon request from the enterprise zone administrator, the Department shall issue an Enterprise Zone Building Materials Exemption Certificate for each construction contractor or other entity identified by the enterprise zone administrator. The Department shall issue the Exemption Certificates directly to each construction contractor or other entity. The Department shall also provide the enterprise zone administrator with a copy of each Exemption Certificate issued.

If the Department of Revenue determines that a construction contractor that was issued an Exemption Certificate made a tax-exempt purchase that was not eligible for exemption or allowed another person to make a tax-exempt purchase that was not eligible for exemption, then, in addition to any tax or other penalty imposed, the construction contractor or other entity is subject to a penalty equal to the tax that would have been paid by the retailer as well as any applicable local retailers' occupation tax on the purchase that was not eligible for the exemption.

For more detailed information on enterprise zones, refer to 86 Ill. Adm. Code 130.1951. Additionally, numerous FY Bulletins have been issued regarding the enterprise zone exemption since it first came into being on September 1, 1985.

13.11.4 HIGH IMPACT BUSINESSES (HIB)

Effective January 1, 1995, sales of building material to a High Impact Business (HIB) to be incorporated into realty in a HIB location are exempt. To qualify for the deduction, the materials being purchased must be building materials. Construction contractors can use the High Impact Business's

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certification to purchase building materials that will be incorporated into the HIB facility. Consumable supplies and tools which are not physically incorporated into the HIB location cannot be purchased using this certificate.

Effective July 1, 2013, in addition to any other requirements to document the building materials exemption, the retailer must obtain from the purchaser the purchaser's High Impact Business Building Materials Exemption Certificate number issued by the Department of Commerce and Economic Opportunity. **A construction contractor or other entity shall not make tax-free purchases unless it has an active Exemption Certificate issued by the Department at the time of purchase.** Upon request from the designated High Impact Business, the Department shall issue a High Impact Business Building Materials Exemption Certificate for each construction contractor or other entity identified by the designated High Impact Business. The Department shall issue the Exemption Certificates directly to each construction contractor or other entity. The Department shall also provide the designated High Impact Business with a copy of each Exemption Certificate issued.

If the Department of Revenue determines that a construction contractor that was issued an Exemption Certificate made a tax-exempt purchase that was not eligible for exemption or allowed another person to make a tax-exempt purchase that was not eligible for exemption, then, in addition to any tax or other penalty imposed, the construction contractor or other entity is subject to a penalty equal to the tax that would have been paid by the retailer as well as any applicable local retailers' occupation tax on the purchase that was not eligible for the exemption.

For more information refer to 86 Ill. Adm. Code 130.1952.

13.12.1 Overview

If signs are permanently affixed to real estate, then the tax consequences attributable to construction contractors apply. Construction contractors are the end users of tangible personal property they affix to realty. As the end user, the construction contractor incurs Illinois use and local retailers' occupation tax reimbursement liabilities when the tangible personal property that will be converted to real estate is purchased. See 86 Ill. Adm. Code Section 130.2155 (d).

A sign vendor who produces a sign and sells it to a customer without installing it will incur either Retailers' Occupation Tax or Service Occupation Tax. However, a sign vendor who also permanently affixes a sign to real estate will be considered as a construction contractor and is subject to the tax reporting requirements detailed in previous sections of this Chapter.

Examples:

- A) A sign is permanently affixed to real estate when it is bolted or otherwise permanently affixed to the building or is hardwired into the building's general wiring system.
- B) A sign is permanently affixed to real estate when a permanent concrete foundation is made for the sign and the sign is affixed to its foundation or hardwired into an electrical system.
- C) A sign is permanently affixed to real estate when it is affixed to a pole that is placed in the ground.

13.13.1 Overview

Sales of carpet and padding to end users are retail sales of tangible personal property and are subject to Retailers' Occupation Tax, local, and transit taxes.

86 Ill. Adm. Code 130.2101(d)(1) defines a Safe Harbor Rule where “a contract or similar document that provides that the seller (or the seller's representative) will install the floor covering by permanently affixing it to real estate evidences a "construction contract" where the contract or similar document demonstrates that the seller and the customer **did not agree** to the installation charge separately from the selling price of the floor covering. The evidence required to be maintained by the seller to demonstrate that the seller and the customer did not agree to the installation charge separately from the selling price of the floor covering is a contract or similar document that states that the installation charges are included in the selling (contract) price.”

When contractors collect tax from customers as a separate item with respect to materials which they have incorporated into realty, the amount that the contractor collects is an overcollection of tax. Any such overcollection of tax must be refunded by contractors to their customers or paid to the Department. On April 28, 2003, the Board of Appeals entered General Order 03-3001 to provide relief for taxpayers who misunderstood their Illinois tax obligations as found in 86 Ill. Adm. Code Sections 130.1940 and 130.2075. Taxpayers (e.g., contractors and subcontractors) under these regulations incur Illinois Use Tax on the cost price of materials converted into real estate. Please see Section 13.9.1 “Overcollection of Tax” of this chapter for more information.

86 Ill. Adm. Code Sections 130.1940, 130.1951, and 130.1952 were amended to clarify which methods of carpet installation the Department of Revenue considers to be permanent installation into real estate. Specifically, the language that was added to these regulations makes carpeting that is affixed using tacks, staples, or wood stripping filled with nails that protrude upward (sometimes referred to as “tacking strips”) a conversion of tangible personal property into real estate. With this change, the tax liability rests with the entity that made the conversion into real estate.

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***This is only an example. It is not to be followed as the exact plan for auditing a contractor. Each audit plan must be tailored to the specific taxpayer. ***

- A. Review applicable portions of Sales and Use Tax Law and rules
- B. Discuss the taxpayer's business operations including:
 - 1. Type of construction done
 - 2. Area of operation (local, state, nation or worldwide)
 - 3. Type of contractor (general or subcontractor, dual retailer/construction contractor)
 - 4. Type of customers (exempt, resale, or owner)
 - 5. Type of contracts (lump-sum, time and material, cost-plus)
 - 6. Number of contracts involved in audit period
 - 7. Who negotiates contracts and establishes taxability status
- C. Obtain and/or prepare a list of contracts with the following information:
 - 1. Type of contract
 - 2. Customer
 - 3. Job site location
 - 4. Any jobs that are subject to any prior contract exemption
 - 5. Start and completion dates
- D. Determine jobs done in Illinois
 - 1. Read contracts to verify taxpayer's stated contract interpretations
 - 2. Examine lump-sum contracts performed out of state to determine if any materials were obtained in Illinois
- E. Verify that resale or exemption certificates are available for each contract claimed to be non-taxable
- F. Taxable purchases
 - 1. Check to see if tax is being paid or accrued on all purchases for lump-sum contracts with taxable entities
 - 2. Check to see if tax is being paid or accrued on all indirect material and equipment used on contracts.
 - 3. Check to see if tax is being paid or accrued on indirect materials and equipment used on contracts with the federal government - an exemption certificate may be issued for qualifying consumables.
 - 4. When the taxpayer is a dual retailer/construction contractor, verify that tax is accrued based on the taxpayer's location, when:
 - a. Materials were purchased on a valid resale certificate, and
 - b. Removed from inventory for use on a taxable lump-sum job
 - 5. Verify that all lump-sum subcontracts include installation labor - subcontract may be for the sale of equipment or material and not an improvement to realty
 - 6. Examine capital asset purchases
- G. Verify that items purchased tax-free with an exemption certificate are used on an exempt job.
- H. Review various Court Cases related to contractors

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