

**TAX EXEMPT PURCHASE OF CONSTRUCTION MATERIALS:
Requirements and Risks**

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Under very strict legal requirements, certain tax-exempt organizations may purchase construction materials, supplies and certain qualified taxable services free of sales taxes in connection with construction, expansion or remodeling of buildings or facilities used principally by the exempt organization. The requirements, however, are very rigorous and even if such requirements can be precisely met, there are other risks that may outweigh the potential rewards.

The construction contract with the prime contractor and every subcontractor that supplies both materials and labor must not be a lump-sum contract or similar type of contract with a guaranteed maximum price covering both materials and labor.

We usually suggest that the agreement with the contractor provide that such materials are excluded from the work described in the contract documents and the costs of such materials be excluded from the cost of the work and from the guaranteed maximum price. The guaranteed maximum price under the contract would then apply to everything except the cost of such materials. The exempt organization assumes the risk for any increase in the cost of materials.

If those requirements are met, then materials may be purchased free from sales taxes if the organization appoints the contractor as its purchasing agent. But that is only if the organization initially advertises for separate bids for materials and labor, the organization may accept one bid without accepting both bids and separate contracts are issued for the accepted bids for materials and labor.

We also usually suggest that the entire bidding and contracting process and any agreements with the prime contractor and every subcontractor be reviewed and modified to ensure compliance with these requirements. If the contractor or a subcontractor is awarded both the contract for materials and the contract for labor, further contract requirements will be necessary.

A significant risk is that the exempt organization must take title to the materials and supplies at the point of delivery and assume the risk of loss for all materials and supplies as well as responsibility for all defective materials and supplies. In that regard, if materials are lost, stolen, destroyed or damaged after delivery to the job site but before incorporation into the project, the loss may be that of the exempt organization, not its contractor. Given this greater risk, the exempt organization may also need to insure the materials.

Another significant risk concern is that the exempt organization (not the contractor acting as purchasing agent) has responsibility for all defective materials and supplies, including any materials that become part of the construction improvements. If there is a claim relating to defective materials, responsibility of the contractor for defective materials may be limited. The exempt organization may have recourse only against the material supplier or subcontractor and not the prime or general contractor.

Finally, any sales tax audit involving the exempt organization or any of its contractors, subcontractors or suppliers can result in not only tax, penalties and interest being claimed against the exempt organization, but also the incurring of significant additional costs, such as attorneys fees. For that reason, the exempt organization may want to have any contractor appointed as purchasing agent indemnify it in the event the contractor fails to properly perform any of its duties and that failure results in denial of the sales tax exemption on construction materials.

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