



## **Item No. 5 Town of Atherton**

### **FINANCE COMMITTEE STAFF REPORT**

**TO: FINANCE COMMITTEE**

**FROM: ROBERT BARRON III, FINANCE DIRECTOR**

**DATE: SEPTEMBER 11, 2018**

**SUBJECT: PRESENTATION, REVIEW, AND DISCUSSION BY HDL CONSULTANTS REGARDING LOCAL USE TAX MAXIMIZATION PROGRAMS-SITUS BASE SALES TAX**

#### **RECOMMENDATION**

Presentation, review, and discussion by HDL consultants regarding local use tax maximization programs- Situs Base Sales Tax

#### **BACKGROUND**

The City Council in recent years has discussed revenue options, alternatives, and updates to the Town General Fund. As part of exploration of alternative revenues staff identified the potential for additional allocation of sales and use tax through local construction contracts. This is in reference to residential home development in the Town. The Town has extensive home construction in the area as there are numerous general contractors and subcontractors in the town throughout the year. Staff enlisted the assistance of HDL, our property tax consultant, to explore the direct allocation of use tax through construction contracts (Situs Base Tax) of \$5,000,000 or more in Atherton. Within this program construction contractors have the option to allocate use tax derived from contracts of \$5 Million or more directly to the local jurisdiction of the site location. It is important to mention this is a voluntary program for the tax payer. This is for construction sites to include voluntary tax allocation on fixtures and materials on construction projects in our jurisdiction.

HDL consultants will assist the Town in exploring the consumer use tax for large construction projects and see if this is an option that Town should further explore. Matt Hinderliter from HDL is here to present to the committee the Construction Project Situs Tax program and other programs that would be feasible and worth exploring in Atherton. Mr. Hinderliter will explain the processes to analyze any instances that would make it possible for the Town to proceed down the path of the

voluntary Situs Base tax allocation. Part of the process would entail discussing options available, possible projections, and review of a point of sales tax of projects from the County Pool and the California Department of Tax and Fee Administration. This tax is primarily based on fixtures and materials installed on a construction project.

**FISCAL IMPACT**

None

**PUBLIC NOTICE**

Public notification was achieved by posting the agenda, with this agenda item being listed, at least 72 hours prior to the meeting in print and electronically. Information about the project is also disseminated via the Town's electronic News Flash and Atherton Online. There are approximately 1,200 subscribers to the Town's electronic News Flash publications. Subscribers include residents as well as stakeholders – to include, but be not limited to, media outlets, school districts, Menlo Park Fire District, service providers (water, power, and sewer), and regional elected officials.

**ATTACHMENTS**

HDL companies- Maximizing Local Use Tax

California's one-cent local sales and use tax is designed to, where feasible, be returned to the agency that services the business generating the tax and is normally allocated to where the seller's sales office, order desk or cash register is located. However, there are circumstances where the seller is not obligated to collect the sales tax thereby making the buyer responsible for a corresponding "use tax", or where the transaction cannot be readily tied to a permanent place of sale. The most significant involve out-of-state purchases or unregistered construction sites where the merchandise is affixed to real property.

The tax from these transactions is primarily distributed via allocation pools that are based on each jurisdiction's pro-rata share of taxable sales. Thus, significant amounts of an agency's revenue can become diluted via the pools and largely credited to other jurisdictions that are not directly involved in serving the business or consumer that pays the tax.

Alternatives are available to allow local use tax to flow to host jurisdictions from major construction projects, some large purchases and even ongoing business operations provided that certain conditions are met. The four major direct allocation alternatives involve:

- Out of State Purchases of \$500,000 or more
- Construction Projects of \$5,000,000 or more
- Direct Payment Permits
- Purchasing Corporations

Many of these programs are *voluntary* for the taxpayer and often do not allow for retroactive reallocation after the tax is paid. Therefore, capturing these opportunities requires vigilance and planning. The following is an overview of each.

## ***OUT OF STATE PURCHASES OVER \$500,000***

For certain large transactions the California Department of Tax & Fee Administration (CDTFA) allows direct reporting of the local sales or use tax to the "jurisdiction of first functional use" for whatever item(s) are being sold. The form used is CDTFA-531-H, commonly referred to as a "Schedule H".

Sellers engaged in business in California are *required* to report qualifying transactions on the Schedule H form. Sellers not engaged in business in California but who voluntarily collect and report use tax *may* report on the Schedule H, but are not required to do so.

### **To qualify, a sale or purchase must meet the following criteria:**

- A single transaction of \$500,000 or more.
- Title to the property passes at a point outside of California.

### **Types of transactions to watch for:**

- Private party vehicle, vessel or aircraft purchase
- Purchases of buses or other vehicles made by a fleet operator or local transportation authority.
- Purchases of machinery and other fixed assets made by:
  - Manufacturing and assembly plants
  - Power plants
  - Hospitals or universities
  - Oil fields and/or refineries
  - Extraction industries (sand, gravel, gypsum, precious metals, etc...)
- Large purchases of consumables such as bunker fuel, chemicals, catalysts, etc...

The unique make-up or characteristics of your jurisdiction should key you in on what types of businesses or transactions to be aware of. If you have an airport or harbor, watch for airplane & boat sales. If you are home to a big maintenance yard or depot for a county transportation authority, watch for bus purchases. If you have a big hospital or medical center, make sure you know when they buy an x-ray or MRI machine.

Open and ongoing communication with your larger consumers will help catch most qualifying transactions on the front end. However, whatever out-of state purchases are missed and end up in the county pool can be pursued retroactively, assuming that a petition (CDTFA-549-S) is filed with CDTFA on a timely basis.

### ***CONSTRUCTION PROJECTS OVER \$5,000,000***

Since January 1, 1995, construction contractors have had the option to allocate use tax derived from contracts or subcontracts of \$5 million or more directly to the local jurisdiction where the jobsite is located. This election pertains primarily to fixtures and materials furnished and installed as part of complex fabrication projects such as power plants, refineries, manufacturing and assembly operations, food processing plants, cold storage plants, high rise buildings and medical or technical facilities housing specialized equipment and fixtures.

### **Taxable Components of a Construction Contract:**

- 1) **Materials** – items attached to real property by contractors in the performance of a construction contract which lose their identity and become an inseparable part of the real property. Typical materials include lumber, structural steel, bricks, cement, roofing, pipe, wiring, wallboard, and windows.

- 2) **Fixtures** – items that are an accessory to a structure but not lose their identity as accessories when installed. Typical fixtures include air conditioning units, elevators, furnaces, boilers, refrigeration units, and lighting fixtures.

Generally speaking contractors are considered to be the consumers of any materials used, with the purchase of said materials being subject to local *sales* tax. If the vendor is located in California allocation must be made to the vendor's place of business, regardless of whether a jobsite sub-permit has been obtained.

In the case of fixtures, the contractor is considered to be the retailer, and the jobsite is considered to be the "place of sale". In the absence of a jobsite sub-permit, the allocation is distributed via the county pool. A sub-permit will allow for direct allocation to the host jurisdiction.

Seller's permits and/or job-site specific sub-permits will not be issued to contractors who are not normally retailers of materials and/or fixtures. However, if the contractor has a valid seller's permit, and the specific project in question meets the \$5 million threshold, a sub-permit may be issued by a CDTFA district office. The only caveat is that the sub-permit *must* be obtained prior to commencement of work on the project. A sub-permit will not be issued once the work has been completed, and/or the local tax reported. Retroactive adjustments are not allowable under this program.

A number of agencies have requested sample language to use in Disposition and Development Agreements or Conditional Use Permits to maximize use tax under this program. The following should be reviewed with your agency attorney:

*Developer will require that all qualifying contractors and subcontractors exercise their option to obtain a California Department of Tax & Fee Administration sub-permit for the jobsite and allocate all eligible use tax payments to [insert jurisdiction here]. Prior to commencement of any construction activity on-site the developer will require that the contractor or subcontractor provide [insert jurisdiction here] with either a copy of their CDTFA account number and sub-permit, or a statement that use tax does not apply to their portion of the project.*

Questions concerning jobsite sub-permits should be directed to the CDTFA's Local Revenue Allocation Unit at (916) 324-3000.

### **USE TAX DIRECT PAYMENT PERMITS**

While the Schedule H form allows for direct allocation on a *single* purchase in excess of \$500,000, any business having reported *a total* of at least \$500,000 in purchases subject to use tax in the most recent calendar year is eligible under CDTFA Regulation 1699.6 for a use tax direct payment permit. The business must hold an active California seller's permit or consumer use tax permit, and must file a "statement of cash flows" or other comparable financial statements acceptable to the CDTFA which discloses total purchases of property and equipment for own use and a separate statement under company letterhead certifying that \$500,000 or more of such purchases were subject to use tax. Application for a direct payment permit is made via form CDTFA-400-DP.

Once obtained, a direct payment permit allows the holder to self assess use tax that would have otherwise been paid to out of state vendors. The local share can then be allocated to the jurisdiction of first use of the item(s) purchased.

The self assessment rules were sponsored by the California Manufacturers Association (CMA) to achieve three key benefits:

- 1) **Provide companies with better control over their use tax liability.** Under California law use tax liability is attached to the purchaser of the property, as opposed to sales tax which is the responsibility of the seller. Some out of state companies may collect the tax as a matter of convenience for their customers, but some may not. Either way the purchaser is responsible if the tax isn't paid. By issuing an exemption certificate to all out of state vendors a company can better control and manage its use tax obligation.
- 2) **Improved Cash flow management.** Under a direct payment permit use tax is paid quarterly, rather than each time a taxable purchase is made. Further, the use tax is paid only when and if the items in question are actually withdrawn from inventory and used. During the time between purchase and accrual any cash retained may be put to better use.
- 3) **Maintain the quality of public services.** Use taxes paid by self assessment accrue to the local jurisdiction where the item or material acquired is placed into "first functional use"; and are used to support local police, fire, and other services that benefit the company. This is an obvious "win-win" for both the agency and the taxpayer.

Any qualifying company can obtain a use tax direct payment permit, including a contractor performing work on a large construction project. Local governments can also obtain a direct payment permit and are not limited to the \$500,000 minimum purchase rule. However, it is important to note that taxpayers are explicitly prohibited from issuing direct payment exemption certificates to vendors for transactions subject to *sales* tax. Any purchase made from a California vendor where title to the property passes in-state is subject to sales tax, with the local share allocated to the vendor's place of business.

Unless it is a "specialty item" most of the building materials used in even a very large construction project will be purchased in-state. The same is generally true of other types of businesses purchasing supplies and consumables in support of their day to day operations. Common exceptions are structural steel used in construction, or bulk purchases of catalysts or other chemicals used by refineries or similar operations. However, it is important to note that direct allocation opportunities under this specific program are relatively limited, and expectations should be correspondingly realistic.

## **PURCHASING CORPORATIONS**

Purchasing corporations (commonly referred to as “buying companies”) are entities established by larger businesses to streamline their procurement operations. These corporations buy equipment and supplies wholesale and then “retail” the goods to their various affiliates and subsidiaries. Sales tax is levied when the goods are sold, and the buying company’s “order desk” is considered to be the place of sale. Benefits for a taxpayer in establishing a purchasing corporation include:

- 1) **Increased purchasing power.** By acting as a buying cooperative for all of its divisions and subsidiaries, a purchasing corporation can obtain larger vendor discounts than can the individual subsidiaries each negotiating separate contracts.
- 2) **Reduction in administrative costs.** Consolidating and streamlining procurement and warehousing operations may help reduce administrative overhead tied to duplicate personnel, procedures, and facilities.
- 3) **Deferral and reduction of sales, use, and property tax.** With a purchasing corporation sales or use tax is not paid until the merchandise is taken out of inventory (as opposed to at the time of purchase). In addition to sales tax, property tax on items held as stock in trade or for resale can be deferred until the property is placed into service.
- 4) **Increased control over sales tax administration.** Companies with complex procurement operations depend on a multitude of vendors to properly collect the appropriate sales tax rate for the various states and counties in which they do business. With a purchasing corporation sales tax responsibilities are clearly outlined and there is never a question as to whether the tax was properly paid at the correct rate.

The CDTFA will *not* issue a seller’s permit to a purchasing corporation if established primarily for the purpose of redirecting local sales tax. The general criteria used to evaluate whether a purchasing corporation has been formed for legitimate business purposes are contained in Regulation 1699(h):

- 1) The purchasing corporation is a legally separate and distinct entity from the company for which it will be performing administrative services.
- 2) A “mark-up” is added to the cost of goods sold in an amount sufficient to cover operating and overhead expenses.
- 3) There is a sufficient “paper trail”, including invoices to account for each sales transaction.

The costs of establishing and operating a purchasing corporation are substantial; as a result this program is generally viable only for very large companies who consume or maintain on standby, large quantities of taxable supplies and equipment. Examples of the types of companies which *may* qualify are refineries, hospitals, universities and large manufacturing, assembly, or distribution facilities. A purchasing corporation is particularly advantageous for companies who keep spare assets on hand for strategic or regulatory reasons. An example is a public utility with extensive fuel reserves.

A buying company could also be established to centralize purchasing for a large construction project; however this is generally not a viable option due to the complex and varied procurement arrangements of the various subcontractors involved.

## **SUMMARY**

Generally, “stick and stucco” construction such as housing projects, warehousing and office buildings do not generate significant one-time revenues because the taxable elements are primarily materials purchased locally with sales tax going to the jurisdiction where the vendor is located. However, projects involving extensive fixtures, machinery, on-site fabrication and out of state purchases do have the potential for generating significant use tax.

Direct reporting of local tax on single transactions exceeding \$500,000 is fairly easy for the taxpayer as no change to the company’s account registration is necessary. With the exception of out-of-state “voluntary” accounts it is also a *requirement*, as opposed to the other programs which are optional. Finally, if a transaction qualifies for direct reporting but was initially reported to the county pool a correction can be obtained retroactively. For these reasons local tax from these types of transactions is the easiest to recover.

Jobsite sub-permits for large construction projects and use tax direct payment permits require a much higher level of involvement and commitment on the part of the taxpayer. They also require that certain actions be taken *prior to* the tax liability being accrued and reported. For these reasons local jurisdictions must be aware at the earliest possible stages of any significant new construction activity, and must work diligently with the developer and/or general contractor to ensure maximum compliance. Agencies should also work to identify significant consumers of supplies and capital equipment, and have an active outreach program to those businesses.

Purchasing corporations require the highest level of commitment and, as indicated, are generally only viable for very large companies and/or projects.

Most large companies genuinely desire to be good corporate citizens, and to be responsive to the communities in which they do business. For this reason they will almost always make themselves available for a discussion of these programs. However, to achieve actual bottom line results you must be diligent and persistent in working with both company management, and with the “front-line” staff who will ultimately be responsible for initiating any necessary registration changes and filing the tax returns in the appropriate manner.

### **Additional Information:**

The HdL Companies maintains a variety of materials to assist its clients with capturing use tax opportunities. It is also available to serve as the liaison or project manager on larger projects. Additional information is also available from the California Department of Tax & Fee Administration website: [www.cdtfa.ca.gov](http://www.cdtfa.ca.gov)

- Reg. 1802:** Criteria for Direct Allocation on Purchases Exceeding \$500,000
- Reg. 1699:** Direct Payment Permits & Buying Companies
- Publication 28:** Tax Information for City & County Officials