

Texas Sales Tax Rules for Declared Disaster Areas

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In August of 2017, Hurricane Harvey devastated much of the Texas coastal region. The storm remained in Texas for days after landfall, creating catastrophic flooding that ravaged major cities where Texans live and work. Preliminary estimates indicate that over 185,000 homes were damaged or destroyed.¹

In response, Governor Abbott designated a long list of Texas counties as disaster areas: Aransas, Austin, Bastrop, Bee, Brazoria, Calhoun, Chambers, Colorado, DeWitt, Fayette, Fort Bend, Galveston, Goliad, Gonzales, Hardin, Harris, Jackson, Jasper, Jefferson, Karnes, Kleberg, Lavaca, Lee, Liberty, Matagorda, Montgomery, Newton, Nueces, Orange, Polk, Refugio, Sabine, San Jacinto, San Patricio, Tyler, Victoria, Walker, Waller, and Wharton.²

Construction services performed in declared disaster areas may or may not be taxable, depending upon the circumstances. This article uses the term “construction” loosely to include all work affecting real property structures, including work to rebuild or repair residential and non-residential structures. The taxability of construction work depends upon the type of customer, the type of work, and the type of contract used by the contractor.

The work to rebuild Texas has just begun, and the project will require a tremendous effort by both Texas and out-of-state contractors. Those who do not have a firm grasp on the Texas sales and use tax rules, including rules specific to disaster relief work, should realize that the uptick in work will likely translate into increased sales tax audits. This article provides contractors and tax professionals with basic answers to construction-related questions specific to declared disaster areas, in the context of a well-known, but fictitious

¹ Gallagher, J.J., *Hurricane Harvey Wreaks Historic Devastation: By the Numbers*, ABC NEWS (September 1, 2017), available at: <http://abcnews.go.com/US/hurricane-harvey-wreaks-historic-devastation-numbers/story?id=49529063>.

² Office of the Governor of the State of Texas, *Proclamation* (August 23, 2017); See Comptroller Rule § 3.357(a)(3) for definition of disaster area; Office of the Governor of the State of Texas, *Proclamation* (September 14, 2017); FEMA, *Texas Hurricane Harvey*, available at: <https://www.fema.gov/disaster/4332/>.

shrimper. The general rules regarding the taxability of construction services are outside this article's scope, so questions regarding work performed in non-disaster counties should be directed to knowledgeable tax practitioners.

Bubba Gump

Bubba Gump is a shrimper who has lived and worked in Rockport for 20 years. He owns a seafood market in downtown Rockport, less than a mile from his home. Bubba's market is located adjacent to a government-owned dock, where he docks his shrimp boat.

Bubba evacuates during Hurricane Harvey. When he returns to Rockport, he sees widespread destruction. He checks on his market and finds that the storm surge partially-flooded the building, rendering it unusable. Most of the contents and furnishings are destroyed. The government-owned dock also sustained damage, so Bubba calls the county to notify them of the damage.

Bubba then checks on his home. A tree fell on his roof during the storm, creating a hole that allowed water and debris to enter. Bubba begins to sort through the contents to decide what can be salvaged and what must be discarded.

Bubba then seeks bids from contractors to tackle the daunting task of repairing and restoring his home and market. First, Bubba contacts Cleaning & Restoration Services, a contractor who specializes in restoring furniture and contents after a storm. Second, Bubba contacts an arborist to remove the tree from his roof. Third, he contacts a demolition contractor to tear down to studs portions of his house and market. Finally, Bubba hires a contractor to remodel his partially-demolished house and market.

This article discusses the sales tax consequences that ensue from Hurricane Harvey's devastation by applying the disaster-area construction rules to Bubba's circumstances.

Lump-Sum Versus Separated Contracts.

Sales tax consequences vary depending upon the type of pricing in the construction contract. In a separated contract, the agreed contract price is split into separately-stated charges for incorporated materials and for labor. If the charges for incorporated materials and labor are separately-stated, the fact that the charges are added together and a sum total given is irrelevant.

The Comptroller generally classifies both cost-plus-a-fee contracts and time and materials contracts as separated contracts.³ In certain instances, contracts that incorporate “schedules of value” are classified as separated.

In a lump-sum contract, the agreed contract price is typically stated as a single lump-sum amount. It does not state a separate charge for incorporated materials from the charges for skill/labor. By default, all contracts are lump-sum unless the material charge is separately-stated or identifiable from other charges. Invoices separately stating labor charges from materials charges will not convert a lump-sum contract into a separated contract, unless the terms of the contract require separated invoices.

Generally, a lump-sum contract is viewed as the sale of a service, with the taxability of the labor component driving the taxability of the entire charge. In contrast, a separated contract is viewed as the separate sale of the labor and materials. As a result, the materials are taxable as the sale of tangible personal property, even if the labor is not taxable.

For sales tax purposes, the terms of the contract control change orders.⁴ If the contract is classified as lump-sum, then the change orders will be treated as lump-sum, even if the change orders show charges for incorporated materials separate from other charges.⁵ If the contract is separated and change orders state lump-sum amounts, then the lump-sum amounts will be treated as charges for incorporated materials unless the contractor can reasonably demonstrate the portion of the charges attributable to labor.⁶

The Resale Exemption.

Since construction charges may include the sale of taxable materials or the performance of a taxable service, a contractor may be entitled to claim a resale exemption when the contractor purchases the materials or services.

³ See Comptroller Hearing No. 10,915 (1980) (“The Comptroller considers cost plus contracts that require complete accounting and invoicing of all costs separated into labor and materials to be separated contracts.”).

⁴ See Comptroller Rule § 3.291(b)(5).

⁵ See *id.*

⁶ See *id.*

To prevent double taxation, the purchase of a taxable item (e.g., lumber) for resale is exempt from sales and use tax.⁷ The resale exemption covers taxable items sold as-is, or sold as an integral part of a taxable service.⁸ Therefore, a contractor who purchases materials for a separated contract may give a resale certificate to its vendor in lieu of paying sales tax when buying the materials. In this instance, the contractor will resell the materials to its customer and collect sales tax. The contractor must transfer care, custody and control of the materials to its customer in order to claim the resale exemption.⁹

Cleaning, Restoring, and Repairing Tangible Personal Property.

Disaster victims, like Bubba, may claim a sales tax exemption on separately-stated charges for labor to repair tangible personal property- such as furniture or appliances- damaged by the disaster.¹⁰ The exemption also applies to labor charges to launder or dry clean damaged clothes or property.¹¹

However, the exemption does not extend to materials. Under a separated contract, the customer owes tax on charges for materials. If the repairman fails to separately-state the labor charge, then the entire charge is taxable.¹²

To claim the exemption from tax on labor, the owner must give a completed exemption certificate to the repairman. The certificate must show both the repairman's and the customer's names, the items being repaired, and include the reason for claiming the exemption.

⁷ See Tex. Tax Code § 151.006(a)(1).

⁸ See *id.*

⁹ See *Clearview Cable v. Sharp*, 960 S.W.2d 424 (Tex. App.—Austin, 1998).

¹⁰ Comptroller Rule § 3.292(g)(1); Comptroller Rule § 3.357(d)(9); Comptroller Publication No. 94-182, *Disasters and Texas Sales Tax* (April 2006), available at: <https://comptroller.texas.gov/taxes/publications/94-182.php#faq3>;

¹¹ Comptroller Rule § 3.310(h).

¹² Comptroller Rule § 3.292(g)(1); Comptroller Rule § 3.357(d)(9); Comptroller Publication No. 94-182, *Disasters and Texas Sales Tax* (April 2006), available at: <https://comptroller.texas.gov/taxes/publications/94-182.php#faq3>.

Cleaning & Restoration Services (“CRS”) removes a refrigerator from Bubba’s market, takes it back to its warehouse, and repairs the electrical components. CRS sends Bubba a bill with separately-stated charges for labor to repair the refrigerator and the cost of the new wiring used. In lieu of paying sales tax on the labor charge by CRS, Bubba may give CRS a completed exemption certificate that states: “Repair of appliance due to Hurricane Harvey in Aransas County.”¹³ Since the exemption does not extend to materials, CRS must collect sales tax from Bubba on the separately-stated charge for the new wiring. CRS, in turn, should not pay sales tax on its purchase of the wiring. Instead, CRS should give a resale certificate to the vendor when it buys the wire.

Removing and Discarding Waste.

Charges for removing and disposing of debris or other waste, such as destroyed furniture, in a disaster area are taxable as waste removal services.¹⁴

CRS hauls away and disposes of the furniture and contents from Bubba’s home and market that cannot be salvaged. CRS must charge sales tax on the full charge for this service.

Landscaping.

Arborists’ services, such as cutting down or cutting up a damaged or dead tree in a declared disaster area, are not taxable.¹⁵ However, charges to haul away branches, limbs, or trees are considered taxable waste removal services.¹⁶

¹³ See *id.*

¹⁴ See Comptroller Rule § 3.356.

¹⁵ Comptroller Publication No. 94-182, *Disasters and Texas Sales Tax* (April 2006), available at: <https://comptroller.texas.gov/taxes/publications/94-182.php#faq3>.

¹⁶ See *id.*

To claim the exemption from sales tax on qualifying labor charges, the owner must provide a completed exemption certificate to the seller. The certificate must include both the seller's and the owner's (purchaser's) names and addresses, a description of the type of arborist services performed, and a description of the reason for claiming the exemption.¹⁷

Bubba hires Arborists Plus to cut down and remove the damaged tree that fell on his home. To claim the exemption from sales tax on the charges for cutting down the damaged tree, Bubba should give a certificate to Arborists Plus that states: "Service to cut down a damaged tree due to declared natural disaster in Aransas County."¹⁸ Arborists Plus's separately-stated charges to haul away the branches from Bubba's tree are taxable.

Contractors should separately state charges for taxable and nontaxable services because the law allows the Comptroller to presume that a single charge for taxable and nontaxable services is entirely taxable if the taxable portion is greater than five percent (5%) of the total charge.¹⁹

If Arborists Plus bills a single amount to Bubba for both cutting down the damaged tree and hauling away the tree limbs, then the Comptroller may presume that the entire charge is taxable if the service to haul away the tree limbs is greater than 5% of the total bill.

¹⁷ See *id.*

¹⁸ See *id.*; See Texas Comptroller of Public Accounts, *Declared Natural Disasters and Emergencies Tax Help*, [comptroller.texas.gov](https://comptroller.texas.gov/taxes/resources/disaster-relief.php), available at: <https://comptroller.texas.gov/taxes/resources/disaster-relief.php>.

¹⁹ See *id.*

Demolition.

Charges for the complete demolition and partial demolition of residential structures are not taxable.²⁰ In addition, charges for the complete demolition of an existing non-residential structure are not taxable.²¹ In declared disaster areas, an owner may also claim an exemption for otherwise taxable labor charges incurred to partially demolish non-residential structures.²²

When Bubba realizes that the storage building behind his market cannot be salvaged, he hires a demolition contractor named Demos-R-U's to demolish the building. Bubba also hires Demos-R-U's to partially demolish a damaged area of the kitchen in his market. Technically, only the partial demolition of the kitchen requires an exemption certificate for Demos-R-U's to forego collecting tax from Bubba because the complete demolition of the shed is non-taxable. However, Demos-R-U's should obtain an exemption certificate covering both activities to avoid audit issues.

Rebuilding Nonresidential Structures.

Special exemptions apply to construction work performed on nonresidential structures in declared disaster areas. Non-residential structures are properties like restaurants, stores, and office buildings; they are not family dwellings.²³

In a declared disaster area, property owners may claim an exemption from sales tax on separately-stated charges for otherwise taxable labor to repair, remodel, or restore non-residential structures damaged by the disaster.²⁴ Charges for the materials used to perform

²⁰ See Comptroller Hearing No. 101,913 (STAR 201012948H) (2010).

²¹ See Comptroller Rule § 3.357(a)(11).

²² Comptroller Publication No. 94-187 (February 2006) (STAR No. 200602645L).

²³ See generally Comptroller Rule § 3.357 for the definition of "residential" property. Non-residential properties are properties that do not fit under the definition of "residential."

²⁴ Comptroller Publication No. 94-182, *Disasters and Texas Sales Tax* (April 2006), available at: <https://comptroller.texas.gov/taxes/publications/94-182.php#faq3>.

the repairs are taxable. To claim the exemption on the labor charge, the property owner should give the contractor a completed exemption certificate.²⁵

If a contractor working in a declared disaster area charges a lump-sum price for both labor and materials, the entire charge is taxable.

Bubba hires Quick-Rebuild to repair and remodel the shrimp market, a non-residential structure, under a lump-sum contract. Quick-Rebuild tears the market down to the studs and begins rebuilding the wiring, sheet rock, and floors. If Quick-Rebuild charges Bubba a lump-sum charge for both labor and materials, Quick-Rebuild must charge and collect sales tax on the full amount. But, if Quick-Rebuild's contract separately-states the materials and labor charge, then Bubba may give Quick-Rebuild an exemption certificate in lieu of paying tax on the labor charge.

Rebuilding Residential Structures.

“Residential structures” means family dwellings, including apartment complexes, nursing homes, condominiums, and retirement homes.²⁶ The labor to repair, remodel, or restore residential real property is nontaxable.²⁷

Charges for materials incorporated into the repair, remodel, or restoration of residential real property are taxable.²⁸ Therefore, a contractor must collect tax from his customer on separately-stated charges for materials. But, if the contractor bills lump-sum, then the contractor should not charge tax on any portion of the contract price; instead, he should pay sales tax when he purchases the materials.

²⁵ See *id.*

²⁶ See *id.*

²⁷ Comptroller Publication No. 94-116, *Real Property Repair and Remodeling* (94-116); See Comptroller Rule § 3.357.

²⁸ See Comptroller Rule § 3.291.

Bubba's home is a residential structure. Bubba hires Fast-Repair to repair and remodel his partially-destroyed home under a time and materials contract. Fast-Repair tears the house down to the studs and replaces the wiring, plumbing, and sheetrock. Because a time and materials contract is treated as a separated contract, Fast-Repair should not charge sales tax on labor charges to repair Bubba's home. However, Fast-Repair must charge sales tax on the price of materials incorporated into the remodel because the law views Fast-Repair as having sold the materials to Bubba. As a result, Fast-Repair can provide a resale exemption certificate when it purchases the materials from its vendor that it will resell to Bubba.

Performing Work for Exempt Entities.

Contractor should be aware of sales tax exemptions available to certain entities, such as governmental entities and religious, educational, and public service organizations.²⁹ This article focuses on governmental entities, who may prove their entitlement to the exemption with less documentation.³⁰ Specifically, most exempt entities are required to prove their exempt status by providing an exemption certificate plus a letter of sales and use tax exemption from the Comptroller that is addressed to the entity.³¹ However, written contracts or purchase orders that are issued by governmental entities are acceptable documentation of exempt contracts.³² Notwithstanding, best practices for documenting work for an exempt governmental entity include requesting an exemption certificate and proof of exempt status letter, if available, due to the penalty for incorrectly claiming the exemption. If the Comptroller subsequently determines that an organization is not exempt, then the contractor is liable for all taxes, penalties, and interest that accrue upon the purportedly exempt entity's purchase.³³

But, if the exemption is properly documented, contractors performing construction services for governmental entities should not charge the customer any tax and are not

²⁹ See Tex. Tax Code §§ 151.309 and 151.310.

³⁰ See Comptroller Rule § 3.2919(c)(1); Comptroller Rule § 3.322(c).

³¹ See Comptroller Rule § 3.291(c)(1)-(2)(A); Comptroller Rule § 3.322(b).

³² See Comptroller Rule § 3.2919(c)(1).

³³ See Comptroller Rule § 3.291(c)(2)(A).

required to pay tax on purchases of materials that are incorporated into the realty, completely consumed items necessary and essential to the contract, or taxable services expressly required by and integral to the contract.³⁴ An item is “completely consumed” if after being used once for its intended purpose, the item is used up or destroyed.³⁵ When making permissible tax-exempt purchases, the contractor must provide its vendors with an exemption certificate that identifies the contractor as the purchaser, the exempt entity for which the work is performed, and the project for which the items are being purchased.³⁶ A contractor may give a completed resale certificate when purchasing materials that will be incorporated into the customer’s realty under a separated contract.³⁷

Quick-Rebuild enters into a contract with the Port Authority, a governmental entity, to repair the damaged dock where Bubba keeps his boat. When Quick-Rebuild purchases lumber, nails, and supplies either to be incorporated into the dock or completely consumed during the project. It may provide its vendors an exemption certificate that identifies Quick-Rebuild as the purchaser and that the work is a Hurricane Harvey repair project performed for the Port Authority. Quick-Rebuild should not collect sales tax from the Port Authority for its construction work, whether billed lump-sum or separated, if a written contract or purchase orders identify the Port Authority as the customer. Although, it would be wise for Quick-Rebuild to request a properly completed exemption certificate and Comptroller letter confirming its customer’s exempt status to avoid audit issues.

Out-of-State Businesses Performing Disaster or Emergency-Related Work in Texas.

An out-of-state business entity that enters Texas at the request of an in-state business under a mutual assistance agreement, or that is an affiliate of an in-state business entity, is exempt

³⁴ See Tex. Tax Code § 151.311(a) and (b); See Comptroller Rule § 3.291(c)(4)(A) and (B).

³⁵ See Tex. Tax Code § 151.311(d).

³⁶ See Comptroller Rule § 3.291(c)(5).

³⁷ *Id.*

from Texas licensing and registration requirements if its business in Texas is limited to performing disaster- or emergency-related work during a disaster period.³⁸

An out-of-state entity will not be considered ‘engaged in business’ in Texas if the entity’s presence in Texas is solely for performing disaster- or emergency-related work during a disaster response period.³⁹ An out-of-state entity will not be required to collect and remit Texas sales and use tax on its sales or purchases of taxable items sold or transferred to its customers during a disaster response period in Texas.⁴⁰ However, the entity will owe sales tax on its purchases of taxable items for its own use.⁴¹

Record Retention Guidelines.

Sales records including contracts, invoices, and exemption certificates must be kept for a minimum of four years. This applies to all contractors, vendors, subcontractors, repairmen, remodelers, consumers of taxable items, and taxable service providers.

The statute is extended indefinitely when no report is filed, the report is fraudulent or the report omits twenty-five percent (25%) or more of the tax required to be shown due on the report. Businesses undergoing an audit or a challenge to a tax assessment must retain all of the relevant records until the underlying assessment is resolved by settlement or litigation.

Conclusion

The Texas sales and use tax rules applicable to contractors performing work in declared disaster areas are complex and pose potential audit issues for contractors. Martens, Todd, Leonard & Ahlrich regularly represents construction contractors and other members of the construction industry during the audit process and in challenging adverse assessments. For more information, please email Jimmy Martens or Danielle Ahlrich at jmartens@textaxlaw.com or dahlrich@textaxlaw.com or call (512) 542-9898.

³⁸ See Tex. Tax Code § 151.0241; See Tex. Bus. & Comm. Code Ch.112.

³⁹ See Comptroller Rule § 3.286(a)(4)(J).

⁴⁰ See Texas Comptroller of Public Accounts, *Declared Natural Disasters and Emergencies Tax Help*, [comptroller.texas.gov](https://comptroller.texas.gov/taxes/resources/disaster-relief.php), available at: <https://comptroller.texas.gov/taxes/resources/disaster-relief.php>.

⁴¹ See *id.*