



FEBRUARY 2008

TAX TOPICS

SALES AND USE TAX

Texas Comptroller of
Public Accounts

Water and Wastewater Systems

Persons who construct or operate water or wastewater systems that supply or treat water for Texans may be entitled to claim sales tax exemptions, depending on the type of system or the exempt status of the entity that owns and operates the system.

Tax Code Section 151.355 provides exemptions related to the construction of two types of water or wastewater systems: regional systems certified by the Texas Commission on Environmental Quality (TCEQ) and water or wastewater systems constructed or operated as a public-private partnership. Tax Code Section 151.309 addresses exemptions that may be claimed by governmental entities, such as cities, counties and water districts that build or operate water systems.

Nonprofit water supply corporations are not exempt from sales tax. Some of the goods and services purchased by a nonprofit water supply corporation may qualify for sales tax exemptions, however.

Certified Regional Water Systems

Sales of equipment, services or supplies used solely to construct or operate a water or wastewater system certified as a regional system by the Texas Commission on Environmental Quality (TCEQ) are exempt from sales tax. For a list of certified regional systems, see the section titled "Regional Certification for Water and Sewer Utilities" on TCEQ's Web Site. TCEQ does not identify a facility as a regional water or wastewater facility until the facility is certified. Once TCEQ certifies a regional water or wastewater system, the facility and contractors can claim an exemption on qualifying purchases.

Qualifying exempt purchases include all purchased or leased equipment, services and supplies used solely on that particular project under either lump-sum or separated contracts. The exemption includes utilities to operate the equipment as well as dedicated office trailers or other facilities at the job site. The exemption also includes all equipment within the office, but only if the equipment is used solely at the regional system site. See Rule 3.318(e) for information about tax responsibility if exempt items are diverted for use in a taxable manner. A contractor should not claim an exemption for any equipment or supplies that will be used on both qualifying and non-qualifying jobs. A contractor that buys equipment for sole use on qualifying jobs that is later used in a taxable manner should refer to Comptroller Rule 3.318(e) concerning taxable divergent use.

Contractors should note that regional water systems are not entitled to the sales and use tax exemptions provided under Tax Code Section 151.309 for Governmental Entities or under Tax Code Section 151.310 for other types of exempt entities. Therefore, a construction company should not assume that purchases made for a regional water system contract are automatically exempt from sales and use tax. Once a construction company has received an exemption certificate, it should check the TCEQ's Web site for certification confirmation.

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Public-Private Partnerships

Tax Code Section 151.355(6) provides an exemption for equipment, services and supplies used solely to construct or operate a water supply or wastewater system by a private entity that is a member of a public-private partnership. The partnership must be certified by the political subdivision that is a party to the project. For example, a private contractor and a city may have a partnership, which the city certifies, to construct a water and wastewater system to serve new areas within the city.

The scope of this exemption is the same as that for certified regional water systems as described in the previous section. The operator of the public-private partnership should provide the construction company with a valid exemption certificate. A construction company should not assume that purchases are tax-free because a public entity is involved. These partnerships are not entitled to the sales and use tax exemptions under Tax Code Section 151.309 for governmental entities or Section 151.310 for other types of exempt entities. Once the construction company has received the appropriate exemption certificate (if applicable) from the operator, it will in turn issue its own exemption certificates to suppliers and cite the appropriate statutory reference as the basis for the exemption.

Governmental Entities

Under Tax Code Section 151.309, purchases by a Texas governmental entity or political subdivision, such as a city, county or water district, are not subject to sales and use tax.

EXEMPTION CERTIFICATE OR VOUCHER

The exempt entity may provide the contractor with an exemption certificate or with the entity's purchase voucher. The contractor for the exempt entity then gives subcontractors an exemption certificate stating that the exempt organization purchases materials tax-free. Subcontractors then may purchase the materials tax-free using the exemption certificate.

EXEMPT ITEMS

Tax Code Section 151.311 addresses the taxability of items used for improving the real estate of an exempt entity.

Comptroller Rule 3.291(c) addresses the tax responsibilities of contractors who perform lump-sum and separated contracts for exempt organizations. Rule 3.291 states that the following items are exempt from sales and use tax when purchased for use in the performance of an exempt entity contract:

- tangible personal property that is incorporated into the realty;
- consumable items that are necessary and essential to the contract and are completely consumed at the job site; and
- taxable services that are performed at the job site and are expressly required by the exempt contract to be provided or purchased by the contractor or integral to the performance of the exempt contract.

Contracts to repair or remodel an exempt organization's property follow the same new construction requirements above. Comptroller Rule 3.357(b) addresses the repair, remodeling or restoration of nonresidential real property. Again, consumable items must be necessary for the performance of the contract and the items must be completely consumed at the job site.

Dedicated Water or Wastewater Systems

A private developer or builder may dedicate a water or wastewater system to a municipality or other type of political subdivision of the state. Before the work begins, the private developer or builder must provide the contractor with a letter of intent or other document from the governmental entity that states its intent to accept the property. Taxable items purchased and used by the contractor prior to the date of tentative acceptance by the political subdivision do not qualify for exemption. If so dedicated, items purchased for the project are exempt to the same extent as if the work was done

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for the exempt governmental entity as discussed in the previous section on Governmental Entities. See Rule 3.291(c)(2)(B) for more information on the requirements for this exemption.

NONPROFIT WATER SUPPLY CORPORATIONS

A nonprofit water supply or sewer service corporation is organized on behalf of a city or town under Water Code Chapter 67. A nonprofit water supply corporation is not automatically exempt from sales and use tax but is exempt from franchise tax.

As explained below, some of the goods and services purchased by a nonprofit water supply corporation may qualify for sales tax exemptions. A nonprofit water supply corporation also may fall under the requirements of a regional water system or private-public partnership, or the nonprofit corporation may receive special state funding that provides for a sales tax exemption.

Special Funding May Affect Taxability of Items

A nonprofit water supply or sewer service corporation may receive special state funding from the Rural Water Assistance Fund. Water Code Section 15.994(f) provides that a nonprofit corporation is exempt from paying sales tax on the purchase, lease or rental of tangible personal property and on the purchase of taxable services for projects that the Rural Water Assistance Fund finances. The nonprofit corporation must keep records that clearly show which taxable items were purchased for projects that the Rural Water Assistance Fund financed.

A nonprofit water supply or sewer service corporation also is exempt from paying sales tax on the purchase, lease or rental of tangible personal property and on the purchase of taxable services for projects that receive funding from the Economically Distressed Areas Program (EDAP) for an economically distressed area as defined in Water Code Section 17.921(1). The nonprofit corporation

must keep records that clearly show which taxable items were purchased for projects the EDAP financed.

Exempt versus Taxable Items

The following identifies some of the goods and services purchased by a nonprofit water supply corporation that may qualify for sales and use tax exemptions.

Electricity

Exempt uses. Sales tax is not due on the cost of electricity used to operate equipment that removes water from a river, lake or well.

Sales tax is not due on the cost of electricity used to operate equipment that transports water from its source to a storage tank or holding facility before the water is treated or to transport water to treatment.

Sales tax is not due on the cost of electricity used to operate water-treating equipment.

Taxable uses. Electricity used to transport water after treatment is taxable. Examples include moving the water to a storage facility or transporting it to the customer. Tax is due on electricity used to heat, cool and light the company office and to run office machines.

Predominant use test. When a single meter measures all electricity for both exempt and taxable uses, the total bill will be taxable or exempt depending on the predominant use of the electricity. If more than 50 percent of the electricity measured by a meter is for an exempt use, the total electric bill is exempt from sales tax. For more information on determining the predominant use of electricity and claiming an exemption, see Comptroller Rule 3.295.

Chemicals, materials and supplies

Sales tax is not due on the cost of chemicals that enter into and become a part of water processed for sale. Materials used to test the quality of the water after processing, however, are taxable.

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Sales tax is not due on the cost of materials necessary or essential to operate processing machinery or equipment. For example, sales tax is not due on the cost of lubricants consumed for operating chlorination equipment.

Machinery and equipment

Exempt. Sales tax is not due on the cost of water processing equipment, repair or replacement parts.

Taxable. Sales tax is due on items that are merely useful or incidental to the water processing operation. For example, rented or leased equipment, hand tools, office equipment, office supplies, cleaning equipment, intraplant transportation equipment and any other support equipment are taxable.

Sales tax is also due on storage tanks, pumps and pipe used to remove water from its source, transport it to a storage tank or processing point and deliver it to a consumer.

Equipment repairs and maintenance

If tangible personal property such as machinery or equipment is exempt from sales and use tax, charges to repair, maintain, restore or remodel these items are also exempt from tax.

New construction labor and materials

New construction labor is not taxable. Sales tax is due on incorporated materials when real property is constructed or built, unless an exemption applies. Examples of improvements to real property include buildings, water towers, water lines and dams.

The type of contract used by a contractor will determine who is responsible for paying sales tax on the incorporated materials. When the contract sets out a lump-sum amount that does not separate the charges for materials from charges for labor, the contractor should not collect sales tax from the water supply corporation. The contractor should pay sales tax to suppliers at the time materials are

bought. When the contract for new construction contains separate charges for labor from materials, the contractor should collect sales tax from the water supply corporation on the charge for the incorporated materials. The contractor is reselling the incorporated materials.

Repair or remodeling real property

Repairing, remodeling and restoring nonresidential real property are taxable services. Whether the bill for nonresidential repair or remodeling contains a single charge or separates the charge for materials from the charge for labor, the total amount is taxable.

Tangible personal property versus real property determination

Sometimes equipment will be installed in a building and become incorporated into realty. The basic and long-established test for determining whether tangible personal property becomes a real property fixture depends on the intent of the parties and the answer to the following three questions. If the answers are yes, the tangible personal property likely has become an improvement to realty; if no, it likely will remain tangible personal property.

- Is there a real or constructive annexation of the personal property to the real property?
- Is there a fitness or adaptation of the personal property to the realty?
- Does the party making the annexation intend for the personal property to become a permanent part of the real property?

Monthly connection fees

Monthly charges to customers who connect their water lines to a water facility are not taxable.

Other taxable services

Nonprofit water supply corporations owe sales tax on their purchases of taxable services, such as debt col-

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lection, pest control, security services, data processing services, waste removal and landscaping.

Use tax may be due

A nonprofit water supply corporation should check invoices when purchasing taxable goods or services. If a supplier fails to charge tax on a taxable item or service and the corporation has not issued an exemption certificate, the corporation should tell the supplier that sales tax is due and include it in the payment.

If a supplier is an out-of-state firm and does not collect Texas tax, then the nonprofit water supply corporation is responsible for sending use tax to the Comptroller.

How to claim an exemption

To claim an exemption from sales tax, the nonprofit water supply corporation or qualifying contractor must give the supplier or repairperson an exemption certificate. The certificate must state the specific reason for claiming the exemption.

Have Questions?

Call the Comptroller's office toll free at **(800) 252-5555** or write to us at tax.help@cpa.texas.gov.

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