

## ***Basics of Public Owner-Direct Purchase Programs for Exemptions from Florida Sales and Use Taxes***



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**T**his article surveys the process under which a governmental unit (the “public owner”) may save on Florida sales and use taxes (collectively, termed “sales tax”) on purchases of tangible personal property that are incorporated into a construction project that the public owner owns.<sup>1</sup> The process is commonly referred to as an “Owner-Direct Purchase Program.” For a program to qualify, the entire project team (the public owner, the contractor, and the vendors) must strictly comply with Florida law. A similar arrangement can be used for non-profit organizations that qualify under Section 501(c)(3) of the Internal Revenue Code.

This article is written for attorneys who review public owner construction contracts or are consulted by clients who are involved in downstream public owner-direct purchase transactions. The objective is to assist counsel for downstream construction participants so that they appreciate the importance and sensitivity of complying with direct purchase requirements. An understanding

of the public owner-direct purchase exemption will allow counsel to do two things: (1) recognize direct purchase provisions and requirements in a contract so that they can understand how subcontracts and purchase orders should be structured to conform to the exemption requirements promulgated by the Florida Department of Revenue; and (2) advise contractor, subcontractor, and vendor clients on the process and necessary structures and requirements to achieve the intended sales tax savings. The potential tax savings are significant. Hypothetically, a \$10,000,000 construction project could present the opportunity for sales tax savings to the public owner of approximately \$650,000. This is based on an applicable sales tax rate of 6.5% and a hypothetical split of 40% labor and 60% (taxable) materials.

### **Background**

Under the usual (non-exempt) rules of the road, purchases of tangible personal property (concrete, lumber, roofing materials, etc.) are taxable to the purchasing contractor or subcontractor, which will in turn include the dollar value of the sales tax in their upstream pricing. The contractor is considered the end user of the materials and is required to pay sales tax on such purchases. Upstream pricing effectively embeds the cost of the sales tax into the project’s price tag. The price tag obviously can affect funding

for the scope of the project and be relevant to what a public owner can accomplish under its overall budget for public works.

A compliant direct purchase program reduces the cost of the project to the governmental unit and saves taxpayer money, provided the applicable requirements are followed. There is no requirement that a public owner utilize a direct purchase program. The telltale sign that a public owner intends to implement an Owner-Direct Purchase Program would be found in the construction bidding or procurement documents and in the ensuing construction documents. The usual reference may be to an “Owner-Direct Purchase Program.”

The foundation for an Owner-Direct Purchase Program is the sales tax exemption for sales of tangible personal property made directly to a public owner. The direct purchase program alters the usual structure for downstream (taxable) purchases of tangible personal property within the construction process. Under the altered structure the purchases are made directly by the public owner, under prescribed and specific rules, and thus exempt from sales tax.<sup>2</sup> The applicable criteria are contrary to the usual procurement process utilized by contractors in the normal course. The exemption will fail if the wrong process is followed, such as the following: the public owner and general contractor simply execute deductive change orders for material purchases (reduce the price for those purchases and applicable sales tax) with the contractor or its subcontractor issuing parallel purchase orders to the public owner, and under which the installing subcontractor sells those materials directly to the public owner with the same subcontractor (or another subcontractor) left to install those same materials. The promulgated rules do not allow a contractor to purchase tangible personal property sales tax exempt with a resale certificate and sell it to the public owner and install it. In such situations, the contractor will be considered the ultimate consumer of the tangible personal property and owe sales tax on its purchases.

### **The “Direct Purchases” Process**

Exempt purchases by the public owner must strictly comply with the applicable criteria of the Florida Statutes and Florida Administrative Code.<sup>3</sup> Compliance with these criteria determines whether the (exempt) public owner, rather than the (taxable) contractor or subcontractor, purchased the materials:

1. **Direct Purchase Order:** The public owner must issue a purchase order directly to the vendor that sells the materials and provide the vendor with a copy of the public owner’s Florida Consumer Certificate of Exemption. In practice, the public owner can be expected to need instruction from the contractor on the specifics of what is being purchased. It is suggested that a reasonable degree of cooperation must occur between the public owner and contractor on descriptions and technical information on items purchased. It is also suggested, however, that the degree of that collaboration must not violate “form over substance,” with the contractor (or its subcontractors) simply ghost-purchasing materials by using the public owner as the purchaser in name only. This purchase order process should follow a deductive change order under which the

purchase price and applicable tax for direct purchase materials are deducted from the contract price. In the usual direct transaction, neither the contractor's fee nor general conditions are deducted from the price. Academically, this leaves the contractor's financial performance "intact," with the public owner realizing the tax savings. However, additional administrative cost burden and project time often will be absorbed by the contractor to pace the process, particularly considering the extent of cooperative collaboration required to coordinate direct purchases (and schedule matters). The administrative burden only increases if the contractor already initiated (and executed) purchase orders, which must be cancelled and reissued to the public owner. The contractor in practice can expect an additional downstream layer of communications (and explanations) to vendors, some of which may be out-of-state and/or have established and valued relationships with subcontractors or the contractor. Still more burden can exist when the contractor or subcontractor has an exclusive distribution and/or installation agreement with an affected manufacturer (seller). Some manufacturers may provide material warranties that in the usual course rely on their subcontractor relationships (or exclusive distributors) for installation and may view a direct sale as disruptive to that relationship. Such wrinkles can take even more time, effort, and cost to resolve but should be resolvable.

2. Direct Invoice: The vendor's invoice for materials must follow the direct sale and be issued to the public owner, not the contractor or subcontractor. This is sensible, since the public owner itself is making the purchase from the vendor. Neither the contractor nor subcontractors can sell the direct purchased materials and then install those materials.

3. Direct Payment: Payment of the vendor's invoice must be made directly to the vendor by the public owner from public funds. Compliance is not achieved by the contractor or a subcontractor issuing payment for the public owner. This means the contractor or subcontractor cannot include sums in its pay applications for direct purchases and then pay the vendor from sums received from the public owner when the pay application is paid.

4. Passage of Title: It is paramount for an exempt transaction that the public owner assumes the risk of damage or loss for the purchase items at the time of purchase. The public owner is deemed to assume that risk of loss if the public owner bears the financial burden of obtaining (paying for)

insurance on the purchased items.<sup>4</sup> An alternate criteria deems the risk assumed by the public owner if the public owner "directly enjoys" the financial benefit of the insurance proceeds.<sup>5</sup> The alternate criteria would appear satisfied when the builder's risk insurance (property insurance) for the project covers a casualty loss incurred by the public owner as an additional insured, when that loss occurs after the public owner's assumption of risk of loss for purchase of the materials. It is common for contract documents to identify the owner as an additional insured for the builder's risk insurance even when the contractor purchases that insurance. The policy (and its conditions and exclusions) should be checked in the event of an off-site casualty loss for which the public owner bears the risk of loss. Coverage may be extended by the builder's risk policy to such off-site casualty losses. Coverage for the public owner's interest in materials suffering casualty in transit after the public owner assumes the risk of loss also may exist through insurance provided, for example, by a common carrier or shipper. It is suggested the purchase order state that such insurance costs are within the purchase price and thus paid by the public owner when this is the case. The main point is that various types of existing insurance, provided through others but paid directly or indirectly by the public owner, may cover the damage or loss to the purchased materials and allow the public owner to enjoy the financial benefit of those insurance proceeds.

5. Certificate of Entitlement: Lastly, for a qualifying purchase, the public owner must issue a Certificate of Entitlement both to the vendor and to the contractor. The certificate is to affirm that the purchased materials will go into or become part of a "public work."<sup>6</sup> Each purchase order the public owner issues must attach a separate Certificate of Entitlement. Copies of the certificate may be used.<sup>7</sup> Notably, the public owner maintains a direct interest and concern with having and executing a complying direct purchase program. The public owner itself bears the liability for any tax, penalty, and interest to be due should the Florida Department of Revenue determine that material sold by a vendor was not tax-exempt under § 212.08(6), Fla. Stat.<sup>8</sup> The public owner may not transfer that liability by contract or agreement to another party.<sup>9</sup> That transfer prohibition likewise should extend to bar a public owner's effort to transfer the liability or resulting loss to the contractor under an indemnity provision in the construction documents. Notwithstanding this restriction on the public owner's transfer of

this liability, all involved in the construction project should strive for compliance with the direct purchase program and applicable legal requirements and avoid conflict with the public owner and the Department of Revenue.

Although there is not a specific set of regulations on point, an Owner-Direct Purchase Program can be used by nonprofit organizations that qualify under Section 501(c)(3) of the Internal Revenue Code. In several written determinations, the Florida Department of Revenue has permitted nonprofit organizations to implement Owner-Direct Purchase Programs if the parties follow the principles set forth in Florida Administrative Code Rule 12A-1.094(4)(b)5, to wit: direct purchase order, direct invoice, direct payment, and passage of title. However, unlike the rule for public owners, the burden of failing to comply with exemption requirements is not shifted to the nonprofit organization. The sales tax liability may be assessed against the contractor, subcontractor, and vendor, unlike the rule for public owners. Such risk makes it vital that contractors, subcontractors, and vendors strictly comply with the terms of the program in the context of the nonprofit organization.

This summary has familiarized the practitioner with the basics of exempt transaction requirements for commonly encountered public Owner-Direct Purchase Programs in Florida.

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<sup>1</sup>Florida Statute §212.08(6)(a), exempts sales made to the United States Government, or a state, or any county, municipality or political subdivision of a state.

<sup>2</sup>§ 212.08(6), Fla. Stat.

<sup>3</sup>§ 212.08(6), Fla. Stat. and *Rule 12A-1.094, F.A.C.*

<sup>4</sup>*Rule 12A-1.094(4)(b)5, F.A.C.*

<sup>5</sup>*Rule 12A-1.094(4)(b)5, F.A.C.*

<sup>6</sup>The requirement for a Certificate of Entitlement does not apply to an agency or branch of the federal government. *Rule 12A-1.094(4)(c)1, F.A.C.*

<sup>7</sup>*Rule 12A-1.094(4)(c)2, F.A.C.*

<sup>8</sup>*Rule 12A-1.094(4)(c)3, F.A.C.*

<sup>9</sup>*Rule 12A-1.094(4)(e), F.A.C.*