Federal contractor concern

Background

Washington imposes sales tax on the total charge for construction activities performed for a consumer. The total charge includes the contractor’s labor and services, and any materials incorporated into the project.

Under the Supremacy Clause of the United States Constitution, the state cannot directly tax the federal government. Therefore, on construction projects for the federal government, the state only imposes sales/use tax on the materials federal contractors incorporate into such projects.

The United States Supreme Court, in a 5-4 decision, upheld Washington’s taxation of federal contractors in *Washington v. United States*, 460 U.S. 536 (1983). The important question, according to the Supreme Court, is whether the tax is discriminatory with regard to the economic burdens that result. In upholding the tax, the Supreme Court explained that Washington imposes sales and use tax on *every* construction transaction and the tax rate is the same for everyone.

Federal contractors pay sales tax on a smaller proportion of value (materials only) than do consumers of non-federal construction services (materials, plus labor and services). Therefore, the Supreme Court concluded that Washington’s tax does not discriminate against the federal government and those with whom the government deals.

Risk

Legislation creating new exemptions and deferrals for construction projects present a significant legal risk that the federal government or federal contractors will seek to re-litigate *Washington v. United States*.

The Department’s legal counsel at the Attorney General’s Office has opined that the federal contractor risk applies to all exemptions and deferrals of construction activity, not just construction projects of the type that the federal government is likely to engage in. It also applies even if the exemption or deferral applies to federal construction projects as well as non-federal construction projects.
Federal contractor concern, Continued

Risk (continued) Sales/use tax exemptions pose the greatest legal risk because they plainly treat the beneficiaries of the exemption more favorably than federal contractors are treated. Sales/use tax deferrals also pose a significant legal risk. Each such exemption or deferral increases the likelihood that the federal government or federal contractors will seek to re-litigate Washington v. United States in which they would claim that Washington now discriminates against federal contractors.

If a legal challenge to a deferral or exemption were successful, in addition to lost future revenues, refunds potentially would be owed under the statutory period for excise tax refunds (current year plus four years back). Each year about $89 million is collected on federal government contracting. If refunds were included as part of a potential court decision, the revenue impact could reach $486 million.

General Fund and Local Impact ($ millions):

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Fiscal Year</th>
<th>Fiscal Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>2014</td>
<td>2015</td>
</tr>
<tr>
<td>($89)</td>
<td>($89)</td>
<td>($89)</td>
</tr>
</tbody>
</table>

Alternatives DOR has identified the following alternatives to reduce the cost of state highway transportation projects:

- Transferring sales and use taxes paid by the Washington State Department of Transportation on highway construction and improvement projects to the multimodal transportation account, or
- Eliminating sales tax on construction labor by taxing state highway construction and improvement projects in the same manner as federal construction projects are taxed.