

Wisconsin Tax Appeals Commission Requires Material Supply Companies to Have Economic Substance

A recent Wisconsin Tax Appeals Commission decision concluded that a separately formed material supply company must have economic substance to be respected for Wisconsin sales and use tax purposes. *Sullivan Bros., Inc., v. Wis. Dep't of Revenue*, Wis. Tax Rep. (CCH) ¶ 401-600 (WTAC Aug 14, 2012).

Generally, a contractor is subject to Wisconsin sales or use tax on materials it purchases and uses in providing real property construction services. This is true even if it transfers these materials to an exempt organization in the course of providing its real property construction services.

However, if the exempt organization purchases the construction materials itself, it can use its Wisconsin exemption (Certificate of Exempt Status number) to reduce its overall construction costs. Several requirements must be met for the organization's exempt status to apply to the purchases of the materials. For example, the exempt entity must provide a purchase order to, and directly pay, the supplier for the materials. Also, the exempt entity cannot purchase the materials from the entity providing the real property construction services.

To assist their exempt customers in taking full advantage of the exemption granted by the legislature, real property construction companies may set up separate material supply companies. These separate legal entities purchase materials and resell them directly to exempt customers for use in their construction projects. This structure has historically been approved by the Wisconsin Department of Revenue—even when the material supply company was a wholly owned subsidiary of, or its owners were identical to, the real property construction company. The recent decision in the *Sullivan Brothers* case seems to add the requirement that a material supply company must have a minimum amount of economic substance to be respected.

The facts in the *Sullivan Brothers* case were somewhat unique. In a typical material supply company structure, the supply company will purchase the materials from third parties and resell them directly to the exempt entity. In this case, the construction company (Sullivan) installed ceiling systems and related items. There were a limited number of manufacturers and suppliers that could provide the

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materials that Sullivan needed. The distribution agreements in the industry prevented sales to independent distributors like the material supply company set up by Sullivan as a wholly owned subsidiary (Supply). As a result, Sullivan had to purchase all the materials from the manufacturers and suppliers itself. It then sold the materials to Supply for resale to exempt customers.

The Wisconsin Tax Appeals Commission emphasized Sullivan's initial purchases of the materials in concluding that Supply lacked economic substance. The Commission also pointed to additional facts in support of its conclusion, including that:

- The ownership, location, and employees of Supply were identical to Sullivan;
- Sullivan admitted Supply was set up to avoid having to charge tax-exempt customers Wisconsin sales tax; and
- The sales from Sullivan to Supply were at cost and only recorded at year end through journal entries.

The decision in *Sullivan Brothers* does not mean that the use of the material supply company form is no longer available to reduce construction costs for exempt entities. In fact, the Commission noted it is still possible to achieve the result intended. Therefore, the lesson from the *Sullivan Brothers*' decision is that even in the generally formalistic world of Wisconsin sales and use taxes, a minimum amount of economic substance may be required to give substance to the chosen form.

This case is currently on appeal, so the decision of the Wisconsin Tax Appeals Commission is not final. Stay tuned for further developments.

If you have questions about material supply companies, Wisconsin sales/use tax matters, or other state and local tax issues, please contact [Kristina E. Somers](#), your Reinhart attorney, or any other member of the Reinhart State and Local Tax team.

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