Cite as Det. No. 01-077R, 21 WTD 169 (2002)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 01-077R[1]
	)	
. . .	)	Reg. No. . . .
	)	FY . . . /Audit No. . . .
	)	Docket No. . . .
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. . .	)	Reg. No. . . .
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	)	Docket No. . . .

[1] RULE 170; RCW 82.04.250, RCW 82.04.050, RCW 82.08.020: RETAIL SALES TAX – RETAILING B&O TAX – PRIME CONTRACTOR – CONSTRUCTION UPON LAND OWNED BY A CORPORATE OFFICER. Where a construction company performs construction services on land owned by its corporate office, it is deemed a prime contractor.

[2] RULE 170, RULE 223; RCW 82.04.250, RCW 82.04.050, RCW 82.08.020: RETAIL SALES TAX – RETAILING B&O TAX – MEASURE OF TAX -- PRIME CONTRACTOR –FORM OVER SUBSTANCE. Payment by a consumer of a contractor's liability is includable in the contractor's tax measure. Taxpayers are free to choose the form of their business relationship, and where their conduct is consistent with that form, there is no reason to disregard the form chosen by the taxpayers.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

NATURE OF ACTION:

[1] The original determination, Det. No. 01-077, is published at 21 WTD 157 (2002).

The taxpayers, a land owner and a construction company, request reconsideration of Det. No. 01-077, in which we upheld the assessment of retail sales tax, retailing B&O tax, and "deferred sales" or use tax with respect to construction we concluded the construction company performed as a prime contractor for the land owner. In addition, the construction company requests reconsideration of Det. No. 01-077 to the extent we upheld the assessment of retailing B&O tax, service B&O tax, and retail sales tax on amounts we concluded the construction company received from maintenance and management agreements.[2] [3]

FACTS, ANALYSIS, AND CONCLUSIONS:

C. Pree, A.L.J. – The Department of Revenue Audit Division audited the records of both taxpayers, referenced above, for the period of January 1, 1995, through December 31, 1998. The audit of [Land Owner] resulted in the assessment of "deferred sales" or use tax of $ . . . and interest of $ . . . . The assessment totaled $ . . . .

[Land Owner] is the sole shareholder of [Construction Company]. The audit of [Construction Company] resulted in the assessment of retail sales tax of $ . . . , retailing B&O tax of $ . . . , service B&O tax of $ . . . , use tax of $ . . . , and interest of $ . . . . The assessment totaled $ . . . .

In their petition for reconsideration, the taxpayers raise two issues, which are addressed below.

[1] 1. **Whether Det. No. 01-077 Erred in Characterizing [Construction Company] as a General Contractor and [Land Owner] as a Consumer of [Construction Company]'s Construction Services.**

Relying on WAC 458-20-170 (Rule 170), Det. No. 01-077 upheld the assessment of retailing B&O tax and retail sales tax against [Construction Company] and deferred sales/use tax against [Land Owner] based on its determination that [Construction Company] was the general contractor in the construction of buildings for [Land Owner] on land owned by [Land Owner]. Specifically, under Rule 170, where a corporation, such as [Construction Company], performs construction on land owned by its corporate officer, such as [Land Owner], the corporation is considered to be "constructing upon land owned by others" and is taxable as a general contractor, not as a speculative builder.

In reaching our conclusion that [Construction Company] was acting as a general contractor, we relied on the taxpayers' records, which reflected that [Land Owner] paid [Construction

[2] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

[3] In Det. No. 01-077, we remanded the assessment of use tax on [Construction Company]'s purchases of consumable supplies, capital assets and "other acquisitions which were not made on a routine or recurring basis," on which the Audit Division determined retail sales tax had not paid to allow the taxpayer the opportunity to provide proof that retail sales or use tax had been paid. In its petition for reconsideration, [Construction Company] stated that it would provide the proof to the Audit Division, and in its response to the petition for reconsideration the Audit Division agreed to review such proof and adjust the assessment accordingly.

Company] for construction labor, construction supervision, contractor expense reimbursement, promotional service reimbursement, wage fees, contractor fees, architectural fees, developer fees, and costs charged by material and service suppliers, which were invoiced to [Construction Company]. We reasoned that these are amounts consumers typically pay to their general contractors and noted that [Construction Company]'s accounting records and federal income tax returns included construction payments from [Land Owner] and that [Land Owner] made regular payments to [Construction Company] for construction labor and supervision based on invoices from [Construction Company]. We did not find the fact that [Construction Company] may not have reported the "reimbursements" of materials expenses and subcontractor costs as part of its gross income on its federal tax returns to be persuasive that it was acting in a capacity other than that of a prime contractor.

In their petition for reconsideration, the taxpayers argue:

> This is not accurate. Only a portion of the construction costs and expenses were "run through the books" of [Construction Company]. The fact that only a portion of the construction costs were passed through [Construction Company] underscores the taxpayers' agreement and understanding between themselves that the payments to [Construction Company] were merely advances or reimbursements of construction costs or expenses incurred by [Land Owner] personally and no contractor-customer relationship was intended to be created.

However, as we discussed in our original determination, we note that the types of payments that [Land Owner] made to [Construction Company] are typical of costs paid by a landowner to its general contractor. If [Construction Company] were not performing services, such as construction supervision and construction labor, we see no reason that [Land Owner] would be paying [Construction Company] for such services.

The taxpayers further argue:

> If there is merit to the Department's contention that the construction costs and expenses that were run through [Construction Company]'s books and records were taxable, then the extent of the tax liability was the actual amount recorded, not the total construction costs incurred by [Land Owner]. Even though subcontractor and supplier invoices may have been sent to [Construction Company], [Land Owner] paid most of the construction costs directly

[2] Again, we find that this issue was adequately addressed in our original determination. As we discussed in that determination, WAC 458-20-223 (Rule 223) provides that where there is no stated contract price, as here, prime contractors are taxed as follows:

> The measure of the tax . . . is the amount of profit or fixed fee received, plus the amount of reimbursements or prepayments received on account of sales of materials and supplies, on account of labor costs, on account of taxes paid, on account of payments made to

> subcontractors, and on account of all other costs and expenses incurred by the contractor, **plus all payments made by his principal direct to a creditor of the contractor in payment of a liability incurred by the latter.**

(Emphasis added.) In this case, the invoices and subcontractor agreements were in [Construction Company]'s name, and [Construction Company] was liable for payment.[4] As such, [Land Owner]'s payments of these amounts constitute payments made by a principal ([Land Owner]) "direct to a creditor of the contractor" ([Construction Company]). Under Rule 223, there is no question that such amounts are properly included in the measure of tax.[5]

In our original determination, we further found the fact that the majority of invoices were billed to [Construction Company] and the subcontract agreements were with [Construction Company], not with [Land Owner] individually, to be persuasive evidence that a prime contractor/consumer relationship existed between [Construction Company] and [Land Owner]. We were not persuaded by the taxpayers' argument that the contracts were written and the billings were arranged in this manner merely for the convenience of [Land Owner]. We concluded, "It is well settled that taxpayers in Washington are generally bound by the form in which they choose to do business.[6]" (Footnote original.)

The taxpayers argue:

> The determination's conclusion that form controls over substance is not supported by law despite the Administrative Law Judge's string cites to the contrary. . . . On the contrary, it has been long-settled in this state that "form is not to be exalted over substance in tax classifications." Fidelity Title Co. v. Department of Revenue, 99 Wn. App. 662, 666-67, 745 P.2d 530 (1987), citing Time Oil Co. v. State, 79 Wn. 2d 153, 146 [sic], 483 P.2d 628 (1971). . . . .So, the determination's reliance on the form of the transaction and holding that form controls over substance, is not supported by case law regardless of departmental published determinations to the contrary

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[4] In their petition for reconsideration, the taxpayers argue, "[t]he subcontractors all looked to [Land Owner] for payment and he was personally liable for all construction costs and expenses." However, the taxpayers provided no authority for this statement, and we find the fact that the contracts were in [Construction Company]'s name to be evidence to the contrary.

[5] Although we determined that the Audit Division properly assessed retailing B&O tax and retail sales tax against [Construction Company] and use tax against [Land Owner], we held that, to the extent retail sales tax was improperly paid on the invoices (because the purchases were for resale by [Construction Company] to [Land Owner]), such tax was not properly included in the measure of the taxes assessed. See Rule 170.

[6] See, e.g., Det. No. 90-108, 9 WTD 231 (1990) ("With respect to the taxpayer's assertion that it could have set up its records and operated differently to comply with the Department's requirements, it must be recognized that the Department consistently assesses taxes according to what was done, not on the basis of what could have been done."); Det. No. 00-045, 19 WTD 965 (2000) ("The Department has long limited a taxpayer's ability to elevate substance over form."); Det. No. 89-331, 8 WTD 53 (1989) ("The taxpayers in this case were free to choose the form of business which they desired, and there is no reason now, other than to escape the clutches of the Washington tax collector, to disregard that form."); see also, Det. No. 85-112A, 1 WTD 343 (1985); Det. No. 92-166, 12 WTD 211 (1992); Det. No. 98-172E, 18 WTD 387 (1999).

We disagree with the taxpayers' characterization that our original determination held that form controls over substance. To the contrary, our determination held that the taxpayers were free to choose the form of their business relationship, their conduct was consistent with that form, and there was no reason to disregard the form chosen by the taxpayers.

Finally, the taxpayers argue that it would "make no economic sense" for [Land Owner] to contract with [Construction Company] for the construction, "since the effect of such scheme would only serve to increase his tax liability to the state of Washington." The Audit Division responded to this argument as follows:

> The formation of two entities clearly make[s] economic sense because [Construction Company] (a corporation) takes the legal responsibility of any possible liability in regards to employees and other construction activity incurred, not [Land Owner], an individual. This is a common business practice for many industries to create separate entities for liability reasons.

We agree with the Audit Division. Further, as addressed above, the taxpayers were free to choose the form in which they engaged in business, and it is not our role to change the tax consequences of that form where, as here, the parties' conduct was consistent with their chosen form of business relationship.

2. Whether Det. No. 01-077 Erred in Sustaining the Assessment Against [Construction Company] of Service B&O Tax with Respect to its Receipt of Management Fees and Retail Sales Tax and Retailing B&O Tax with Respect to its Receipt of Maintenance Income.

In Det. No. 01-077, we sustained the assessment of service B&O tax and retailing B&O tax and retail sales tax with respect to amounts we determined [Construction Company] received from [Land Owner] for management and maintenance services, respectively. [Construction Company] reported these amounts on its income statements, but did not report the amounts for Washington tax purposes. On reconsideration, as in its original petition, the taxpayers argue that [Land Owner] did not contract with [Construction Company] for services and any amounts allegedly paid to [Construction Company] were, instead, merely reimbursements for moneys paid to [Land Owner] for his own management services, and were not services rendered by [Construction Company].

On reconsideration, the taxpayers further argue:

> Here, the determination once again failed to recognize economic reality. In other words, there was no economic reason why [Construction Company] would perform management and maintenance services for [Land Owner] other than to increase the parties' tax liability. This does not make sense. What does make sense is that [Construction Company] was performing the accounting and bookkeeping for [Land Owner], and that is the reason the costs may have appeared on the business records of [Construction Company]. The expenses

> were incurred by [Land Owner] with respect to properties he owned individually. The fact that the accounts payable and receivables were run through [Construction Company], did not mean that [Construction Company] was performing these services for [Land Owner]. Rather, [Construction Company] was receiving reimbursement of expenses incurred by [Land Owner]. The tax assessments are therefore erroneous.

The Audit Division again responded to the petition for reconsideration by noting that the use of a corporation makes economic sense because of the limited liability afforded by a corporation. Again, we agree with the Audit Division. Further, as we noted in our original determination, we find the taxpayers' explanation of the inclusion of the management income on the statements as "reimbursements for moneys paid to [Land Owner] for his . . . management services" to be questionable, at best. Further, we do not find the taxpayers' explanation on reconsideration that the amounts "appeared on the business records" of [Construction Company] because it was performing accounting services for [Land Owner] to be an adequate explanation of why [Construction Company] reported these amounts on its income statements. As we concluded in our original determination, we again conclude:

> "[T]he Department consistently assesses taxes according to what was done, not on the basis of what could have been done." Det. No. 90-108, 9 WTD 231 (1990). Because the taxpayers have failed to meet their burden of proving that this income was properly excluded from tax, the taxpayers' petition is denied with respect to this issue.

DECISION AND DISPOSITION:

The taxpayers' petitions for reconsideration are denied. [This matter is remanded to the Audit Division for adjustment consistent with the decision in Det. No. 01-077.]

Dated this 28th day of January 2002.