

STATE OF WASHINGTON
Board of Tax Appeals

THE WASHINGTON WATER)	
POWER CO.)	
)	Docket No. 85-169
Appellant)	
)	Re: Excise Tax Appeal
vs)	
)	<u>O R D E R</u>
STATE OF WASHINGTON)	
DEPARTMENT OF REVENUE)	FINAL DECISION
)	
Respondent)	
)	

This matter came before the Board of Tax Appeals for a formal hearing on March 28, 1986. The appellant, the Washington Water Power Company, was represented by Jerry Boyd and John Quinlan of Paine, Hamblen, Coffin, Brooke & Miller. Robert Henriques, Manager of thermal operations and Robert Hanson, Assistant Treasurer of Washington Water Power Company appeared as witnesses for the appellant. The respondent, State of Washington, Department of Revenue, was represented by the Attorney General through Assistant Attorney General, John M. Gray. The Board, having heard testimony in support of the appellant's appeal and of the respondent's answer and having considered all the evidence and arguments presented on behalf of both parties, now makes its order as follows:

FINDINGS OF FACTS

1. The Washington Water Power Company (WWP) is an investor-owned multi business public utility located in Spokane, Washington that generates and sells, among other things, electrical energy.

2. The Department of Revenue of the State of Washington (DOR) is an agency of the State of Washington charged with the collection of, among others, the use tax.

3. This appeal involves a levying of the Washington Use Tax (Retail Sales Tax), on the professional engineering services performed for the Washington Water Power Company (WWP) and WP Energy, WWP's wholly owned subsidiary, by the Morrison-Knudsen Company (M-K) in connection with a wood burning plant constructed near Kettle Falls, Washington to provide electrical energy.

4. M-K did not collect sales tax from WWP) , and did not remit sales tax to the DOR pertaining to the design engineering of the Kettle Falls facility. The taxpayer, an investor-owned utility, was audited by the DOR for the period January 1, 1981

through August 31, 1983. Assessment No. 5412400 was issued on August 9, 1984 for use tax and interest liability with regards to this matter. The Use Tax assessed was \$359,739. Interest in the amount of \$78,750 was also assessed on the tax, for a total tax and interest of \$438,489. The \$438,489 was paid on or about March 19, 1985. The taxpayer seeks a refund of the \$438,489 plus applicable interest earned thereon since the date of payment.

5. Mr. R. E. Henriques was the manager of thermal projects for WWP at all times relevant to the facts in this case.

6. In 1978, WWP retained the H. A. Simons Company to conduct a feasibility study for an energy-producing wood waste burning facility near Kettle Falls, Washington.

7. On March 2, 1979, Mr. Henriques wrote to D. L. Olson, Senior Vice President for WWP, concerning the selection of a consultant for the Kettle Falls facility, recommending that WWP solicit proposals based on an engineering, procurement, and construction type of contract.

8. On April 30, 1979, WWP sent a letter (Exh. A-1) to Rust Engineering Company (Rust) of Portland, Oregon, indicating that Rust had been selected to perform the engineering, procurement and construction of the Kettle Falls wood waste electrical generating plant. The letter indicated that Rust was only authorized to commence work on preliminary engineering activities. On June 12, 1979, a WWP Purchase Order No. 79-3399 (Exh. A-2) was issued by WWP for the Rust Professional Engineering Services. The letter of April 30, 1979, indicated an intent later to contract with Rust to construct the plant.

9. Rust completed the preliminary engineering work at a cost of approximately \$1 million. The permits for the project were obtained in the Spring of 1980. However, WWP made a decision to delay or defer the project. No sales taxes were paid on such services and no payments to Rust are involved in this case.

10. On October 20, 1980, Mr. Henriques, in his capacity as manager of thermal projects for WWP, wrote a memorandum (R-2) to Mr. Olson, Senior Vice President of WWP concerning the reactivation of the Kettle Falls project. In this memorandum he discussed an offer from M-K and made the following recommendation.

"If the Kettle Falls project is authorized at the board of Directors' meeting in November, we recommend that the Company retain Morrison-Knudsen to perform the engineering, procurement and construction activities."

This recommendation is based on our evaluation of the total capabilities of M-K and the commitment of their senior management as represented in their proposal letter. While

their proposal provides a very attractive offer with incentives to bring the project on line within budget, I believe their goal of establishing track record with WWP for potential work at Creston is the added incentive that will insure a high quality project at the lowest installed cost. (Emphasis added)

11. On October 30, 1980, Mr. Keith Price, M-K Group Vice President-Power Group wrote a letter (R-2) to Mr. Henriques in which he stated the following, in pertinent part:

"In accordance with your request we are enclosing alternatives for financing construction of the Kettle Falls wood-fired power plant. Also enclosed is an outline of an engineer/procure/construction approach which we feel would meet your major milestones of detailed design beginning February 1, 1981, and commercial operation by September 1, 1983.

M-K's PRIME MANAGER concept places all responsibility with a single management team"

12. Mr. Keith Price of M-K described M-K's Prime Manager concept in this proposal (R-2) entitled, "M-K Power Group: Financing Alternatives For Kettle Falls", which follows in pertinent part:

"M-K's Prime Manager concept places all design/construction responsibility within a single management team. As pieces of the design are completed, procurement and/or construction can begin. The construction plant and facilities and the construction equipment spread are executed by one entity for the complete plant. This reduces overlap and duplication of resources." (Emphasis added)

13. In the fall of 1980, WWP reviewed its decision to delay or defer the Kettle Falls project. The minutes of the November 7, 1980 meeting of the Board of Directors of WWP show that the Board of Directors moved and seconded and unanimously adopted the following resolution, in pertinent part:

"BE IT RESOLVED by the Board of Directors that the Officers of the Company are authorized and directed to take all steps necessary to arrange for the construction of what is known as the Kettle Falls Wood Waste Power Plant, provided, that in the Officers' judgment, the financing plan for construction is feasible and consistent with the Company's projected financing plans, and the terms and conditions of the financing are in the best interest of the Company."

14. In a separate proceeding before the Washington Utilities and Transportation Commission (WUTC) in 1982, the WUTC found that as a matter of fact, WWP deferred awarding a construction contract in 1978 or 1979, but decided in November of 1980 to proceed. (R-5)

15. On December 22, 1980, Mr. Henriques wrote to Mr. Olson (R-3) concerning the reactivation of the Kettle Falls project and stated the following, in pertinent part:

"During November, I had several conversations with Rust Engineering regarding the work on Kettle Falls. As a result of these discussions, Rust sent in a letter proposal dated November 24, 1980, and requested that we evaluate a new project team that they had assembled. Since their offer was equivalent to the Morrison-Knudsen letter offer dated October 30, 1980, we decided to perform a comparative evaluation of the two firms.

An evaluation team, consisting of myself, Gary Normoyle, Scott Hamilton, Bob Escalante, and Tony Broyles, visited the offices of Morrison-Knudsen and Rust on December 12 and 15 respectively. The comparative evaluation is attached for your information.

As a result of this work, it is still my recommendation that the Company retain Morrison-Knudsen to perform the engineering, procurement, and construction activities for the Kettle Falls project, if and when final project approval is given. (Emphasis added)

16. The five criteria and the weighing used by WWP in the evaluation process were:

1. Team and staff experience	Weight	5
2. Project Management Personnel	Weight	2
3. Senior Management Commitment	Weight	1
4. <u>In-House Engineering</u>	Weight	1
5. Modeling Capabilities and Interest (Emphasis added)	Weight	1

17. The Kettle Falls Consultant Evaluation statement attached to Mr. Henriques December 22, 1980 letter to Mr. Olson (R-3) stated the following, in pertinent part:

*"The recent reactivation of the Kettle Falls Project with new financial alternatives has caused the need for a reevaluation of the contractor who will design and construct the project .
. . .*

The reevaluation was limited to re-scoring the original "wants" list included in the April 27, 1979 evaluation. The

results indicate a shift in the scoring from Rust to M-K in three of the five areas. . . .

Based on the above and the result of the two meetings, the evaluation team recommends Morrison-Knudsen for the design, procurement, and construction of the Kettle Falls Project.
(Emphasis added)

18. On February 3, 1981, Mr. Henriques wrote to Mr. Keith M. Price, Group vice President-Power Group of the Morrison-Knudsen Company, Inc., stating that WWP had selected M-K to perform the engineering, procurement, and construction of the Kettle Falls Project, and authorizing M-K to commence work on the engineering activities to support WWP's schedule and that the detailed scope of those activities will be developed jointly between WWP and M-K during the next two weeks.

19. In the same February 3, 1981 letter to Mr. Price, Mr. Henriques stated that, confirming their recent telephone conversations, it was their intention to work out the details of a mutually acceptable contract for the full project scope of work.

20. On February 3, 1981, a Requisition on Purchasing (Exh. A-4) was issued by Robert E. Henriques, Thermal Project Manager for WWP, which resulted in the issuance by WWP of Purchase Order No. 81-1242 (Exh. A-5) on February 12, 1981 to M-K for professional engineering services for preliminary engineering for the Kettle Falls Wood Waste Project.

21. M-K actually started performing the design engineering services during the week of February 3, 1981, after receipt of the letter sent to M-K by WWP dated February 3, 1981. M-K had performed prior to July 31, 1981 design engineering services in the amount of \$891,500. The engineering design services continued through the construction period. All the design engineering, except for less than two-tenths of one percent (0.2%) were performed by M-K personnel in Boise, Idaho.

22. A written contract entitled "Engineering and Design Service Contract for Services Performed In The State of Idaho, Kettle Falls Wood Fired Power Plant" (Exh. A-6) was executed between WWP and M-K. The engineering contract was signed on July 31, 1981

23. A separate construction contract was entered into "Construction and Startup Contract Kettle Falls Wood Fired Power Plant" (Exh. A-7) . The construction contract was signed on July 31, 1981.

24. Mr. D. L. Olson, the Senior Vice President for WWP and Mr. Keith M. Price, Group Vice President-Power Group for M-K, signed both documents in their representative capacities on July 31, 1981.

25. Both contracts were approved as to form by Jerry K. Boyd, attorney for the WWP on July 31, 1981.

26. Both contracts were signed on July 31, 1981 because the contracts were not ready for signing until then, both parties engaging in negotiations after February, 1981 and prior to July 31, 1981.

27. Two amendments were made a part of the July 31, 1981 Construction and Startup Contract on October 4, 1982 (A-8) and May 3, 1984 (A-9).

28. The accounting for expenditures was kept separate by WWP as between the engineering and construction contracts. Some engineering services actually performed at the construction site as part of the construction activity for the plant were included as part of the construction contract. The Washington Retail Sales Tax was paid on the work performed under the construction contract, including construction engineering services.

29. Construction of the project was commenced in the summer of 1981 and completed in the fall of 1983. Total engineering design services performed by M-K on the Kettle Falls plant in Boise, Idaho approximated \$6.35 million. Total construction costs of the Kettle Falls plant amounted to approximately \$58.2 million.

30. WWP appealed to the Board of Tax Appeals on March 25, 1985. From the foregoing Findings of Fact, the Board now makes the following Conclusions of Law:

CONCLUSIONS OF LAW

1. The Board of Tax Appeals has jurisdiction over the parties and the subject matter of this proceeding, Chapter 82.03 RCW.

2. The Washington Retail Sales Tax is imposed under Chapter 82.08 RCW. The tax levied in this matter is a use tax levied under the provisions of Chapter 82.12 RCW. Under RCW 82.12.010(5) the meaning ascribed to words and phrases in Chapter 82.04 and 82.08 RCW, insofar as applicable, shall have full force and effect with respect to taxes imposed under the provisions of Chapter 82.12 RCW.

3. What constitutes a "sale at retail" or "retail sale" is defined in RCW 82.04.050.

4. RCW 82.04.050(2) states the following, in pertinent part:

"The term 'sale at retail' or 'retail sale' shall include the sale of or charge made for tangible personal property consumed and/or for labor or services rendered in respect to the following: . . . (b) the constructing, repairing, decorating,

or improving of new or existing buildings or other structures under, upon, or above real property or for consumers, including the installing or attaching of any article of tangible personal property therein or thereto, whether or not such personal property becomes a part of the realty by virtue of installation, . . .

(Emphasis added)

5. Under RCW 82.32.300, Rules of the Department of Revenue published and promulgated after public hearing pursuant to the Washington Administrative Procedures Act, have the same legal force and effect as the law itself unless declared invalid by the judgement of a court of record not appealed.

6. The Department of Revenue Rule 138 (WAC 458-20-138) provides that personal services are not subject to retail sales tax, as follows:

"The retail sales tax does not apply to the amount charged or received for the rendition of personal services to others, even though some tangible personal property in the form of materials and supplies is furnished or used in connection with such services."

7. However, the Department of Revenue Rule 170 (WAC 458- 20-170) provides that service activities rendered in respect to constructing are subject to the retail sales tax, as follows:

"The term 'constructing, repairing, decorating or improving of new or existing buildings or other structures,' in addition to its ordinary meaning, includes the installing or attaching of any article of tangible personal property in or to real property whether or not such personal property becomes a part of the realty by virtue of installation. . . .

The term includes the sale of or charge made for all service activities rendered in respect to such constructing, repairing, etc., regardless of whether or not such services are otherwise defined as 'sale' by RCW 82.04.040 or 'sales at retail' by RCW 82.04.050. Hence, for example, such service charges as engineering fees, architectural fees or supervisory fees are within the term when the services are included within a contract for the construction of a building or structure. The fact that the charge for such services may be shown separately in bid, contract or specifications does not establish the charge as a separate item in computing tax liability. (Emphasis added)

8. The Supreme Court of Washington has stated the following in Chicago Bridge v. Department of Revenue, 98 Wn.2d 814, 659 P.2d 463, at page 822 & 823, in pertinent part:

"Furthermore, CBI's isolation, for taxing purposes, of its contracts for design and manufacturing from those for installation appears an exaltation of form over substance. See Time Oil Co. v. State, 79 Wn.2d 143, 483 P.2d 628 (1971)."
(Emphasis added)

9. The Board holds that in form there are two separate documents for the contractual relationship between M-K and WWP for the design engineering services and construction of the Kettle Falls project.

10. The Board holds that in substance WWP had one contract which places all design/construction responsibility for the Kettle Falls project within a single management team of M-K.

11. The Board finds that although M-K's services were provided by M-K's personnel in two locations they worked under the control of a single management team.

12. The Board affirms its position in Don Williams Co. v. Department of Revenue, Docket No. 4291, December 14, 1972, in which the Board held that services provided before there was a contract to perform construction services are not subject to the retail sales tax under the provisions of WAC 458-20-138.

13. The Board finds that the \$891,500 of design engineering service provided by M-K to WWP before the contract to construct was signed on July 31, 1981 are not subject to the retail sales tax under the provisions of WAC 458-20-138.

14. The Board holds that the design engineering services performed by M-K for WWP after the contract to construct was signed on July 31, 1981 are service activities rendered in respect to the construction of the Kettle Falls project and are subject to the retail sales tax under the provisions of RCW 82.04.050(2) and WAC 458-20-170.

15. Any Finding of Fact which is deemed a Conclusion of Law is hereby adopted as such.

DECISION

The Board holds that the design engineering services of \$891,500 performed by M-K prior to July 31, 1981, the date the contracts to perform engineering design and construction were signed between M-K and WWP are not subject to the retail sales tax as provided in Department of Revenue Rule 138 (WAC 458-20-138).

The Board holds that engineering services performed after WWP had contracted with M-K to perform construction services are

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taxable as retail sales under Department of Revenue Rule 170. (WAC 458-20-170).

DATED at Olympia, Washington
This 25 day of July, 1986

STATE OF WASHINGTON BOARD OF TAX APPEALS