Cite as Det. No. 99-011R, 19 WTD 423 (2000)

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. 99-011R
. . .	)	Registration No. . . .
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[1] RULE 136; RCW 82.04.260(7); RCW 82.04.270: B&O TAX – PERISHABLE MEAT PRODUCTS. A taxpayer who processes perishable poultry and meat is not selling the same processed meat product when it adds other food items to the poultry and meat to produce a new or different food product, and the special B&O tax rate contained in RCW 82.04.260(7) does not apply to the wholesaling of this new product.

[2] RULE 170; RCW 82.04.050; RCW 82.04.051: RETAIL SALES TAX – RETAILING B&O TAX – SERVICES IN RESPECT TO CONSTRUCTING – CONSTRUCTION MANAGEMENT. In addition to services that involve the actual physical construction of buildings and structures, services in respect to such constructing activity are subject to retail sales tax and retailing B&O tax. To be rendered in respect to construction the services must "directly relate to the constructing," the provider of the services must be responsible for "the performance of the constructing," and the "predominant activity" must involve "services in respect to constructing." In general, construction management services are directly related to the physical activity of constructing itself. A person who either supervises or directs the work, such as a construction manager, is also considered "responsible for the performance." The "predominant" activity is the one having the greatest importance, influence, authority, or significance. In this case, although some of the projects involved administrative and other services not directly related to the construction, the most significant, important, or predominant activities involved the supervision or direction of the constructing activity. Because the predominant activities were directly related to the constructing activity and the taxpayer's agent was responsible for the performance, services rendered on those projects were subject to retail sales tax.

[3] RULE 111; RCW 82.04.220: WHOLESALING B&O TAX—PASS-THROUGHS—DIRECT OR DROP SHIPMENTS. Because the taxpayer is liable to the manufacturers regardless of whether it receives payment from retailers on drop or direct shipments from the manufacturers to the taxpayer's retail customers, the taxpayer is liable other than as an agent, and the receipts are not excluded from gross income under Rule 111.

[4] EQUITABLE ESTOPPEL—GOVERNMENT ENTITY—ELEMENTS—BURDEN OF PROOF. Equitable estoppel claims against the government require proof: (1) of an admission, statement or act inconsistent with a claim later asserted; (2) of reasonable reliance on that admission, statement, or act by the other party; (3) of an injury to the relying party if repudiation of the admission, statement, or act is allowed; (4) that relief must be necessary to prevent a manifest injustice; and (5) that the exercise of government functions will not be impaired as a result. Each element must be proved by clear, cogent, and convincing evidence. Because each element was proven by clear, cogent, and convincing evidence, the Department is estopped, except on a prospective basis, from collecting wholesaling B&O tax on the direct or drop shipments.

[5] WAC 458-61-555; RCW 82.04.390; RCW 82.45.060: REAL ESTATE EXCISE TAX (REET)—OPTIONS TO PURCHASE—EXERCISE FEES. Payments for an option to purchase real property are "not derived from the sale of real estate" and, therefore, payments for the grant of an option to purchase real property do not qualify for the B&O tax exemption of RCW 82.04.390. However, a fee to

exercise an option for the purchase of real property is additional consideration for the purchase, and it does qualify for the B&O tax exemption.

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.

Mahan, A.L.J. -- Wholesale grocery distributor seeks reconsideration of a determination affirming the assessment of: (1) business and occupation (B&O) tax on various perishable deli items at a rate other than the rate for the slaughtering, breaking, and processing of perishable meat products and the wholesaling of the same; (2) use tax on construction management services; (3) B&O tax on direct sales from manufacturers to retailers; and (4) B&O tax on the alleged sale of real estate.[1]

ISSUES

1. Does the B&O tax rate for slaughtering, breaking, and/or processing perishable meat products and the wholesaling of the same apply to the wholesale sale of various perishable deli products that contain meat or poultry products as only one of the ingredients in the items being sold?

2. Are payments to a company that provides management services related to the design, development, and construction of a grocery store subject to retail sales tax?

3. When a vendor makes a direct or drop shipment to retailers, the taxpayer is billed for the shipments, and the taxpayer is liable for payment of the bills, is the taxpayer's B&O tax liability limited to any commission or discount it receives on the payments?

4. If payments on such direct or drop shipments are not treated as pass-through payments, is the Department estopped from collecting the tax as a result of past instructions?

5. Is B&O tax due on exercise fees related to the purchase of real property?

FACTS

. . ., the taxpayer, is . . . based [outside Washington]. Its primary business in Washington State is that of a wholesale grocery distributor. It operates distribution centers in . . ., Washington and . . ., Washington. It also operates several retail stores in Washington. It is also involved in the development of retail grocery stores for others (what it refers to as "turn-key" developments), the retail and wholesale sale of grocery store equipment, and the providing of retail store accounting and other services for its customers.

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

During the period covered by the audits at issue, 1991 - 1994, the taxpayer went through several organizational changes. The Department of Revenue (Department) prepared separate audit reports for each period when a particular entity was in existence.

As part of the audit, the Department reclassified certain wholesales of meat from the wholesaling B&O tax rate to the lower tax rate for the slaughtering, breaking, and/or processing of perishable meat products (RCW 82.04.260(7)). The taxpayer contends that more products should have been reclassified to the lower B&O tax rate. The Department, for example, reclassified various fresh meat products, including spiced sausage products, under the lower B&O tax rate, but declined to do so for breaded or sauce covered products containing meat. The Department reasoned:

> [T]he term "processing" means, we believe, grinding, seasoning, packaging, and similar terms. It does not include adding other products which are foods unto themselves, such as breading and cheeses.[2]

The taxpayer contends that the lower rate should also be applied to other products, such as, Salisbury steak with gravy, chicken Kiev, breaded and fried chicken, chicken nuggets, sliced beef with gravy, corn dogs, and pork ribs with barbecue sauce. In its brief, the taxpayer argued the statute should be broadly interpreted "to include all manufactured or processed products which have meat as an ingredient, notwithstanding the fact that there is no clear, definitive statement of legislative intent behind the enactment of RCW 82.04.260(7)." The taxpayer repeats this argument on reconsideration. In further legal support on reconsideration, the taxpayer refers to various agricultural statutes where a distinction is drawn between processed and unprocessed agricultural products.

The Department also assessed retail sales tax on the taxpayer's payments to a company, [Company] (. . .), that assists the taxpayer in developing and building grocery stores. According to the taxpayer, [Company] provides real property acquisition and management services. In its initial brief the taxpayer stated that [Company]'s services included "management activities relating to site construction but no actual construction." It argued that such construction management services were not subject to retail sales tax and made no attempt to distinguish such services from any other services provided by [Company]. On reconsideration, the taxpayer provides a description of the services provided on various projects by [Company]. On most projects [Company] provided primarily pre-development, permitting, and administrative services. Only on two projects, . . ., did it provide construction management services to any significant degree. According to the taxpayer, it also hired general contractors on [two] projects. Although the taxpayer did not present copies of contracts or other documents regarding the services provided by [Company], it characterizes [Company]'s services on the [two] projects as including, on a day-to-day basis, "monitoring and coordinating work", "working with the general contractor's job superintendent", "acting in place of

[2] Auditor's Detail of Differences and Instructions to Taxpayers for . . ., Registration No. . . . . To the extent applicable, the statements in this audit apply equally to the other audits. Future references to the Department's position are to this document.

an in-house employee responsible for construction/project development", "monitoring the scheduling and timing of the construction project", and "negotiating with general contractors."

The taxpayer also disputes the assessment of B&O tax on what it variously referred in briefs and contracts as "drop shipments" or "direct shipments" from vendors to retailers. According to the taxpayer, its drop or direct shipment program involves items not carried in its warehouse, e.g., items for which there is little demand or specialty items. Vendors send these items directly to retailers with billing going through the taxpayer. According to the taxpayer, it never receives possession, title, or ownership of the goods. Rather, it acts as a "billing agent" for the vendors under the terms of a "Direct Shipment Agency Agreement". Under the terms of this agreement, the taxpayer when it accepts a drop shipment invoice must remit "promptly to seller the invoice price less any discount." The taxpayer retains any discount, pays B&O tax on that amount, and bills the retailer for the amount due. The agreement further provides that if the taxpayer does not reject an invoice when first received, "its position shall be that of guarantor of the payment of the amount thereof, less any agreed discount." The taxpayer further noted the Department previously accepted this practice. As noted in a 1988 audit, "these agreements are the same as those previously reviewed and accepted in a previous audit by the Department of Revenue." Accordingly, the taxpayer contends that the Department, at a minimum, should be estopped from assessing tax.

The Department noted the taxpayer accounted for the transactions as sales and costs of goods sold and had rights of subrogation to title and collection. Therefore, it concluded the transactions did not qualify for treatment as pass-through payments under WAC 458-20-159 (Rule 159) or WAC 458-20-111 (Rule 111).

Finally, the taxpayer disputes the assessment of service B&O tax on a payment of $. . . from . . . . It contends this fee is related to the purchase of real property and, therefore, not subject to B&O tax. In the initial appeal the taxpayer asserted that no tax was due on the receipt of an "option fee" for the purchase of real property. On reconsideration, the taxpayer now refers to the fee as an "exercise fee" and, for the first time, presented closing documents regarding the payment and the nature of the fee.

ANALYSIS

1. Perishable Meat Products.

In general, the wholesaling B&O tax is imposed on gross proceeds of sale at the rate of .484 percent. RCW 82.04.270. A special B&O tax classification and lower tax rate for "perishable meat" products is found at RCW 82.04.260(7), which provides:

> Upon every person engaging within this state in the business of slaughtering, breaking and/or processing perishable meat products and/or selling the same at wholesale only and not at retail; as to such persons the tax imposed shall be equal to the gross proceeds derived from such sales multiplied by the rate of 0.138 percent.

WAC 458-20-136 (Rule 136) implements the statute and makes it clear the statute applies to both manufacturing and wholesaling activities. In pertinent part it provides:

> (10) The special classification and rate for slaughtering, breaking and/or processing perishable meat products and/or selling the same at wholesale (RCW 82.04.260(7)) combines manufacturing and nonmanufacturing activities into a single taxable business activity. For persons who break, slaughter, and/or process meat products for others, the statutory classification and rate are applicable to the value of products so processed and delivered to customers within this state and to interstate or foreign customers. The mere wholesale selling of perishable meat products not manufactured by the vendor is subject to the statutory classification and rate only upon gross receipts from sales within this state. Interstate or foreign sales are deductible from gross proceeds of sales.

In this case, the taxpayer contends that products containing processed perishable meat in combination with other manufactured products, such as sauces and breading mixtures, are subject to this special lower wholesaling B&O tax rate.

Statutes are to be construed as a whole, considering all provisions in relation to each other and giving effect to each provision. In this regard, "[a]ll the provisions of an act must be considered in their relation to each other and, if possible, harmoniously construed to insure proper construction of each provision", *Publishers Forest Products Co. v. State*, 81 Wn.2d 814, 816, 505 P.2d 453 (1973); and "[s]tatutory provisions are construed in light of one another and in view of the statute's overall purpose". *Nelson v. National Fund Raising Consultants, Inc.*, 120 Wn.2d 382, 392, 842 P.2d 473 (1992).

Related statutes make it clear that the B&O tax is imposed on the gross proceeds of sale of a product as finally completed. RCW 82.04.450; WAC 458-20-112 (Rule 112). The tax is not imposed on intermediate steps of a manufacturing process or, in this case, the wholesaling of the same. As we explained in Det. No. 88-329, 6 WTD 321 at 333-334 (1988):

> It is the Department's position that the manufacturing B&O tax does not apply to the intermediate substances which are produced during any manufacturing/refining process where such substances inhere in the end product being manufactured or refined. Such intermediate possessions and uses are not deemed to be industrial or commercial use when they occur on-line, within the continuing manufacturing/refining process. It is only when any such intermediate substance is withdrawn from the process for sale or some different industrial or commercial use that the B&O tax applies to the value of such substances. <u>In short, the B&O tax does not apply to every substance produced at each and every step or stage within a continuous production process. The tax applies only to the value of the end-product.</u>

(Emphasis supplied.)

Under the taxpayer's proposed interpretation of the statute, one step of a manufacturing process, the processing of perishable meat, would control the rate applicable to the finished product. The special rate would become the rule for any product containing a processed meat product. Such a strained reading of the statute is contrary to the plain meaning of the statute and to other tax

provisions. *See, e.g.,* RCW 82.04.450; Rule 112. Statutes are construed so as to avoid strained or absurd consequences. *Wright v. Engum*, 124 Wn.2d 343, 351-52, 878 P.2d 1198 (1994).

Accordingly, we held in our initial decision that processing perishable meat as an intermediate step and combining it with other ingredients to create a new and different product does not entitle the final product to the special B&O tax rate for perishable meat products. Under such circumstances, the taxpayer is not "selling the same", but is selling new or different manufactured products. Det. No. 98-190, 18 WTD 402 (1999); *see also* RCW 82.04.260(7).

In arguing on reconsideration that the legislature intended to include any product that contains perishable meat within the special rate classification, the taxpayer refers to various agricultural statutes. *See, e.g.,* RCW 15.65 (promotion of agricultural commodities); RCW 15.36 (public safety in milk manufacturing); RCW 15.63 (apple marketing). According to the taxpayer, these statutes demonstrate a "clear distinction between pure products and manufactured or processed products under Washington law."

However, the distinction between "pure" and "processed" products is not the issue in this case. The issue in this case is whether the special rate for "processing perishable meat products" and the wholesaling of the same applies to any manufactured product that happens to contain meat and is perishable. Clearly, grinding, seasoning, cooking, adding filler, enclosing in a casing, or other processing of perishable meat products and the wholesaling of such processed or manufactured perishable meat products are subject to the special rate. Also the rendering of fat, the making of bone meal, and similar processing of meat products may be subject to the special rate. In contrast, using wheat to manufacture a pastry, breading, or gravy and the wholesaling of the same are not subject to the special manufacturing and wholesaling rate. As discussed above, combining meat with such manufactured products to create a new and different product does not entitle the final product to the special B&O tax rate for processing perishable meat products and the wholesaling of the same. The creation and wholesaling of a dinner entrée, such as chicken Kiev, is not simply the processing of a perishable meat product and the wholesaling of the same.

The statutes relied on by the taxpayer also do not concern the same subject matter. Statutes that concern the same subject matter, that is, in pari materia, should be construed "as constituting one law to the end that a harmonious total schema which maintains the integrity of both is derived." *Beach v. Board of Adjustment*, 73 Wn.2d 343, 346, 438 P.2d 617 (1968); *State v. Houck*, 32 Wn. (2d) 681, 684, 203 P. (2d) 693 (1949).[3] Unlike the agricultural statutes relied on by the taxpayer, which concern marketing or public safety, the tax statutes have a more narrow focus, the identification of the appropriate tax classification.

In considering the appropriate tax classification, we note the Department for many years (and the taxpayer for that matter) has not interpreted the special rate statute to include manufactured items

[3] To the extent that the taxpayer seeks to rely on rules promulgated by other governmental agencies, they are not controlling with respect to taxation matters. *TLR, Inc. v. Town of la Center*, 68 Wn. App. 29, 34, 841 P.2d 1276 (1992).

that contain meat as only one of many ingredients. In interpreting a statute, courts grant deference to the interpretation made by the agency charged with the statute's enforcement. *Impecoven v. Department of Rev.*, 120 Wn.2d 357, 841 P.2d 752 (1992*); Seattle Bldg. and Construction Trades Council v. Apprenticeship and Training Council*, 129 Wn.2d 787, 799, 920 P.2d 581, *cert. denied*, 117 S. Ct. 1693 (1996). This is so especially when the legislature has silently acquiesced in such construction over a long period. *In re Sehome Park Care Center, Inc.*, 127 Wn.2d 774, 780, 903 P.2d 443 (1995).[4]

In construing the statutory language and in granting due deference to the Department's interpretation of the statute, we hold that the taxpayer's wholesale sales of the food products at issue do not qualify for the special tax classification and rate contained in RCW 82.04.260(7). Instead, the proper rate is the general wholesaling B&O tax rate under RCW 82.04.270.[5]

2. Construction Management.

In general, a company constructing, repairing, or improving new or existing buildings for a consumer is required to collect retail sales tax from the consumer and to pay retailing B&O tax. RCW 82.04.050; WAC 458-20-170 (Rule 170).[6] RCW 82.04.050(2) defines a "sale at retail" to include:

> [T]he 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 of 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.) Thus, "services rendered in respect to . . .constructing" activities are subject to retail sales tax. The legislature recently enacted clarifying legislation on the taxation of such

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[4] The taxpayer in fact benefits from granting deference to the Department's long-standing interpretation of the statute. Many of the taxpayer's products that received the special rate involved poultry products. The Department has interpreted the statute as including the processing of perishable poultry products. In other contexts, the legislature has treated meat and poultry products differently. Compare RCW 16.74 (poultry products) and RCW 16.49A (meat products). The Department has also not strictly applied RCW 82.04.270(1) to the in-state wholesaling of perishable meat and poultry products.

[5] Additionally, perishable meat products that are not manufactured by a wholesaler must still be perishable when sold in this state. If such products are not perishable when sold at wholesale, they do not qualify for the special classification and rate. Det. No. 98-190, 18 WTD 402 (1999).

[6] In contrast, a company that provides only professional services, such as engineering or design services, under most circumstances, is not required to collect retail sales tax, but must pay B&O tax at the higher "service and other activities" rate on its gross income. RCW 82.04.290; WAC 458-20-224 (Rule 224). From July 1, 1993, until repealed effective July 1, 1998, certain business activities were classified for B&O tax purposes as selected business services. RCW 82.04.290. Various professional services, such as engineering and architectural services, were specifically included as selected business services.

services. *See* Laws of 1999, 1st Reg. Sess., ch. 212, effective July 25, 1999, and codified at RCW 82.04.051.[7]

Because RCW 82.04.051 is intended to provide clarification and not to amend the statute, it has retroactive application. *Marine Power and Equip. Co. v. Human Rts. Comm. Hearing Tribunal*, 39 Wn. App. 609, 614, 694 P.2d 697 (1985). RCW 82.04.051 may apply retroactively even though an appeal may be pending. *See Marine Power* at 620-21. Accordingly, we will apply the clarifying language to this appeal even though the activities in dispute took place before the statute's effective date.

As part of its clarification, the legislature defined the term "services rendered in respect to" as follows:

> As used in RCW 82.04.050, the term "services rendered in respect to" means those services that are directly related to the constructing, building, repairing, improving, and decorating of buildings or other structures and that are performed by a person who is responsible for the performance of the constructing, building, repairing, improving, or decorating activity. The term does not include services such as engineering, architectural, surveying, flagging, accounting, legal, consulting, or administrative

[7] The legislation included a statement of legislative findings and intent, as follows:

> (1) The legislature finds that the taxation of "services rendered in respect to constructing buildings or other structures" has generally included the entire transaction for construction, including certain services provided directly to the consumer or owner rather than the person engaged in the performance of the constructing activity. Changes in business practices and recent administrative and court decisions have confused the issue. It is the intent of the legislature to clarify which services, if standing alone and not part of the construction agreement, are taxed as retail or wholesale sales, and which services will continue to be taxed as a service.
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> (2) It is further the intent of the legislature to confirm that the entire price for the construction of a building or other structure for a consumer or owner continues to be a retail sale, even though some of the individual services reflected in the price, if provided alone, would be taxed as services and not as separate retail or wholesale sales.
>
> (3) Therefore, the intent of this act is to maintain the application of the law and not to extend retail treatment to activities not previously treated as retail activities. Services that are otherwise subject to tax as a service under RCW 82.04.290(2), including but not limited to engineering, architectural, surveying, flagging, accounting, legal, consulting, or administrative services, remain subject to tax as a service under RCW 82.04.290(2), if the person responsible for the performance of those services is not also responsible for the performance of the constructing, building, repairing, improving, or decorating activities. Additionally, unless otherwise provided by law, a person entering into an agreement to be responsible for the performance of services otherwise subject to tax as a service under RCW 82.04.290(2), and subsequently entering into a separate agreement to be responsible for the performance of constructing, building, repairing, improving, or decorating activities, is subject to tax as a service under RCW 82.04.290(2) with respect to the first agreement, and is subject to tax under the appropriate section of chapter 82.04 RCW with respect to the second agreement, if at the time of the first agreement there was no contemplation by the parties, as evidenced by the facts, that the agreements would be awarded to the same person.

> services provided to the consumer of, or person responsible for performing, the constructing, building, repairing, improving, or decorating services.

RCW 82.04.051(1) (emphasis added).

As a consequence, the new statute requires consideration of both the types of services being provided and the entity providing the services in characterizing the services for tax purposes. To be rendered in respect to construction the services must "directly relate to the constructing" and the provider of the services must be responsible for "the performance of the constructing." The term "responsible for the performance" is then defined as follows:

> As used in this section "responsible for the performance" means that the person is obligated to perform the activities, either personally or through a third party. A person who reviews work for a consumer, retailer, or wholesaler but does not supervise or direct the work is not responsible for the performance of the work. A person who is financially obligated for the work, such as a bank, but who does not have control over the work itself is not responsible for the performance of the work.

RCW 82.04.051(4) (emphasis added).

The second sentence of RCW 82.04.051(4) clarifies what is meant by the definition of who is "responsible for the performance". Persons who merely review construction work are not responsible for the performance. In contrast, a person who either supervises or directs the work is considered "responsible for the performance". The taxpayer argues that the definition requires a taxpayer to be legally obligated to complete the physical construction itself (e.g., the general contractor) and not just be responsible for supervision or direction. Were we to accept this argument, the second sentence would be unnecessary. Statutes are to be construed, wherever possible, so that "no clause, sentence or word shall be superfluous, void, or insignificant." *United Parcel Service, Inc. v. Department of Rev.*, 102 Wn.2d 355, 362-3, 687 P 2d 186 (1984).

Moreover, the taxpayer's reading would be contrary to the stated intent of the statute, that is, to be merely a clarification of the law. For many years, the Department has held that services involving supervising or directing construction (e.g., construction management services) constitute services in respect to constructing activity. *See, e.g.*, Det. No. 99-001, 18 WTD 420 (1999) and the cases cited therein. The taxpayer's interpretation would have the effect of changing the Department's long-standing interpretation and application of the law, and not merely a clarification of the law. The Legislature is presumed to have been aware of the administrative rules, prior legislation, and prior court decisions, pertaining to the effect of legislation. *Ashenbrenner v. Dept. of Labor & Ind.*, 62 Wn.2d 22, 380 P.2d 730 (1963).

If a contract requires a taxpayer to provide services subject to the B&O tax under the Services and Other Activities and either Retailing or Wholesaling classifications, then we must also determine if the "predominant activity" involves "services in respect to constructing". In this regard, RCW 82.04.051(2) provides:

> A contract or agreement under which a person is responsible for both services that would otherwise be subject to tax as a service under RCW 82.04.290(2) and also constructing, building, repairing, improving, or decorating activities that would otherwise be subject to tax under another section of this chapter is subject to the tax that applies to the predominant activity under the contract or agreement.

The term "predominant activity" is not defined in the statute. When a term is not defined in the statute, reference to a dictionary definition is appropriate. *City of Seattle v. Hill*, 40 Wn. App. 159, 697 P.2d 596 (1985). Under common usage, the term "predominant" is not defined solely in quantitative terms. It means, among other things, as having "greatest ascendancy, importance, influence, authority, or force." Webster's II New Riverside University Dictionary 927 (1988).

Consistent with this definition, the Washington Supreme Court, in trying to determine whether activities at a "hotel" were legitimate or illegitimate, stated the "showing mathematically that the principal business of the establishment is legitimate" would not identify the predominant activity. Rather, the Court stated "[t]he legitimate and the illegitimate activities occurring on the premises may be so intermingled that the lesser activity is predominant and controls the determination that the premises are, or are not, houses of lewdness, assignation or prostitution." *State ex rel. Carroll v. Gatter*, 43 Wash. 2d 153, 260 P.2d 360 (1953).[8] Accordingly, in identifying the predominate activity we must look to the activities of greatest importance in relation to the business being conducted.

In this case, [Company]'s services on certain projects involved only development or pre-construction services. Development or pre-construction services, which are not directly related to constructing activity, are subject to sales tax only if they are functionally integrated with the construction phase.[9] This occurs when a taxpayer is hired by an owner to both develop and to build or manage a project. For example, when an agreement exists from a project's inception that a contractor would develop and construct or manage the project, retail sales tax is properly assessed on the developer's fee. *See* Det. No. 89-248, 10 WTD 282 (1990); RCW 82.04.051(3). Accordingly, [with respect to] the projects where [Company] provided only development or pre-construction services, e.g., where no projects were ever built, its services are not subject to retail sales tax.

On certain projects [Company] provided pre-construction services, administrative services, and construction management services. With the exception of the [two] projects, the predominate activities in these other projects appear to involve services that were not directly related to the

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[8] In a similar fashion, in applying a "predominate purpose" test to determine whether the Uniform Commercial Code applies to a contract for the sale of both goods and services, many courts have declined to apply a purely quantitative analysis. *See, e.g., Midwest Mfg. Holding v. Donnelly Corp.*, 975 F. Supp. 1061, 1067 (N.D. Ill. 1997); *Bonebrake v. Cox*, 499 F.2d 951 (8th Cir. 1974); *see also Glacier Optical, Inc. v. Optique Du Monde*, 46 F.3d 1141 (9th Cir. 1995)(applying Washington law).

[9] If the services are functionally integrated with what is predominately a retail activity, such as occurs under a contract to design and build a new structure, then the entire contract price is subject to tax. *See Chicago Bridge and Iron v. Department of Rev.*, 98 Wn.2d 814, 659 P.2d 463, *appeal dismissed*, 464 U.S. 1013 (1983).

constructing activity. Subject to verification, those projects would also not be subject to retail sales tax. The [two] projects are different. They appear to predominately involve what the Department has routinely considered to be construction management services. See Det. No. 99-001, 18 WTD 420 (1999) and the cases cited therein. Although the projects involve some administrative and other services not directly related to the construction, the most significant, important, or predominate activities involved the supervision or direction of the constructing activity. Because the predominate activities were directly related to the constructing activity and [Company] was responsible for the performance, services rendered on those projects are subject to retail sales tax.

3. Pass-Through of Drop or Direct Shipments.

The state imposes B&O tax on the gross income of the business. RCW 82.04.220. The term "gross income of the business" is broadly defined as:

> [T]he value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

RCW 82.04.080. Although this statute does not allow expense or other deductions, the Department adopted Rule 111 and Rule 159, administrative rules that exclude certain advances or reimbursements from gross income.

In this case, the taxpayer received as part of its gross income amounts derived from billings for the direct or drop shipments. It contends that it operates as a billing agent for those shipments, and its tax liability should be limited to the discounts it retains. In the initial appeal and again on reconsideration, the taxpayer noted that its direct or drop shipment arrangements did not fall under Rule 159, because the taxpayer never received actual or constructive possession of the goods being sold.[10] This leaves Rule 111 as a possible basis to exclude the direct or drop shipment receipts, less retained discounts, from the taxpayer's gross income.

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[10] Rule 159 was promulgated in accordance with RCW 82.04.480, which provides:

> Every consignee, bailee, factor, or auctioneer having either actual or constructive possession of tangible personal property, or having possession of the documents of title thereto, with power to sell such tangible personal property in his or its own name and actually so selling, shall be deemed the seller of such tangible personal property within the meaning of this chapter; and further, the consignor, bailor, principal, or owner shall be deemed a seller of such property to the consignee, bailee, factor, or auctioneer.
>
> The burden shall be upon the taxpayer in every case to establish the fact that he is not engaged in the business of selling tangible personal property but is acting merely as broker or agent in promoting sales for

In relevant part Rule 111 provides:

> The words "advance" and "reimbursement" apply only when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no personal liability therefor, either primarily or secondarily, other than as agent for the customer or client.
>
> There may be excluded from the measure of tax amounts representing money or credit received by a taxpayer as reimbursement of an advance in accordance with the regular and usual custom of his business or profession.
>
> The foregoing is limited to cases wherein the taxpayer, as an incident to the business, undertakes, on behalf of the customer, guest or client, the payment of money, either upon an obligation owing by the customer, guest or client to a third person, or in procuring a service for the customer, guest or client which the taxpayer does not or cannot render and for which no liability attaches to the taxpayer. It does not apply to cases where the customer, guest or client makes advances to the taxpayer upon services to be rendered by the taxpayer or upon goods to be purchased by the taxpayer in carrying on the business in which the taxpayer engages.

In this case, the taxpayer accounts for direct or drop shipment sales in the same fashion as it does with non-direct sales. The manufacturer invoices the taxpayer for the goods, the taxpayer is liable to the manufacturer for payment of the invoices, and the taxpayer bills the retailers for the cost of the goods, along with its own mark-up or a reservation of some of the manufacturer's discount. Based on the evidence presented, we find that the taxpayer is liable other than as an agent for the payment. It is liable to the manufacturers regardless of whether it receives payment from retailers. As such, liability for the payments attaches to the taxpayer other than as an agent, and the receipts are not excluded from gross income under Rule 111.

Accordingly, we affirm the Department's imposition of wholesaling B&O tax on the drop or direct shipment payments received by the taxpayer.

4. Estoppel.

An equitable estoppel claim requires proof of:

> (1) an admission, statement or act inconsistent with a claim later asserted; (2) reasonable reliance on that admission, statement, or act by the other party; and (3) injury to the relying

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a principal. Such claim will be allowed only when the taxpayer's accounting records are kept in such manner as the department of revenue shall by general regulation provide.

Rule 159 provides that, irrespective of the presence of an agent-principal relationship, if a party has actual or constructive possession of property, has the power to sell the property in its own name, and has in fact sold the property in its own name, that party will be presumed to be a seller and will be taxable as either a wholesaler or retailer. This presumption of a wholesale or retail sale may be rebutted. *See* Det. No. 92-190, 12 WTD 227 (1993).

> party if the court permits the first party to contradict or repudiate the admission, statement or act. *Berschauer/Phillips Constr. Co. v. Seattle Sch. Dist. No. 1*, 124 Wash. 2d 816, 831, 881 P.2d 986 (1994). Equitable estoppel against the government is not favored. *Kramarevcky v. Department of Social & Health Serv.*, 122 Wash. 2d 738, 743, 863 P.2d 535 (1993). Therefore, when the doctrine is asserted against the government, equitable estoppel must be necessary to prevent a manifest injustice, and the exercise of government functions must not be impaired as a result of estoppel. *Id.* Each element must be proved by clear, cogent, and convincing evidence. *Id.* at 744.

Department of Ecology v. Theodoratus, 135 Wn. 2d 582, 599, 957 P.2d 1241 (1998). In addition, where the representations allegedly relied upon involve matters of law, rather than fact, equitable estoppel will not be applied. *Id.* at 599.[11] With respect to state taxes, ultra vires acts cannot be a basis to deprive the state of the power to collect taxes. *Kitsap-Mason Dairymen's Assoc. v. Tax Comm.*, 77 Wn.2d 812, 818, 467 P.2d 312 (1970) ("The state cannot be estopped by unauthorized acts, admissions, or conduct of its officers").

In *Kramarevcky v. Department of Social & Health Serv.*, 122 Wn. 2d 738, 743, 863 P.2d 535 (1993) (cited with approval in *Theodoratus*), the court found the Department of Social and Health Services (DSHS) was estopped from recouping overpayments of benefits. The first two estoppel elements were not at issue. With respect to the third element, injury, the court stated: "In Washington, injury, prejudice and detrimental reliance have been used interchangeably to express the requirement that a party asserting equitable estoppel must show a detrimental change of position." *Id.* at 540. In that case evidence showed that, had DSHS not made an error in determining benefits, the recipients would have, for example, sought less costly or no cost medical care from other sources. With respect to the manifest injustice element, the court noted that the recipients had provided correct information, the overpayments resulted solely from errors by DSHS, and that recipients were not financially able to make repayments.

The issue of manifest injustice in a tax liability case was addressed in *Harbor Air v. Bd. of Tax Appeals*, 88 Wn.2d 359, 560 P.2d 1145 (1977). In that case, a corporate successor argued a March 29, 1972 letter from the Department was ambiguous and misleading in reference to the tax period encompassed by a pending audit and, therefore, the Department was estopped from asserting liability for any taxes due prior to January 1, 1972. The court found that the successor had relied on the letter in releasing purchase funds and that manifest injustice would result if it

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[11] In *Theodoratus*, the appellant contended that equitable estoppel required the Department of Ecology to continue using a system capacity measure of his water right. In discussing estoppel, the court reasoned:

> Whether the Department can issue Appellant a water right certificate on any basis other than actual beneficial use is an issue of law. Insofar as the Report of Examination stated a system capacity measure of a water right, it was a statement of law, which was incorrect. Equitable estoppel does not require adherence to a systems capacity standard in this case.

135 Wn.2d at 540.

allowed the Department to collect the tax liability from the successor corporation given the ambiguous letter from the Department.

That manifest injustice may result if the Department provides incorrect or misleading advice is consistent with a subsequent statutory enactment, RCW 82.32A.020, which states:

> The taxpayers of the state of Washington have:
>
> . . .
>
> (2) the right to rely on specific, official written advice and written tax reporting instructions from the department of revenue to that taxpayer, and to have interest, penalties, and in some instances, tax deficiency assessments waived where the taxpayer has so relied to their proven detriment.

With respect to the final estoppel element, impairment of government functions, the court in *Kramarevcky* found no basis to conclude a failure to require repayment would impair government functions. In fact, the court noted that estoppel may provide an impetus for DSHS to more adequately monitor and control benefit payments.

In the present case, the taxpayer submitted a copy of a 1988 audit, where the auditor noted "These agreements [drop shipment agreements] are the same as those previously reviewed and accepted in a previous audit by the Department of Revenue." After briefly mentioning Rule 111 and Rule 159, the audit report stated that agency agreements must be dated. However, no adjustments were made in the 1988 audit. Copies of agreements from 1989 to 1995 provided on appeal are dated.

With respect to the first estoppel element, the Department's position on pass-through treatment of drop shipments under Rule 111 and Rule 159 in 1988 was inconsistent with its later position. The taxpayer also relied on the Department's instructions by dating its agreements and continuing the program. On reconsideration, the taxpayer presented evidence to support the third element, that there was a detrimental change in position. The taxpayer testified that, had it received the correct advice in 1988, it would not have continued the program as it did, because the small return was insufficient in light of the tax consequences. Manifest injustice would result if we allowed the Department to collect the tax given the ambiguous or incorrect instructions from the Department. The granting of the estoppel claim in this case also will not impair government functions.

Accordingly, we find the taxpayer met its burden on each element of its estoppel claim. The taxpayer's petition is granted with respect to this claim.

5. Exercise Fee on Sale of Real Property.

RCW 82.04.390 exempts from B&O tax the "gross proceeds derived from the sale of real estate." Instead, RCW 82.45.060 imposes the real estate excise tax (REET) upon the "sale" of real property. RCW 82.45.010(1) defines the term "sale" to mean:

> As used in this chapter the term "sale" shall have its ordinary meaning and shall include any conveyance, grant, assignment, quitclaim, or transfer of the ownership of or title to real property, including standing timber, or any estate or interest therein for a valuable consideration . . . .

WAC 458-61-555 provides that an option to purchase does not constitute a conveyance and, therefore, it is not subject to REET, as follows:

> (1) The real estate excise tax applies to a conveyance of real property upon the exercise of an option to purchase.
>
> (2) The tax does not apply to the grant of the option and the real estate excise tax affidavit is not required.

Payments for an option to purchase real property are "not derived from the sale of real estate". Therefore, payments for the grant of an option to purchase real property do not qualify for the B&O tax exemption of RCW 82.04.390.[12]

On reconsideration, the taxpayer provided documentation showing the payment in question involved a fee for exercising a right to purchase the property, rather than a payment for the granting of an option. In closing papers, the fee was referred to as "other consideration—exercise fee" and real estate excise tax was paid on that additional consideration. Accordingly, the payment in question qualifies for the B&O tax exemption of RCW 82.04.390.

ORDER

The taxpayer's petition for reconsideration is granted in part and denied in part. The petition is granted with respect to the exercise fee and the estoppel claim. It is granted with respect to [Company]'s services (subject to verification), except for the [two] projects, which are denied. The taxpayer will have 30 days from the date of this determination to make arrangements with the Audit Division to provide it with records to verify that the projects other than the [two] projects do not predominately involve construction management services. The petition is denied

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[12] We note Det. No. 93-163, 13 WTD 322 (1994), a case concerning option payments, incorrectly held that:

> Options to purchase constitute an interest in real property. Strong v. Clark, 56 Wn.2d 230, 233, 352 P2d 183 (1960). The payment for such a right is exempt from business and occupation tax under RCW 82.04.390.

The case relied on in that determination concerned the definition of a "conveyance" for recording purposes under RCW 65.08.070. That definition is much broader than what constitutes a sale for REET purposes. This determination was effectively overruled by the adoption of WAC 458-61-555.

as to the perishable meat product rate. It is also denied on a prospective basis (because of the estoppel ruling) for the pass-through of income for direct or drop shipments.

Dated this 22nd day of December, 1999.