Cite as Det. No. 98-215, 19 WTD 26 (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. 98-215
. . .	)	
	)	Registration No. . . .
	)	FY . . ./Audit No. . . .

[1] RULE 170; RCW 82.04.050: RETAIL SALES TAX – RETAILING B&O TAX – SERVICES IN RESPECT TO CONSTRUCTING – CONSTRUCTION MANAGEMENT – CONSULTING SERVICES. 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. In general, services that are directly related to or in direct reference to the activity of constructing a building constitute services in respect to constructing activity.

[2] RULE 170; RCW 82.04.050: RETAIL SALES TAX – RETAILING B&O TAX – SERVICES IN RESPECT TO CONSTRUCTING – CONSTRUCTION MANAGEMENT – CONSULTING SERVICES. In general, supervisory, management, or other services that direct or control how or when constructing activity take place are directly related to the activity of constructing buildings and structures. In contrast, most design, contract administration, inspection, accounting, educational, or other related services--which may be related to the general process of construction--are not directly related to the physical activity of constructing itself. Accordingly, they would not be considered services in respect to constructing activity, except when they are functionally integrated with a building or installation activity.

[3] RULE 170; RCW 82.04.050: RETAIL SALES TAX – RETAILING B&O TAX – SERVICES IN RESPECT TO CONSTRUCTING – CONSTRUCTION MANAGEMENT – CONSULTING SERVICES. Services that solely involve consulting with and educating owners on acting as their own general contractors do not constitute services in respect to constructing.

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:

Construction consultant protests the reclassification of income from the service business and occupation (B&O) tax classification to the retailing B&O tax classification and the imposition of retail sales tax.[1]

FACTS:

Mahan, A.L.J. – The taxpayer is in the business of providing assistance to owners so as to allow the owners to act as general contractors or construction managers in building their own homes. It also receives some income from contractors that pay a fee to be on a list of recommended contractors. Currently, the taxpayer is not a licensed general contractor. In the past it has been licensed as a general contractor in order to meet certain requests, e.g., by a lender who wanted assurance the taxpayer was qualified to provide its services.

The taxpayer uses two different contracts with its clients; a "Phase I" contract for pre-construction services and a "Phase II" contract for services during the construction of a project. Under the Phase I contract, the taxpayer assists the owner with land acquisition, plan design, and establishment of a budget, based on preliminary bids from subcontractors. The contract specifies the subcontract bids will not be supplied to the owner until commencement of Phase II.

The taxpayer's Phase II contract states it will provide owners with a handbook, consult with owners during construction, review contractors' bids with owners, and make between five and twenty-six visits to the site, depending on the scope of the project. The handbook contains sections, inter alia, on preparing permit applications, loan applications, a construction summary, choosing contractors, bid specifications and change orders, a construction calendar, and a list of approved subcontractors and suppliers. The suppliers identified in the handbook have agreed to provide supplies at a discount to the taxpayer's customers. Owners are responsible for ordering and paying for materials.

The contract further states the taxpayer provides only consulting services, it does not provide "hands on work", all decisions as to subcontractors and suppliers are that of the owner, and the taxpayer does not warrant any of the work. In exchange for its services, the taxpayer receives a flat fee based on a percentage of the construction budget. This fee is substantially less than is typically charged by a general contractor or construction manager.

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[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410. After this determination was issued, the legislature enacted clarifying legislation on the taxation of services in respect to constructing. See Laws of 1999, 1st Reg. Sess., ch. 212, effective July 25, 1999, and codified at RCW 82.04.051.

The Department of Revenue (Department) audited the taxpayer's records for the January 1, 1993 through December 31, 1996 period. The Department concluded that the taxpayer was engaged in providing "construction management" services and, accordingly, classified the activity as a retail sale. In doing so, it relied on the Board of Tax Appeals (BTA) decision in Steele v. Department of Rev., No. 47590 (Bd. of Tax Appeals 1996), which involved construction management services.

On appeal, the taxpayer distinguishes its activities from the Steeles' activities in various respects. For example, the taxpayer notes that the Steeles dealt directly with subcontractors and material suppliers, resolved disputes, and approved payments, whereas the taxpayer does not. The Steeles contracted to provide construction management and supervision services, whereas the taxpayer does not. The Steeles also prepared and monitored construction schedules, whereas the taxpayer does not.

As further evidence of the limited services provided by the taxpayer, it provided copies of letters from its customers. The letters confirm that the hiring and supervision of subcontractors, the purchase of materials, the sequencing and management of the construction process, and the resolution of disputes rested solely with the owners. For example, the following is a typical description of the owners' activities:

> It was I [the owner] who sought and took the bids; It was I who hired and scheduled the work for all subcontractors; It was I who ordered and purchased all supplies and materials from vendors; It was I who navigated governmental requirements and mandates through the maze of county offices; It was I who arranged the financing and monitored expenses; and It was I who supervised ongoing construction and resolved the inevitable problems that arise in such an undertaking.

Based on these factual distinctions, the taxpayer contends that its services should not be treated as services in respect to constructing activity.

ISSUE:

Does a company's services constitute services in respect to constructing when it provides professional assistance to owners, whereby owners can act as their own construction managers or general contractors?

DISCUSSION:

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). In contrast, a company that provides services, including professional services such as engineering or design services, under most circumstances, is not required to collect retail sales tax, but must pay tax at the higher "service

and other activities" B&O tax rate on its gross income. RCW 82.04.290; WAC 458-20-224 (Rule 224).[2] However, under certain circumstances a company must collect retail sales tax and pay retailing B&O tax for such services.

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).[3] If the design phase is bifurcated from the construction phase, and separate contracts are awarded to the same company, a factual inquiry is required to determine whether the two phases are functionally integrated. See Det. No. 88-39, 5 WTD 125 (1988).

[1] In addition, 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.) Accordingly, "services rendered in respect to . . .constructing" activity are subject to retail sales tax.[4]

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[2] 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.

[3] In Chicago Bridge, the taxpayer sought a refund of a portion the B & O taxes paid on the gross receipts from the sales of goods designed, manufactured, and installed for customers in Washington, but contracted for outside the state. It contended the tax was unconstitutional as a violation of due process (U.S. Const. amend. 14, § 1 and Const. art. 1, § 3) and the commerce clause (U.S. Const. art. 1, § 8, cl. 3). The contracts at issue bifurcated the design and manufacturing of three products from their installation. Hence, the taxpayer argued that the 3 contracts covering only the design and manufacturing phase had no nexus to Washington. The Washington Supreme Court did not recognize the bifurcation, stating:

> CBI generally performs all aspects of design, manufacture, delivery and installation of its products, and customers negotiate a single, lump-sum price for a finished, installed product. CBI's engineering, manufacturing, and installation operations are functionally integrated and coordinated from the first proposal to a customer through each phase of the design, manufacturing and installation process.

98 Wn.2d at 818. Accordingly, the design and engineering services were subject to B&O tax because the contracts were "functionally integrated."

[4] Rule 170 addresses the bifurcation of design and build activities as involving services rendered in respect to constructing activity, as follows:

In several recent cases the Board of Tax Appeals (BTA) has discussed services rendered in respect to construction. Steele v. Department of Rev., No. 47590 (Bd. of Tax Appeals 1996); Beacham v. Department of Rev., No. 47414 (Bd. of Tax Appeals 1996); Traffic Expediters, Inc., v. Department of Rev., No. 96-83 (Bd. of Tax Appeals 1998); Riplinger v. Department of Rev., No. 51234 (Bd. of Tax Appeals 1998).[5] In Steele, the BTA concluded that construction management services were subject to retail sales tax. In reaching its conclusion, the Board recognized that the Department applied a direct relationship test to determine when services were rendered in respect to constructing activity, but the Department had not articulated factors to be used in applying this test. The Board analyzed Steele's activities as follows:

> We find these activities are directly related to the actual construction of the building in question. They encompass the classic construction management function without which no building more complex than an unheated chicken coop could be built on time and within budget. . . . [T]hey agreed to deal directly with contractors and suppliers to obtain bid proposals; prepare, monitor and continuously update the construction schedule; and determine whether the contractors' work was up to standards. These were necessary, essential--indeed crucial--activities to the successful completion of the buildings.

(Emphasis added.) Subsequently, in Traffic Expediters, the BTA abandoned the direct relationship test and stated that "the test is whether Taxpayer's . . .services are necessary" for the construction.

The Washington State Supreme Court has defined the phrase "with respect to" to mean "with reference to, or relating to". In re Weyerhaeuser Tbr. Co., 53 Wn.2d 235, 238, 332 P.2d 947 (1958); see also .Phoenix Leasing v. Sure Broadcasting, Inc., 843 F. Supp. 1379, 1388 (D. Nev. 1994); aff'd, 89 F.3d 846 (9th Cir. 1996). In Phoenix Leasing, a case involving the interpretation of a jury waiver provision in a loan agreement, the court adopted Washington's definition of the phrase "with respect to", and held that it was not a "but for" test (which would be similar to a "necessary" test).[6]

> The term "constructing, repairing, decorating or improving of new or existing buildings or other structures," . . . includes the sale of or charge made for all service activities rendered in respect to such constructing, repairing, etc., . . . Hence . . . such service charges such 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 . . . .

(Emphasis added.)

[5] Traffic Expediters was appealed to Thurston County Superior Court, Docket No. 98-00831-5 (1998).

[6] In Phoenix Leasing, at 1377-1378, the court reasoned:

> Plaintiff argues that any claim which would not have arisen "but for" the loan agreements should be subjected to the jury waiver provision.

We find that the phrase "in respect to . . . constructing" should be similarly limited. In general, all words and provisions of the applicable statute and the act as a whole must be harmonized so as to ascertain the legislative intent. International Paper Co. v. Department of Rev., 92 Wn.2d 277, 595 P.2d 1310 (1979). The legislature clearly intended that, under most circumstances, retail sales tax is not imposed on architectural and other services. See RCW 82.04.290.[7] In order to harmonize the applicable statute with other provisions of the tax code, we must limit the scope to something other than a "necessary" or "but for" test.

Several examples illustrate the unworkable extent to which a "necessary" or "but for" test would reach. For example, development fees, architectural fees, hazardous materials consultant fees, testing fees, and engineering fees, which all involve fees for services "necessary" to the construction of a project, would be subject to retail sales tax. Under some circumstances, for example when a contractor or owner uses testing services, the service provider may not even be aware that a structure is being built.[8] Even some administrative, legal, or accounting services may be deemed necessary for the successful completion of a construction project.[9]

> This is far too broad a proposition. A single example illustrates the ridiculous extent to which this would reach. If Defendant had a question regarding a provision of the contract decided to go to Plaintiff's place of business to discuss the question and slipped and fell on Plaintiff's freshly waxed floors, any injury suffered would not have occurred "but for" the loan agreement. Thus Plaintiff argues it should be subjected to the jury waiver. It is too clear for explanation that any suit arising from such slip and fall would not be an action "on or with respect to" the loan agreement. Such an action could be decided without any reference to the loan agreement, without interpreting the loan agreement and without determining the legal effect of the loan agreement.
>
> If determination of an action would require reference to, or if the action relates to or pertains to the loan documents covered by the waiver, then such action is "with respect to" the loan documents and the jury waiver provision applies.

[7] The practice of architecture is defined to mean "the rendering of services in connection with the art and science of building design . . . including but not specifically limited to schematic design, design development, preparation of construction contract documents, and administration of the construction contract." RCW 18.08.320(10).

[8] In Det. No. 91-183ER, 13 WTD 96 (1993), we held that field testing of construction materials was not services in respect to constructing activity and stated "simply performing a service with respect to property that will be used in a construction activity is not sufficient to convert that service to a retail sale."

[9] In Riplinger, a case involving change order administration services for contractors, the BTA may have recognized the potential overreaching of its prior test, where it stated:

> This Board has not developed its own bright-line test, nor are we able to do so in this appeal. The issue is complex and does not lend itself to a simple, widely applicable, easy-to-apply solution. We agree with the Department that it is the nature of the service provided, rather than the business of the client, that determines the applicable tax rate.

In identifying the scope of what constitutes services "in respect to . . .constructing", it is first important to note the statute refers to the activity of "constructing", not construction in general.[10] Accordingly, services that are directly related to or in direct reference to the activity of constructing a building are covered.[11] The further removed an activity is from the physical activity of constructing a building, the less likely it is to be considered a service rendered in respect to such activity.

[2] In this regard, when the relationship at issue involves a service that controls or determines how or when the constructing activity takes place, the service is directly related to building activity.[12] For example, in Steele, the taxpayer supervised construction on a day-to-day basis, purchased materials, and kept the construction on schedule, all of which concern how and when the constructing takes place. Such services are directly related to the activity of constructing a building or structure. See also Det. No. 89-63, 7 WTD 163 (1989); Det. No. 93-159, 13 WTD 316 (1994); Det. No. 98-27, 17 WTD 99 (1998). In contrast, most design, contract administration, inspection, accounting, or other related services--which may be related to the general process of construction--are not directly related to the activity of constructing itself. Accordingly, they would not be covered, except when they are functionally integrated with a building or installation activity.

Such an interpretation of the phrase "services rendered in respect to . . . constructing" is consistent with the Department's past administration of the statute. See, e.g., Det. No. 89-63, 7 WTD 163 (1989); Det. No. 93-159, 13 WTD 316 (1994); Det. No. 92-183ER, 13 WTD 96 (1993); Det. No. 98-27, 17 WTD 99 (1998). An administrative agency's interpretation of its own regulations is entitled to great weight. Washington State Liquor Control Bd. v. Washington State Personnel Bd., 88 Wn.2d 368, 561 P.2d 195 (1977).

Although it did not develop a bright line test, the BTA reasoned that change order administration services were more in the nature of legal or accounting services, rather than management services. It concluded the services were not services in respect to constructing activity.

[10] The term "constructing" means "to put together by assembling parts; BUILD", whereas the term "construction" has a more general meaning, that is, "the act or process of constructing." Webster's II New Riverside University Dictionary, at 303 (1988).

[11] In general, when a taxpayer must refer to the terms of a construction contract or contracts (whether oral or written) to define the scope of the services to be provided is a good indication that the services are directly related to constructing activity. See Rule 170.

[12] In contrast, an architect who contracts to design a building and who also provides contract administration services would not be providing service in respect to constructing the building. Although the architect is administering the contract for the owner, such services are significantly removed from the actual construction--the architect does not control or direct how or when the building activity takes place. In this regard, a standard American Institute of Architects agreement, which includes construction administration services, specifically states: "The architect shall not have control over or charge of and shall not be responsible for construction means, methods, techniques, sequences or procedures. . . ." AIA Form B151, § 2.6.6 (1987). See also fn. 6, supra.

[3] In this case, we find that the taxpayer did not supervise or manage the construction projects, and it did not direct or control how or when any constructing activity took place. In this regard, the taxpayer did not deal directly with subcontractors and material suppliers. It did not keep the projects on schedule by monitoring construction schedules. It also did not supervise or manage any of the construction activity itself. Rather, its services were in the nature of professional services, such as are provided by architects, inspectors, and other consultants to project owners. Although its services were related to the general process of construction in that the taxpayer educated and consulted with owners about the construction, its activities did not directly relate to the physical activity of constructing itself. Accordingly, its services are not services in respect to constructing activity.

DECISION AND DISPOSITION:

The taxpayer's petition is granted.

Dated this 15th day of December, 1998.