THIS WTD IS WITHDRAWN EFFECTIVE 02/14/2003 AND IS NO LONGER IN EFFECT. SEE ETA 2011-1S.32.

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Ruling of	)	EXECUTIVE LEVEL DETERMINATION
	)	No. 97-111ER
. . .	)	Registration No. . . .

[1] RULE 17001; RCW 82.04.050(2)(b); RCW 82.04.190(6): GOVERNMENT CONTRACTING – CONTRACTORS DEEMED TO BE CONSUMERS – PRIMARY NATURE OF CONTRACTS. Taxpayer engaged in the business activity of "government contracting" is subject to B&O tax under that classification even though it believes the primary nature of its contract with the government is "retailing."

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:

A corporate taxpayer seeks reconsideration of Det. No. 97-111, in which the Appeals Division affirmed a decision by the Department of Revenue's (Department's) Audit Division that the corporation was a government contractor liable for use tax on the value of the computer hardware and software sold to, and installed for, the United States Department of Defense (DOD).[1]

FACTS:

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

Gray, A.L.J. – The taxpayer sought and obtained executive-level reconsideration of Det. No. 97-111. WAC 458-20-100(5) and (6). The taxpayer does not allege any factual errors in Det. No. 97-111. Rather, the taxpayer challenges our conclusion based on a "primary nature" test that government contracting was the correct tax classification for its contract receipts.

The taxpayer originally requested the Department's Taxpayer Information & Education (TI&E) Section to confirm the contract with DOD for the sale and installation of computer software and hardware was a retail sale. Usually, TI&E issues rulings of prior determination of tax liability (ruling). However, in this instance TI&E referred the matter to the Audit Division because that division was auditing the taxpayer.[2] The Audit Division concluded the taxpayer should be taxed as a government contractor. The taxpayer then appealed the Audit Division's ruling, arguing that it should be classified as a retailer.

In Det. No. 97-111, we agreed with the Audit Division with respect to the taxpayer's contract. In doing so, we reaffirmed the Department's position regarding the primary nature test. We said the measure of the tax is the full contract price, even though there may be receipts generated by secondary activities included under the contract, the performance of which by themselves might be separately taxable under a different B&O tax classification. We said that if the secondary activities are more than "incidental," or if the taxpayer bills its customer separately for the secondary services, then the Department will bifurcate the contract and tax according to each business activity.

Thus, in our original determination, we found the taxpayer's separate activity of installing the computers sold to the U.S. government was more than "incidental" to the contract for sale of the computers. We found the contract the taxpayer had with the government was for the sale of the computers (both hardware and software) as well as the custom-design of a computer system and the installation of that system on government property (. . .).

The taxpayer argues that because the determination affirms the Audit Division's conclusion that installing "LAN drops" constituted labor used to improve real property under RCW 82.04.050, it forces the entire contract into the government contracting classification. The taxpayer states this result creates a sales and use tax burden that it neither budgeted for, nor is capable of recouping from the federal government. Further, the taxpayer objects to the determination because it claims its contract is primarily a retail transaction that also includes some incidental services that would otherwise be included in the retail classification but for the fact that we based our decision on whether the secondary activity was essential or nonessential to the performance of the contract. Basing the decision on whether the secondary activity is "essential" or "nonessential" taxpayer says, is a meaningless test. The taxpayer relies on Det. No. 89-433A, 11 WTD 313 (1991); Det. No. 90-154, 9 WTD 286-29 (1990); Det. No. 92-183ER, 13 WTD 96 (1993); Det. No. 90-034, 9 WTD 71 (1990); WAC 458-20-17001; and ETA[3] 544.04/08.245.

[2] This determination does not include any appeal of a tax assessment. Its scope is limited to the appeal of the ruling.
[3] The Department cancelled all Excise Tax Bulletins effective July 1, 1998 and replaced them with Excise Tax Advisories (ETAs). We will refer to ETAs in this determination.

In its petition for reconsideration, the taxpayer argued "[Det. No. 97-111] puts into turmoil the predictability of properly classifying contracts that call for a mixture of activities that are differently classified for B&O tax purposes."

The taxpayer argued the Department erred in Det. No. 97-111 when it concluded the LAN drops were essential and therefore the amounts received on the entire contract should have been classified as "government contracting." It argues there is no evidence to support a conclusion that the government required the taxpayer to install the computer system, and further argues the "test," to determine "essential" or "incidental" functions, has not been the test used by the Department in the past.

ISSUES:

Was the taxpayer's contract with DOD subject to B&O tax under the government contracting classification?

DISCUSSION:

The taxpayer says our original determination incorrectly applied the primary nature test. The "primary nature" test is not statutorily derived, but is a concept applied by the Department to determine a taxpayer's liability when a contract may have several activities, separately taxable under different B&O tax classifications. It is used when the other activities may be incidental to the primary function or purpose of the contract. We explained this concept in Det. No. 92-183ER, supra:

> The B&O tax is imposed for the privilege of engaging in business activities. RCW 82.04.220. The tax rate or rates applicable to a particular taxpayer depends upon the type of activity or activities in which it engages, e.g., manufacturing, wholesaling, or retailing. Generally, if a taxpayer engages in activities which are within the purview of two or more tax classifications, it will be taxable under each applicable classification. See RCW 82.04.440; Group Health Coop. v. Department of Rev., 106 Wn.2d 391 (1986).
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> However, where a taxpayer agrees to perform an activity taxable primarily under a particular classification and only incidentally engages in other activities in furtherance of that activity, the taxpayer will be taxed according to its primary activity. In Final Det. No. 89-433A, 11 WTD 313 (1992), we stated:
>
> > [B]ifurcation of a contract for taxation will be the unusual case. In most cases income from a performance contract will be taxed according to the primary nature of the activity.
>
> See, e.g., [ETA] 544.04\08.245; [ETA] 85.08.107; Det. No. 91-163, 11 WTD 203 (1991).

> In short, taxpayer's income from its contracts should be taxed according to the primary nature of the work performed under the contracts.[4]

In Det. No. 97-111, we affirmed the letter ruling from the Audit Division in which it concluded the taxpayer's gross receipts were subject to government contracting B&O tax and the taxpayer was liable for use tax on the value of the property.[5] We reached this decision based on the following facts, gleaned from documents the taxpayer submitted to the Department. We think a recap of those facts, as explained in greater detail in the original determination, is helpful:

> The taxpayer designs computer software. It sells its software and compatible hardware to the public. The software is "modular" in nature; i.e., the buyer can purchase pieces of the software at different times as the need arises, and the additional software and hardware will function correctly as the pieces are added.
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> In this case, the software, known as the [program], is designed for . . ., creating and managing an "integrated . . . database." There are eight [program] modules that run on computer hardware: . . . . This software improves access to complete . . . and administrative information. [Businesses] use this information to gain efficiencies in . . . .
>
> Unless a single module is used on a stand-alone computer, the software and hardware must run in a network environment. This means hardware connections are required.
>
> The installation of LAN drops[6] is accomplished by running cable behind the walls and through the ceiling. Then, the cable is connected to a wall plate in a designated area or office.
>
> DOD bought this system under an umbrella procurement contract (. . .) for its military bases throughout the world. Pursuant to this contract, the petitioner sold software, hardware, and some services to DOD.
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> The statement of work, found in the February 28, 1991 Order for Supplies or Services (DOD Form 1155), describes the contractor's duties as follows:

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[4]Simply separating an activity into component activities and entering into a separate contract for each component activity is insufficient to overcome the requirement that the taxpayer be taxed according to its "primary" activity; there must be substance to the charges for individual activities. See, e.g., ETA 373.08.172\135. [footnote in the original].

[5] The Audit Division's result regarding Phase 5 of the taxpayer's project was stated in the alternative. Income from sales to the U.S. government of custom disk (software) upgrades and installation labor were subject to selected business services B&O tax if contracted for and custom upgrading was performed outside the equipment installation contract. Otherwise, it was subject to government contracting B&O tax and the taxpayer was liable for use tax on the value of the standard or canned software and on the value of materials used to provide custom software.

[6] LAN means "local area network." It is a communications network that serves users within a confined geographical area. It is made up of servers, work stations, a network operating system, and a communications link. A LAN "drop" refers to the wire or cable that is typically "dropped" from a ceiling or wall to connect an individual computer terminal to the server.

> The Contractor shall provide materials, services and personnel required to install a system sufficient to support the operation of [program] at . . . Washington. The system will be a replacement of the . . . currently being provided by the . . . system at . . . . The hardware suite to be installed shall be the minimum configuration necessary to accommodate initial file and table build activities, initial training, and operation of the system.

Based on these contract terms, we found the total receipts from taxpayer's contract with the DOD was derived from the sale and installation of a computer system, including hardware and software, and was, therefore, subject to this state's government contracting B&O tax classification. As a result of this classification, we also found the taxpayer was liable for use tax on the tangible personal property installed on U.S. government property. In our original decision we said the primary nature of the taxpayer's activities under the contract was government contracting because the installation of the network computer system was an essential part of the contracted for services. On reconsideration, we reach the same result, but for different reasons.

In Det. No. 97-111, we said that contractors (prime or subcontractors) who install or attach any article of tangible personal property to federal buildings are the consumers as defined in RCW 82.04.190(6). We also said that a retail sale includes constructing or repairing new or existing buildings of or for consumers, whether or not such personal property becomes a part of the realty. RCW 82.04.050(2)(b). We applied these statutory definitions to the facts of the taxpayer's contract and concluded the taxpayer was subject to tax under the government contracting classification of the B&O tax and owed use tax on the materials. WAC 458-20-17001(5) says:

> The retail sales tax does not apply to the gross contract price, or any part thereof, for any business activities taxable under the government contracting classification. Prime and subcontractors who perform such activities are themselves included within the statutory definition of "consumer" under RCW 82.04.190 and are required to pay retail sales tax upon all purchases of materials, including prefabricated and precast items, equipment, and other tangible personal property which is installed, applied, attached, or otherwise incorporated in their government contracting work. This applies for all such purchases of tangible personal property for installation, etc., even though the full purchase price of such property will be reimbursed by the government or housing authority in the gross contract price. It also applies notwithstanding that the contract may contain an immediate title vesting clause which provides that the title to the property vests in the government or housing authority immediately upon its acquisition by the contractor.

As was discussed in Det. No. 97-111, it is unnecessary for the installed or attached items to become fixtures in order for the contractor to be a consumer and the contract to constitute a retail sale. RCW 82.04.190(6) is quite explicit on that point: "whether or not such personal property becomes a part of the realty by virtue of installation." The fact the taxpayer was required to install or attach the cables for the computer system inside the walls and ceiling is critical here, because

it satisfies the statutory criteria for the contractor to be a consumer and for the contract to constitute a retail sale.

Viewing the taxpayer's contract as a whole, we find this type of contract falls under the statutory and administrative classification of government contracting, and the gross receipts from that contract should be taxed under the government contracting B&O tax classification. The taxpayer's duties and the scope of the contract involved more than simply the retail sale of tangible personal property. It required the taxpayer to design the computer system, and install both the computers and the system. That work is properly classified as government contracting.

If the taxpayer had not been the actual installer of the computer system, it would not be liable for use tax on the value of the cable and other materials so long as the actual installer had paid the use tax. In this particular case, however, the taxpayer was also the actual installer.

We conclude that the taxpayer's business activity in its DOD contract was properly classified as government contracting.

DECISION AND DISPOSITION:

Det. No. 97-111 and the ruling from the Audit Division are affirmed, except to the extent that the reasoning in Det. No. 97-111 is inconsistent with this determination. Because this is not an appeal that arose under RCW 82.32.160 or 82.32.170, there is no further appeal.

The reporting instructions in this Determination constitute "specific written instructions" within the meaning of RCW 82.32.090. Failure to follow the instructions would subject the taxpayer to the additional ten percent penalty mandated by that statutory section.

Dated this 21st day of April 1999.