Cite as Det. No. 98-194, 19 WTD 9 (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. 98-194
. . .	)	Registration No. . . .
	)	FY . . ./Audit No. . . .

[1] RULE 170; RCW 82.04.050: RETAIL SALES TAX – RETAILING B&O TAX – SERVICES IN RESPECT TO CONSTRUCTING – DEVELOPMENT FEES – FUNCTIONALLY INTEGRATED. When a taxpayer agrees from a construction project's inception that the taxpayer will develop and construct the project, the development activities are considered functionally integrated with the construction activities. Under such circumstances, the fees from the development and construction phases of the project are subject to retail sales and retailing B&O taxes. In contrast, when the general partner of a limited partnership incurs development costs on a speculative basis, prior to securing investors for the project, those services are not functionally integrated with the construction activity and the development fees are subject to service and other activities B&O tax.

[2] RULE 170; RCW 82.04.050: 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. When a general partner of a limited partnership is paid amounts variously identified as a "management fee" or a "construction supervision fee" for providing services customarily performed by a general contractor, those amounts are subject to retail sales and retailing B&O taxes for services in respect to constructing activity.

[3] RULE 111: RETAIL SALES TAX – RETAILING B&O TAX – PASS-THROUGH PAYMENTS – LOANED EMPLOYEES. When a general partner acts as the general contractor on a partnership construction project, the construction laborers under the general partner's payroll are not considered employees loaned to the partnership, and the payments it receives are not considered advances or reimbursements.

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 company operating as a general manager of various limited partnerships and limited liability companies and receiving development fees, project management fees, and reimbursements for construction labor protests the assessment of retail sales tax and retailing business and occupation (B&O) tax on those fees and costs.[1]

FACTS:

Mahan, A.L.J. -- The taxpayer develops, manages, and constructs multi-family and commercial real estate projects in Washington. Some projects it develops and builds for its own account. On other projects it acts as the managing or general partner for a limited partnership or a limited liability company (collectively referred to as partnerships). The taxpayer's duties as general manager are outlined in written agreements for each of the partnerships. It receives development fees and project management fees under the terms of the agreements. It provides an on-site foreman and superintendent for each of the projects. It also has in its employ construction laborers who may be used on some of the projects.

The Department of Revenue (Department) audited the taxpayer's books and records for the January 1, 1993 through December 31, 1996 period. The Department issued a deficiency assessment that included, among other items, retail sales tax and retailing business and occupation (B&O) tax on development fees, project management fees, and on charges for the construction laborers. The taxpayer appealed each of these items.

With respect to the development fees, the taxpayer describes those fees as being provided in exchange for "services in procuring the project, 'value engineering' the scope and design of the project, handling financial matters, and managing the permit process." They were identified under one part of a limited partnership agreement and not as part of a construction contract.

[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.

Moreover, they are not "functionally integrated" with construction activities and were earned prior to the commencement of any construction activity. As such, the taxpayer contends that such fees are not for services rendered in respect to construction and, therefore, are not subject to retail sales tax. Because of the claimed lack of functional integration, the taxpayer distinguishes the decisions in Chicago Bridge and Iron v. Department of Rev., 98 Wn.2d 814, 659 P.2d 463 (1983) and Steele v. Department of Rev., BTA Doc. No. 47590 (1996).

With respect to the management fees, the taxpayer contends that, even if the fees related to construction supervision are subject to tax, not all of the fees are for construction related services. For example, they may include accounting and other services fees related to the management of the partnerships. It further notes that only a couple of the agreements referred to construction related activities.

With respect to construction laborers, for whom the taxpayer received reimbursements from the partnerships, the taxpayer contends that those amounts do not constitute income from services performed by the taxpayer. In this regard, the taxpayer states: "given that [the taxpayer] did not have a contract to construct, and did not otherwise have a contractual obligation to deliver services for which laborers were required...it is only practical to assume that the laborers were under [taxpayer's] direction in its capacity as manager."

In other words, the taxpayer contends that, in its capacity as a manager, it loaned employees to the partnerships, for which it received reimbursement. As such, the taxpayer states that those payments should be treated as reimbursable expenses under WAC 458-20-111 (Rule 111).

Under all of the partnership agreements the taxpayer, as manager, is given very broad powers to contract on behalf of the partnership, to acquire property, borrow funds, and to otherwise manage the partnerships. Each of the agreements concerned the development and construction of commercial or residential real estate ventures. The taxpayer completed all projects with similar construction management and development services provided by the taxpayer.

With respect to "development fees", the earlier agreements had no specific services identified for the fees. Later agreements provided that the fees were for "value engineering the project and managing the permit process." An Exhibit for one of the projects provided a cost breakdown for all development costs, including fees for legal, engineering, marketing, and accounting services separate from a line item for a development fee. Development fees were generally due out of loan proceeds or upon issuance of a building permit.

With respect to "management fees" for the two oldest projects, the partnership agreements contained very general language concerning the construction and development of the projects. The agreements for the later projects had more specific language, which provided "Manager shall oversee construction ...and shall cause the Company to enter into multiple prime contracts...." They further provide that services performed by the taxpayer "shall include all

services customarily performed by a general contractor." Fees were generally paid on a completion of project basis.

The Department also reviewed copies of permit documents for one of the earlier projects. The permit documents identified the taxpayer as the licensed general contractor on the project. With respect to any claim the payments constituted partnership distributions rather than business income, the Department reviewed the taxpayer's federal income tax returns. They showed the payments as gross business income and not partnership distributions.

At the second hearing, the taxpayer emphasized the fact that, when the partnership agreements are drafted, the development work has already been completed. In general, the taxpayer must purchase or take an option on real property, go through the master use permit process, and otherwise develop a project before it can package and sell an interest in a partnership. Once a project has been developed, interests in the partnership are marketed and sold, under the terms of the partnership agreements. After investors are on board, a building permit is pulled and construction commences. According to the taxpayer, consumers (the partnerships) did not hire it to develop and construct projects.

ISSUES:

1. Under what circumstances are fees from the development phase of a project subject to retail sales and retailing B&O taxes when the general partner of a limited partnership also provides general contracting or construction management services?

2. When a general partner of a limited partnership is paid amounts variously identified as being a "management fee" or a "construction supervision fee" for providing services customarily performed by a general contractor, are those amounts subject to retail sales and B&O taxes?

3. When a general partner also acts as the general contractor on a partnership construction project, can construction laborers under its payroll be considered employees loaned to the partnership?

DISCUSSION:

1. Retail Sales Tax Imposed on Construction Services

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 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).

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 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:

> 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., . . .

In several recent cases the Board of Tax Appeals (BTA) has discussed services rendered in respect to construction. Steele v. Department of Rev., BTA Doc. No. 47590 (1996); Beacham v. Department of Rev., BTA Doc. No. 47414 (1996); Traffic Expediters, Inc., v. Department of Rev., BTA Doc. No. 96-83 (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]

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.

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

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 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. Even some administrative, legal, or accounting services may be deemed necessary for the successful completion of a construction project.

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.[8] Accordingly, only services that are in direct relation to or in direct reference to the activity of constructing a building are covered.[9] The further removed an activity is from the activity of constructing a building, the less likely it is to be considered a service rendered in respect to constructing activity.

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 clearly related to building activity.[10]

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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] 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).

[9] 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.

[10] 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

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 construction activity 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. 98-27, 17 WTD 99 (1998). In contrast, 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 the 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. 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).

2. Development Fees

[1] In this case, the taxpayer incurred development costs on a speculative basis, prior to securing investors for a project. The limited partnership agreements, which set forth the rights and obligation of the general and limited partners, cannot be equated with contracts to develop and build a project. Although they provide for reimbursement of development costs and associated fees, this does not mean such fees were functionally integrated with the construction phase. This is not a case where a taxpayer was hired by an owner to both develop and to build a project. In this regard, it is different from Det. No. 89-248, 10 WTD 282 (1990), where an oral agreement existed from the project's inception that the taxpayer would develop and construct the project. Under such circumstances, retail sales tax was properly assessed on the developer's fee. That is not the case here.

The pre-construction services at issue here neither required reference to a construction contract nor were the services related to how or when the constructing activity took place. Accordingly, the taxpayer's petition is granted with respect to development fees and costs.

3. Management Fees

[2] With respect to management fees, the agreements disclose that the fees were earned for performing services traditionally provided by general contractors.[11] Such service providers direct or control the manner, means, methods, or sequences of the constructing activities and must refer to construction contracts and plans. They are also the type of services that the

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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.

[11] RCW 18.27.010 defines a general contractor as one whose business operations require the use of more than two unrelated building trades or crafts.

Department has routinely found to be services in respect to construction. See, e.g., Det. No. 89-63, 7 WTD 163 (1989); Det. No. 98-27, 17 WTD 99 (1998).

We recognize some of the taxpayer's services involved accounting and tax services not directly related to construction activity. However, the agreements do not distinguish between accounting services and general contracting or construction supervision services. The Department does not generally allow a single contract to be bifurcated, unless there is a reasonable basis on which to do so. As we stated in Det. No. 89-433A, 11 WTD 313 (1992):

> We do believe that bifurcation 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. For example, income from processing for hire is taxed at the processing for hire rate even though some storage or other services are also involved.

In that case, segregation was allowed because the taxpayer's contract, which was negotiated before the work was performed, provided a reasonable basis for determining the value of the various activities performed. See also Det. No. 92-183ER, 13 WTD 96 (1993) (the Department looks to the primary activity in order to identify the proper tax classification for work completed under that contract).

In this case, the general contracting or construction supervision services were clearly the primary nature of the activity and no basis exists under the contract to bifurcate the accounting services. Accordingly, the taxpayer's petition in this regard is denied.

4. Loaned Employees

[3] In order to succeed on its claim that it received nontaxable reimbursements for the cost of the laborers it loaned to the partnerships, the taxpayer must show that it received reimbursements in accordance with WAC 458-20-111 (Rule 111). In order for there to be an advance or reimbursement under this rule, the payments to the taxpayer must: (1) be made as part of the regular and usual custom of the taxpayer's business or profession; (2) be for services to the customer which the taxpayer does not or cannot render; and (3) not involve fees or costs for which the taxpayer is personally liable, either primarily or secondarily, except as the customer's agent. Rho Co. v. Department of Rev., 113 Wn.2d 561, 567-568, 782 P.2d 986 (1989), citing, Christensen v. Department of Rev., 97 Wn.2d 764, 769, 649 P.2d 839 (1982).
In this case, the taxpayer is a licensed general contractor and holds itself out as providing those services. The taxpayer also provides or can provide construction laborers on construction projects. Without considering the other elements, the taxpayer does not meet the second element for the Rule 111 pass-through exemption. See also RPM 90-1; Det. No. 85-231A, 1 WTD 309 (1986). Accordingly, the taxpayer's petition in this regard is denied.

DECISION AND DISPOSITION:

The taxpayer's petition is granted in part and denied in part. The assessment is remanded to the Audit Division for adjustment in accordance with this decision.

Dated this 30th day of November, 1998.