

Cite as Det. No. 04-0081, 24 WTD 21 (2005)

BEFORE THE APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition For Correction of )	<u>D E T E R M I N A T I O N</u>
Assessment and Refund of )	
)	No. 04-0081
)	
... )	Registration No. . . .
)	Document No. . . .
)	Audit No. . . .
)	Docket No. . . .

RULE 170: B&O TAX -- RETAIL SALES TAX -- DEFAULT BY PRIME CONTRACTOR -- DIRECT PAYMENT BY CUSTOMER TO SUBCONTRACTOR. If a customer invokes a right to pay subcontractors directly in the event of insolvency by the prime contractor pursuant to terms in the customer's contract with the prime, any payments made to the subcontractors on behalf of the prime remain wholesale sales from the subcontractors to the prime.

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.

Okimoto, A.L.J. -- A subcontractor that was paid for its contracting services directly by the customer after the customer became aware that the prime contractor was unable to fulfill its financial obligations to its subcontractor's objects to Audit's reclassification of the payments from the wholesaling to retailing and retail sales tax classifications. We hold that the payments should be reported as wholesale.<sup>1</sup>

ISSUE

Where a customer invokes a right to pay subcontractors directly after the prime contractor becomes insolvent, should those payments be reported as retail or wholesale sales by the subcontractor?

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<sup>1</sup> Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

## FINDINGS OF FACT

. . . (Taxpayer) operates a construction company that specializes in building [structures]. In the year 2000 the Town of . . . (Town) needed to build a [structure] and put the project out for competitive bidding. Taxpayer submitted two separate bids on the project, one as the prime contractor of the project (to build an access road and [structure]) and another as a subcontractor (to build the [structure] only.) The latter bid was submitted in case Taxpayer failed to receive the primary contract.

After evaluating the bids, Town awarded the prime contract to build the access road and [structure] to . . . (Prime) in . . . 2000. Prime then awarded the subcontract to build the actual [structure] to Taxpayer on . . . , 2001, in the amount of \$ . . . .

Soon thereafter, Taxpayer began building the [structure] for the Town's construction project. Prime began experiencing financial problems almost immediately. On May . . . , 2001, Taxpayer sent Progress Billing #1 to Prime for subcontractor construction services that it had already performed for a net amount (excluding retainage) of \$ . . . .<sup>2</sup> Prime did not make payment to Taxpayer and this amount remained owing.

Because Town recognized that Prime was having difficulty meeting its financial obligations, it called a Special Town Council Meeting on May 31, 2001. At the meeting an engineering consultant advised the Council that Prime was in breach of its construction contract and that Town should take steps to protect it from future liabilities. The consultant advised Town to ask Prime to furnish evidence that all subcontractors and suppliers had been paid and, if no evidence was forthcoming, Town should pay the subcontractors directly under Section 19.6 of the construction contract.

[T]he construction contract between Prime and Town provides in part: [Contractor shall, at Owner's request, furnish satisfactory evidence that all obligations to subcontractors, workmen and material suppliers have been paid. If Contractor fails to do so the Owner may pay unpaid bills. In paying any unpaid bills of the Contractor, payment by Owner shall be considered as payment under the Contract by Owner to Contractor.]

On June . . . , 2001 Town issued a check directly to Taxpayer in the amount of \$ . . . to pay for Taxpayer's subcontracting services which Prime had been billed for, but not paid. Town issued a second check to Taxpayer on July . . . , 2001 for \$ . . . . Neither payment included any amount for retail sales tax. Taxpayer later received a payment from Prime's bonding company for the balance of the subcontract.

In 2002, the Audit Division (Audit) of the Department of Revenue (DOR) examined Taxpayer's books and records for the period January 1, 1998 through December 13, 2001. As a result of that examination, Doc. No. . . . was issued on May 16, 2002 for additional taxes and interest owing of

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<sup>2</sup> This amount did not include retail sales tax because Prime was purchasing Taxpayer's services for resale to Town.

\$ . . . . Taxpayer paid the assessment in full on June 14, 2002 and now petitions for a partial refund.

Schedules 3 & 4: [Structure] Built for Town

In this schedule Audit reclassified the above [structure] construction contract from the wholesaling business and occupation (B&O) tax classification to the retailing and retail sales tax classifications. Audit examined the direct payments from Town and concluded that once Prime had defaulted on its construction contract with Town, Taxpayer had entered into a subsequent contract with Town to complete the water construction project. Since Audit believed that Taxpayer was contracting directly with Town, the payments that it received would have been from a consumer and should have been reported under retailing and retail sales tax.

ANALYSIS

RCW 82.04.050(2)(b) includes within the definition of a retail sale charges for “The constructing, repairing, decorating, or improving of new or existing buildings or other structures under, upon, or above real property of or for consumers . . . .” [Structures] are structures and therefore, Taxpayer is engaged in a retailing activity if performed for a consumer.

WAC 458-20-170 (Rule 170) is the rule covering the construction industry. Rule 170(3)(a) provides that “Prime contractors” are taxable under the retailing classification, and “subcontractors” under the wholesaling classification upon the gross contract price. Rule 170 further defines a “prime contractor” as a person engaged in the business of performing construction work for consumers and a “subcontractor” as a person engaged in the business of performing a similar service for persons other than consumers, either for the entire work or a specific portion, thereof.

In Taxpayer’s case, there is no dispute that, under the original [structure] construction contract awarded by Town, Prime was the prime contractor and Taxpayer was a subcontractor to Prime. The only question is whether Prime’s financial inability to pay its subcontractors, thereby causing Town to pay Prime’s subcontractors and suppliers directly, resulted in a separate retail construction contract between Town and Taxpayer. We think not.

The facts clearly show that Prime’s default allowed Town to pay Prime’s subcontractors and suppliers directly. This right arose solely out of Town’s contract with Prime and did not arise out of a separately negotiated contract between Town and Taxpayer. In fact, Section . . . clearly states:

[In paying any unpaid bills of the Contractor, payment by Owner shall be considered as payment under the Contract by Owner **to Contractor . . . .**]

(Underling and bolding added.)

Therefore, we conclude that the payments received by Taxpayer directly from Town under Sect. . . . of the [structure] construction contract between Town and Prime were for services performed as a subcontractor to Prime and should have been reported under the wholesaling tax classification.<sup>3</sup> Taxpayer's petition is granted on this issue. This decision is without prejudice to the assessment of unpaid retail sales tax against any other party.

#### DECISION AND DISPOSITION

Taxpayer's petition for correction of tax assessment and refund is granted. Taxpayer's file shall be remanded to Audit for the proper adjustment consistent with this determination.

Dated this 31<sup>st</sup> day of March 2004.

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<sup>3</sup> We note this interpretation is consistent with the way DOR has treated payments made directly by a customer to a prime contractor's subcontractors and suppliers in DOR rules and decisions. *See* WAC 458-20-223; Det. No. 01-077, 21 WTD 157 (2002).