

Cite as Det. No. 18-0125, 39 WTD 034 (2020)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS 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 of)	
)	No. 18-0125
)	
...)	Registration No. . . .
)	

[1] RCW 82.04.050; RCW 82.04.051: RETAILING B&O TAX – RETAIL SALES TAX – DEVELOPMENT SERVICES CONTRACT – DEVELOPMENT FEES. A real estate developer’s development fees will be considered retail sales when its development services contract states it is a party responsible for the performance for the constructing activity, when the developer’s activities are directly related to the construction, and when retail services are the predominant activities.

[2] RULE 111; RCW 82.04.080: B&O TAX – ADVANCES AND REIMBURSEMENTS – STORMWATER CONNECTION FEES. When a contractor pays a municipal stormwater connection fee itself, and is later paid back by its client, the contractor must be able to show that a true agency relationship existed with the client and that the contractor’s liability to pay constituted solely agent liability in order to exclude the payment from its client from gross income.

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.

Sattelberg, T.R.O. (successor to Simons, T.R.O.) – A real estate acquisition and land development company protests the Department’s assessment of retail sales tax and retailing business and occupation (“B&O”) tax on several sources of income. First, regarding development fees, the company argues it did not provide services in respect to construction, and so the income was not from a retail activity. Second, the company argues that income it received from a stormwater connection fee it paid was excludable as a reimbursement. . . .We deny the petition.¹

ISSUES

1. Whether the development company engaged in services rendered in respect to construction, under RCW 82.04.051(4), when it [coordinated] design, engineering, construction, and marketing services in exchange for development fees.

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

2. Whether amounts the development company received from a customer for stormwater connection fees are advances or reimbursements, under WAC 458-20-111 (“Rule 111”), and excluded from the measure of tax.

...

FINDINGS OF FACT

... (“Taxpayer”) is a Washington corporation that manages land development in Washington State.² Taxpayer both develops property it owns and provides development services to other landowners.

[Member 1], [Member 2], and [Member 3] own Taxpayer in equal shares. Taxpayer does not have any employees, only the three governing members. Taxpayer sometimes reimburses [Member 3] (“Project Manager”) for development work done in excess of his share of ownership.

Taxpayer often works with an affiliate, ... (“Affiliate”), which is owned 75% by [Member 1] and 25% by [Member 2]. Affiliate often uses Project Manager as a senior project manager, and has other employees as well. [Member 1] also acts a project manager for Affiliate. Both Taxpayer and Affiliate also occasionally work independently from each other in addition to working with each other.³

The Department’s Audit Division (“Audit”) reviewed Taxpayer’s records for the period January 1, 2013, through June 30, 2015. On March 14, 2017, Audit assessed Taxpayer a total of \$⁴ Taxpayer timely sought review of the assessment and raised the following three issues.

1. Development Fees

Taxpayer provides land development services, including arranging a land survey, site review, feasibility review, assistance in acquiring easements, project scope planning, permitting, and preparation. These services involve working with the title company, surveyor, architect, structural engineer, civil engineer, traffic engineers, federal and state regulatory agencies, and municipalities. These services are necessary to prepare for construction at the site.

Taxpayer also provides construction management services for its customers that own commercial and industrial properties, through Affiliate. Taxpayer operates as a project manager and provides project budgeting and scheduling services, which include coordinating, monitoring, and supervising the performance of the architects, engineers, and contractors.

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³ Taxpayer estimates that Affiliate does nine out of ten jobs for Taxpayer, and one out of ten for clients not working with Taxpayer.

⁴ The assessment is comprised of \$. . . in retail sales tax, \$. . . in retailing B&O tax, \$. . . in credit for small business service and other activities B&O tax, \$. . . in small business credit, \$. . . in credit for service and other activities B&O tax, \$. . . in use tax/deferred sales tax, \$. . . in interest, and \$. . . in a 5% assessment penalty.

As stated above, Taxpayer's customers frequently hire Affiliate to perform the site preparation work, the construction work, or both. Project Manager often works on development plans for Taxpayer's clients and as project manager for Affiliate's clients. Thus, all three persons often receive fees for both development services and construction services on the same project.

At issue are Taxpayer's contracts for the following three development projects: . . . ("Customer A"), . . . ("Customer B"), and . . . ("Customer C"). The development agreements contained similar language with respect to Taxpayer's obligations under the agreements and the fee arrangements. The development agreements provided that, in exchange for services rendered, Taxpayer would receive a "Development Fee" equivalent to a percentage of the total construction costs and projects costs. Customer A used Project Manager as project manager for the construction phase. Customer B had not entered the construction phase at the time of the hearing. Customer C used another employee of Affiliate as project manager for the construction phase and the Project Manager served as a senior project manager to provide oversight.

Each development agreement defined "construction costs," to include project site, shell and tenant improvements, demolition, environmental cleanup, contractor fees, as well as customary general conditions.⁵ Each development agreement defined the term "project costs" as:

All third party costs incurred by [Taxpayer] and or [Taxpayer's customers] specifically related to the project except the cost of wages of its principals, home office overhead and insurance. The project costs shall include but not be limited to all design, engineering, copying, consultant costs, permitting, testing, inspections, mitigation fees, legal fees, utility connection fees, builders risk insurance, bonds, B&O tax, and sales tax. The project costs shall include the construction costs paid directly to the contractor via separate agreement.⁶

Taxpayer's contractual obligations under the development agreements are as follows:

- Prepare the boundary line surveys, as-built surveys, topographic surveys, soil tests, and other matters related to the usability of the real property Customer A acquired. The agreement also required Taxpayer to recommend the services of an architect, contractor, engineer, and major subcontractors for the project to Customer A.
- Prepare a development and construction schedule for the project.
- Prepare architectural and engineering plans such as the availability of labor, equipment and materials, and the costs of alternative designs and materials, for the project.
- Obtain all applicable zoning and other land use approvals, land disturbance, and building permits, utility approvals and connection permits, permits or approvals required under the environmental laws, permits and approvals to permit access to the project from adjoining roads, and all other licenses, permits, and governmental

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approvals required in connection with the development and construction of the project.

- Direct, coordinate, monitor, and supervise the performance of the architect, engineer, contractor and other professionals providing services in connection with the development of the project.
- Inspect the project on a regular basis.
- Ensure construction proceeds in accordance with the development timeline.

Audit determined that Taxpayer’s development fees constituted services in respect to construction of buildings or structures to its customers because the services were directly related to construction. Audit reclassified Taxpayer’s income attributable to these development agreements, from the Service and Other Activities B&O Tax Classification to the Retailing B&O Tax Classification, and assessed retail sales tax on the income.

Taxpayer petitioned for review on this issue arguing Audit erroneously reclassified its development fees, stating that the fees were for service-taxable activities, instead of retail-taxable construction services.

2. Stormwater Connection Fee

Taxpayer contracted with Customer C to acquire and develop real property in . . . Washington. On June 2, 2016, the city of . . . (the “City”) Department of Community Development issued a building permit to Taxpayer.⁷ The building permit listed Affiliate as the contractor. The City charged Taxpayer a total fee of \$. . . , which included a stormwater connection fee of \$⁸ Customer C later paid Taxpayer for the full cost of the [connection fee], and Taxpayer did not report the income from this payment when reporting its gross income to the Department.

Audit concluded the payment from Customer C for the stormwater connection fee should be included in Taxpayer’s gross income, and assessed retail sales tax and retailing B&O tax on it. Taxpayer disputes this portion of the assessment, arguing the payment from Customer C is a reimbursement that is excluded from its measure of tax under Rule 111.

. . .

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⁸ The additional fees that the City of . . . charged Taxpayer are not in dispute:

Building Permit Plan Review Fee	\$. . .
Planning and Zoning Review Fee	\$. . .
Administrative Fee	\$. . .
Building Permit Fee	\$. . .
State Surcharge	\$. . .
Total	\$. . .

ANALYSIS

1. Development Fees

Washington imposes B&O tax upon the privilege of engaging in business activities in this state. RCW 82.04.220(1). The measure of the tax as well as the tax rate vary depending upon the nature, or classification, of the activity. *Id.* Retailing B&O tax is due on all retail sales. RCW 82.04.250.

RCW 82.08.020 imposes retail sales tax on each retail sale in Washington. The seller must collect sales tax from the buyer, and then remit the collected tax to the Department. RCW 82.08.050.

The term “retail sale” is defined in RCW 82.04.050 and includes construction activities. RCW 82.04.050(2)(b) states:

(2) The term “sale at retail” or “retail sale” shall include the sale of or charge made for tangible personal property consumed and/or for labor and *services rendered in respect to* the following . . .

(b) The constructing, repairing, decorating, or improving of new or existing buildings . . . under, upon, or above real property of or for consumers. . . .

(Emphasis added.)

RCW 82.04.051 defines the term “services rendered in respect to,” for purposes of RCW 82.04.050, as “those services that are directly related to the constructing . . . of buildings . . . and that are performed by a person who is *responsible for the performance of* the constructing . . . activity.” RCW 82.04.051(1) (emphasis added).

RCW 82.04.051(4) defines “responsible for the performance” as follows, in pertinent part:

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.

We have held that when the services were necessary for the timely completion of the project, such as advising and coordinating information, but did not entail the direction or management of the actual construction process or actual building activities, the person was not “responsible for the performance of” the constructing, and, therefore, not engaged in a retail activity. Det. No. 99-346, 19 WTD 891 (2000); Det. No. 99-152, 19 WTD 643 (2000). We have also held that when a taxpayer acted as an owner’s representative on a construction project, including advising and managing the design and reporting back on the construction process, these services did not include being responsible for the construction, and were also not a retail activity. Det. No. 14-0358, 34 WTD 320 (2015).

In contrast, we have held that when the construction manager's activities were predominantly performed during the construction phase of the project, and the construction manager supervised and directed the constructing activity, the services fit the definition of a "retail sale." Det. No. 99-011R, 19 WTD 423 (2000). In that determination, we rejected the argument that a taxpayer must be obligated to complete the physical construction itself and not just be responsible for supervision or direction. *Id.* at 432. Services involving supervising or directing construction constitute services in respect to construction. *See, e.g.*, Det. No. 99-001, 18 WTD 420 (1999).

Here, under the development agreements, Taxpayer contracted with various customers to secure building permits and to manage the projects in exchange for substantial compensation. The entities agreed to exclusively use Taxpayer for design, development, *construction*, and marketing. The project management included activities such as ensuring that the construction complied with all building codes, planning ordinances and regulations, and zoning ordinances and regulations. Taxpayer was obligated to design, engineer, and complete the construction within the construction schedules provided in the agreements. Taxpayer subcontracted with Affiliate for project management and construction, and the same personnel drafted the plan and supervised the ensuing construction for Customer A and Customer C. Accordingly, we find that Taxpayer was responsible for the performance of the construction activity.

We find these activities are "directly related" to the construction, and Taxpayer was responsible for the performance of the construction, regardless of whether Affiliate was deemed to be the general contractor of record as provided in the development agreements and entered into contracts with vendors directly. Because the services were directly related to construction and performed by a person responsible for the performance of the construction, the services were "rendered in respect to construction" under RCW 82.04.051.

However, the agreements at issue include both service-taxable services, such as engineering, as well as retail construction services. Under RCW 82.04.051(2), the "predominant activity under the contract or agreement" determines whether income from a construction contract that includes both retail activities and service-taxable services is retail taxable or service taxable. The term "predominant" is not defined solely in quantitative terms, but also as having "greatest ascendancy, importance, influence, authority, or force." Det. No. 14-0177, 34 WTD 102 (2015), *citing* Det. No. 99-011R, 19 WTD 423 (2000). We have previously held that where both design and construction work was completed by the same person, the construction was the predominant activity. Det. No. 14-0177, 34 WTD 102 (2015).

Here, Taxpayer contracted with Affiliate to provide development services, which appear to involve services related to developing the land prior to construction for the landowning entities, and subsequently contracted with the landowning entities to perform or cause to be performed all design, engineering, construction and marketing. Taxpayer asserts that during the construction phase, other entities handled the construction, and Taxpayer was concerned with monitoring the construction and performing other administrative duties. However, this is not supported by the development agreements, which clearly identify Taxpayer as responsible for the construction itself. Additionally, this argument implies a clearer distinction between the activities of Taxpayer and that of Affiliate than is present here. Project Manager, as co-owner of Taxpayer and senior project manager for Affiliate, acted on behalf of both entities. Effectively, for Customer A and

Customer C, Taxpayer oversaw both phases through Project Manager. Because construction was the ultimate goal for all three customers, being responsible for the construction would have the greatest importance under the agreements for these customers. Thus, we conclude that Taxpayer's construction services were the predominant activity, and its development fees under the agreements were subject to retail sale tax on these projects.

2. Stormwater Connection Fee

As explained above, under RCW 82.04.051(4) "responsible for the performance" means that the person is obligated to perform the activities, either personally or through a third party. WAC 458-20-170(1)(e) ("Rule 170") defines the term "constructing, repairing, or improving new or existing buildings" as including:

. . . [T]he sale of or charge made for all service activities rendered in respect to such constructing, repairing, etc., regardless of whether or not such services are otherwise defined as "sale" by RCW 82.04.040 or "sales at retail" by RCW 82.04.050. Hence, for example, such service charges 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 or structure. The fact that the charge for such services may be shown separately in bid, contract or specifications does not establish the charge as a separate item in computing tax liability.

Rule 170(1)(e), As we concluded above, Taxpayer was responsible for constructing the project, and its "services rendered in respect to" the construction were its predominant activity under RCW 82.04.051(2). The development agreements required the customers to pay Taxpayer for those services necessary to construct the building, along with the fees it paid to the City. Therefore, even if the services at issue would otherwise fall outside of the definition of "retail sale," they are subject to retail sales tax and retailing B&O tax because the predominant activity of the contract is retail construction.

Retailing B&O tax is imposed on the gross proceeds of sales, multiplied by the applicable B&O tax rate. RCW 82.04.250. "Gross proceeds of sale" is defined as:

[T]he value proceeding or accruing from the sale of tangible personal property and/or for services rendered, without any deduction on account of the cost of property sold, the cost of materials used, labor costs, interest, discount paid, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

RCW 82.04.070.

Rule 170(3)(b) recognizes that [fees] and other charges by a contractor are included in total construction costs used to measure B&O tax:

Where no gross contract price is stated in any contract or agreement between the builder and the property owner, then the measure of business and occupation tax is the total amount of construction costs, including any charges for licenses, *fees*, permits, etc., required for the construction and paid by the builder.

(Emphasis added.) Rule 170(4)(a) defines the measure of retail sales tax similar to how Rule 170(3)(b) defines the measure of B&O tax and reads as follows:

Prime contractors are required to collect from consumers the retail sales tax measured by the full contract price. Where no gross contract price is stated, the measure of sales tax is the total amount of construction costs including any charges from licenses, *fees*, permits, etc., required for construction and paid by the builder.

Rule 170(4)(a) (emphasis added).

Here, the cost of [paying certain fees] was a prerequisite to building, which included a stormwater connection fee. That fee was an expense for Taxpayer when it paid it to the City. Thus, Taxpayer's stormwater connection fee is a fee included in total construction costs under Rule 170(3)(b) that is subject to retailing B&O tax. Consistent with this, the stormwater connection fee is included in full contract price under Rule 170(4)(a) and subject to retail sales tax.

Taxpayer argues that the stormwater connection fee is excludable from these measures of tax under Rule 111. Rule 111 recognizes that certain receipts are merely advances or reimbursements for expenses paid for a client, and not gross receipts of the business. Rule 111 states, in pertinent part:

The word "advance" as used herein, means money or credits received by a taxpayer from a customer or client with which the taxpayer is to pay costs or fees for the customer or client.

The word "reimbursement" as used herein, means money or credits received from a customer or client to repay the taxpayer for money or credits expended by the taxpayer in payment of costs or fees for the client.

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 . . . the payment of money . . . to a third person, or in procuring a service for the customer which the taxpayer does not or cannot render and for which no liability attaches to the taxpayer

On the other hand, *no charge which represents an advance payment on the purchase price of an article or a cost of doing or obtaining business, even though such charge is made as a separate item, will be construed as an advance or reimbursement.* Money so received constitutes a part of gross sales or gross income of the business, as the case may be. For example, no exclusion is allowed with respect to amounts received by . . . (4) a manufacturer or contractor for materials purchased in his own name or in the name of his customer if the . . . contractor is obligated to the vendor for the payment of the purchase price, regardless of whether the customer may also be so obligated

(Emphasis added.)

The Washington Supreme Court has set out the three conditions to qualify as advancements or reimbursements under Rule 111: “(1) the payments are ‘customary reimbursements for advances made to procure a service for the client’; (2) the payments ‘involve services that the taxpayer did not or could not render’; and (3) the taxpayer ‘is not liable for [making the payment] except as the agent of the client.’” *Washington Imaging Services, LLC. v. Dep’t of Revenue*, 171 Wn.2d 548, 561-62, 252 P.3d 885 (2011) (internal citations omitted, emphasis in original).

Because we find it dispositive in this case, we only address the third element. In order for the third element to be satisfied, two conditions must be present: (1) a true agency relationship between the customer and the taxpayer is required, and (2) the taxpayer’s liability to pay constituted solely agent liability. 171 Wn.2d at 562. Taxpayer, here, has not presented any evidence that it was acting as an agent on behalf of its customers when [paying the] stormwater [connection fee]. Additionally, Taxpayer has not presented evidence that any contracts between itself and its customers include language indicating the customer is the principal and Taxpayer is the agent. Thus, Taxpayer has not shown that a true agency relationship exists with its customers.

Further, Taxpayer has not presented any evidence that its liability to pay the stormwater [connection fee] was based solely on agent liability. There is no agreement between Taxpayer and its customers that addresses the duty to obtain the stormwater [connection], nor is there any evidence that Taxpayer’s customers had any liability to obtain the stormwater [connection] directly from the local municipality. Instead, Taxpayer [paid] the stormwater [connection fee] as a business practice, and, therefore, the amounts Taxpayer received from its customers to cover its costs cannot qualify for Rule 111 treatment. This is consistent with our past decisions. In an analogous case, a contractor paid a fee to obtain a building permit for the contractor’s customer, and billed the customer for the permit fee without charging retail sales tax on that amount. 6 WTD 133. We held that the recovery of building permit fees by a construction contractor from its clients was not excludable from retail sales tax because the contractor had not shown that it had no primary or secondary liability for such fees. *Id.* Taxpayer, here, has likewise not shown that it had no primary or secondary liability; to the contrary, as applicant for the stormwater [connection], it had primary liability for the fee. Since Taxpayer has not satisfied either condition of Rule 111’s third element, we find that Audit properly included the fee in Taxpayer’s measure of B&O tax and retail sales tax.

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DECISION AND DISPOSITION

We deny Taxpayer's petition.

Dated this 10th day of May 2018.