

Cite as Det. No. 17-0106, 37 WTD 028 (2018)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| 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. 17-0106 |
|) | |
| ...) | Registration No. . . . |
|) | |

RCW 82.08.050, RCW 82.04.050, RCW 82.04.051; RULE 170: RETAILING B&O TAX – RETAIL SALES TAX – CONSTRUCTION CONTRACT – DESIGN FEES. A contract for services, such as design work, will be combined with a construction contract and taxed as a single activity if at the time of the first contract it was contemplated by the parties that the same person would be awarded both contracts.

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.

Eckholm, T.R.O. – A construction company objects to reclassification of its design services as services rendered in respect to construction and retail sales under RCW 82.04.051. The taxpayer asserts that at the time it executed the design contract it was not contemplated by the parties that the taxpayer would be awarded the subsequent construction contract. . . . The taxpayer’s petition is denied.¹

ISSUE

1. When a customer awarded the taxpayer the design contract, was it contemplated by the parties that the customer would also award the subsequent construction contract to the taxpayer, such that the design fees would be taxable as retail sales under RCW 82.04.051?

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FINDINGS OF FACT

... (the taxpayer) is a construction company based in ... Washington. The taxpayer’s business model includes both speculative and custom residential construction. The Department of Revenue, Audit Division reviewed the taxpayer’s records for excise tax purposes for the period January 1, 2011, through June 30, 2014. The Audit Division reclassified design income reported under the

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

services and other activities business and occupation (B&O) tax classification to the retailing B&O tax classification and assessed retail sales tax. . . . As a result, the Audit Division issued an assessment in the total amount of \$² The taxpayer filed a petition for review of the reclassification of its design income

Reclassification of design services income.

The auditor based the reclassification of the taxpayer's design income on the taxpayer's design and construction contracts, associated records and business model. All but one of the taxpayer's clients that contracted with the taxpayer for design work also contracted with the taxpayer for the subsequent construction work. In the one exception, the client cancelled the design contract. The taxpayer's "Agreement for Home Design Services" (design agreement) includes the following provisions:

1. Basic Services. The services to be provided under this Agreement (the "Basic Services") shall be divided into the following phases (i) the Schematic Design Phase, (ii) the Design Development Phase and (iii) the Construction document Phase. The design drawings and documentation included in each phase are described separately below. The person designated by [taxpayer] to perform the Basic Services is referred to in this Agreement as the "Designer." [Taxpayer] will provide the following Basic Services in connection with the design of the Home on the Property:

. . .

2. Fee for Basic Services. Client agrees to pay [taxpayer] a fee ("Basic Services Fee") for the Basic Services in the amount of \$_____. An initial non-refundable retainer of _____% (50% if not filled in) of the total basic compensation shall be due and payable upon execution of this Agreement. The balance of the Basic Services Fee shall be paid in two equal installments. The first installment shall be due and payable upon Client's written approval and acceptance of the Design Development Drawings. The final installment is due and payable upon approval of the building permit.

Should [the taxpayer] and Client enter into a Custom Construction Contract within six months of fulfillment of this agreement [taxpayer] agrees to credit Client _____% of the Basic Services Fee applicable to other budget items included in the Custom Construction Contract.

3. Additional Services. The Basic Design Services do not include any drawing, service or meeting other than those described in Section 1. In particular, Basic Services do not include preparation of specifications, changes to plans or drawings previously approved by Client, or changes due to Owner's failure to make decisions in a timely manner, or construction administration. . . .³

² Document No. . . . , issued March 16, 2016, includes assessment of retail sales tax of \$. . . , retailing B&O tax of \$. . . , a credit of service and other activities B&O tax of \$. . . , use tax and/or deferred sales tax of \$. . . , and interest of \$. . . , for a total amount of \$

³ The taxpayer indicated that since the audit it has removed from its form design agreement the credit incentive in paragraph (2) and the reference in paragraph (3) to "construction administration."

(Emphasis added.)

The auditor also reviewed the taxpayer's business model and marketing. The taxpayer describes its homes on its website as distinguished in the industry by the taxpayer's quality craftsmanship, artistry and perfection.⁴ The taxpayer refers to its homes as having the "[taxpayer]" look, described as follows:

Each home showcases the "[taxpayer]" look, marked by artful mixtures of brick and stone, lush landscaping, balanced designs and overall quality. [Taxpayer] builds for longevity, believing that a home should be more than the sum of its parts, and is a structure that contains and shapes a family's life. This extraordinary combination has proven successful. [Taxpayer]'s homes are frequently listed by name in resale transactions-an uncommon distinction in the industry.⁵

The taxpayer describes the loyalty of its customers and credits its success to its comprehensive in-house services, as follows:

One of the company's mottos "Loyalty Is Earned" is reflected in the number of customers who have purchased multiple [taxpayer] homes and say they would accept no other. Crucial to this success is in-house service. [Taxpayer] employs staff to oversee every stage of design and production. From architectural and interior design to sales and marketing, everything is under one roof. [Taxpayer]'s newest resale program, [taxpayer] Preferred Homes, further enhances the [taxpayer] service program.⁶

The taxpayer describes its unique business approach, as follows:

Our comprehensive services, available individually or as a package, include land acquisition and development, architectural engineering and design, interior design and decorating, and customer centric, quality driven craftsmanship that yields a home that is uniquely yours and distinctly [taxpayer]. Our unique business approach allows us to combine the resources, purchasing power and efficiency of a larger builder with the customer-first, detail-oriented attentiveness and quality-driven practices you expect from a private contractor. When every detail counts, demand the best!⁷

Based on the taxpayer's records, the language in the design agreement and the taxpayer's business model, and marketing, the auditor determined that the taxpayer's design services were rendered in respect to construction. The Audit Division reclassified the taxpayer's design services as retail services based on the six-factor analysis in Det. No. 02-0142, 22 WTD 90 (2003). The auditor shared this analysis with the taxpayer.

⁴ . . . (last visited April 4, 2017).

⁵ *Id.*

⁶ *Id.*

⁷ . . . (last visited October 11, 2016).

In support of its petition for review, the taxpayer responded with its own application of the six-factor analysis and relies on the holding in 22 WTD 90. The taxpayer provided six declarations from clients (one outside the audit period) that state they hired the taxpayer solely for design services and they were under no obligation whatsoever to contract with the taxpayer for the subsequent construction.

...

ANALYSIS

Reclassification of design services income.

Washington imposes the B&O tax on the privilege of engaging in business in this state. Depending on the nature of the business activity conducted, the tax is levied upon the value of products, the gross proceeds of sales, or the gross income of the business. RCW 82.04.220. The rate of B&O tax depends on the classification of the business activity being conducted. Sales of tangible personal property and certain services are defined as “retail sales” and are subject to the retailing B&O tax classification and retail sales tax. RCW 82.04.050; RCW 82.04.250; RCW 82.08.020.

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. In contrast, providing services, including professional services such as engineering or architectural design services, generally is not classified as a retail activity, but the company must pay service and other activities B&O tax on its gross income. RCW 82.04.290(2); WAC 258-20-224(2). However, under certain circumstances, a service ordinarily classified as a professional service is considered a retail service activity. In those circumstances, the gross receipts received for providing those services are subject to retailing B&O tax and the sale is subject to retail sales tax. RCW 82.04.050(2)(b); RCW 82.04.051(1); RCW 82.04.250; RCW 82.08.020(1).

RCW 82.04.050(2)(b) expressly provides that the term “retail sale” includes:

[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.)

RCW 82.04.051(1) clarifies that the term “services rendered in respect to” means:

[T]hose services that are directly related to the constructing, building, repairing, improving, and decorating of buildings or other structures and that are performed by a person who is responsible for the performance of the constructing, building, repairing, improving, or

decorating activity. The term does not include services such as engineering, architectural, surveying, flagging, accounting, legal, consulting, or administrative services provided to the consumer of, or person responsible for performing, the constructing, building, repairing, improving, or decorating services.

Thus, if the taxpayer is not responsible for constructing, building, etc., as indicated in RCW 82.04.051(1), then that taxpayer's directly-related services are not retailing activities.

The issue presented in this review is whether the taxpayer's design services are considered services rendered in respect to construction under RCW 82.04.051 and "retail sales" under RCW 82.04.050. Subsection (3) of RCW 82.04.051 specifically addresses the transactions at issue here, where the taxpayer entered into two contracts with its client – a contract for design services and a subsequent contract for construction services. RCW 82.04.051(3) provides:

Unless otherwise provided by law, a contract or agreement under which a person is responsible for activities that are subject to tax as a service under RCW 82.04.290(2), and a subsequent contract or agreement under which the same person is responsible for constructing, building, repairing, improving, or decorating activities subject to tax under another section of this chapter, shall not be combined and taxed as a single activity if at the time of the first contract or agreement it was not contemplated by the parties, as evidenced by the facts, that the same person would be awarded both contracts.

(Emphasis added.)

The Department recently applied RCW 82.04.051(3) in Det. No. 15-0135, 35 WTD 135 (2016), which also involved a taxpayer who provided both design services and construction services for its clients. In 35 WTD 135, the Department correctly recognized that:

[RCW 82.04.051(3)] does not require a fixed agreement that both contracts are to be awarded to the same person, and specifically applies even when there are two separate contracts. Thus, the fact that the Taxpayer subsequently negotiates a separate contract for the construction work is not sufficient to segregate the two activities.

35 WTD at 138.

The Department then went on to describe the relevant inquiry under RCW 82.04.051(3), as follows:

When the work is in fact performed by the same person, as is the case for the projects at issue here, to retain the service taxable nature of the initial work, it [is] necessary to show that the parties did not contemplate . . . that the work would be performed by the same person. *Id.* Thus, conversely, if there is evidence that the parties contemplated . . . that the design and construction work would be done by the same person, the design work will also be characterized as a retail service.

35 WTD at 138 (brackets and ellipses in original).

The Department held in 35 WTD 135 that the language in the taxpayer's design contract and the taxpayer's marketing of the benefits of consolidating its professional and construction services, was sufficient evidence that the parties contemplated that the taxpayer would perform both the design and construction services. The same circumstances presented in this case constitute sufficient evidence that the parties contemplated that the taxpayer would provide both the design and construction services.

Here, the taxpayer's design agreement includes the following provision:

Should [the taxpayer] and Client enter into a Custom Construction Contract within six months of fulfillment of this agreement [the taxpayer] agrees to credit Client ____% of the Basic Services Fee applicable to other budget items included in the Custom Construction Contract.

The taxpayer's design agreement refers to the taxpayer's construction contract and provides the client a credit to construction costs based on a percentage of the design costs. The inclusion of this provision in the design agreement and the credit incentive is evidence that the parties contemplated the taxpayer would also perform the construction.

The taxpayer asserts that the language in the design agreement is insufficient to support a finding that the parties contemplated the taxpayer would also perform the construction. The taxpayer asserts that the taxpayer's clients were under no obligation to contract with the taxpayer for the subsequent construction; therefore, under RCW 82.04.051, the taxpayer's design services income should be taxed as a service under RCW 82.04.290(2). The taxpayer provided six declarations from clients (one was outside the audit period) that declare the design agreement was solely for design services and the clients were under no obligation to contract with the taxpayer for subsequent construction. The taxpayer also indicated that the credit incentive is not evidence of the parties' contemplation and would be negligible because the taxpayer constructs \$2 million homes, and the credit would be a small fraction of that amount. In addition, the taxpayer notes that the design agreement in 35 WTD 135 contained the term "anticipated" in relation to the subsequent construction, which is different from the language in the taxpayer's agreement.

The fact that the clients were under no obligation to contract with the taxpayer for construction is not sufficient to establish there was no contemplation by the parties under RCW 82.04.051(3). As noted above, RCW 82.04.051(3) does not require a fixed agreement or obligation that both contracts are to be awarded to the same person – the inquiry is whether there was contemplation by the parties that the subsequent contract would be awarded to the same person. 35 WTD at 138. Though the language in the agreement in 35 WTD 135 is different than in the taxpayer's agreement, the language in both agreements refers to a construction contract with the taxpayer that is yet to be determined. The agreement in 35 WTD 135 provided that "[it] is anticipated that [Taxpayer] will also handle the construction phase of the project if the client so wishes" 35 WTD at 136. This agreement recognizes that the client has not yet made a decision on the subsequent construction contract with the taxpayer. Here, there is further evidence of the contemplation of the parties by the credit incentive to be applied to the costs in a subsequent construction contract with the taxpayer. See Det. No. 01-184, 22 WTD 238 (2003) (design contract

credit incentive to construction costs if client chooses to execute construction contract with the taxpayer within one year was evidence of contemplation of the parties under RCW 82.04.051(3)).

The circumstances in 35 WTD 135 are also similar to those in this case in regards to the taxpayer's marketing of the benefits of providing both design and construction services. The Department in 35 WTD 135 found that such marketing was further evidence of the parties' contemplation of the taxpayer performing both services. The taxpayer, here, markets the benefit of its comprehensive services as its "unique business approach," which results in a quality, distinctive taxpayer home.⁸ The taxpayer's marketing constitutes evidence that the parties contemplated that the taxpayer also perform the construction work.

There is additional evidence in this case of the parties' contemplation of the taxpayer performing the subsequent construction contract. The taxpayer markets its homes as having its signature look and the increased resale value gained by a home built by the taxpayer with the taxpayer's signature name.⁹ The taxpayer indicated that customers seek this signature look. This is evidence that the parties contemplated that the taxpayer would also perform the construction work because the design work would necessarily support the taxpayer's construction of its unique, signature homes.

The Audit Division applied six factors considered in 22 WTD 90 in determining whether the taxpayer's design income should be reclassified to retail under RCW 82.04.051(3). The taxpayer responded with its own analysis of the six factors and relies on the holding in 22 WTD 90 in support of its position. The six factors in 22 WTD 90, stated as inquiries, are: (1) Were the service and construction contracts awarded within a short period of time? (2) Were the service and construction contracts performed separately? (3) Were the service and construction contracts awarded subject to an open, competitive bidding process? (4) Was the decision to award the construction contract made independently of the decision to award the service contract? (5) Was the customer free to choose a different construction contractor or abandon the project? (6) Is the compensation for the service contract separate from the construction contract?

The Department published 35 WTD 135 after the audit and assessment in this case. The Department did not apply the six factors in 35 WTD 135 in reaching its conclusion and cited to 22 WTD 238 (published the same year as 22 WTD 90) which also did not address the six factors. In certain cases the inquiries posed in those factors may identify evidence that is relevant to the determination under RCW 82.04.051(3), but application of those factors is not required and the Department is not limited to considering those factors. Reviewing those factors may not be helpful in light of the evidence in any given case. For example, some of the inquiries relate to whether the contracts were separate, where the existence of two contracts (the construction contract as the subsequent contract) is the circumstance that triggers application of RCW 82.04.051(3) in the first place. The factors also inquire whether there was a fixed agreement between the parties regarding the subsequent contract, which is not required under RCW 82.04.051(3). Here, as indicated above, there is sufficient evidence that the parties contemplated that the taxpayer would be awarded the construction contract.¹⁰

⁸ . . . (last visited October 11, 2016).

⁹ See . . . (last visited April 4, 2017).

¹⁰ [To the extent that 22 WTD 90 implies that there is one exclusive six-factor test to determine if design income should be reclassified to retail under RCW 82.04.051(3) to be applied in all circumstances, it is in error.]

The Audit Division correctly reclassified the taxpayer's design income because there is evidence that the parties contemplated that the construction and design work would be performed by the taxpayer, and this is sufficient to classify the design work as a retail service.

...

DECISION AND DISPOSITION

The taxpayer's petition is denied.

Dated this 26th day of April 2017.