Cite as Det. No. 02-0142, 22 WTD 90 (2003)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| 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. 02-0142[1] |
| . . . | ) | Registration No. . . . |
| | ) | FY . . . /Audit No. . . . |
| | ) | Docket No. . . . |

[1] RULE 170; RCW 82.04.051: B&O TAX AND RETAIL SALES TAX – CONSTRUCTION AND DESIGN BUSINESS – SERVICES RENDERED IN RESPECT TO CONSTRUCTION. A determination of whether services were rendered in respect to construction is made on a case by case basis and requires looking at the six factors enumerated in Det No. 88-39, 5 WTD 125 (1988).

[2] . . .

[3] RULE 13601; RCW 82.08.0256: SALES AND USE TAX – M&E EXEMPTION – SOFTWARE USED IN A MANUFACTURING PROCESS. Taxpayer's software used to transfer design drawings into joinery machinery cutting settings qualifies for the M&E exemption.

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.

[1] Non precedential portions of this determination have been deleted.

NATURE OF ACTION:

Taxpayer appeals the results of an audit examination.[2]

FACTS:

Lewis, A.L.J. -- . . . ("Taxpayer") design and production staff works together with architects, designers, builders and developers to create timberframe homes and public buildings.[3] Taxpayer provides to its customers design services and/or construction of the timberframe and wall enclosure system. Taxpayer does not act as a general contractor, thus Taxpayer's customers must either act as their own general contractor or hire one.

Customers of Taxpayer's design services sign a "Design Agreement," whereby:

> . . . agrees to supply the following services to facilitate in the preparation of construction documents for the owner[']s proposed timber-frame home:
>
> DESIGN: During the preliminary phase of your project we work closely with you to translate your program (wish list, scrapbook, sketches, etc.) into a design solution. We use sketches, sections and perspectives to communicate to one another various options and alternative solutions. Typically we meet to discuss the plan, revise the plan as needed, and decide on the basic building materials that will go into the house. During the preliminary design phase we will decide on the structural system, mechanical systems, wall systems, cladding (siding and roofing), windows and doors. When we have arrived at a preliminary plan, a preliminary timber frame design and basic specifications that satisfy everyone, including any architectural review committee, which may be involved, we recommend that you review your plan with one or more general contractors. An experienced general contractor will be able to provide an estimate of the construction cost of the finished house, using the information on your preliminary plans.

If the customer decides to hire Taxpayer to fabricate and erect the timber-frame structure, a second agreement is signed. The second agreement may be signed before or after all the design work is completed. The "Purchaser/Manufacturer" Agreement specifies the rights and responsibilities of both parties, as related to the timber-frame construction work.

The Audit Division of the Department of Revenue ("Department") audited Taxpayer's books and records for the period January 1, 1997 through December 31, 2000. On November 16, 2001, the Department issued a $ . . . tax assessment.[4] The assessment included additional tax resulting from the:

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

[3] Timber framing refers to a specific type of post and beam construction in which solid wood timbers are connected with mortise and tennon joinery and secured with hardwood pegs

[4] The $ . . . assessment was comprised of $ . . . tax and $ . . . interest.

- Reclassification of a portion of Taxpayer's design income from the service B&O tax classification to the retailing business and occupation ("B&O") and retail sales tax classifications.[5] The Audit Division reasoned that the design services were part of the retail construction activity because, at the time the design work was performed, it was contemplated that Taxpayer would do the timber-framing.

- . . .

- Disallowance of the M&E exemption taken on the purchase of software. The Audit Division reasoned that the software did not qualify for the M&E exemption because the software was not part of the manufacturing process.

Taxpayer disagreed. On February 14, 2002 Taxpayer filed a petition requesting correction of the assessment. Taxpayer's petition argued that the design services were separate and distinct from the construction activity.

Taxpayer supported its position citing the fact that it conducted its business using two separate agreements -- one agreement for design services and one agreement for construction services. Taxpayer emphasized that.

- The Design Agreement contains no mention of subsequent construction by Taxpayer.

- The Design Agreement recommends that the plan be reviewed with one or more general contractors.

- Neither the Design nor Construction Agreement speaks to construction based on plans supplied by Taxpayer.

To further support its contention that the design services are separate and distinct from construction, Taxpayer analyzed the number of design contracts that resulted in a subsequent construction contract. Taxpayer found that:

> . . . [f]or the 1998 through 2000 year period at issue, only 17 of taxpayer's 41 design contracts for projects in Washington State ultimately resulted in timber-frame contracts with taxpayer. In other words, in most cases (59%) performing design contracts for projects in Washington State have not resulted in taxpayer performing timber-frame construction services for that design service customer.

Taxpayers also argued that in order to find that the design services were rendered in respect to construction requires that Taxpayer be "responsible for both" the design service and the construction activity. Taxpayer maintains that since at the time the design contract is signed it

[5] Taxpayer paid retailing B&O and collected retail sales tax on design income received after a construction contract was signed.

has no responsibility to perform construction activities, the design services cannot be rendered in respect to construction.

Finally, Taxpayer supplied five letters from past customers to support of its contention that at the time the design work was contracted, it was not contemplated that Taxpayer would be awarded the construction contract.

In the alternative, Taxpayer argued that no reclassification of income should be made because of the tax reporting instructions given in a prior audit and in a letter issued by the Department's Taxpayer Information and Education ("TI&E") Division.

. . .

Taxpayer protests the Audit Division's disallowance of the M&E sales/use tax exemption on the purchase of specialty software. The Audit Division disallowed the software purchase asserting that the software was not used in the manufacturing process. Taxpayer maintained that the software was used to program the automated joinery machines and thus was part of the manufacturing process. Taxpayer has taken special effort to distinguish its purchase of specialty software to program the settings of the joinery equipment from the more common and cheaper CAD software commonly purchased by architects solely for drafting plans.

ISSUES:

1. Whether design fees collected under a written agreement separate from and signed prior to a construction contract are part of the construction contract and require payment of retailing B&O tax and retail sales tax?

2. . . .

3. Whether software used to translate architectural drawing information into joinery equipment cutting settings qualifies for the M&E tax exemption?

DISCUSSION:

[1] In general, a person must collect retail sales tax on the gross amounts it charges to construct, repair, or improve new or existing buildings for a consumer. RCW 82.08.050(2); WAC 458-20-170 ("Rule 170"). The person must also pay retailing B&O tax on the gross amounts charged the consumer. RCW 82.04.050 and .220. A person that provides a service, including professional services such as engineering or design services, under most circumstances, is not required to collect retail sales tax, but must pay service and other activities B&O tax on the gross income derived from providing those services. In some circumstances involving construction activities, however, a person who provides a service, normally taxable at the service and other B&O tax rate, would be taxed, instead, at the retailing B&O tax rate and would be required to collect retail sales tax on the amounts a consumer pays that person for those services. The Audit

Division maintained that the design services provided by Taxpayer were performed in such a circumstance.

In 1999, the legislature enacted RCW 82.04.051 to explain the taxation of "services rendered in respect to construction . . . ." RCW 82.04.050(c). RCW 82.04.051 states:

> (2) A contract or agreement under which a person is responsible for both services that would otherwise be subject to tax as a service under RCW 82.04.290(2) and also constructing, building, repairing, improving, or decorating activities that would otherwise be subject to tax under another section of this chapter is subject to the tax that applies to the predominant activity under the contract or agreement.
>
> (3) 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.
>
> (4) 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. A person who is financially obligated for the work, such as a bank, but who does not have control over the work itself is not responsible for the performance of the work.

(Emphasis added.)

Thus, Taxpayer's design services would not be considered part of construction activity and subject to retailing B&O and retail sales tax unless, at the time of the first contract or agreement, it was contemplated by the parties that the same person would be awarded both contracts.

The intent of the legislation in adopting RCW 82.04.051 is stated in paragraph 3 of ch. 212, Laws of 1999:

> (3) Therefore, the intent of this act is to maintain the application of the law and not to extend retail treatment to activities not previously treated as retail activities. Services that are otherwise subject to tax as a service under RCW 82.04.290(2), including but not limited to engineering, architectural, surveying, flagging, accounting, legal, consulting, or administrative services, remain subject to tax as a service under RCW 82.04.290(2), if the person responsible for the performance of these services is not also responsible for the performance of the constructing, building, repairing, improving, or decorating activities. Additionally, unless otherwise provided by law, a person entering into an agreement to

> be responsible for the performance of services otherwise subject to tax as a service under RCW 82.04.290(2), and subsequently entering into a separate agreement to be responsible for the performance of constructing, building, repairing, improving, or decorating activities, is subject to tax under RCW 82.04.290(2) with respect to the first agreement, and is subject to tax under the appropriate section of chapter 82.04 RCW with respect to the second agreement, if at the time of the first agreement there was no contemplation by the parties, as evidenced by the facts, that the agreements would be awarded to the same person.

(Emphasis added.)

Because RCW 82.04.051 is intended to provide clarification and not to amend the statute, it has retroactive application. Marine Power and Equip. Co. v. Human Rts. Comm. Hearing Tribunal, 39 Wn. App. 609, 614, 694 P.2d 697 (1985). RCW 82.04.051 may apply retroactively even though an appeal may be pending. See Marine Power, 39 Wn. App. at 620-21. Accordingly, we will apply the clarifying language to this appeal, even though the activities in dispute took place before the statute's effective date.

RCW 82.04.051's clarification of the law has not changed the Department's long-standing interpretation and application of the law. See, Det. No. 99-011R, 19 WTD 423 (2000). For many years, the Department has looked at six factors to determine whether a service contract was "rendered in respect to" a construction contract when both a service and construction contract are awarded to the same contractor. See, Det. No. 88-39, 5 WTD 125 (1988). These factors remain applicable under the clarification statute. Thus, we must review these six factors to determine if the design fee contract and the subsequent timber frame contract should be combined and taxed as a single retail activity.

**FACTOR ONE**. Were the service and construction contracts awarded within a short time period?

A review of Attachment E submitted with Taxpayer's appeal petition shows the time period between the earliest receipt of design fee income (using the design contract date) and the timber frame contract date ranges from 81 to 736 days.

**FACTOR TWO**: Were the service and construction contracts performed separately? Yes.

**FACTOR TWO - PART A**: Was the service contract finished before the construction contract was awarded?

A review of Attachment E submitted with the appeal petition shows that 12 of the 17 contracts which resulted in subsequent timberframe construction contracts are dated before the design work was completed, as determined by the last billing period. Of the 5 remaining projects, one timberframe contract was dated 4 days after the final billing for the design service. The others are dated from 88 to 346 days after the design service final billing period. Thus, while the timberframe

construction contracts were dated well after the design contract was signed, in most cases the timberframe construction contract was signed before the design work was completed. . . .

**FACTOR TWO – PART B**: Were the services performed independently of the construction?

Yes, the nature of the design function is to have the design completed prior to beginning construction. The plans that result from the design function are submitted for building permits. Construction cannot begin until building permits are issued.

**FACTOR THREE**: Were the service and construction contracts awarded subject to an open, competitive bidding process?

Taxpayer has submitted letters from five design customers attesting that the design and construction contracts were separate and that there was no expectation that Taxpayer would receive the construction contract. In one case, Taxpayer's design customer awarded the timberframe construction contract to another firm.

**FACTOR FOUR**: Was the decision to award the construction contract made independently of the decision to award the service contract?

As stated above, Taxpayer has submitted letters from five customers attesting to the fact that the construction contract was awarded independently from the service contract.

**FACTOR FIVE**: Was the customer free to choose a different construction contractor or abandon the project?

The evidence shows that a minority (40%) of the construction contracts follow the design service contracts. For the 1998 through 2000 year period at issue, only 17 of taxpayer's 41 design contracts for projects in Washington State ultimately resulted in timber-frame contracts with taxpayer.

**FACTOR SIX**: Is the compensation for the service contract separate from the construction contract?

Taxpayer always uses two contracts, one for design services and one for construction. The contracts are awarded separately and paid for separately.

Based on the facts presented, analyzed in light of the six factors, we find that the design services Taxpayer offers were not "rendered in respect" to constructing activities. We have no doubt that Taxpayer would like to receive the construction contract for each design job it performs. The facts, however, show that Taxpayer receives a construction job only in about 40% of the cases where it performs a design contract. Taxpayer has also provided statements from customers attesting to the separation between Taxpayer's design and construction operations. In further support of our finding is the fact that Taxpayer uses two separate contracts and that the design

contract makes no mention of Taxpayer's construction activities. Accordingly, we grant Taxpayer's petition as it relates to the reclassification of portions of its design income. . . .

[2] Taxpayer also protests the Audit Division's disallowance of the M&E sales/use tax exemption on . . . CAD software.

RCW 82.08.02565 provides the retail sales tax exemption at issue. The M&E exemption, like all tax exemptions in Washington, is strictly construed in favor of application of the tax and against the person claiming the exemption. Yakima Fruit Growers Ass'n v. Henneford, 187 Wash. 252, 258, 60 P.2d 62 (1936); All-State Constr. Co. v. Gordon, 70 Wn.2d 657, 425 P.2d 16 (1967).

RCW 82.08.02565 provides that the retail sales tax will not apply to "sales to a manufacturer . . . of machinery and equipment used directly in a manufacturing operation . . . ." RCW 82.08.02565(2) defines "machinery and equipment":

> (a) "Machinery and equipment" means industrial fixtures, devices, and support facilities . . . . .
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> . . .
>
> (c) Machinery and equipment is "used directly" in a manufacturing operation . . . if the machinery and equipment:
>
> (i) Acts upon or interacts with an item of tangible personal property [or] . . .
>
> (iv) Provides physical support for or access to tangible personal property. . .
>
> (d) "Manufacturing operation" means the manufacturing of articles, substances, or commodities for sale as tangible personal property. . . .

Thus, the qualification for the exemption requires: (1) a sale; (2) to a manufacturer or processor for hire; (3) of machinery and equipment; (4) used directly; (5) in a manufacturing operation. Det. No. 99-288, 19 WTD 582 (2000). [6]

. . .

> (3) **Definitions**. For purposes of the manufacturing machinery and equipment tax exemption the following definitions will apply.
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> (b) "Device" means an item that is not attached to the building or site . . . .
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> . . .

[3] Taxpayer also protested the Audit Division's denial of the M&E exemption related to the purchase of certain software.

In November 1997, Taxpayer purchased a . . . joinery cutting machine. Prior to the purchase of the . . . machine, the joinery work on the timbers was entirely completed by hand using portable

[6] The statute requires that the buyer give the seller an exemption certificate. See RCW 82.08.02565(1). Because the Audit Division did not address this issue, we assume that the taxpayer complied with this requirement.

machines. While the joinery cuts made by the [machine] can be manually set, the machine's operation is most efficient when the joinery settings are made by special CAD software that transfers information contained in architectural drawings into computer language that the joinery machine understands and utilizes to set the joinery cuts. The special . . . software that Taxpayer purchased are used exclusively and are necessary to translate the architectural drawings into joinery machine settings. Taxpayer argues that the software is an integral part of the output of the . . . machine and thus qualifies for the M&E exemption.

. . . , the M&E exemption requires satisfaction of five elements. . . . , the Audit Division did not challenge the software satisfying elements one, two, or [five]. Thus, whether the software qualifies for the M&E exemption depends on whether the software qualifies as "machinery" or "equipment."

RCW 82.08.02565(2)(c)(iii) specifically exempts from the Washington sales and use tax equipment and/or software which "Controls, guides, measures, verifies, aligns, regulates or tests tangible personal property."

In determining whether the software purchase qualifies for the exemption, we look to prior Appeals Division ("Appeals") decisions. In Det. No. 00-104, 20 WTD 75 (2001), the Taxpayer appealed the disallowance of the M&E exemption on the purchase of computers, which the taxpayer maintained were used in a manufacturing process. Appeals affirmed the M&E disallowance because, except for 10% of the use which automatically transferred information to the equipment, "the information and specific settings produced by the system at issue" were "entered by hand into plant machinery."

We find the instant case distinguishable. Here, Taxpayer's software interacts electronically with the joinery machine and makes the process automatic. Taxpayer does not enter anything manually into the machine. The purpose of the software is to translate and transfer information from drawings into machinery settings. Taxpayer's facts are like those relating to the automatic transfer of information to a router in Determination No. 00-104, which the Department acknowledged would have qualified for the exemption if it had constituted at least 50%, rather than only 10%, of the software's use. See also, Det. No. 00-103, 20 WTD 67 (2001), allowing the exemption where "used directly" in the manufacturing process. Consistent with the cited rulings, we find software that automatically makes the joinery equipment cutting settings qualifies for the M&E exemption. Accordingly, we grant Taxpayer's petition as it relates to this issue.

DECISION:

Taxpayer's petition is granted as it relates to the reclassification of design service fees and the use tax assessed on the disallowed M&E exemption taken on the manufacturing software. . . . The matter will be remanded to the Audit Division for an adjustment consistent with this determination.

DATED this 29th day of August 2002.