Cite as 6 WTD 73 (1988)

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition)	D E T E R M I N A T I O N
For Refund of)	
)	No. 88-239
CITY OF . . ., LIGHT DEPARTMENT)	Registration No. . . .
)	
)	

[1] **RULE 170 AND RCW 82.04.050(2)(b):** RETAIL SALE -- SERVICES RENDERED IN RESPECT TO CONSTRUCTION. Charges for designing testing and furnishing tangible personal property and charges for engineering services for monitoring the installation of the property by a third-party contractor are subject to retail sales tax where the charges are part of one contract awarded to the same contractor. Such services are rendered "in respect to" the construction. Washington Water Power Co. and Chicago Bridge & Iron cited.

[2] **RCW 82.04.050(7):** RETAIL SALES -- CONSTRUCTION FOR BUYER WITH LICENSE TO USE LAND OWNED BY UNITED STATES -- SALES TO UNITED STATES DISTINGUISHED. Where a taxpayer/City had a license to use federal land and purchased tangible personal property which was installed on the land, the taxpayer was the buyer and retail sales tax was due.

[3] **RULE 179 AND RCW 82.04.417:** B&O TAX AND PUBLIC UTILITY TAX -- EXEMPTION -- CHARGES FOR CAPITAL COSTS. Revenue received as a result of monthly payments for services rendered is taxable gross income even if used wholly or in part for capital purposes; the revenue received for billing a customer for the cost of electric distribution system improvements which is not related to the

customer's general obligation to pay the monthly service charge is not taxable income to the utility. Seattle v. State, 12 Wn. App. 91 (1974) followed.

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.

TAXPAYER REPRESENTED BY: . . .
. . .
. . .
. . .

DATE OF HEARING: October 27, 1987

NATURE OF ACTION:

The taxpayer, a city electric utility, protests the assessment of retail sales tax on engineering fees for supervising the installation of property and the assessment of tax on charges to customers which the taxpayer contends are deductible under RCW 82.04.417.

FACTS AND ISSUES:

Frankel, A.L.J. -- The taxpayer's records were examined for the period January 1, 1982 through March 31, 1986. The audit disclosed taxes and interest owing in the amount of $ . . . . Assessment No. . . . in that amount was issued on November 20, 1986.

The taxpayer protests the following portions of the assessment:

1) Deferred sales tax assessed on payments to [Corporation A] for professional engineering services. (. . .) - The services at issue were for supervising the installation of two vertical shaft generators and two hydraulic turbines. [Corporation A] designed, tested, and furnished the turbine/generators and another contractor installed them. The contract with [Corporation A] for the furnishing of turbine/generators included the agreement for the supervision of the installation.

The taxpayer contends the payments at issue were for professional services and should be taxed as such. The taxpayer contends the fact that the services were provided for in the construction contract does not convert the services to a retail sale.

In addition, the taxpayer seeks a refund of more than $ . . . in retail sales tax on the labor and services related to the general construction of the structure within the existing building. In a post-hearing letter, the taxpayer stated:

> The construction of the generators and turbines occurred in and became a part of the . . . (an existing underground structure) on Government Lot no. . . . County, Washington. This existing structure is on United States land and the City of . . . is an instrumentality of the United States Government under FERC License No. . . . to construct and operate the facility on government land. By virtue of this installation this structure becomes a part of the realty and the existing building.

Because the turbines and generators were installed on real property owned by the United States, the taxpayer contends the labor and services related to the construction were not taxable retail sales. The taxpayer relies on RCW 82.04.050(7) in support of its refund claim.

2) Sundry "C" Bills Review. The auditor assessed Service B&O on unreported income from contractors and home owners for "installing new service;" (. . .) and public utility tax on unreported income from "expanding service" or "water." (. . .). "New services" included service drops and meter charges for installation. "Expanding service" included increasing the capacity of an electric system.

The taxpayer protests both assessments on grounds the amounts received are nontaxable under RCW 82.04.417 as "contributions representing a share of the costs of capital facilities." The taxpayer stated the "C" Bills are invoices for payments that were not part of the utility's regular service charge for electric service. "C" Bills are special billing invoices for material and labor costs incurred by the taxpayer when an applicant or customer receives a new or enlarged service or converts on existing service from overhead to underground. The taxpayer explained that it owned the equipment from the power pole to the weather head to the meter. The customer owns the lines from the meter to the house. The charges at issue include charges for upgrading the taxpayer's equipment where a customer requested an increased load for more service.

DISCUSSION:

[1] Engineering Services -- In numerous cases, the Department has upheld the assessment of retail sales tax on fees, as engineering or supervising fees, when the services were included as part of a construction contract. For example, in a similar appeal by a P.U.D. in 1970, the Department affirmed the assessment of retail sales tax on fees for supervision based on the fact that the manufacturing company "agreed to furnish generator equipment and supervision of erection of the equipment all under one contract agreement with the District."

The Department relies on RCW 82.04.050(2) which defines a "sale at retail" to include:

> "the 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, . . ."

The Department's Rule 170 (WAC 458-20-170) provides that service activities rendered in respect to constructing are subject to the retail sales tax, as follows:

> (e) The term "constructing, repairing, decorating or improving of new or existing buildings or other structures," in addition to its ordinary meaning, includes: The installing or attaching of any article of tangible personal property in or to real property, whether or not such personal property becomes a part of the realty by virtue of installation; . . . . The term includes the 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.

In Washington Water Power Co. v. Department of Revenue, the Board of Tax Appeals upheld the assessment of retail sales tax on design engineering services performed by Morrison-Knudsen Company in connection with the construction of a wood burning plant. (BTA Docket No. 85-169, issued July 25, 1986). The Board relied on RCW 82.04.050(2) and WAC 458-20-170.

The Board also quoted language from Chicago Bridge & Iron Company v. Department of Revenue, 98 Wn.2d 814 (1983). In that case, the Washington Supreme Court upheld the assessment of retail sales tax on six contracts which bifurcated the design and manufacturing of three products from their installation. Three of the contracts were with the purchaser for the design and manufacturing and three with the purchaser's affiliate for the installation of the products. The 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 Court rejected CBI's argument that the three contracts covering only the design and manufacturing phase had no nexus with Washington, and upheld the B&O tax assessed on the total revenue from the sales.

The taxpayer in the present case argues Chicago Bridge & Iron is not apposite. We do not agree. Although "nexus" is not an issue in the present case, whether the services are part of the construction is at issue. Contrary to the taxpayer's assertion, in Chicago Bridge & Iron the tax on professional services was converted to a "retail sale" as the court found the contracts were "functionally integrated."

The taxpayer's primary argument is that [Corporation A] provided a professional engineering service to the City and not a service on its personal property. The taxpayer relies

on Rule 138 (WAC 458-20-138) and Rule 224 (WAC 458-20-224) which provide that the Service B&O tax applies to the income received by persons rendering professional or personal services to others. The taxpayer contends Rule 224 provides the clarification to distinguish between the manufacturing services and sale of the product provided by [Corporation A], the installation services provided by . . . , and the engineering monitoring services provided by [Corporation A].

The taxpayer provided the following example to illustrate its position:

> [A] purchaser buys an auto part from the manufacturer, that sale would be subject to the retail sales tax. If the purchaser hires an auto mechanic under a separate contract to install the auto part, that would also be subject to the retail sales tax. However, suppose the purchaser is concerned about the installation of the part and does not want to monitor the installation himself. To ensure himself that the part is installed properly the purchaser hires, under a separate contract, the auto parts manufacturer's expert engineer to observe the installation. The expert engineer is to report to the purchaser if the auto mechanic does not install the part correctly or damages the part during the installation. This is a personal service and not a retail sale. Since the service is provided to the buyer and is not a service rendered on installation of the part. If the sale of the product and engineering observation were covered by one contract rather than two, the personal service (engineering observation) would <u>not</u> be converted to a retail sale simply because it is contracted for in the same document.

The taxpayer contends the auditor incorrectly applied the retail sales tax to the contract rather than the products or services purchased under the contract.

We do not agree. Although the professional services are not themselves defined as sales, the entire contract and total charges are taxable as retail sales. The initial contract called for the seller ([Corporation A]) not only to design, test, and furnish the generators and turbines, but to furnish one or more supervising erectors and test engineers to advise the installation contractor in matters of methods, procedures, and precautions to be followed. As part of the total

contract, [Corporation A] was responsible for "proper alignments, adjustments, clearances, inspection, field testing of the equipment, and other matters pertaining to the installation and/or testing of the equipment." (. . .).

In a recent Determination, the Department set forth the following factors to determine whether services are rendered "in respect to" construction when done by the same contractor:

> (1) Were the service and construction contracts awarded within a short time period?
>
> (2) Were the service and construction contracts performed separately?
>
> > (a) Was the service contract finished before the construction contract was awarded?
> >
> > (b) Were the services performed independently of the construction?
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> (3) Were the service and construction contracts awarded subject to an open, competitive bidding process?
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> (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?

In this case, the service and construction activities were part of the same contract and they were not bid separately. In such cases, the retail sales tax applies to the total contract amount.

[2] Refund claim -- The taxpayer claims a refund of sales tax paid on the income from labor and services related to the construction of the generators and turbines on grounds they were installed on land owned by the United States. RCW 82.04.050(7) provides that the term "retail sale" shall not include:

> . . . the sale of or charge made for labor and services rendered in respect to the constructing, repairing, decorating, or improving of new or existing buildings or other structures under, upon, or above real property of or for the United States, any instrumentality thereof, . . . 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 . . . .

In such cases, the contractor becomes the "consumer" for purposes of the retail sales tax. RCW 82.04.190(6).

In this case, the contract was executed by the taxpayer/City as "owner" of the generators and turbines. The City, not the United States, was obligated to pay for the construction. The City is not a "federal instrumentality" because it had a license to construct and operate the facility on land owned by the United States See, e.g. Rainier National Park Co. v. Henneford, 182 Wash. 160 (1935). The taxpayer/City was the "buyer" and liable for the retail sales tax. Even where the United States becomes the owner after completion of construction, the court has affirmed the collection of sales tax in connection with construction. See, e.g. Murray v. State, 62 Wash. 2d 619 (1963) appeal dismissed Inland Empire Builders, Inc. v. Washington, 378 U.S. 580.

[3] Sundry "C" Bills -- RCW 82.04.417 provides an exemption for "contributions in aid of construction" as follows:

> The tax imposed by chapters 82.04 and 82.16 RCW shall not apply or be deemed to apply to amounts or value paid or contributed to any county, city, town, political subdivision, or municipal or quasi municipal corporation of the state of Washington representing payments of special assessments or installments thereof and interests and penalties thereon, charges in lieu of assessments, or any other charges, payments or contributions representing a share of the cost of capital facilities constructed or to be constructed or for the retirement of obligations and payment of interest thereon issued for capital purposes.
>
> Service charges shall not be included in this exemption even though used wholly or in part of capital purposes.

Rule 179 (458-20-179), the administrative rule dealing with the public utility tax, states the above exemption and adds that "[t]he business and occupation tax is likewise inapplicable to such amounts." 458-20-179(f).

In King County Water District 68 v. Tax Commission, 58 Wn.2d 282 (1961), the Department of Revenue had included amounts charged customers for installation and inspection of water mains and meters in the measure of the public utility tax on the ground the income constituted "operating revenue" within the meaning of RCW 82.16.010(12). The court found that constructing, installing, and inspecting facilities for the purpose of operating a plant do not constitute operations of such facilities. In that case, the charges at issue were to qualify the parties or make them capable of purchasing water rather than consideration for their purchase of water itself from the water district. The court upheld the refund because the revenue was not operating revenue accruing from the performance of a water distribution business.

Using the same analysis, the Court granted a refund to the City of Seattle for revenue received from prospective customers as reimbursement for construction and installation of facilities. Seattle v. State, 59 Wn.2d 150 (1961). The Court held that revenue received from prospective customers did not constitute consideration for delivery of water by the district and, therefore, did not constitute part of the "gross operating revenue" within the meaning of RCW 82.16.010(12).

In a subsequent case, Seattle v. State, 12 Wn.App. 91 (1974), the court held Seattle was entitled to a refund for excise taxes paid on revenue received exclusively from customers for the cost of conversion from an overhead to an underground electric power distribution system. The court noted that those payments were separately billed and not part of the utility's "regular charge" for electric service. 12 Wn.App. at 92.

The taxpayer relies on the above cases in support of its position that the amounts at issue are exempt "contributions representing a share of the costs of capital facilities." The taxpayer quoted the following language from the 1974 Seattle v. State, decision:

> There is no dispute regarding customer contributions after 1969, because following the enactment of Laws of 1969, 1st ex. sess., ch. 156, §[RCW 82.04.417],

> such direct customer contributions toward the construction cost of capital facilities are expressly exempted from the public utility tax.
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> . . .
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> . . . The revenues received from City Light's customers exclusively for the cost of conversion from an overhead to an underground electric power system were revenues necessary to construct or establish a distribution system. They were not revenues accruing from 'the business of operating a plant or system from the generation, production or distribution of electrical energy for hire or sale, . . .' RCW 82.16.010(5).
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> "It is clear to this court from the statutes and from the opinion in King County Water Dist. 68 v. Tax Comm'n, supra, that the taxable 'gross income' which is within the purview of RCW 82.16 must accrue from the performance of the public service, in this case the operation of a plant or system to supply electrical energy, and not from customer contributions towards the capital cost of constructing such a system, underground or otherwise. . . .
>
> . . . [T]he revenue proceeded from bilateral transactions whereby the customer was required to assume a separate and distinct obligation to pay the cost of constructing service lines peculiar and special to the property of the individual consumer. This obligation and payment was in no way connected with the general obligation of all the utility's customers to pay the monthly rate for services rendered." (Emphasis Supplied by taxpayer.)

12 Wn. App. at 93, 96.

The taxpayer argues the system modification costs at issue, like the costs at issue in Seattle v. State case, are billings for a separate and distinct obligation of the customer for the cost of distribution system improvements requested by the customer. The taxpayer noted that [the city]'s Municipal Code requires each customer who installs a new or enlarged service installation or converts on existing service from an overhead connection to an underground connection to pay the taxpayer the system modification cost incurred for the new or enlarged

service installation. These charges, the "C" Bills at issue, are not connected with the general obligation of the taxpayer's customers to pay the monthly rate for services rendered. Thus the taxpayer argues the "C" Bills are exempt.

We agree. Another city utility's water division made similar arguments in 1984 in an appeal of an assessment of public utility tax on water service construction charges. The fees at issue were for the piping and meters connecting the customers' premises with the water main. We agreed with the City that such amounts were entitled to an exemption under RCW 82.04.417 because they were charges which represented the customer's share of the construction costs of the taxpayer's capital facilities. The 1984 Determination advising a Water Division that its charges to customers for installation of water meters and the attendant water lines going between the trunk line and meter were non-taxable contributions in aid of construction was a departure from earlier Determinations which had upheld the tax on such charges.

Seattle v. State, supra, supports the taxpayer's present appeal. The case concerned charges to customers for converting an electric power distribution system. As the charges were not for the "performance or operation" of the business, but rather charges for billing customers for the cost of constructing a distribution system to his property, they were deductible. We agree with the taxpayer that Seattle v. State is apposite.

The taxpayer's petition is granted as to its claim for refund for taxes assessed on "C" Bills.

DECISION AND DISPOSITION:

1) The taxpayer's request for a refund of the retail sales tax assessed on the [Corporation A] fees (. . .) is denied;

2) The taxpayer's request for a refund of $ . . . in retail sales tax assessed on labor and services related to the construction of the turbine/generators is denied;

3) The taxpayer's request for a refund of the public utility tax assessed in Schedule . . . and the Service B&O assessed in Schedule . . . is granted. The taxpayer shall receive a refund of the taxes and interest paid plus interest on the amount due as provided by RCW 82.32.060.

DATED this 22nd day of June 1988.