Cite as Det. No. 02-0123, 22 WTD 206 (2003)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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. 02-0123
. . .	)	
	)	Registration No. . . .
	)	FY . . . /Audit No. . . .
	)	Docket No. . . .
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	)	Docket No. . . .

RULE 170; RCW 82.04.050(2): RETAIL SALES TAX – LIMITED LIABILITY COMPANY (LLC) -- GENERAL CONTRACTOR — LIABILITY ON LLC PAYMENTS. A general contractor who is a member of a limited liability company (LLC) and who seeks to avoid taxation on a payment it receives from the LLC must establish that the payment was a profit-sharing payment, a pass-through payment deductible in accordance with WAC 458-20-111 (Rule 111), or is otherwise exempt.

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.

Mahan, A.L.J. –A general contractor working for a limited liability company (LLC) engaged in speculative building protests the assessment of retail sales tax and retailing business and occupation (B&O) tax on labor and material costs. The LLC protests the assessment of use tax on payments it contends were not subject to sales tax. They contend the payments to the Contractor were not subject to tax because the contractor was a member of the LLC and it was providing services as an LLC member.[1]

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

ISSUES

1. Was a general contractor providing construction services subject to retail sales tax and retailing B&O tax and, if so, is the measure of the tax all amounts paid by the LLC to the contractor for labor and materials?

2. Were subcontractors working for a speculative builder or were they working on a subcontract basis with the builder's general contractor for purposes of determining retail sales tax and retailing B&O tax liability?

FACTS

Taxpayer . . . . (LLC), a Washington limited liability company, was formed in 1996. Under the terms of an Operating Agreement, it was formed for the purpose of developing and selling single family homes or finished lots on real property located in Washington. Taxpayer . . . (Contractor), an Oregon limited liability company, is a licensed general contractor in Washington and has offices in Oregon and Washington. Under the terms of the LLC's Operating Agreement, the Contractor was specifically identified as a "Contractor Member . . . who will be retained by the Company as a general contractor. . . ." As a Contractor Member, the Contractor was entitled to "5% of net income and gain from operations from any fiscal year."

The LLC also had a Manager (entitled to 45% of net income) and "Unit Holders." The Manager was . . . Company, whose president is [Mr. A]. Mr. [A] is a licensed contractor in [State A] and [State B]. Vendors supplying labor and materials on the project were supervised and directed to differing degrees by both the Contractor and the Manager's president. Any losses were first allocated to the Unit Holders until all capital accounts were reduced to zero and, thereafter, on a pro rata basis to the Manager and the Contractor Member.

In 1996, the LLC and Contractor also entered into a Construction Agreement. Under the terms of this agreement, Contractor was hired to "provide all labor and materials necessary to construct the Subdivision Improvements and the Homes, and supervise course of that work" in return for certain fees. Those fees included a general & administrative fee equal to 1-1/2% of gross sales price, a sales management fee, and a cost savings bonus. The Contractor's duties included, among others, the duty to "negotiate and enter into Subcontract Agreements and Purchase Orders," to "prepare a job schedule for approval by the Owner," to "update the construction schedule each month," and to "maintain full-time supervision of the construction work by means of a field superintendent."

Bank loans provided financing for the development. The LLC, the Manager, and the Contractor all guaranteed payment of the loans. Loan draws were used to pay invoices for labor and materials for the development. At the outset of the development, invoices for labor and materials were variously directed to the LLC and to the Manager for payment. For the most part, after entering into the construction agreement, invoices were directed to the Contractor for payment. To the extent the Contractor or the Manager was invoiced for the work and paid those amounts,

they were reimbursed by the LLC without a mark-up on the invoice amount. All invoices, even those directed to the Contractor, had to be reviewed and initialed by the Manager's president for payment. With limited exception, invoices for labor and materials included sales tax. The Contractor did not provide resale certificates to any vendor.

Both the Contractor and the Manager received fees out of the loan draws. Because the project lost money, neither the Contractor nor the Manager received a profit payment under the terms of the Operating Agreement.

The Contractor had a written "Subcontract" with some subcontractors. For example, a subcontract with a site development subcontractor provided that the work was to be done under the direction of the Contractor. The subcontract agreement also provided a schedule of payments that the Contractor agreed to pay to the subcontractor.

In late 1998, the Contractor ceased working on the project and, in accordance with a letter dated November 5, 1998, a final payment was made by the LLC to the Contractor. Under the terms of this letter, the Contractor agreed to release its right to 5% of the net income as a Contractor Member of the LLC upon a refinancing of the loan and elimination of personal guarantees by the Contractor.

The Department of Revenue (Department) audited the LLC's records for the May 10, 1996 through September 30, 1999 period and issued a deficiency assessment against the Contractor. The Contractor was assessed retail sales tax and retailing B&O tax on all loan draws for work on the development. It was given credit for tax paid at source on subcontract payments that included sales tax. The Department issued a "protective" assessment against the LLC for use tax in an amount corresponding to the retail sales tax assessed against the Contractor for the 1996 period. On June 21, 2001, the Department issued a Post Assessment Adjustment (PAA) giving the Contractor credit for labor and material costs included in the original assessment, but which had been paid by the LLC or the Manager prior to the Construction Agreement between the Contractor and the LCC and for sales expenses.

To the extent that relief is not granted on other grounds, the taxpayer contends that approximately 50% of amounts classified by the Department as additional loan funds and subject to retail sales tax were for public road construction and, accordingly, should be reclassified.

ANALYSIS

Retailing B&O tax is imposed upon persons engaging in the business in this state of making sales at retail. RCW 82.04.250. Washington also imposes a retail sales tax upon each retail sale in this state. RCW 82.08.020. The term "sale at retail" or "retail sale" is defined in RCW 82.04.050. Generally, sales of tangible personal property and certain services to consumers are retail sales. Specifically included in the term are sales of services rendered in respect to the constructing of buildings or other structures on real property of or for consumers. RCW 82.04.050(2).

WAC 458-20-170 (Rule 170) is the Department's administrative rule implementing the statute as it applies to construction services. Under Rule 170(2)(a), the term "speculative builder" is defined to mean "one who constructs buildings for sale or rental upon real estate owned by him." Rule 170(2)(a). The LLC was clearly a speculative builder. The LLC constructed buildings for sale on land owned by the LLC. In general, speculative builders must pay sales tax upon all materials purchased by them and all charges made by contractors or subcontractors. Rule 170(2)(e). Under Rule 170(1)(a), the term "prime contractor" is defined to mean "a person engaged in the business of performing for consumers, the constructing, repairing, decorating or improving of new or existing buildings or other structures under, upon or above real property, either for the entire work or for a specific portion thereof." Prime contractors are taxable under the retailing classification and must collect retail sales tax from the consumers of their services. Rule 170. At issue in this case is whether the Contractor was acting as a prime contractor and was liable for tax on the amounts it received from the LLC both for services it performed for the LLC and for payment of third-party costs.

In analogous cases involving joint ventures and partnerships, if a joint venturer or a partner has an absolute right to payment for services rendered to a joint venture or partnership, that is, the payment is not based on any right to profit or gain, the payment is subject to tax. *See* Excise Tax Advisory 073.08.1062 (ETA 73); Det. No 90-174, 9 WTD 143 (1990); Det. No. 01-028, 20 WTD 514 (2001).[2]

As stated in ETA 73:[3]

> [P]artners are considered as third party service providers to the partnership of which they are a member when the obligation of the partnership to pay for such services is "absolute" or fixed, and exists independently of any right to profit or gain. Where a partner has no right to any payment unless some profit or gain exists, the payment is not absolute and therefore not subject to tax.

Accordingly, partners will be considered third party service providers to the partnership, of which they are members, when the partnership has an "absolute" or fixed duty to pay for such services and that duty exists independently of any right to profit or gain. When a partner has no right to any payment unless some profit or gain exists, the payment is not absolute and, therefore, it is not subject to tax.

Det. No. 90-174 concerned income received by a general contractor that worked on real estate

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[2] *See also* Rule 170(2)(f), which provides: "[p]ersons, including . . . joint ventures, among others, who perform construction upon land owned by their . . . co-venturers, etc., are constructing upon land owned by others and are taxable as sellers under this rule, not as 'speculative builders.'"

[3] ETA 73 involved a case wherein a partnership was assessed sales tax on payments it made to one of its members for equipment furnished by that member to the partnership. In that case, it was determined there was not an "absolute" right to payment under the rental contract and, therefore, the reimbursement to the partner was not taxable.

developments in which it was a joint venturer. With respect to construction draws received by the general contractor, we held the taxpayer was liable for retailing B&O and retail sales taxes if the taxpayer had a right to payment, which existed independently of its right to share profits. We reasoned:

> Taxpayer is subject to retailing B&O tax, and these amounts are subject to retail sales or use tax, as would be any other provider of materials or services, if taxpayer has a right to payment of those amounts that exists independently of its right to share in the profits.
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> . . .
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> Here, when taxpayer receives money from the partnership, by way of the construction draw, that is not in proportion to its ownership interest, for services it has performed, it is acting as a third-party service provider and taxable on that income.

Had the assessment at issue in the present case involved the 5% net income payments to the Contractor as a Contractor Member under the LLC's Operating Agreement, we would find such payments not taxable. However, the present case involves payments made in accordance with the terms of the Construction Agreement between the Contractor and the LLC for services rendered by the Contractor. Under the terms of that agreement, the Contractor had an absolute right to payment for services it performed. Those payments were independent of its right to share in profits of the LLC.

The Contractor received payments or reimbursements under the taxpayer's accounts for "Indirects" including for "supervision" and other costs and under "General & Administrative" expenses. Although the taxpayers have argued that certain "Indirects" involved reimbursement of partnership expenses rather than payment for services, the taxpayers have not met their burden of proof in this regard. For example, some indirect expenses involved the purchase of furniture for a construction trailer and the Contractor retained those items when it left the project. As to reimbursements for general and administrative expenses, in addition to the general and administrative fees provided for under the terms of the construction contract and paid to the Contractor, those amounts included fees paid to the Manager. The Contractor is not liable for tax on fees paid to the Manager.[4] In all other respects the Contractor is liable for tax on amounts disbursed under the accounts for "Indirects" and "General and Administrative" expenses. To the extent the Contractor received fees for its services under accounts for "Supervision and Labor" (. . .) or for "Overhead Costs – contractors fees" (. . .), it would be liable for such payments as well.

Although the Contractor was a member of the LLC, which was acting as a speculative builder, the Contractor was subject to retailing B&O tax and retail sales tax on the reimbursement amounts it received under its agreement with the LLC to act as general or prime contractor. It

[4] To the extent the Contractor was assessed tax on the amounts paid to the Manager, the case will be remanded for adjustment.

was acting as a third-party service provider and was taxable on that income.

The next issue involves whether the retailing B&O tax and sales tax imposed on the Contractor properly included amounts paid by the LLC to the Contractor to reimburse it for amounts the Contractor paid to subcontractors for labor and materials. In the context of partnerships, an issue arises whether a subcontractor is working as a partner or as a general contractor when it pays subcontractors. For example, in Det. No. 90-74 we reasoned:

> In this case, the Audit Division believed that taxpayer was acting as a prime contractor for the partnerships. For the most part, we believe that such a conclusion is in error. The taxpayer was supervising and managing, in the capacity of a partner, construction activities upon land owned by the partnership of which it was a member. To the extent that the taxpayer was not receiving consideration for its efforts, the taxpayer was acting as a partner in the partnership, and had no right to any payment as anything but as a partner.
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> . . .
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> Under these circumstances, when taxpayer is paying third-party providers for services rendered to the partnership, the taxpayer is acting as a partner and not as a prime contractor, and the money is not attributable to it.

More recently, in Det. No. 01-028, 20 WTD 514 (2001) we held:

> When one of the joint venturers is a construction contractor, there may be a question whether it obtained materials and subcontractor services as a prime contractor, or obtained them in the capacity of a partner. See Det. No. 90-74, 9 WTD 143 (1990); Det. No. 87-254, 3 WTD 431 (1987); Det. No. 86-296, 2 WTD 19 (1986); Excise Tax Advisory (ETA) 73.08.106; Rule 170(f).
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> The facts presented are consistent with the Audit Division's resolution of this question. [Fs] Construction treated the transactions with third parties as purchases by the joint venture rather than purchases by itself as a prime contractor. It did not give the sellers resale certificates, which would have been appropriate had it considered itself a prime contractor. Rather, it followed a pattern of paying retail sales tax on the purchases, out of the joint venture's loan funds. The facts are similar to those in Det. No. 90-74, supra, in which a general contractor was found to be acting on behalf of a joint venture, of which it was a member, when it incurred and paid third-party expenses.

The determination further recognized that "Since joint venturers are jointly and severally liable for everything chargeable to the joint venture, [Mr.] and [Mrs. B.] were jointly and severally liable for any unpaid retail sales tax obligation of the joint venture." *Id.*

The facts in the present case are similar in many respects to those in Det. No. 90-74 and Det. No. 01-028. The Contractor treated transactions with third parties as purchases by the LLC rather

than purchases by itself as a prime contractor. It did not give vendors resale certificates and, instead, followed a pattern of paying retail sales tax on the purchases. In other words, it did not treat the purchases of labor and materials as being for resale to the LLC. Further, the Manager had to authorize payment of all invoices, including those that were paid by the Contractor out of its own funds. When the Contractor or Manager paid an invoice, it was then reimbursed by the LLC without mark-up. The Contractor was also liable for losses by the LLC and was a guarantor on the LLC's bank loan.

However, there are dissimilarities as well. The present case involves an LLC, not a partnership. As a member of the LLC, the Contractor would generally not be jointly and severally liable for unpaid retail sales tax. *See* RCW 25.15.125. Whereas partners are considered agents of the partnership when conducting partnership business (*see* RCW 25.04.090), we find no similar provision for a member of an LLC. In accordance with the terms of the construction agreement in this case, the Contractor also entered into written subcontract agreements with third-party subcontractors. Such evidence indicates the Contractor was not acting merely as a member or agent of the LLC.

Given these dissimilarities, we cannot simply apply the rulings in Det. No. 90-74 and Det. No. 01-028 to the present case. Rather, we hold that a taxpayer who is a member of an LLC and seeks to avoid taxation on a payment from the LLC must establish that the payment was either a profit-sharing payment, a pass-through payment deductible in accordance with WAC 458-20-111 (Rule 111), or is otherwise exempt. The taxpayer was not previously afforded the opportunity to demonstrate whether a payment should be treated as an advance or a reimbursement.

Accordingly, the case will be remanded to the Audit Division. On remand, the taxpayers can present evidence on whether any payment to the Contractor should be considered a pass-through payment. The taxpayers can also produce evidence to support their claim that certain amounts identified in the LLC's accounts as additional loan funds were in fact for public road construction. Further, to the extent that the Contractor can show that the Department inadvertently assessed tax on payments by the LLC to another service provider (e.g., by the LLC to the Manager), the assessment should be adjusted accordingly.

DECISION AND DISPOSITION:

The taxpayers' petitions are granted in part and denied in part. The case is remanded to the Audit Division for adjustment in accordance with this decision.

Dated this 26th day of July, 2002