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Sales Tax Exposure on Hybrid Agreements for Construction and Consulting Activities

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Retail sales tax is a primary revenue source for Washington. It was no surprise that the state legislature responded to the ongoing budget crisis by passing revenue enhancements in 2009 and 2010 granting the Washington State Department of Revenue (DOR) additional resources with which to conduct audits and improve compliance with existing tax laws. Compliance auditing allows the government to generate revenue without increasing a taxpayer's underlying liability. If an audit indicates that certain income should have been subject to retail sales tax, the DOR will reclassify all of that income, assess the appropriate amount of sales tax, and charge penalties and interest on the amount of past-due tax. Design professional and environmental consultants need to be particularly aware of this new DOR focus – a reclassification that results in the application of sales tax as opposed to the business and occupation (B&O) tax can have significant financial consequences.

Hybrid agreements encompassing both construction and consulting activities are potentially susceptible to reclassification, if retail sales tax was not initially collected. Ordinarily, construction activities and related services are taxable as retail sales, while consulting and engineering services are subject only to the B&O tax.

When must an engineering firm collect Washington sales tax on contracts under which consulting and construction services are performed?

According to the tax statute, the answer depends on which activity was "predominant." Properly identifying the predominant activity is, therefore, crucial to ensuring compliance with Washington's tax laws.

This article introduces general precepts that design professionals and environmental consultants should keep in mind when determining whether to collect sales tax on a contract that has a construction component. Because the DOR has previously recognized that this can be a thorny issue for the environmental consulting industry in particular, the article includes a special focus on environmental remediation contracts.

Each taxation inquiry is contract-specific, so we recommend you consult your attorney

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regarding specific factors relevant to a particular contract.

Sales Tax Must Be Collected on Sales of Services Rendered in Respect to Construction

Sales tax is assessed on all retail sales, as well as on any contract in which the "predominant" activity is classified as a retail sale. The term "retail sale" is very broadly defined to encompass sales of certain services, including "services rendered in respect to" – that is, services directly related to – the construction of structures.[1] The term includes any earthmoving activities. The statutory definition of "services rendered in respect to construction," does not, however, include engineering and consulting services provided to the consumer of the constructing services.[2] These professional services are subject only to the B&O tax. Any contract for both engineering services and construction activity is subject to the tax that applies to the predominant activity.[3]

Determining the Predominant Activity under a Contract

The DOR has conceded that "the line is not always clear as to whether a transaction is a sale or a service."[4] Given the lack of a clear dividing line between sales and services, the DOR has advised that "[t]he examination must focus upon the real object of the transaction sought by the taxpayer's customers and not just its component parts."[5]

The Department's prior tax decisions provide guidance in interpreting the term "predominant activity." DOR precedents establish that the predominant activity under a contract is the activity of greatest importance in relation to the business being conducted. The predominant activity is not necessarily the costliest activity under the contract. Nonetheless, if the most expensive line item on a firm's project budget relates to construction, the DOR may assume that construction is also the "predominant activity" and, on that basis, impose sales tax on the entirety of receipts under the contract.

It is important for the taxpayer to understand that nothing in the tax statute mandates that the term "predominant activity" be defined solely in quantitative terms. Rather, an activity can achieve predominance by other measures. The DOR has recognized the inherent flexibility of the term "predominant" and has espoused the dictionary definition of that term, stating that "[u]nder common usage, the term predominant is not defined solely in quantitative terms. It means, among other things, as having "greatest ascendancy, importance, influence, authority, or force."[6] In order to give effect to the natural reading of the term "predominant activity," the DOR has prescribed: "In identifying the predominate activity we must look to the activities of greatest importance in relation to the business being conducted."[7] Importantly, the DOR has also acknowledged that in certain circumstances, the lesser activity may be predominant.[8] The bottom line is that the test employed by the DOR is subjective; it is applied from the standpoint of the intent of the consultant's client.

Additional Guidance for Activities Commonly Performed under Environmental Remediation Contracts

In 2003, the DOR recognized that environmental remediation contracts frequently include both consulting services and construction activities. The DOR issued a special notice confirming that such environmental remediation contracts are subject to the general statutory rule requiring hybrid contracts to be taxed according to the "predominant activity" under the contract.[9] The special notice provides examples of service activities that are subject only to the B&O tax, as well as examples of retail activities for which sales tax must be collected from the consumer:

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Service Activities
Monitoring
Treating groundwater
Waste disposal
Testing
Surveying
Engineering and design services
Consulting
Planning Services
Other activities not elsewhere defined in Chapter 82.04 RCW

Retail Activities
Repairing, improving, or cleaning an existing building or structure
Razing an existing building or structure
Removing underground storage tanks
Installing a cap over contaminated soil
Cleaning contaminated soil, when performed in conjunction with the razing and/or construction of a building or structure, such as a dry cleaner or gas station.

The DOR's special notice states that remediation of contaminated soil in connection with the demolition of a gas station or dry cleaner, or with the removal of underground storage tanks, is considered a retail sale.

Recommendations

Ambiguities regarding the applicability of the retail sales tax can be minimized if the client contracts directly with the construction contractor. If, however, the client prefers to execute one contract with the engineering consultant and have the consultant subcontract with the construction contractor, then it would be prudent to discuss the sales tax implications of such an arrangement prior to entering into the contract. The discussion should include identifying the activity of greatest importance to the client. Subsequently, the project manager should ensure that the firm's contract administrator and accounting department all share an accurate and consistent understanding of the object of the contract and the goals of the client.

If a firm is audited by the DOR and questions arise as to the identity of the predominant activity, it is incumbent upon the consultant to explain the client's initial goals and reasons for hiring the consultant. A consultant seeking to establish that the predominant activity was engineering or consulting services may need to provide considerable background information in order to give appropriate context to the contract and ensure that the DOR is sufficiently able to evaluate the taxpayer's position. For example, where a consultant undertakes the cleanup of a contaminated site but does not raze or construct a structure, any construction activity that was merely incidental to the remediation arguably would not be the predominant activity for tax purposes. In that case, the consultant may wish to describe the decision-making process that led to the selection of the remedial action and the manner in which the construction activity facilitated the cleanup. Documents in the project file, such as correspondence with the client and any insurance company, may plainly show that the client's overriding objective was to remediate soil. If the work was done under the auspices of the Department of Ecology's Voluntary Cleanup Program, correspondence with Ecology and any reports prepared by the consultant may also serve as objective support for the position that the client's goal was to obtain a "no further action" determination from Ecology, rather than to construct an improvement.

Tax issues are notoriously complicated to begin with, but they are even more complicated when questions arise about work performed in the past. The best time to address the retail sales tax question is during the negotiation of the contract with your client. If you are contemplating a contract that involves a combination of construction and consulting activities, take a moment to consider whether retail sales tax must be assessed on the contract amount.

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[1] RCW 82.04.050(2)(b).

[2] RCW 82.04.051(1).

[3] RCW 82.04.051(2).

[4] Wash Dept. of Revenue, Det. No. 98-202, 19 Wash. Tax. Dec. 771 (2000).

[5] Id.

[6] Wash. Dept. of Revenue, Det. No. 99-011R, 19 Wash. Tax Dec. 423 (2000) (citing Webster's II New Riverside University Dictionary, 927 (1988)).

[7] Id.

[8] Id. (citing with approval a Washington Supreme Court case holding that the lesser activity may be predominant).

[9] The Special Notice published June 23, 2003, entitled "Environmental Remedial Action Sunsets" was issued in connection with the expiration of tax incentives for environmental remedial action. Specifically, a reduced B&O rate and sales tax exemptions for remedial actions that had been in effect since 1998 no longer applied after June 30, 2003. The special notice confirmed that any work done after that date was subject to the same taxes assessed on other consulting engineering and construction services.