Cite as Det. No. 94-154, 15 WTD 46 (1995).

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

In the Matter of the Petition for Correction of Assessment	)	D E T E R M I N A T I O N
	)	No. 94-154
(Taxpayer A)	)	Registration No. . . .
	)	FY. . ./Audit No. . . .
(Taxpayer B)	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

[1] RULE 170; RCW 82.04.050, RCW 82.04.190: SPECULATIVE BUILDERS -- RETAIL SALES TAX -- USE TAX -- OWNERSHIP OF PROPERTY. When determining "ownership" of real property for purposes of distinguishing between "prime contractors" and "speculative builders," record title is but one of the factors to be considered, together with the "attributes of ownership" set forth in Rule 170(2)(a). Overruling Det. No. 92-204, 12 WTD 391 (1993) to the extent inconsistent herewith.

[2] RULE 106; RCW 82.04.040, RCW 82.04.050: CASUAL OR ISOLATED SALE -- RETAIL SALES TAX. If a seller of tangible personal property is registered or required to be registered with the Department it must collect and remit retail sales tax even if a sale of that property is casual or isolated.

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.

NATURE OF ACTION:

Partnership engaged in business as general contractor protests assessment of retailing business and occupation (B&O) tax and

retail sales tax on income from construction activities characterized as "prime contracting."[1]

FACTS:

Prather, A.L.J. -- In late 1988, Taxpayer A and his son-in-law entered into an oral agreement to form a general partnership, Taxpayer B.[2] The purpose of Taxpayer B was to engage in the speculative construction and sale of new residential homes and to share profits in proportion to their respective interests in the partnership. To this end, Taxpayer B registered with the Department of Revenue (Department),[3] obtained a general contractor's license, opened a partnership checking account,[4] and established and kept partnership books and records.

Taxpayer B attempted to obtain bank financing to purchase lots and construct homes. Taxpayer B was unable to do so, however, because the son-in-law's credit was impaired. To circumvent this problem Taxpayer B's lender agreed to make lot purchase and construction loans to Taxpayer A.[5] Thus, five lots were purchased between June 1989 and September 1990. Since the loans were secured by the lots, only Taxpayer A took title, signed the promissory notes, and granted deeds of trust in favor of the lender.[6] According to Taxpayer A, the only reason the lots were not subsequently conveyed to Taxpayer B was because the deeds of trust contained due-on-sale clauses prohibiting any transfers prior to repayment of the loans.

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

[2]Taxpayer A and his son-in-law are referred to collectively as "the partners."

[3]Taxpayer B registered with the Department and obtained a UBI number in September 1990. However, since the auditor found that Taxpayer B had conducted business during 1989 he changed the open date of the registration to January 1, 1989.

[4]Taxpayer B's banking records indicate that a partnership checking account was opened in March 1989.

[5]The loan officer who handled Taxpayer B's accounts testified that he understood the lots to be partnership assets and that the loans were made to Taxpayer A alone because of the son-in-law's impaired credit.

[6]A copy of a working trial balance maintained by Taxpayer B's bookkeeper indicates that as of the first entries in 1989 the lots were carried on the books as partnership assets.

Before construction began, Taxpayer B paid for and obtained, in its name, the building permits necessary to construct the homes. During construction Taxpayer B hired subcontractors, purchased materials, and paid retail sales tax at the source. Construction draws, although payable to Taxpayer A, were endorsed and deposited directly into Taxpayer B's account and used to acquire the lots and pay the expenses of construction.

In April 1990, the partners executed a written partnership agreement in order to formalize the arrangement under which they had been operating. The agreement provided that "The purpose of the partnership is to conduct a general contracting business in the State of Washington."

By September 1990, three homes had been completed and sold. The proceeds of the sales were first used to repay the loans. The balance was divided by the partners according to their respective interests in Taxpayer B. Real estate excise tax was paid when the homes were sold. During the life of the partnership, Taxpayer B filed federal income tax returns which reflected that the lots and homes were owned by the partnership.

In January 1992, the partners executed an agreement dissolving Taxpayer B, effective December 31, 1991. The dissolution agreement provided that Taxpayer A was to assume all partnership liabilities, including the two remaining loans. In exchange, the son-in-law released his interest in the partnership and executed quit claim deeds in favor of Taxpayer A for the two unsold homes.

Taxpayer A's books and records were audited by the Department for the period January 1, 1988, through March 31, 1992. At the same time Taxpayer B's books and records were audited for the period January 1, 1989, through March 31, 1992. The audits resulted in assessments of retailing B&O and retail sales tax against Taxpayer B measured by the full contract price of the homes constructed. A use tax assessment, in like amount, was issued against Taxpayer A. In both assessments credit was given for retail sales tax paid at the source by Taxpayer B and for real estate excise tax paid when the homes were sold.

The assessments were based upon the Department's conclusion that Taxpayer B was a prime contractor which had performed custom construction services for the owner of the properties, Taxpayer A. The Department relied on the fact that Taxpayer A held record title to the lots and that the funds for lot acquisition and construction were drawn from loans made solely to Taxpayer A. The partners, on the other hand, contend that Taxpayer B was a speculative builder because it owned the lots and constructed the homes.

The Department also assessed retail sales tax on a sale in 1992 of a small truck owned by Taxpayer B. The record does not reflect to whom the truck was sold or why. The auditor concluded that the sale was made to a consumer and, therefore, was subject to retail sales tax. The partners contend that the sale is exempt from retail sales tax as a casual or isolated sale because Taxpayer B was not engaged in any other retail sales.

Both taxpayers appealed the assessments and, for convenience and economy, their joint request to consolidate the appeals was granted.

ISSUES:

1. Whether a partnership engaged in business as a general contractor can be deemed the "owner" of the lots upon which it constructed homes when record title was held by one of its partners?

2. Whether the casual and isolated sale of a truck owned by a partnership engaged in business as a general contractor is subject to retail sales tax even though the partnership is not otherwise engaged in retail sales?

DISCUSSION:

RCW 82.08.020 imposes a tax upon every retail sale which occurs in this state. A retail sale, as defined in RCW 82.04.050, includes:

> . . . the sale of or charge made for tangible personal property consumed and/or for labor and services rendered in respect to the . . . constructing . . . of . . . buildings or other structures under, upon, or above real property of or for consumers, . . .

Insofar as the construction of improvements upon real property is concerned, RCW 82.04.190(4) defines the term "consumer" as:

> Any person who is an owner, lessee or has the right of possession to or an easement in real or personal property . . . .

These statutes are implemented by WAC 458-20-170 (Rule 170). Under Rule 170, one's status as either a "speculative builder" or "prime contractor" determines the tax result. Rule 170 distinguishes between speculative builders and prime contractors by looking to the "ownership" of the underlying real property. Speculative builders perform construction upon real property owned by them and are the consumers of the labor and materials purchased for the construction. Speculative builders must pay retail sales tax on all tangible personal property and labor

purchased for the project from third party providers. In contrast, prime contractors perform construction upon real property owned by others, either for the entire work or for a specific portion. They must collect retail sales tax from the owner (consumer) measured by the full contract price.

"Ownership" of the underlying real property is also the determining factor under Rule 170 in cases involving construction by partnerships upon land owned by the partners. For example, Rule 170(2)(f) provides in part:

> . . . partnerships . . . who perform construction upon land owned by their partners, . . . are constructing upon land owned by others and are taxable as sellers [prime contractors] under this rule, not as "speculative builders."

(Bracketed material ours.)[7]

In the Department's view we need only apply Rule 170(2)(f) in order to reach the proper result, since Taxpayer A held record title to lots upon which Taxpayer B constructed homes. Our research discloses that some support for this position can be found in Det. No. 92-204, 12 WTD 391 (1993). In that case, the taxpayer purchased undeveloped land to subdivide and sell to builders. With respect to three of the transactions, the builders were unable to obtain financing from commercial lenders. Accordingly, the taxpayer and each builder entered into written construction loan agreements under which the taxpayer provided financing. The taxpayer retained title to the lots until the finished homes were sold to third parties. The agreements provided that upon sale the taxpayer would be entitled to $30,000 of the gross proceeds from the sale of each house and that the builders would be entitled to the difference between that sum and the gross sales price after repayment of the construction loans. Following an audit the Department determined that the taxpayer was a speculative builder constructing upon real estate owned by it and assessed use tax based on the loan amounts it provided to the builders. In upholding the Department we said:

> We do not need to determine what, if any, interest the builder had in the properties to resolve this appeal. We note at all times the taxpayer retained record title and enough possessory interests in the properties to be an owner.

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[7]The Department does not dispute the existence of the partnership from the inception of the relationship, that the partnership performed the construction at issue in this case, or that the partnership handled borrowed funds as partnership assets. Therefore, it is not necessary for us to consider the guidelines set forth in Det. No. 87-93, 2 WTD 411 (1987).

> See Reliable Builders, Inc. v. Department of Revenue, Docket No. 17074 (1978) where the Board of Tax appeals rejected an argument that record title should be disregarded in favor of an implied trust or agency in others. The Board held the substantive ownership interest in land was a matter of record and notice to the whole world. For tax purposes ". . . this is the decisive and sole factor to be considered herein. The actual acquisition of title by deed . . . clearly constitutes ownership under Rule 170.

Det. No. 92-204 relied in large part upon the Board of Tax Appeals (Board) decision in Reliable Builders, supra. In that case a corporation secured the right to purchase building lots by executing earnest money agreements. The corporation's lender, however, insisted that the shareholders, individually, obtain the lot acquisition and construction loans and take title to the lots. And so it happened, except that thereafter the lots and the improvements were carried as assets on the books of the corporation. Construction funds, as advanced, were turned over to the corporation, which paid all lot acquisition and construction costs and, upon the sale of each completed home, paid off the lender and retained the profits as its own. Following an audit, the Department taxed the corporation as a retail seller of construction labor and materials to the shareholders, in whose name the lots were purchased and held, rather than as a speculative builder making excise tax exempt sales of its own improved realty.

As noted above, the Board held that record title was the sole determining factor in identifying the "owner" of the property for purposes of Rule 170. The Board quoted the following language from the Final Determination which formed the basis of the appeal:

> All of the facts and arguments postulated on behalf of the taxpayer, though indicative of a close business relationship between the taxpayer and its officers/stockholders, still do not alter the conclusion that for all legal purposes the taxpayer had no substantive ownership interest in the land.
>
> We recognize the validity of much of the case law authority cited for establishing rights and liabilities between litigant parties to an oral agreement for acquisition of land. Such cases, however, are inapposite to the issue here. Rather, the Revenue Act and Rule 170 operate upon substantive fact and not what might or might not be established in a contract battle between the parties.

Subsequent to the Board's decision in Reliable Builders, the Department amended Rule 170 to include certain "attributes of ownership" to be used in determining whether one is a "prime

contractor" or "speculative builder."[8] The subsection of Rule 170 to which these attributes were added now provides:

> As used herein the term "speculative builder" means one who constructs buildings for sale or rental upon real estate owned by him. The attributes of ownership of real estate for purposes of this rule include but are not limited to the following: (i) The intentions of the parties in the transaction under which the land was acquired; (ii) the person who paid for the land; (iii) the person who paid for the improvements to the land; (iv) the manner in which all parties, including financiers, dealt with the land. The terms "sells" or "contracts to sell" include any agreement whereby an immediate right to possession or title to the property vests in the purchaser.

[1] We view the amendment as a clear indication by the Department that record title alone is not, by itself, to be considered determinative of real property "ownership" for purposes of Rule 170. If record title alone were the sole criterion by which ownership is to be measured, then the addition of the attributes of ownership to the rule would be rendered meaningless.

Furthermore, in order to remain consistent with the statutes it implements, the amendment to Rule 170 was inevitable. For example, RCW 82.04.050 requires only that we identify the "consumer" of the construction services in order to determine the proper tax result. The word "owner" does not appear in the statute at all. RCW 82.04.190(4), however, defines "consumer" to include owners, lessees, possessors, and easement holders, but makes no mention of record title as a determining factor. It is apparent that the legislature did not intend the status of consumer to be determined solely by whether one holds record title to the underlying real property. Had the legislature intended otherwise, it could have easily said so.

In a decision following the amendment of Rule 170, but predating our decision in Det. No. 92-204, we acknowledged that record title alone was not the sole factor to be considered in determining whether someone is an "owner" of real property in construction cases:

> The Department of Revenue will look behind mere title of record to see who owns the land upon which construction is being done, as a matter of substantive law and fact. The attributes of ownership now included in Rule 170 have been relied upon since as early as 1972 for determining the tax consequences of construction work upon real property. The

[8]The amendment became effective March 15, 1983.

> reason these criteria are valuable is because a person can hold title to something which it does not own.

Det. No. 85-231A, 1 WTD 309 (1986). (Emphasis added.)

We believe the decision in Det. No. 85-231A is persuasive. It occurred after the amendment of Rule 170 and considered the attributes of ownership on par with record title. Det. No. 92-204, on the other hand, relied upon a decision of the Board which not only predated the amendment of Rule 170, but which contained a statement regarding the conclusive effect of record title which is no longer an accurate statement of the law. Although our decision in Det. No. 92-204 did consider the attributes of ownership set forth in Rule 170, and would have been decided as it was without reliance upon the Board's decision in Reliable Builders, we must lay to rest any notion that record title alone is the "decisive and sole factor to be considered" in determining ownership under Rule 170.

With respect to determining ownership, therefore, we hold that RCW 82.04.050, RCW 82.04.190(4), and Rule 170 demand an analysis more rigorous than a simple search for the holder of record title; one that weighs all of the facts and circumstances of the particular case in order to identify the "consumer" of construction labor and materials. We further hold that record title is but one of the factors to be considered in identifying the "owner" of real property in construction cases and must be considered in conjunction with the attributes of ownership set forth in Rule 170(2)(a). To the extent Det. No. 92-204 is inconsistent with our holding, it is overruled.

Applying the attributes of ownership to the facts of the instant case, we conclude that Taxpayer B was the owner of the lots and should be treated as a speculative builder, despite the fact that record title remained in Taxpayer A: (1) The lots were acquired with the intention that they become partnership property. Only the presence of due-on-sale clauses in the deeds of trust prevented conveyances to the partnership; (2) the partnership paid for the lots since the borrowed funds used to purchase them were owned by the partnership; (3) by the same reasoning the partnership paid for the improvements to the lots; and (4) the partners and their lender dealt with the lots and improvements as partnership assets.

In reaching this conclusion we have considered all of the facts and circumstances surrounding the relationship between the taxpayers, from the inception of the partnership to its ultimate demise. The following acts, undertaken solely by the partnership, are consistent with these intentions: registering with the Department; obtaining a general contractor's license; establishing a partnership bank account; establishing and maintaining partnership books and records; obtaining and paying

for building permits; carrying the lots on the books as partnership assets; carrying the loans on the books as partnership liabilities; handling borrowed funds as partnership assets; taking possession of and constructing homes on the lots; hiring and paying subcontractors and suppliers; paying retail sales tax at the source on all construction-related purchases; paying real estate excise tax on sales of finished homes; and filing federal partnership tax returns in which the lots and homes were characterized as partnership assets. In addition, the partners shared profits and losses and divided assets and liabilities upon dissolution in proportion to their respective interests in the partnership.

It is clear that Taxpayer A and his son-in-law intended to, and did, form a partnership to acquire the lots and construct and sell the homes. It is equally clear that the partnership acquired substantive ownership rights in and to the lots and homes. We cannot ignore either the legal relationship which existed between the taxpayers, or the rights and responsibilities which resulted from that relationship. Accordingly, the retailing B&O tax, retail sales tax, and use tax assessments are cancelled.[9]

With respect to Taxpayer B's sale of the truck, WAC 458-20-106 (Rule 106) provides in part that:

> A casual or isolated sale is defined by RCW 82.04.040 as a sale made by a person who is not engaged in the business of selling the type of property involved. Any sales which are routine and continuous must be considered to be an integral part of the business operation and are not casual or isolated sales.
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> . . .
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> The retail sales tax applies to all casual or isolated sales made by a person who is engaged in the business activity; that is, a person required to registered under WAC 458-20-101. Persons not engaged in any business activity, that is, persons not required to be registered under WAC 458-20-101, are not required to collect the retail sales tax upon casual or isolated sales.

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[9]One reason the Department examines cases such as this so rigorously is that in some cases prime contractors will attempt to characterize their relationship with the owner as a partnership in order to avoid paying retail sales tax on their profit. However, where, as here, the partners have formed a legitimate partnership and have, in fact, divided the profits in proportion to their respective interests, that concern is minimized.

[2] The Department has long interpreted Rule 106 to mean that as long as the seller is registered, or required to be registered, it must collect and remit the retail sales tax, even if the sale is casual or isolated. See, e.g., Det. No. 89-482, 8 WTD 293 (1989). Here, Taxpayer B's sale of the truck was clearly casual or isolated. However, since Taxpayer B was registered with the Department, it should have collected and remitted the retail sales tax when it sold the truck. Having failed to do so, it is liable to the Department for the amount of the tax. RCW 82.08.080. The assessment of retail sales tax on the sale of the truck is sustained.

DECISION AND DISPOSITION:

Taxpayer's petition is granted in part and denied in part. The assessments of retailing B&O tax, retail sales tax, and use tax are cancelled and this matter is remanded to the Audit Division for any other adjustments necessitated by our finding that Taxpayer B was a speculative builder. The assessment of retail sales tax on the sale of the truck by Taxpayer B, however, is sustained.

DATED this 25th day of August, 1994.