Cite as 2 WTD 275 (1986)

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

In the Matter of the Petition For Correction of Assessment and Refund of	)	D E T E R M I N A T I O N
	)	No. 87-61
	)	Registration No. . . .
. . .	)	Real Estate Excise Tax Assessment dated April 1, 1986
and	)	
	)	Registration No. . . .
. . .	)	Tax Assessment No. . . .

[1] **RULE 170:** SALES TAX -- CONTRACTOR -- SPECULATIVE BUILDER -- ALLOCATION --CLARIFIED.
When speculative builder sells or contracts to sell property upon which he is presently constructing a building, the rule provides that retail sales tax applies to "that portion of the sales price allocable to construction done after the agreement." "Allocable" does not mean "as may be allocated by the parties in their agreement," but refers to the portion of the sales price actually related to construction that occurs after the agreement.

[2] **REAL ESTATE EXCISE TAX:** LEASEHOLD INTEREST -- DEFINITION -- LEASEHOLD IMPROVEMENTS -- OWNERSHIP -- OPTION TO PURCHASE.
Unless the lease provides otherwise, improvements made by a lessee become part of the land upon construction and are owned by the lessor. Thus a transfer by a lessee of its interest in such improvements is the transfer of a leasehold interest and not subject to real estate excise tax unless accompanied by an option to purchase.

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: August 7, 1986

NATURE OF ACTION:

Buyer and Seller of commercial real estate jointly petition for correction of assessment of retail sales tax against Buyer for full value of construction work performed by the Seller pursuant to contract, alleging that the bulk of the construction work was performed by the Seller in the capacity of a speculative builder prior to the sale of the realty.

FACTS:

Rosenbloom, A.L.J. -- At issue is the proper application of retail sales tax to a transaction involving the development and sale in 1982 by . . . to . . . of a commercial real estate project known as the . . . Project (the "Project"). The parties to the transaction are herein referred to as the "Seller" and "Buyer," and collectively as the "Taxpayers." The Project consists of three separate buildings on adjacent parcels of land comprising a full city block in downtown . . . . The . . . and . . . Buildings are on leased land and the . . . Building is on land owned in fee.

The Seller initiated the Project as a commercial real estate development for its own account. In May 1980, the Seller acquired title to the . . . Building site and the lessee's interest under the ground lease for the . . . and . . . sites. The Seller then commissioned plans for rehabilitation and development of the three buildings, which were in a state of disrepair. Detailed construction specifications were completed and construction contracts were entered into between the Seller and its contractors for each building by August 1981. Construction began in the Summer of 1981 and was substantially completed by the Fall of 1982.

In early 1982, the Seller decided to sell rather than hold the Project. On April 30, 1982, the Seller and Buyer entered into

a series of agreements for sale of the completed Project. These agreements consisted of two separate contracts of sale (Sales Agreements), one for the leasehold interest in the two buildings on leased parcels (. . . sites), and one for the fee interest in the remaining parcel (. . . site). There was also a third agreement entitled "Agreement for Development of Property" (Development Agreement).

The Sales Agreements allocated a total purchase price of [approximately $5,000,000] as follows:

[Bldg. A:]

Leasehold Interest in Land		[approximately $1,000,000]
Improvements		[" 500,000]
	Total	[" $1,500,000]

[Bldg. B:]

Leasehold Interest in Land		[approximately $1,000,000]
Improvements		[" 500,000]
	Total	[" $1,500,000]

[Bldg. C:]

Fee Interest in Land		[approximately $1,000,000]
Improvements		[" 1,000,000]
	Total	[" $2,000,000]

The Sales Agreements provided for the Buyer to take possession of the property upon close of escrow.

The Development Agreement covered all three buildings and specified the manner in which the renovation, rehabilitation, and construction of the Project, which was substantially under way, would be completed under the Seller's supervision. The Development Agreement also provided that the Project would be completed on or before December 1, 1982 for a fixed sum of

[approximately $30,000,000], broken down among the three buildings as follows:

[Bldg. A]	[approximately $9,000,000]
[Bldg. B]	[" $7,000,000]
[Bldg. C]	[" $13,000,000]

These amounts were in addition to the amounts specified in the Sales Agreements, and represented the guaranteed price to the Buyer of the completed Project improvements. It also included certain amounts for initial leasing commissions ($ . . .) and tenant improvements ($. . .), which the Seller agreed to complete to achieve initial lease up.

The various conditions to closing under the Sales Agreements were satisfied by the end of May 1982, and on June 2, 1982, . . . conveyed record title to the real estate to the Buyer. From and after this date, the Buyer was the record owner and, pursuant to the Sales Agreements, was entitled to possession of the Project. The Seller, as developer, completed the remainder of the construction work. As previously noted, substantial completion of the Project occurred in the Fall of 1982, although tenant improvement work and other items for which the Seller remained responsible under the Development Agreement continued through 1983.

At the time record title was conveyed, the Seller remitted real estate excise tax measured by the consideration ($ . . .) allocated to the fee interest in the land and the improvements on the . . . Building site.

The Seller did not collect or remit retail sales tax from the Buyer on any portion of the consideration paid for the Project, either under the Sales Agreements or the Development Agreement. However, pursuant to its contracts with the two general contractors actually performing the construction work, the Seller did pay retail sales tax on its construction costs, both before and after June 2, 1982.

On April 1, 1986, the Department's Property Tax Division issued a real estate excise tax assessment against the Seller. The Property Tax Division determined that real estate excise tax was due on $ . . . , which is the total consideration paid under the Sales Agreements and Development Agreement less the amounts allocated in the . . . site Sales Agreement to the

value of the leasehold interest in the land. The assessment provided further:

> However, due to a pending audit by our Excise Tax Unit, full payment is not due at this time. We are at this time assessing real estate excise tax based on the following breakdown:
>
> Sale of Buildings Prior to Improvements:
>
> | | |
> |---|---|
> | [Bldg. A] | $ . . . |
> | [Bldg. B] | . . . |
> | [Bldg. C] | . . . |
>
> Sales of Land Prior to Improvements:
>
> | | |
> |---|---|
> | . . . | $ . . . |
> | Value of Improvements as of 6/2/82: | . . . |
> | TOTAL | $ . . . |
> | REAL ESTATE EXCISE TAX (.0104) | . . . |
> | LESS AMOUNT PAID | . . . |
> | SUBTOTAL | . . . |
> | DELINQUENT PENALTY FROM 6/2/82 (46%) | . . . |
> | TOTAL | $ . . . |

The Property Tax Division accepted the Seller's statement that 64 percent of the construction had been completed as of the date that record title was conveyed to the Buyer. Thus, the item identified above as "Value of Improvements as of 6/2/82" represents the consideration for the Development Agreement ($ . . .) less initial leasing commissions ($ . . .) multiplied by 64 percent. (Incidentally, the author of this Determination derives $ . . . from this computation.) In other words, pending the outcome of the excise tax audit, the Property Tax Division agreed to treat 64 percent of the value of the construction work performed under the Development Agreement as a sale of real estate subject to the real estate excise tax.

Meanwhile, the Excise Tax Division determined that retail sales tax was due on the entire consideration for the Development Agreement less initial leasing commissions (i.e., $ . . .), and issued an assessment which included retail sales tax measured by that amount against the Buyer.

TAXPAYERS' EXCEPTIONS:

The taxpayers contend that the transaction involving the sale of the Project should be "bifurcated" for tax purposes such that the value of that portion of the Project which was completed prior to June 2, 1982 is treated as subject to the real estate excise tax and the portion of the Project's value constructed after the sale is treated as subject to the retail sales tax. The taxpayers assert that the Project was 64 percent complete as of that date. Thus, the taxpayer's position is that 36 percent of the consideration for the Development Agreement less initial leasing commissions is subject to retail sales tax (. . .).

The taxpayers argue further that the Seller is entitled to a refund of all retail sales tax paid by it to general contractors and subcontractors with respect to the Project after June 2, 1982.

Finally, the taxpayers assert that the retail sales tax deficiency should not have been assessed against . . . . " . . . " is not a legal entity but a trade name of the Buyer. Furthermore, the Seller is willing and able to pay any additional amount of retail sales tax found due, and so it is an abuse of discretion for the Department to proceed directly against the Buyer for payment of the tax. Accordingly, any retail tax deficiency should be issued against the Seller who would then be entitled to a credit for retail sales tax paid to its contractors following sale of the property. (No such credit was allowed in the assessment issued against the Buyer.)

DISCUSSION:

WAC 458-20-170 provides in part:

> SPECULATIVE BUILDERS. As used herein the term "speculative builder" means one who constructs buildings for sale or rental upon real estate owned by him. . . . 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.
>
> Amounts derived from the sale of real estate are exempt from the business and occupation tax. (RCW 82.04.390). Consequently, the proceeds of sales by speculative builders of completed buildings are not subject to such tax. Neither does the sales tax apply to such sales, since such a sale involves no charge made for construction for a consumer but the price paid is for the sale of real estate.
>
> However, when a speculative builder sells or contracts to sell property upon which he is presently constructing a building, all construction done subsequent to the date of such sale or contract constitutes a retail sale and that portion of the sales price allocable to construction done after the agreement shall be taxed accordingly. Consequently the builder must pay business and occupation tax under the retailing classification on that part of the sales price attributable to construction done subsequent to the agreement, and shall also collect sales tax from the buyer on such allocable part of the sales price.

The Seller was a speculative builder at the outset but sold or contracted to sell the Project during the course of construction. Thus, the question is this: What portion of the sales price is allocable to construction done after the agreement and therefore subject to retail sales tax?

The theory represented in the excise tax assessment is essentially as follows. The Seller and Buyer made their own allocation contractually by entering into the Sales Agreements, which conveyed the buildings and fee or leasehold interests to the underlying land, and separately entering into a Development Agreement, which provided for the rendition of construction services. In short, the auditor determined that the consideration for the Sales Agreements established the value of the Project including all improvements as of the date of sale, while the consideration for the Development Agreement less initial leasing commissions, represented the selling price of construction work to be performed subsequent to the date of sale. The auditor therefore refused to look beyond these contracts to determine the amounts subject to tax.

We disagree with this analysis. First, the transaction must be taxed according to facts which exist at the time of conveyance, not what the parties intend or specify by agreement. WAC 458-20-170 provides:

> When a speculative builder sells or contracts to sell property upon which he is presently constructing a building, all construction done subsequent to the date of such sale or contract constitutes a retail sale and that portion of the sales price allocable to construction done after the agreement shall be taxed accordingly.

[1] The term "allocable" does not mean "as may be allocated by the parties in their agreement." Rather, it refers to the portion of the sales price actually related to construction that occurs after the agreement as determined by some reasonable and verifiable method, such as an allocation of construction costs. Otherwise, the parties could "allocate" a disproportionately large part of the sales price to construction done prior to the agreement in an attempt to avoid their proper retail sales tax liability. Certainly, the Department will not hesitate to look beyond their contracts for the amounts subject to tax where the parties attempt such an artifice.

The agreements at issue do not purport to make any allocation between construction work performed before and after the sale. The only allocation made is to break down the cost of the Project into its basic components: land, unimproved buildings, and rehabilitation improvements. The taxpayer represents, and there is no evidence to the contrary, that this breakdown was essential to both parties for financial accounting and tax purposes to establish, among other things, (i) the value of the portion of the property that is nondepreciable, (ii) the value of the portions that are depreciable, and (iii) the initial basis in the unimproved buildings in order to determine whether the rehabilitation was "substantial" for federal income tax purposes.

Furthermore, even if the agreements purported to allocate as between pre-sale and post-sale construction, the allocation would be patently unreasonable. The taxpayer has represented that rehabilitation of the buildings was 64 percent complete as of the date of sale. The Department has not conceded the accuracy of this figure (though it was accepted by the Property Tax Division for the limited purposes of their provisional real estate excise tax assessment). However, it

is apparent from all accounts that a substantial portion of the rehabilitation work had been completed as of the date of sale. Thus, to accept the auditor's theory, we would have to find that the Seller agreed to sell fee and leasehold interests in land, and three buildings well on the way toward being totally rehabilitated, all for [approximately $5,000,000]; and that the Buyer agreed to pay more than five times that amount ([approximately 30,000,000]) for the construction work required to complete the rehabilitation. No reasonable inference from the facts presented for our review could support such a finding.

We conclude that the consideration for the Development Agreement, less initial leasing commissions is not entirely attributable to construction done subsequent to the agreement. Rather, it is attributable to construction done both before and after the sale. The retail sales tax applies only upon the portion allocable to construction done after the sale. The term "sells" or "contracts to sell" is defined for purposes of WAC 458-20-170 to include "any agreement whereby an immediate right to possession or title to the property vests in the purchaser." Both right of possession and title were transferred to the Buyer upon close of escrow, which occurred on June 2, 1982, according to the taxpayer; and not on April 30, 1982, which was merely the date on which the Sales Agreements and Development Agreement were executed.

Accordingly, we shall refer this matter to the Audit Section for a determination of what portion of the consideration for the Development Agreement is allocable to construction done after the close of escrow. As noted, the taxpayer asserts that rehabilitation to the Project was 64 percent complete as of the close of escrow, but we hesitate to accept that figure without audit verification.

With regard to retail sales tax paid after June 2, 1982 by the Seller to its contractors, WAC 458-20-170 provides:

> Speculative builders must pay sales tax upon all materials purchased by them and on all charges made by their subcontractors. Deductions for such tax paid with respect to materials used or charges made for that part of the construction done after the contract to sell the building should be claimed by the speculative builder on his tax returns in accordance with WAC 458-20-102, subheading purchases for dual purposes.

WAC 568-20-102 in turn provides:

> On the other hand, if the buyer has not given a resale certificate but has paid tax on all purchases of such articles and subsequently resells at retail a portion thereof, he must, nevertheless, collect the tax from the purchaser and report such sales in making his tax returns. However, in such case, the buyer may take a deduction on his return representing his cost of the property thus resold on which sales tax was paid.

The Seller was unable to avail itself of this deduction because it apparently considered itself a speculative builder, even after June 2, 1982, and failed to collect retail sales tax from the Buyer. If the Department had assessed the retail sales tax against the Seller, then a credit would have been allowed for retail sales tax paid subsequent to June 2, 1982 by the Seller to its contractors. No credit was allowed, and properly so, in the present assessment issued against the Buyer. The credit is personal to the Seller because it represents an erroneous overpayment of taxes. Accordingly, the Seller and not the Buyer is entitled to any credit due for retail sales tax paid to its contractors subsequent to June 2, 1982. Upon verification of the amount of taxes so paid and upon verification that those taxes have been remitted to the state, the Audit Section shall issue a credit or refund in the appropriate amount directly to the Seller.

Finally, it is not an abuse of discretion for the Department to proceed directly against the Buyer for payment of the retail sales tax. RCW 82.08.050 provides in part:

> The tax hereby imposed shall be paid by the buyer to the seller, and each seller shall collect from the buyer the full amount of the tax payable in respect to each taxable sale . . .
>
> In case any seller fails to collect the tax herein imposed or having collected the tax, fails to pay it to the department in the manner prescribed by this chapter, whether such failure is the result of his own acts or the result of acts or conditions beyond his control, he shall, nevertheless, be personally liable to the state for the amount of the tax.

> The amount of tax, until paid by the buyer to the seller or to the department, shall constitute a debt from the buyer to the seller.
> . . .
>
> Where a buyer has failed to pay to the seller the tax imposed by this chapter and the seller has not paid the amount of the tax to the department, the department may, in its discretion, proceed directly against the buyer for collection of the tax, . . .

Thus, the retail sales tax is legally imposed upon and is primarily the obligation of the Buyer. The Seller is also personally liable, having failed to collect the tax from the Buyer. If the Department had collected the tax from the Seller then the amount of the tax would have constituted a legal debt from the Buyer to the Seller.

Usually, it is a seller, upon whom retail sales tax has been assessed, who argues that the Department has abused its discretion in failing to proceed directly against the buyer; an argument the Department has routinely denied. In any event, we fail to perceive how pursuing the Buyer, the person who is primarily obligated for payment of the tax, can be an abuse of discretion.

[2] Incidentally, although the Seller has paid its provisional real estate excise tax assessment without protest, we are constrained to observe that a recent determination of the Department may have some bearing on the Seller's proper tax liability. As the taxpayer is no doubt aware, a transfer of any leasehold interest which does not include an option to purchase does not constitute a taxable "sale" for purposes of the real estate excise tax RCW 82.45.010. The Department has had recent occasion to consider the question whether the real estate excise tax applies to a transfer of improvements constructed by a lessee on leased land. Under Washington case law, unless the lease provides otherwise, improvements made by a lessee become part of the land at the time of construction and are owned by the lessor. Pier 67, Inc. v. King County, 71 Wn.2d 92, 94, 26 P.2d 610 (1967), rev'd on other grounds, 78 Wn.2d 48, 469 P.2d 902 (1970); Murray v. Odman, 1 Wn.2d 481, 485, 96 P.2d 489 (1939); Toellner v. McGinnis, 55 Wash. 430, 435-36, 104 Pac. 641 (1904). Thus, the Department has concluded that a transfer by a lessee of its interest in such improvements is the transfer of a leasehold interest and not subject to real estate excise tax unless accompanied by an option to purchase.

We are not able to determine whether the transfer of the two buildings located on leased land is subject to real estate excise tax because the ground lease was not available for our review. If, after review of the ground lease, the Seller determines that a refund may be in order, then it may file a petition for a refund: Provided, that application for such refund is made within the period of limitations imposed by RCW 82.32.060.

DECISION AND DISPOSITION:

The taxpayers' petition for correction of Tax Assessment No. . . . is granted. The Audit Section will issue an amended assessment consistent with this Determination.

The taxpayers' petition for refund is granted upon verification of the amount of retail sales tax paid by . . . to its contractors subsequent to June 2, 1982, and verification that such taxes were remitted to the state, the Audit Section shall issue a credit or refund of such taxes directly to . . . .

The Real Estate Excise Tax assessment dated April 1, 1987 is provisionally sustained, subject to verification of the taxpayer's assertion that rehabilitation of the Project was 64 percent complete as of the close of escrow.

DATED this 27th day of February 1987.