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BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Ruling	)	D E T E R M I N A T I O N
	)	No. 01-129
. . .	)	Registration No. . . .
	)	Docket No. . . .

RCW 82.04.050(9); 10 U.S.C. § 2875: RETAIL SALES TAX -- FEDERAL INSTRUMENTALITY. An entity carrying out projects for the acquisition or construction of housing units suitable for use as military family housing or as military unaccompanied housing, established pursuant to 10 U.S.C. § 2875, is not an instrumentality of the United States for purposes of RCW 82.04.050(9), since it serves a commercial purpose for private profit which is separate and distinct from the purposes of the United States.

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:

A limited liability company (LLC) formed by a private party and the United States Navy to construct and manage a housing project for Navy personnel appeals a ruling that construction of the project will not constitute government contracting, and the retail sales tax will apply to the entire gross contract price charged by building contractors.[1]

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

FACTS:

Prusia, A.L.J. -- On July 11, 2000, [A member of an LLC], submitted a request for a written predetermination by the Department of Revenue (Department) that the Washington retail sales tax will not apply to the gross contract price of a project to construct military housing for the United States Navy. The request stated [Member] and the Navy intended to form a limited liability company, [Taxpayer] (also referred to as the ". . ."), to own, construct, and manage the project. The request asserted that the construction would be upon real property of or for the United States, and under RCW 82.04.050(9), charges for labor and services rendered in respect to the constructing of the project would be excluded from the definition of "retail sale."

On July 19, 2000, the Taxpayer Information and Education Section (TI&E) of the Taxpayer Services Division of the Department issued a ruling to [Member], that the project would not be considered a government contracting job, the gross amount charged by all contractors hired by the project owner would be subject to the retailing classification of the business and occupation (B&O) tax, and retail sales tax must be collected from the owner.

On August 25, 2000, [Taxpayer], appealed the TI&E ruling. At the same time, Taxpayer modified the request for predetermination, as follows: "On this appeal we wish to modify our position and request a determination that the retail sales tax will not apply to that portion of the project that is attributable to the U.S. Navy's capital investment in the Military Housing Project." The appeal letter adds, in this regard:

> Although the Navy owns differing percentages of the operating profits and the sale or refinancing proceeds of the [Taxpayer], we think that the appropriate percentage on which the sales tax exemption should be based is the Navy's capital investment in the Project, i.e. . . . because the construction of the project is the activity upon which the retail sales tax is based.

The facts given in support of the request, as set out in the July 11, 2000 submission, are as follows:

> In 1996 the United States Congress adopted the Defense Authorization Act (the "Act"), PL 104-106, February 10, 1996, 110 Stat. 186, which provides the Department of the Navy (the "Navy") with alternative authorities for the acquisition, operation, and improvement of military housing. 10 U.S.C.A. §§ 2871-2885. The Act empowers the Secretary of Defense to invest in "eligible entities" carrying out Projects for the acquisition or construction of housing units suitable for use as military family housing or as military unaccompanied housing. An "eligible entity" means any private person, corporation, company, State or local government, or housing authority of the State or local government.
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> Pursuant to this authorization, the Navy issued a Request for Qualification and Request for Proposals . . ., and Amendments 0001 through 0004, for the creation of a

partnership for development of housing in support of Navy operations in the . . ., Washington region (the "RFP"). [Member], responded to the RFP, and submitted its offer to participate with the Navy in the design, finance, construction, ownership, management, operation and maintenance of . . . residential units and associated improvements on a designated . . . acre site in . . . County, Washington (the "Military Housing"). The Navy and [Member] intend to form [Taxpayer], . . . to effectuate the construction of the Military Housing (the "Project"). The sole purpose of the [Taxpayer] is to "design, finance, construct, own, operate, manage and maintain a . . . Project, including associated improvements, on a designated . . . acre site in . . . County, Washington . . .", and the [Taxpayer] is prohibited from engaging in any other business.

The Navy and [Member] will be the members of [Taxpayer]. The Navy will make a cash capital contribution in the amount of $. . . to [Taxpayer] ("the Navy's Capital Contribution"). The Navy will also agree to pay to the LLC additional amounts to supplement the monthly rental income received from the military tenants in an amount approximately equal to $. . . . The Navy's Capital Contribution will be invested by a Trustee appointed by the Project's lender and will be disbursed from the account as a ratable portion of each construction progress payment approved by the Project's architect. The progress payments will be applied by the Trustee to costs associated with the land acquisition, design, construction, and financing of the Project. [Member] will make an initial capital commitment to [Taxpayer] of $. . . or the amount necessary to complete the Project ("[Member]'s Capital Commitment"). [Members]'s Capital Commitment will be applied to development costs of the Project. Development costs include all costs associated with the acquisition of the land, design, development, financing, site improvements, completion and initial operation of the Project. [Member] currently owns the . . .-acre site upon which the Military Housing will be constructed. [Member] will sell the land to [Taxpayer].

Thus, the Navy will contribute approximately 87% of the initial equity necessary to develop the Project ($. . .) plus additional amounts as rental supplements. [Taxpayer] will obtain the construction financing in an amount of approximately $. . . to use to construct the Project. The [Taxpayer] will finance, construct, own and operate the Project. The [Taxpayer] will hire various contractors to construct the Military Housing. The contractors will include a general contractor, and perhaps other subcontractors.

[Member] will be the managing member of [Taxpayer] and will be responsible for the day-to-day activities of the LLC. The Navy must approve the annual budget for the Project, the encumbering, mortgaging, selling, refinancing, incurring additional borrowed debt (other than trade payable), the exchanging, transferring or assigning any portion of the Project, and other items.

The [Taxpayer] will enter into a management agreement with [Management Co.], a Washington corporation, to manage, operate, and maintain the Project, including all

> associated improvements. [Management Co.] will act as a consultant to the Project but will not provide construction service.
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> Operating revenue from the Project (after payment of operating expenses and Project debt service) will be applied as follows: . . .
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> The Project may be sold, at the Navy's sole option, after fifteen years. The Project may also be refinanced if both members consent to the refinancing. If the Project is sold or refinanced, the net sales or refinancing proceeds will be distributed in the following order of priority: . . .

ISSUE:

Will the retail sales tax apply to the entire gross contract price of construction contracts entered into between Taxpayer and contractors for the construction of the Military Housing?

DISCUSSION:

Washington imposes a tax on "retail sales." RCW 82.08.020. The term "retail sale" includes:

> the sale of or charge made for tangible personal property consumed and/or for labor and services rendered in respect to . . . (b) The constructing, repairing, decorating, or improving of new or existing buildings or other structures under, upon, or above real property of or for consumers. . . .

RCW 82.04.050(2)(b). For such "retail sales," the legal incidence of the sales tax normally is on the landowner as the "consumer" of the construction work. RCW 82.04.190(4). The sales tax is measured by the full contract price for the construction, including the cost of materials consumed in the construction, labor costs, and markups. RCW 82.08.010; WAC 458-20-170(4)(a).

When construction is performed for the United States or its instrumentalities, however, the activity is statutorily excluded from the definition of "retail sale." RCW 82.04.050(9) provides:

> 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 . . . .

Also, RCW 82.08.0254 provides that the retail sales tax shall not apply to sales which the state is prohibited from taxing under the Constitution or laws of the United States. These statutes accommodate a restraint first recognized in *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819) – a state may not, consistent with the Supremacy Clause of the United States Constitution (Art. VI, cl.2), tax the operation of any instrument or means employed by the federal government to carry its powers into execution.

To prevent federal construction from completely escaping the sales tax, Washington imposes a retail sales tax and use tax on materials purchased or used by contractors in federal construction projects. For purposes of such projects, the contractors are the consumers of the materials incorporated into construction, and are responsible for paying sales tax that normally would be the responsibility of the property owner. RCW 82.04.190(6); WAC 458-20-17001 (Rule 17001).

The Defense Authorization Act of 1996, Public Law 104-106, 110 Stat. 186, provides the Navy with alternative authorities for funding the construction of new military housing, including lending authority, leasing authority, and investment authority. In pertinent part, the Act, as codified at 10 U.S.C. § 2875, provides:

> § 2875. Investments
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> (a) Investments authorized. The Secretary concerned may make investments in an eligible entity carrying out projects for the acquisition or construction of housing units suitable for use as military family housing or as military unaccompanied housing.
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> (b) Forms of Investment. An investment under this section may take the form of an acquisition of a limited partnership interest by the United States, a purchase of stock or other equity instruments by the United States, a purchase of bonds or other debt instruments by the United States, or any combination of such forms of investment.
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> (c) Limitation on value of investment.
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> (1) The cash amount of an investment under this section in an eligible entity may not exceed an amount equal to 33 1/3 percent of the capital cost (as determined by the Secretary concerned) of the project or projects that the eligible entity proposes to carry out under this section with the investment.
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> . . .
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> (3) In this subsection, the term "capital cost", with respect to a project for the acquisition or construction of housing, means the total amount of the costs included in the basis of the housing for Federal income tax purposes.

[Taxpayer] is a limited partnership the Navy has entered into pursuant to 10 U.S.C. § 2875.

Taxpayer contends that the construction of the Military Housing is effectively for the United States (the Navy). It argues [Taxpayer] should also be treated as an instrumentality of the United States for purposes of RCW 82.04.050(9). In either case, the RCW 82.04.050(9) exemption would apply to construction contracts.

We find that the construction is not on real property of or for the United States. The construction will be on real property owned by [Taxpayer], an LLC in which the United States is only a limited

partner. The property will never vest in the United States, unless [Taxpayer] sells the property to the United States. The construction will be for [Taxpayer]. [Taxpayer] will own the housing units.

Is [Taxpayer] an "instrumentality" of the United States, as that term is used in tax law? To answer that question, we look to general guidelines and factors the U. S. Supreme Court has considered in addressing the question. Justice Clarence Thomas recently emphasized, in *Arizona Department of Rev. v. Blaze Constr. Co.*, 526 U.S. 32, 35 (1999), that the Supreme Court has taken a "narrow approach" to the scope of governmental tax immunity under the U. S. Constitution. Constitutional immunity from state gross receipts, sales, and use taxes is appropriate in only one circumstance: "when the levy falls on the United States itself, or on an agency or instrumentality so closely connected to the Government that the two cannot realistically be viewed as separate entities, at least insofar as the activity being taxed is concerned" (quoting from *U.S. v. New Mexico*, 455 U.S. 720, 735 (1982).[2] The Supreme Court's decisions describing the nature of a "federal instrumentality" immune from state taxes have used language such as "virtually . . . an arm of the Government,"[3] and "[entities that have been] incorporated into the government structure."[4]

In *Department of Employment v. United States, supra* footnote 3, the Court relied upon the following factors in determining that the American National Red Cross was an instrumentality of the United States: (1) Congress chartered the Red Cross in 1905, subjecting it to government supervision and to a regular financial audit by the Defense Department; (2) its principal officer is appointed by the President, who also appoints seven (all government officers) of the remaining 49 Governors; (3) the Red Cross is obligated by statute to meet U.S. commitments under the various Geneva Conventions, to perform a wide variety of functions indispensable to the workings of the U.S. Armed Forces around the globe, and to assist the federal government in providing disaster assistance to the states in time of need; (4) although its operations are financed primarily from private contributions, the Red Cross does receive substantial material assistance from the federal government; and (5) time and time again, both the President and the Congress have recognized and acted in reliance upon the Red Cross' status virtually as an arm of the government.

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[2] In *U.S. v. New Mexico*, 455 U.S. 720 (1982), the Supreme Court set the current constitutional parameters which guide us in analyzing whether a taxpayer is a federal instrumentality. In that case, the State of New Mexico imposed its use tax and gross receipts tax on receipts from management contracts paid by the Department of Energy (DOE). The Court summarized its decisions regarding the Supremacy Clause and tax immunity doctrine. The Court recognized that this "much litigated and often confused field" has "been marked from the beginning by inconsistent decisions and excessively delicate distinctions." *Id*. at 730. The Court then stated the underlying principle, *Id.* at 735:

> What the Court's cases leave room for, then, is the conclusion that tax immunity is appropriate only in one circumstance: when the levy falls on the United States itself, or on an agency or instrumentality so closely connected to the Government that the two cannot realistically be viewed as separate entities, at least insofar as the activity being taxed is concerned.

[3] *Department of Employment v. U.S.*, 385 U.S. 355, 359-360 (1966).

[4] *United States v. Boyd*, 378 U.S. 39, 48 (1964).

In *Standard Oil Co. v. Johnson*, 316 U.S. 481 (1942), the Court found the following factors determinative in holding that army post exchanges are instrumentalities of the United States: (1) that by authority of Congressional enactments, the Secretary of War had promulgated regulations establishing the post exchanges, those regulations had been amended from time to time, and the exchanges had become a regular feature of Army posts; (2) Congressional recognition that "the activities of post exchanges are governmental" has been frequent, including appropriations for the construction and maintenance of post exchange buildings; (3) the establishment and operation of the exchanges are subject to the military commander of the post and a military officer is detailed to manage it under a supervisory council of military officers; (4) the military officers receive no extra pay for these services and the "object of the exchange is to provide convenient and reliable sources where soldiers can obtain their ordinary needs at the lowest possible prices"; and (5) the government assumes no financial obligation of the exchange; profits, if any, do not go to individuals; instead they are used "to improve the soldiers' mess, to provide various types of recreation, and in general to add to the pleasure of and comfort of the troops." "From all this," said Justice Black for the Court, "we conclude that post exchanges as now operated are arms of the Government deemed by it essential for the performance of Governmental functions."

The Red Cross and post exchanges have in common that each was created by Congress for the specific purpose of fulfilling, on a full-time, continuous basis, what have clearly been identified as important federal governmental responsibilities and functions, while subject to a significant degree of ongoing operational supervision by employees of the federal government, and they are not formed and managed for private profit.

Applying the general guidelines and factors the Supreme Court has set out in the decisions cited above, we conclude [Taxpayer] is not an "instrumentality of the United States" for purposes of RCW 82.04.050(9).

[Taxpayer] is a legal entity separate and apart from the United States. The United States' interest in it is limited. [Taxpayer] is not charged with carrying out essential governmental obligations, but rather is one of many alternative suppliers of housing "suitable for" military family housing. Its activities are not essential to the performance of governmental functions. It is clear the purpose of Section 2875 is to foster commercial development and operation of housing suitable for military families and personnel as an alternative to the government itself constructing housing, thereby relieving the government of financial and administrative burdens. [Taxpayer] and its housing project will not be managed by employees or appointees of the federal government, but rather by a private company. Most importantly, [Taxpayer] was formed for a commercial purpose for private profit.

Taxpayer cites *Clallam County v. United States*, 263 U.S. 341 (1923) ("*Clallam*"), *F.D. Rich Co. v. State*, 79 Wn.2d 296, 484 P.2d 1138 (1971) ("*Rich*"), and *Murray v. State*, 62 Wn.2d 619, 384 P.2d 337 (1963), in support of its contention that [Taxpayer] is an instrumentality of the federal government for purposes of RCW 82.04.050(9).

In *Clallam*, the Supreme Court held that a corporation created for the purpose of operating a sawmill and railroad in the promotion of the war effort during the first World War, which was wholly owned by the United States, was an agency of the United States, and the corporation's property was, therefore, immune from state taxation. The Court found the U.S. had organized the corporation as an instrumentality for carrying on the war, all its property was conveyed to it by or bought with money coming from the U.S. and used by it solely as means to that end, and when the war was over the corporation stopped its work other than as necessary to wind up.

Taxpayer argues the present case is similar to *Clallam*, as follows. [Taxpayer] is organized as an instrumentality of the Navy for constructing the Military Housing. The U.S. will contribute . . .% of the initial equity and those contributions will be used solely to fulfil the Navy's goal of building the Military Housing. All major business decisions relating to [Taxpayer] require the Navy's consent. Use of the Project will generally be limited to military personnel.

We disagree. One could just as easily cite the same factors as dissimilarities. In *Clallam*, the U.S. contributed 100% of the money and property going into the operation, whereas here the U.S. is restricted to contributing . . .% of the capital cost. In *Clallam*, the U.S. exercised control over the entire operation, whereas here the commercial partner manages the operations and the Navy's role is limited to exercising consent over major decisions.

The crucial difference between the corporation in *Clallam* and [Taxpayer] is that [Taxpayer] has a separate commercial purpose for private profit. In *Clallam*, the Court used language that emphasized this distinction, 263 U.S. at 345:

> This is not like the case of a corporation having its own purposes as well as those of the United States and interested in profit on its own account. The incorporation and formal erection of a new personality was only for the convenience of the United States to carry out its ends.

Murray and *Rich* addressed the question whether corporations awarded contracts to construct military housing under the provisions of the Capehart Act (69 Stat. 651-654 as amended) were "instrumentalities" of the United States. Under the Capehart Act, the Secretary of Defense issued an invitation for bids, which required the successful bidder to establish a private mortgagor-builder corporation. The U.S. executed a lease to the corporation of the real estate upon which the housing was to be constructed. The corporation had to obtain private financing. The contract between the U.S. and the corporation required U.S. approval of progress payments on construction, and provided that upon completion of construction and full payment, title to the housing units vested in the U.S. The U.S. executed a written guarantee to pay the mortgage installment payments to the mortgagee. In both *Murray* and *Rich*, the Washington Supreme Court held that the mortgagor-builder corporation was not an agent or instrumentality of the U.S. with resulting immunity from state taxation. It found the following factors determinative. The mortgage-builder corporate entity served a separate function from that of the United States. It was created for a commercial purpose for private profit, as distinguished from a governmental

function. And, the Capehart Act evidenced no congressional intent to immunize such corporations from state taxation.

Taxpayer argues that the facts in *Murray* and *Rich* are dissimilar to the facts of this case, and the dissimilarities require a different conclusion in this case. It argues that in *Murray* and *Rich* the contractor rather than the federal government created the corporations for its own interest of receiving payment for services, the corporations were wholly owned by the private party, and the U.S. did not make any capital contribution to the corporations. There are dissimilarities. However, we believe [Taxpayer]'s situation is more like the situation in *Murray* and *Rich* than the situation in *Clallam*. [Taxpayer] has a dual function and purpose, which reflects the identity of the two partners. One function and purpose is a commercial one, for private profit. As in *Murray* and *Rich*, and unlike in *Clallam*, the corporate entity serves a separate function and purpose from that of the United States. [Taxpayer] does not exist only for the convenience of the United States to carry out its ends.

Taxpayer argues that the fact one member of [Taxpayer] stands to realize a return on its investment in the project is not sufficient to cause the Navy to lose its immunity from state taxation and be subject to tax on its portion of the project. At most, it contends, sales tax should apply only to the extent of the private party's ([Member]'s) interest in the Project. It argues, in its August 25, 2000 petition:

> An analysis must be made of the Navy's participation in the limited liability company and a determination needs to be made whether the Navy's ownership interest serves any purpose other than the interests of the United States. If the answer is that the Navy's ownership of a portion of the Project serves only the interests of the United States, then that portion of the Project should be immune from state taxation. We think that there is not question that the Navy's ownership interest in the Project serves only the interests of the United States.

The difficulty with this argument is that only construction performed for the United States or its instrumentalities is excluded from the definition of "retail sale" under RCW 82.04.050(9). [Taxpayer] will be neither the United States nor an instrumentality of the United States. RCW 82.04.050(9) does not provide for partially exempting construction performed for an entity in which the United States owns an interest and a private entity owns the remainder. Exemptions from a taxing statute must be strictly construed in favor of taxation, *Budget Rent-A-Car, Inc. v. Department of Revenue*, 81 Wn.2d 171, 500 P.2d 764 (1972); *Evergreen-Washelli Memorial Park Co. v. Department of Revenue*, 89 Wn.2d 660, 574 P.2d 735 (1978).

Taxpayer argues that its position that the Navy does not lose its immunity from tax by participating in the Project as a member of a limited liability company is supported by the Washington Supreme Court's decision in *City of Kennewick v. Benton County*, 131 Wn.2d 768, 935 P.2d 606 (1997). In *City of Kennewick*, Benton County assessed property taxes on the entire value of a stadium that was owned and operated by a joint venture in which the City of Kennewick and a private corporation were the partners. The Supreme Court held that the City of Kennewick's 49% beneficial interest in the property was exempt from property taxes. Taxpayer argues that although *City of Kennewick*

involved property tax, the same principles should apply to the application of the retail sales tax to the [Taxpayer] project. Taxpayer argues that imposing the retail sales tax only to the extent of the interest of the private property:

> is consistent with the well-established principle that although a local or state government may impose a use tax on a private entity when it uses or possesses government property for its own beneficial use, it may not impose the tax on a government property itself. *New Mexico, Detroit, U.S. v. Allegheny, Pa.*, 322 U.S. 39, 64 S.Ct. 908, 88 L.Ed. 1209 (1944), *U.S. v. Clark County Indiana*, 113 F. Supp.2d 1286 (7th Cir. 2000). An entity cannot be taxed on the portion of the property that is attributable to the government. *U.S. v. Clark County Indiana*, 113 F. Supp.2d 1286 (7th Cir. 2000). The government property may not be taxed beyond the private entity's use of that property. *U.S. v. Hawkins County, Tenn.*, 859 F.2d 20 (6th Cir. 1988). In *United States v. County of Fresno, 50 L.Ed. 2d 683, 692 (1977)*, the Court held that a state may:
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> > raise revenues on the basis of property owned by the United States as long as that property is being used by a private citizen or corporation and so long as it is the possession or use by the private citizen that is being taxed.

We do not believe *City of Kennewick* provides us with authority to partially exempt construction performed for [Taxpayer] from the retail sales tax. *City of Kennewick* involved application of a property tax exemption in the state constitution. As noted above, as a general rule grants of tax exemptions are given a strict interpretation against the assertions of the taxpayer and in favor of the taxing power. However, an exemption from state property tax is entitled to a generous construction in favor of nonliability of a subordinate agency of government that owns the property when the property is used for a public purpose or the state enjoys beneficial ownership of it. 3A NORMAN J. SINGER, STATUTES AND STATUTORY CONSTRUCTION § 6609, at 43 (5th ed. 1992); *Spokane County v. City of Spokane*, 169 Wash. 355, 13 P.2d 1084 (1932). There is no such generally-recognized exception with respect to sales tax. And, as Justice Thomas said in *Arizona*, *supra*, the Supreme Court has taken a "narrow approach" to the scope of governmental tax immunity under the U. S. Constitution.

Based upon the facts presented, we conclude constructing the Military Housing for [Taxpayer] will not constitute federal government contracting for purposes of RCW 82.04.050(9) and Rule 17001. The retail sales tax will apply to the gross contract price of construction contracts entered into between [Taxpayer] and contractors for the construction of the Military Housing.

DECISION AND DISPOSITION:

We deny Taxpayer's petition. The TI&E letter ruling dated July 19, 2000, correctly determined that the federal government contracting classification will not apply to construction performed for [Taxpayer], and such construction will be a "retail sale." The retail sales tax will apply to the gross contract price of construction contracts entered into between [Taxpayer], and contractors for the construction of the Military Housing.

Dated this 29th day of August 2001.