

Cite as Det. No. 99-066, 19 WTD 64 (2000)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Refund of)	<u>D E T E R M I N A T I O N</u>
)	
)	No. 99-066
...)	
)	Registration No. . . .
)	FY . . ./Audit No. . . .
)	

[1] RCW 82.04.040; RCW 82.08.020: MUNICIPALITY -- ECONOMIC DEVELOPMENT GRANT -- TEMPORARY TITLE TO IMPROVEMENTS -- SALE OR SECURITY INTEREST. A temporary taking of title to improvements on private property by a municipality, intended only to secure the private owner's performance of obligations that are conditions of an economic development grant for construction of the improvements, does not constitute a sale of the improvements to the municipality.

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:

City utility division that owns and operates a railroad petitions for refund of retail sales tax assessed on funds it paid a private business to build a rail spur line on the business' land in exchange for a guaranteed level of traffic to the railroad for a minimum period.¹

FACTS:

Prusia, A.L.J. -- . . . ("City"), doing business as the . . . ("Railroad") of the Department of Public Utilities, owns and operates a railway in a . . . industrial district. A Public Utility Board ("Board") manages and oversees the operations of the railway.

The Audit Division of the Department of Revenue ("Department") examined Railroad's books and records for the period January 1, 1993 through December 31, 1996. The audit, based in part on test-year sampling, resulted in additional taxes and interest owing. The Department issued a

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

tax assessment, Document No. FY . . . , on June 17, 1997. In a subsequent post-audit adjustment based upon actual amounts, the Department amended Schedule 4 of the assessment, assessing \$. . . in additional taxes on Railroad's purchases of tangible personal property during the audit period, and made other minor adjustments. On November 19, 1997, the Department re-issued the tax assessment, in the amount of \$. . . , as Document No. FY

City paid the assessment. It paid the additional taxes assessed by the amendment to Schedule 4 under protest. It petitions for a refund of \$. . . plus interest.

The amendment to Schedule 4 principally concerns \$. . . City paid to . . . ("Business") in April 1994, to build a spur track on Business' property in the industrial district. The assessment assesses use tax or deferred retail sales tax on that payment.

The facts do not appear to be in dispute. It is City's policy to encourage the development of additional industrial railway track as a means of retaining and attracting industry to City. In pursuance of that policy, in 1992 the Board adopted an official policy on the construction of industrial track to serve present and potential customers of Railroad. The policy authorizes Railroad to spend up to \$. . . to build industrial track (a spur) for a railway switch customer, in exchange for which the customer must contract to provide Railroad a minimum traffic volume or revenue per year, for five consecutive years. The policy requires that "[t]he customer agreement shall provide that [Railroad] shall own the track for its depreciation life span and thereupon shall transfer title to the track to the customer." The customer is to be responsible for maintaining the track. The customer is to have the option to buy the track at any time prior to full depreciation at the then current book value.

In December 1992, City entered into an industrial track agreement with Business. The agreement provided Business would construct an industrial spur line on its property to connect its facility to Railroad's tracks. City would pay all sums required to construct the project up to a maximum of \$ Business would handle the construction, subject to City's approval of plans and specifications. Business would become a customer of Railroad and provide a minimum level of traffic or revenue for at least five consecutive years. Railroad would own the spur track for its depreciated life span of seven years, at which time title to the spur track would "transfer automatically" to Business, and the agreement would automatically terminate. During the life of the agreement, Business would grant Railroad a non-exclusive limited license to use the track, so long as Railroad's use did not impede or impair Business' use of the track and its property. Business would have an option to purchase the track during the seven-year depreciation period, which would terminate the agreement early. Business would maintain the track. Business is to indemnify and hold Railroad harmless from any claims for injury or damage occurring on or at the spur.

Business handled construction of the spur. It incurred costs of \$. . . in the construction. In April 1994, City paid \$. . . to Business toward the cost of construction. Other than the agreement with Business, City did nothing to protect its interest in the track.

The Auditor's Detail of Differences and Instructions to Taxpayers summarized the provisions of the agreement with Business, and provided the following explanation for assessment of use tax on the \$. . . City paid Business:

Per WAC 458-20-170, the definition of retail sale includes everything artificially built up or composed of parts joined together in some definite manner and attached to real property. It includes not only buildings in the general and ordinary sense, but also tanks, fences, and **railroad tracks**. The total construction contract for the track is a retail sale and has been subjected to the deferred sales tax. (Emphasis in original).

City contends the Department mischaracterizes the transaction. It contends the transaction was not a retail sale of the track, but rather a contribution or subsidy for economic development, with the retention of title by City a security device to protect City's interest during the period of Business' commitment. It argues the transaction is in the nature of a loan, with Railroad repaid through guaranteed track volume, and the temporary title to the tracks taken only to secure performance.

City argues in its petition:

It should be obvious that the auditor's examination of this transaction was grossly superficial and mischaracterized the essence of the deal when it was labeled a "retail sale." In a retail sales transaction does the seller obligate itself, by reason of the sale, to become a customer of the buyer? In a retail sale does the seller usually guarantee future business with the buyer? In a retail sale does the buyer agree that the item purchased shall revert automatically to the ownership of the seller after the elapse of some time period? In a retail sale does the buyer affix his newly purchased property to the real estate of the seller? In a retail sale does the seller agree to maintain the newly purchased property of the buyer and retain or acquire a right to continue to use the buyers property after the sale? The ownership for potentially a period of seven years, with a cash out provision is obviously a security device to protect the City in the event that the deal should fall through. Even a cursory examination of this transaction reveals how it differs from a sale at retail.

The auditor based his determination that this was a sale at retail on the language of WAC 458-20-170 where a "retail sale is anything built on real property" and thus, in the auditor's words "The total construction contract for the tracks is a retail sale and has been subjected to the sales tax." There is no doubt that railroad tracks qualify as "other structures." They are specifically mentioned in 458-20-170(d). The reason that the payment to [Business] of . . . should not be subject to the tax has nothing to do with the classification of the structure, it has to do with the classification of the transaction. The City did not buy the railroad track, it aided in the construction of the track. It provided a subsidy for the construction of the track. Now it did not do this for mere benevolence.

[Business] is required to use the track to take [Railroad's] Services and to guarantee a certain level of business. It is clear that the transaction is really a financing arrangement with the retention of title by the City was a security device to last only during the period of the guarantee. Ultimately as a fixture [Business] will own the track. Ultimately through the years of continued business at the specified level the City will be compensated for the advanced funds. The actual construction conducted by [Business] would have been subject to a sales tax, but the provision of funds to [Business] under the Industrial Track Agreement simply was not a sale.

In support of its argument, City provided the affidavit of the superintendent of Railroad. The superintendent states the ownership of the track by Railroad "was a security device, collateral in the event of default, designed to protect the City in the event [Business] was unable to fulfill its guarantee." The superintendent states the "transaction was a development grant with the purpose, not to buy a rail spur, but to retain a valued customer." In the teleconference, the superintendent added that the grant was made because Business was losing its lease, and was being courted by the [a railroad] to relocate along [a railroad] tracks. City offered Business the construction grant as an inducement to stay in Railroad's service area.

In support of its argument, City provided the affidavit of a vice president of Business. The affidavit states the "grant of aid toward the construction of the track" induced Business to remain in City, and that "[t]he funds received by [Business] were used to purchase railroad materials which were used to construct the track and construction services. We believe all applicable sales taxes were paid at the time of purchase by [Business]."

ISSUE:

Is the transaction in which City paid \$. . . to Business a retail purchase of the railroad tracks, and therefore subject to retail sales tax, or a conditional grant and disguised security agreement?

DISCUSSION:

RCW 82.08.020 imposes a retail sales tax on each retail sale in this state. RCW 82.04.050(1) defines "sale at retail" or "retail sale" as follows:

"Sale at retail" or "retail sale" means every sale of tangible personal property . . . to all persons, irrespective of the nature of their business . . .

RCW 82.04.040 defines the term "sale." It states:

"Sale" means any transfer of the ownership to, title to, or possession of property for a valuable consideration and includes any activity classified as a "sale at retail" or "retail sale" under RCW 82.04.050. It includes renting or leasing, conditional sales contracts, leases with option to purchase, and any contract under which possession of the property

is given to the purchaser but title is retained by the vendor as security for the payment of the purchase price.

RCW 82.04.040 clearly contemplates that ownership of property may be in the possessor of chattels even though legal title may be held by another person. The retention of legal title does not preclude the transfer of ownership and a sale taking place.

The inverse also is true. The transfer of legal title does not preclude a finding that a sale has not taken place. A common situation in which there is a transfer of title without a sale to the transferee is the chattel mortgage situation, where an owner transfers legal title as security for payment of money or performance of some other act. See Sullivan v. Lewis, 170 Wash. 413, 16 P.2d 834 (1932); Hughbanks Incorporated v. Gourley, 12 Wn.2d 44, 120 P.2d 523 (1941). When the intent of the parties is to create a security interest rather than transfer ownership, the transfer is not a “sale” and is not subject to retail sales tax. See Bullock v. Citizens Nat. Bank of Waco, 663 S.W.2d 923 (Tex. App., Austin 1984). See also WAC 458-61-400 (a transfer of an interest in real property merely to secure a debt is not subject to real estate excise tax).

Here, the taxpayer states it included the provision that it have temporary title to the tracks solely as a security device to protect City’s interest in the event Business failed to perform its obligations under the agreement. City granted Business the \$. . . in exchange for it becoming a customer of Railroad and guaranteeing a minimum revenue stream. That statement of intent is uncontroverted. A number of facts are consistent with that characterization of the transaction, and inconsistent with a sale of the track. Railroad did not pay the full cost of the track, and Business received no additional consideration that would explain its selling the track at less than cost. The transaction does not involve a simple exchange of property for a price. In exchange for the \$. . . Business not only gives Railroad title, it agrees to become a customer of Railroad, and guarantees Railroad a minimum revenue stream. Under the agreement, Railroad obtains only temporary title to the tracks, with title automatically transferring to Business if Business completes its performance under the agreement. Business retains the indicia of ownership. It has possession of the tracks, and is responsible for all maintenance and insurance. Railroad is given only a limited license to use the tracks during the period of the agreement, and uses it only to serve Business. Other than the agreement with business, City did not take any action to protect its “title.”

The taxpayer’s situation is similar to a chattel mortgage to secure the performance of the obligations of a lessee under a lease. Such chattel mortgages are valid in Washington. See Pollock v. Ives Theaters, Inc., 174 Wash. 65, 24 P.2d 396 (1933); Hoare v. United States, 294 F.2d 823 (9th Cir. 1961).² It also is similar to a loan situation, in which a lender advances funds to one who uses them to purchase chattels. The taxpayer is in the position of a secured creditor

² In Hoare, lessors expended nearly \$30,000 in remodeling the premises for use as a restaurant and cocktail lounge. The lessees gave the lessors a chattel mortgage on the lessees’ property located on the premises, as security for the performance of the lease.

having only a security interest in the property. In Washington, a chattel mortgage is an appropriate means for affording protection to the creditor when the property mortgaged is purchased with the borrowed funds. Hughbanks Incorporated v. Gourley, *supra*. Although the agreement between City and Business does not state that the temporary vesting of title in Railroad is a mere security device, it does not preclude a finding that it is such. In the analogous chattel mortgage situation, a bill of sale, absolute on its face, is a chattel mortgage, when both parties intended it as security. Sullivan v. Lewis, *supra*.

We find the agreement between City and Business transfers only a security interest in the tracks to City as security for future performance under the agreement, and does not constitute a “sale” within the meaning of RCW 82.04.040. The taxpayer is not required to pay deferred retail sales tax or use tax on the \$. . . payment to Business. The taxpayer should be refunded the use tax it paid on that payment, with statutory interest.

DECISION AND DISPOSITION:

The taxpayers’ petition is granted.

Dated this 23rd day of March 1999.