Cite as Det. No. 98-214, 19 WTD 201 (2000)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	<u>D E T E R M I N A T I O N</u>
	)	No. 98-214
. . .	)	Registration No. . . . FY. . ./Audit No. . . .
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[1] RULE 170; RCW 82.04.050; ETA 275: RETAIL SALES TAX -- SPECULATIVE BUILDER – JOINT VENTURE – PROFIT AND LOSS. Joint ventures can be taxed as speculative builders provided the parties meet the joint venture requirements including the right to share profits and losses as well as control. If one party agrees to be liable to the other party for all of the losses, they are not sharing losses, and not operating as a joint venture.

[2] RULE 170; RCW 82.04.050; RCW 82.04.190: RETAIL SALES TAX – B&O TAX – SPECULATIVE BUILDER – TITLE – SECURITY. A speculative builder means a person who constructs buildings for sale on land owned by the builder. To determine ownership of the land, record title is only one factor to consider. Legal title to secure financing may be considered a mortgage. Det. No 97-189, 17 WTD 148 (1997) and Det. No. 94-154, 15 WTD 46 (1994).

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 builder and a financier protest an assessment taxing their relationship as that of a prime contractor and owner.[1]

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

FACTS:

M. Pree, A.L.J. -- . . . (builder) is a licensed contractor with expertise in the development and construction of multi-family projects. . . . (financier) is not a licensed contractor but has significant financial and management expertise. Together the financier and the builder developed and constructed affordable residential multi-family housing units. They[2] considered their projects joint ventures, and did not report or pay tax on transfers or credits between the builder and the financier.

The Department of Revenue (Department) reviewed the records of the financier and the builder. The Department's Audit Division issued the two assessments referenced above. The Audit Division determined the financier contracted with the builder to construct the units on the financier's land. The Audit Division found that most of the projects were not joint ventures performed by the financier and the builder, but rather transactions between a consumer, the financier, and a contractor, the builder. The Audit Division assessed retail sales tax and business and occupation tax on the transactions for projects that it determined were not joint ventures. Credit was allowed for retail sales tax paid by the builder to vendors. After further review, the Audit Division issued a post audit adjustment crediting the tax assessed on one project. The Audit Division assessed sales tax against the builder, with a duplicate, protective assessment against the financier for the same tax.[3] The taxpayers filed a joint appeal.

The builder and the financier contend they operated all of the projects included in the assessment as joint ventures. The taxpayers considered the projects speculative joint ventures. The taxpayers state that together they made the decisions from inception to completion of each project. According to the taxpayers, they shared the profits and the losses.

Generally, the financier and the builder conducted business in the following manner during the audit period. The builder located land for a potential project, and signed an earnest money agreement in the builder's name. The builder and the financier then entered a property development agreement for the particular project. Pursuant to the agreement, the builder assigned the earnest money agreement to the financier at the close of escrow. The financier took title to the land. According to the taxpayer, the financier entered the agreements prior to work commencing on any project.

Contracts with the subcontractors and the material vendors showed the builder as the purchaser. The builder paid retail sales tax on the purchases.[4] After the hearing, the taxpayers provided copies of assorted records showing that many vendors understood they were dealing with the

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[2] We will also refer to the builder and the financier as the "taxpayers" regarding their statements, contentions, allegations, assertions or characterizations pertaining to this appeal.

[3] See RCW 82.08.050. While retail sales tax is imposed upon the buyer (financier) in a retail sale (construction services), if the seller fails to collect the tax and remit it to the department, the seller becomes personally liable for the tax as well.

[4] On some retail purchases sales tax may not have been paid. The taxpayers do not dispute the assessment of tax in those cases.

financier as well as the builder. Similarly, the taxpayers provided records from realtors and purchasers of the condominium to support their contention others recognized most of their business was transacted with parties who realized both the builder and the financier participated in the projects as joint venturers. However, the language in the contracts between the builder and the financier placed the parties in different roles, stating:

> 14. Agency. [Builder] will operate the Project in its own name, as agent for [financier], and shall not disclose the identity of the Principal in connection with operations of the Project, without the consent of [financier].

The various local permits designate the financier as the owner, and the builder as the contractor. Tax was not paid on the permit fees and other charges for services that would not have been retail transactions for speculative builders. Some agreements even included signed copies of the American Institute of Architects, *Standard Form of Agreement Between Owner and Design/Builder*.[5] The financier signed as owner and the builder signed as the design/builder.

Both the financier and the builder participated in the subsequent decisions involving the project. Basically, the financier provided financing, while the builder contributed construction expertise. The financier controlled a special checking account. The builder wrote the checks, but only the financier could sign them. The taxpayers state that they did not create separate loan or financing documents. They contend that the financier acted as nominee for the joint venture. Generally,[6] they agreed to share the profits, allocating receipts as follows:

Financier profit per unit sale	$X (fixed amount. A portion of which may actually be due upon entering agreement[7] or due before the division of any revenue at the time of sale.
Paid to financier, to reduce builder's loan to financier.	$Y (fixed amount drawn for each sale)
Financier interest equivalent on project costs	Computed at time of sale

[5] AIA Document A191, Part 2 (1985). However, portions of the agreement were deleted. For instance, the builder and the financier initialed a deletion whereby the financier would have reserved the right to perform work related to the project or award separate contracts to perform the work.

[6] The language in a representative Property Development Agreement for . . ., read:

> **6. Distribution of Revenues**
>
> From the sale of each unit in the project, the first $[X] shall be paid to [financier] as [financier's] profit. The next $[Y] shall be applied to reduce [builder's] obligation to [financier's affiliate] on loan No. ____. Then the next revenues plus all other revenues arising from the project shall go to [financier] to repay compounded Interest Equivalent, then to [financier] to reduce the advancements. Thereafter, all net revenues, after paying all Project costs and repaying any additional Advancements or Interest Equivalent shall constitute [builder's] development fee bonus.

[7] See Section 3 of the . . . .

Financier reimbursement for project costs	Computed at time of sale for which builder is liable to financier
Builder's fee bonus	Any remainder (unlimited)

The agreement did not guarantee income. In fact, some projects incurred losses. The effect of the arrangement was to give the financier a preferred return in the form of the interest equivalent for funding the project. The builder could realize profits in the remainder. Under all of the contracts, the builder was liable to the financier for all expenses. The effect of the expense requirement was to hold the builder responsible to the financier for losses. If a loss was incurred on a project, the builder still owed the financier its "profit", fees, and "interest equivalent".

Some projects incurred substantial losses. The split of the losses appeared to be negotiated after the project was completed, when they determined the amount of the loss on a particular project. The builder and financier then entered a settlement agreement. Because the builder lacked funds to cover the losses, following completion of unprofitable projects, the builder signed notes to repay the losses to the financier.

A representative Property Development Agreement between the financier and the builder states:

> The parties agree that regardless of the nomenclature used herein, this contract is for personal services, and [the builder has] no equity ownership in The project and builder is acting only as a fee financier, contractor, manager, operational officer, and agent, and [financier] as guarantor of [builder's] performance hereunder. After issuance of the building permit, [builder] agrees to devote at least eight hours a day, six days a week on the Project until all construction activity is completed and certificates of occupancy for all units are issued.

Regarding the interest equivalent, the Property Development Agreement states:

> [Financier] shall be entitled to an additional return on its investment equal to the equivalent of interest (the "Interest Equivalent") on all Advances at the rate of fourteen percent (14%) per annum. . . .

The auditor considers the arrangement between the financier and the builder similar to that of an owner, building a home for resale, contracting to pay a general contractor a construction bonus when the home is completed. Construction bonuses based upon a job's profitability or completion schedule are not uncommon. Under their arrangement, the taxpayers note that unlike incentive bonuses, the builder's potential profit is unlimited, while the financier's profit is capped.

Later, regarding control of the funds, the contracts provided:

> All net proceeds from the sale of units shall be paid into the Development Account. [Financier] expressly reserves the sole right to convey units in the Project and the Land by deed, and to approve of all unit sale closing papers.

The Audit Division bases the assessment upon a sale of construction services provided by the builder to the financier. The Audit Division agrees with the taxpayer that if these services were provided by and for a joint venture, there would not be sale or taxable transaction from the builder to the financier. Otherwise, one entity, the builder, sold them to another entity, the financier. We must determine whether the parties acted as a joint venturers.

ISSUES:

[1] Were the parties acting as joint venturers?

[2] If the projects were not joint ventures, what were they, and how should they be taxed?

DISCUSSION:

For excise tax purposes, a "person" includes individuals as well as joint ventures. RCW 82.04.030. The taxpayers contend they developed the properties as a joint venture. The joint venture should be taxable as a speculative builder. The Audit Division contends the builder acted as a prime contractor improving land for the owner, the financier. Any receipts from the financier should be retail sales to the builder [according to the Audit Division].

We do not agree with the taxpayers that the parties acted as joint venturers. Nor do we agree with the Audit Division that the builder constructed the condominiums as a prime contractor for the financier. Rather, we consider the transactions a financing arrangement in which the builder titled the land to the financier to secure financing, and improved the land for its own benefit. The builder should pay retail sales tax as a consumer. The payments from the builder to the financier should be taxed as finance charges to the financier.

First, we will analyze why the parties were not acting as joint venturers. Then we will analyze the transactions to determine what actually occurred, and how the receipts should be taxed.

[1] For two or more parties to be taxed as a joint venture, we have considered either four or five requirements. Under the first set of requirements, the tax consequences applicable to joint ventures are proper when all of these five elements are met:

(1) the joint venture was specifically formed to perform the contract work,
(2) the formation of the joint venture occurred before any of the work required by the contract had been undertaken,
(3) the contract work was in fact performed by the joint venture,
(4) the funds were handled as a joint venture rather than as separate funds of any party to the joint venture agreement, and

(5) there is a contribution of money, property and/or labor so that any profit or loss incurred by the joint venture is proportionately shared by all joint venturers.

Det. No. 87-93, 2 WTD 411, 416 (1987); Det. No. 88-14, 5 WTD 19, 24 (1988); and Det. No. 90-108, 9 WTD 231 (1990).

In other cases, we have relied on four joint venture requirements, as set forth by the Washington Supreme Court:

(1) a contract,
(2) a common purpose,
(3) a community of interest, and
(4) equal right to a voice, accompanied by an equal right of control.

Det. No. 88-155, 5 WTD 179, (1988) and Det. No. 98-8, 17 WTD 236 (1998), citing *Carboneau v. Peterson*, 1 Wn.2d 347, 95 P.2d 1043 (1939). We will refer to these as the "*Carboneau*" requirements.

Regarding these joint venture requirements, in a business venture, the parties must share profits and losses. *Knisely v. Burke Concrete*, 2 Wn. App. 533, 537, 466 P. 2d 717 (1970). When applied together, the "five element" test or the four "*Carboneau*" requirements plus a sharing of profits and losses in a business setting should result in the determination of whether an arrangement constitutes a joint venture. The difference between the five element test we use on some occasions and the *Carboneau* requirements plus profit and loss used on other occasions, may only be in the ease of applying the test to particular facts and circumstances.

Of the "five element" test, the taxpayer may have met the first three elements, but we find the last two elements lacking. While separate accounts were set up for each project, the funds were entirely controlled by the financier. Each account was in the name of the financier, who was the only person with the right to sign the checks.

Likewise, the fifth element was not met. Profits and losses were not shared proportionately. The financier received its principal, interest equivalent, and a fee. These payments were not contingent upon a profit. The financier received a preferred return[8] designated as "profit." That profit was not proportionately shared with the builder. It was a flat amount. Likewise, the builder's bonus or profit, if any, was not proportionate. The builder's profit was any excess, in its entirety. Because the financier's receipts were not dependent upon profit, they were not really profits.

We have recognized that payments similar to interest may be considered a preferred return on investment by a joint venturer, but only if the payment was contingent upon a profit. *See* Det.

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[8] The developer's profit was a flat amount to be paid upon signing the agreement, before any "profit" was paid to the builder. Realistically, any real profit could only be determined after the units were sold.

No. 89-290, 8 WTD 1 (1989). The agreements entitle the financier to the "interest equivalent", regardless of profit. In fact, even when the projects resulted in losses, the builder agreed to pay the financier an amount greater than the "interest equivalent." That amount even included amounts designated as "profits" due before construction. Therefore, neither the "interest equivalent" nor the financier's receipts designated as "profits" were contingent upon actual profit.

Under the contracts, the builder was responsible for any expenses, which in this construction context, translated directly into losses. While the financier and the builder often renegotiated amounts due, the losses, after completion of projects and sale of the units, we do not consider these negotiations to be based upon the financier's joint venture agreement to share the losses.[9] The agreements specifically held the builder responsible. Recognizing that the builder was incorporated, the principal officer and shareholder of the builder guaranteed the builder's obligation under the agreements. Therefore, the parties did not agree to share the losses.

One of the most important tests of a joint venture is whether the parties share the losses. *Skrivanich v. Davis*, 64 Wn. 2d 150, 164, 186 P.2d 364 (1947). It may be true that if a project lost money, the financier could have received less.[10] In that sense the financier sustained a loss. The financier's loss, however, was more contingent upon the builder's ability to pay, rather than an agreement to share losses. A deduction for certain expenses from gross receipts before a division of the balance, does not convert the arrangement into a joint venture. *Skrivanich v. Davis*, at 164.

Generally,[11] the financier received all of its money first. Upon the sale of each condominium unit, the financier received a flat amount designated as profit. A flat amount was applied to a note reducing amounts owed by the builder to the financier. The remainder was next applied to the financier's advances and interest equivalents. The financier's right to these receipts was not dependent upon a profit. Rather, the receipts were a function of the sale price of each unit, and indirectly, the builder's ability to pay any losses. Obviously, to the extent the builder profited, it was able to meet its obligations to the financier.

The builder on the other-hand *needed* to make a profit. The contract expressly held the builder responsible for all expenses, which really meant losses. In the event of losses, the builder still had to pay the financier, even after the financier had received the amounts designated "profits". This responsibility was clearly written in the contracts and acknowledged in the settlement

[9] The negotiations occurred after completion of projects and may have been based upon the builder's ability to pay or other consideration. [The builder had credit problems.] The principal officers and shareholders of the builder signed the notes. The agreements reached in the negotiations to determine the amount owed by the builder's principals did not result from a joint venture agreement to share losses proportionally or otherwise.

[10] Because the financier controlled the expenses as well as any sale of the condominium units, the financier could control losses in such a way that it was highly unlikely a loss on any project would directly effect the financier's receipts, provided the builder was able to meet its obligations under the agreement.

[11] The amounts due under each contract varied, as did the designations. However, the affect of the agreements was the same. The builder was liable to the financier for amounts due the financier under the agreements.

agreements. Once the obligations to the financier were met, the builder received any profit. They did not agree to share profits, rather their agreement was to divide receipts with the financier receiving preference, and the builder entitled to excess profits.

Similarly, the taxpayers failed to meet the "*Carboneau*" test for joint ventures. They had a contract. While they intended to develop and sell condominiums, their purposes were slightly different. The financier sought to recover its principal, fees, interest equivalent, and an amount designated as "profit". The amount designated as "profit", was not really profit. In fact, as discussed above, the financier received that amount when the contract was signed, regardless of a profit or loss on the project. Profits were not shared. The financier took its cut, and left the remainder for the builder.

While certain aspects of the agreement may resemble a joint venture agreement, essential elements are missing. The financier clearly controlled the funds by retaining sole check writing authority as well as approval of any sale. The parties did not agree to share the profits or losses. The financier received amounts regardless of whether the projects were profitable. The builder received the actual profits, if any. Only the builder was responsible for losses. Losses were not shared. Because the financier controlled the funds, and because the builder realized the true profits as well as losses, we find the projects listed in the assessments were not joint ventures.

[2] We consider the "interest equivalent" consideration paid to the financier, a financial business, for use of its money. The "interest equivalent" was taxable as interest. Similarly, the fees paid to the financier, as well as the amounts due upon signing the agreements designated as "profits", but really flat fees due from the builder, were taxable under RCW 82.04.290(2).[12]

The land was deeded to the financier to secure financing. The financier's role was not that of a consumer, but of a financial business. It offered money to a debtor, the builder, who had little if any collateral. These projects were high-risk investments, which could not be secured by normal means such as a mortgage with a note, but required the financier to actually take legal title to protect its investment. Without offering legal title as security, it is unlikely the builder could obtain funds from any financial business to develop the properties. The builder also had entered an arrangement paying special fees and other money on a preferred basis, which payments were designated as "profits", before the builder was entitled to receive any profit.

The arrangement allowing the financier to take title is similar to financing leases that consumers often enter into with financial institutions. Often, rather than financing the purchase of personal property with a note and security agreement, consumers enter agreements with financial institutions, which pay the vendors for the property and enter a lease with the consumer. The financial institution takes title to the property as security, but the consumer gets possession under the terms of the lease. We tax such financing arrangements as installment sales rather than leases. *See* WAC 458-20-211(2)(g); Det. No. 98-43, 17 WTD 179 (1998); and Det. No. 88-458, 7 WTD 75 (1988).

[12] Effective until July 1, 1998. RCW 82.04.290(2) applied a special rate with respect to financial business income.

Persons, including joint ventures, who perform construction upon land owned by their co-venturer are constructing upon land owned by others and are taxable as sellers. WAC 458-20-170 (Rule 170(2)(f)). However, deeds may be titled in one party to secure financing. For instance, a landowner may deed a lot to a contractor as security for the contractor to build a house. Upon receipt of payment, the contractor reconveys the property to the original owner. The Department does not tax the contractor as a speculative builder who owns the land. Excise Tax Advisory 275.08.170 (ETA 275).[13] Rather, because the primary reason to transfer title to the contractor was to secure financing, we consider the deed as security in lieu of a mortgage between the landowner and the contractor. Therefore, in that case, the contractor is taxed as prime contractor, rather than a speculative builder.

In determining if someone is a speculative builder, Rule 170 directs us to analyze the attributes of ownership. In doing so, we look beyond legal title:

> 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).

Det. No. 94-154, 162, 15 WTD 46 (1994).[14]

Recently, we looked beyond legal title held by a trust for security purposes to find a contractor was not a speculative builder:

> In this case, during construction, Taxpayers had the right to possession of the property and, in fact, operated as the possessor of the property. They occupied the land; constructed the condominiums; borrowed money for construction of the buildings; paid the real property taxes on the buildings; marketed the condominiums; and eventually, signed all earnest money agreements for the sale of the condominiums. According to Taxpayers, the Trust did nothing with respect to possession of the real property or the condominiums built on the real property, except receive repayment of the original cost of the undeveloped land, plus ten percent (10%).

. . .

[13] Formerly Excise Tax Bulletin 275.08.170 (ETB 275).

[14] Det. No. 94-154 specifically overruled Det. No. 92-204, in holding that record title alone was not determinative for distinguishing between prime contractors and speculative builders.

> The intentions of the parties govern and are determinative. In this case, there appears to be no dispute regarding the parties intentions. All parties state that their intentions were to treat the deed as security to ensure the payment of the cost of acquisition of the land. The actual intentions of the parties were confirmed by the actions of the parties, in which all parties treated the obligation owed to the Trust as a debt, which was paid from the proceeds of the sale. Accordingly, we find that pursuant to Rule 170 Taxpayers were the owner, possessor and consumer of the real property upon which the condominiums were built. Thus, we grant Taxpayers' petition finding that the condominiums were speculatively built.

Det. No. 97-189, 17 WTD 148, 152-154 (1998).

Such an approach is consistent with case law that holds that a deed will be construed as a mortgage if the parties intended to create a security interest. *See Kendrick v. Davis*, 75 Wn. 2d 456, 460, 452 P.2d 222 (1969).

Our case is similar in many respects to Det. No. 97-189. The builder had the right of possession, constructed the condominiums, was ultimately liable to pay for the improvements and other expenses, and sold the condominiums. We recognize the financier in our case was more involved with the project than in Det. No. 97-189. The circumstances demanded more involvement to secure the investment. The financier needed to control the expenditures of the insolvent builder, as well as sales of the property. The projects were more complex, the builder's ability to repay, less certain. However, the parties' underlying roles were the same: the financier put up the money with a stated, albeit risky, rate-of-return; while the builder took possession with the equitable right of profit and risk of loss.

In analyzing whether the financier was acting as a financial institution, more involved to secure its investment versus an equitable owner of the property hiring the builder as a prime contractor, we find the profit and loss critical to a joint venture determination. An equitable owner would be entitled to profit and responsible for the losses of the project. We found the builder was entitled to profits and responsible for losses. The financier's interests matched that of a secured creditor. The financier invested its money as a financial institution would have done. The amounts the builder paid the financier as "profit", fees, and interest should be subject to business and occupation tax as finance charges under RCW 82.04.290(2).

DECISION AND DISPOSITION:

We grant the taxpayers' petition in part. The files are remanded to the Audit Division for revision consistent with this determination. The builder not a prime contractor, but a speculative builder, and was liable to pay retail sales tax to its vendors. The financier was not required to pay the builder retail sales tax. The financier was liable for business and occupation tax on the various finance charges it received from the builder.

Dated this 23rd day of December, 1998.