Cite as Det No. 08-0197, 28 WTD 76 (2009)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 08-0197
. . .	)	
	)	Registration No. . . .
	)	Doc. No. . . ./Audit No. . . .
	)	Docket No. . . .

RULE 170; RCW 82.04.050(2)(b); RCW 82.08.020: RETAIL SALES TAX – RETAILING B&O TAX - PRIME CONTRACTOR. An LLC construction business (the taxpayer) was a prime contractor and not a speculative builder when it constructed residential buildings on land owned by other separately registered and organized LLCs, which were also owned by the taxpayer's principals.

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.

De Luca, A.L.J. – A LLC in the construction business (the taxpayer) protests the assessment of retail sales tax and retailing business and occupation (B&O) tax and a five percent substantial underpayment penalty by asserting that it and its owners were speculative builders of condominiums and small apartment buildings rather than it being a prime contractor constructing buildings on properties owned by other LLCs, which were also owned by its principals. We affirm the assessment.[1]

ISSUES

1. Pursuant to WAC 458-20-170 (Rule 170), was the taxpayer a prime contractor constructing buildings on properties owned by other LLCs, which were owned by its principals, or was it a speculative builder constructing buildings on properties that it and its principals owned?

2. May the Department of Revenue (DOR) cancel the five percent substantial underpayment penalty pursuant to RCW 82.32.105 and WAC 58-20-228 (Rule 228)?

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

FINDINGS OF FACT

The taxpayer is a Washington LLC that is registered with the Department of Revenue (DOR) to do business in this state. Its activities in Washington during the audit period included speculative and custom construction of residential properties in this state, typically building multiple housing units such as condominiums and apartment buildings. According to the audit report, beginning in the last quarter of 2004 and continuing through June 2006, the taxpayer was engaged in prime contracting and had discontinued its speculative building.

The taxpayer's customers were separately organized and registered LLCs, which held title to their respective properties that were improved. The taxpayer and these other LLCs were wholly owned by the taxpayer's principals ([a] husband and wife). The taxpayer and the audit report explain that the taxpayer's principals created separate LLCs for their various properties to limit their liability and the taxpayer's liability if litigation were to occur. The taxpayer asserts it believed the construction activities were speculative building because there were no unaffiliated third-party buyers for the projects when construction began. Accordingly, when the taxpayer performed construction on land owned by the LLCs, the taxpayer treated the projects in certain ways as speculative building rather than custom construction. For example, the taxpayer paid sales taxes at source on many of the materials purchased and the subcontracted labor. The taxpayer and the other LLCs had neither written agreements nor specific gross contract prices for the construction projects.

The taxpayer has presented letters from three banks that loaned money for the various construction projects. The content of the letters is similar in that they state that the loans were made to and in the names of the LLCs that owned the respective properties and upon which the buildings were constructed. But the banks required personal guarantees from [the principals] for the construction loans to their LLCs. The draws on the construction loan funds went from the LLCs directly to the taxpayer. The banks stated that they considered the taxpayer, its owners, and the LLCs "one inter-related business" or "one business operation overall."

The Audit Division of DOR audited the taxpayer for the period January 1, 2003, through June 30, 2006, and determined the taxpayer was a prime contractor and not a speculative builder. The Audit Division tabulated the total draws that the LLCs obtained from the banks and then assessed retailing B&O tax and retail sales tax on those amounts they paid to the taxpayer, while allowing a credit for sales tax paid at source by the taxpayer on materials and subcontracted labor. The Audit Division assessed the taxpayer $. . . in taxes, interest and a five percent substantial underpayment penalty. The assessment remains unpaid. The taxpayer does not contest the $. . . in use tax assessed . . ., but it does contest the $. . . in retail sales tax and the $. . . in retailing B&O tax, and the penalty of $. . . .

ANALYSIS

The taxpayer argues that it is a speculative builder and not a prime contractor. It believes that it, its owners, and their various LLCs were one business that was constructing buildings on

properties they all owned together although titles to the individual properties were held by the respective LLCs. Consequently, the taxpayer contends it owes no B&O tax and no sales tax, other than the sales tax it paid at source for materials and subcontracted labor.

The term "sale at retail" or "retail sale" includes the sale of or charge made for tangible personal property consumed and/or for labor and services rendered in respect to the constructing, repairing, decorating, or improving of new or existing buildings on real property of or for consumers. RCW 82.04.050(2)(b).

Rule 170 is the administrative rule dealing with the taxation of the construction of buildings. Rule 170 explains that a "speculative builder," defined as "one who constructs buildings for sale or rental upon real estate owned by him," is the consumer of materials the builder purchases, and the consumer of all charges made by the builder's subcontractors, for excise tax purposes. Speculative builders must pay retail sales tax upon all materials purchased by them and on all charges made by their subcontractors. Speculative builders do not owe B&O tax on the sale of the constructed building, but rather owe real estate excise tax (REET) upon sale of the property. Whereas a "prime contractor" is a person engaged in the business of performing construction for consumers. Prime contractors are required to collect from consumers (e.g., from the speculative builder in speculative construction), the retail sales tax measured by the prime contractor's full contract price. Prime contractors owe B&O tax on their gross contract price, under the retailing B&O classification. Prime contractors do not owe retail sales tax on their purchases of materials and subcontractor charges for which they give resale certificates, because these sales are sales for resale not subject to the retail sales tax.

Rule 170(2)(a) further defines "speculative builder" by explaining:

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

Thus, according to RCW 82.04.050 and Rule 170, the holder of 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). The issue of ownership is to be determined by 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. Det. No. 04-0004, 24 WTD 283 (2005). We examine those four factors.

1. What were the intentions of the parties in the transaction under which the land was acquired?

The parties' intention was clear that the individual LLCs were formed to hold title to the lands on which the construction projects took place, largely to limit possible legal liability resulting from

the projects to the individual LLCs that held titles to the properties while affording protection from legal liability to the taxpayer and its owners. The intention was for the LLCs to obtain loans for the lands and projects in their own names and have the taxpayer construct the buildings for them. But by paying sales taxes at source the taxpayer and its owners treated the projects as a speculative builder would.

2. Who paid for the land?

The LLCs paid for the lands from the loan proceeds that they obtained from the banks, accompanied with the personal guarantee of their owners.

3. Who paid for the improvements to the land?

The LLCs obtained the construction funds from the banks and transferred those funds to the taxpayer to allow the taxpayer to pay third parties for materials and labor. We find that the LLCs paid for the improvements from their construction loans.

4. In what manner did all parties, including financiers, deal with the land?

Titles to the land were in names of the LLCs and the LLCs sold their respective properties to buyers when the projects were completed or near completion. Although the banks stated that they considered the taxpayer, its owners and their other LLCs to be one inter-related business, the individual owners were named as guarantors on the LLCs' loans, which supports the finding that the banks considered the LLCs as the primary borrowers and owners of the land and improvements.

Consequently, based on these findings, we conclude that the LLCs were the owners of the properties and projects and they hired the taxpayer to perform retail prime construction services on land they owned. The taxpayer was not a speculative builder of the projects, but a prime contractor. The disputed tax was properly assessed against the taxpayer.

In *Washington Sav-Mor Oil Co. v. State Tax Commission*, 58 Wn.2d 518, 364 P.2d 440 (1961), the court found the sale of property by a wholly owned subsidiary to its parent corporation constituted a sale for purposes of the B&O tax. The court quoted the following portion of the annotation "Sale by wholly owned subsidiary to parent corporation, or vice versa, as within retail sales tax, or similar, statute," 64 A.L.R.2d 769 (1959).

> Since a wholly owned subsidiary is generally incorporated or acquired by the parent corporation for the purpose of advantageously carrying on some phase of the parent corporation's activities or business, the courts have been reluctant to disregard the separate legal entities of the parties merely to grant relief from sales, or similar, taxes at the expense of the state or its subdivision. Thus, the contention that because the wholly owned subsidiary and the parent corporation are so closely integrated, sales by one to the other do not constitute 'sales' within

> the meaning of a sales tax, or similar, statute has been rejected by a number of courts.
>
> This result has been reached in a number of cases involving sales by a wholly owned subsidiary to the parent corporation, especially where the parties to the transaction have recognized their status as separate legal entities for a considerable time, enjoyed the economic advantages resulting therefrom, and in making the transactions observed the usual formalities of purchase and sale.

58 Wn.2d at 521. *See also* Det. No. 87-342, 4 WTD229 (1987); Det. No. 96-046, 16 WTD 74 (1996) (Where a subsidiary, as a separate legal entity, had secured financial and competitive advantages by its separate existence, it was not in a position to ask that the separate corporate existence be disregarded at the expense of the state, citing *Washington Sav-Mor Oil Co., supra)*.

Even assuming arguendo that the taxpayer, its owners, and their other LLCs had an "inter-related business," they were separately organized to enjoy the limited liability protections offered by their business structures. In short, the taxpayer and the LLCs seek the best of both worlds. They want the limited liability benefits afforded an LLC while enjoying the tax advantages afforded speculative builders when compared to prime contractors and their customers. Had the taxpayer, and its owners truly operated as a speculative builder they would have enjoyed the accompanying tax benefits, but with the risk of possibly greater exposure to legal liability for them jointly and severally. On the other hand, by acting as a prime contractor and not as a speculative builder, the taxpayer avoided the risk of possible legal liabilities faced by the owners of the properties (the LLCs). We cannot ignore or disregard the legal existence of the LLCs. *Washington Sav-Mor Oil Co., supra.*

The five percent substantial underpayment of tax penalty was assessed in accordance with RCW 82.32.090(2). DOR is an administrative agency, and its authority to waive or cancel interest and penalties is restricted to the authority granted by the Legislature. DOR has no discretionary authority to waive or cancel penalties or interest. Det. No. 98-85, 17 WTD 417 (1998); Det. No. 99-285, 19 WTD 492 (2000).

DOR is authorized to waive or cancel penalties if the taxpayer's payment of a tax less than that properly due was the result of circumstances beyond its control. RCW 82.32.105(1) and Rule 228(9)(a). But a misunderstanding or lack of knowledge of a tax liability that caused the failure to pay the tax is not considered to be a circumstance beyond the taxpayer's control. Rule 228(9)(a)(iii)(B). Moreover, financial hardship is not considered to be a circumstance beyond the taxpayer's control. Rule 228(9)(a)(iii)(A). We have no basis to cancel the penalty.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 30th day of July 2008.