

Cite as Det. No. 03-0126, 24 WTD 163 (2005)

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. 03-0126
)	
...)	Registration No. . . .
)	FY . . . /Audit No. . . .
)	Docket No. . . .

RULE 24001A; RCW 82.60: SALES TAX – USE TAX – DEFERRAL OF – CONSTRUCTION -- R&D -- DISTRESSED AREA. Eligibility for the retail sales/use tax deferral on the construction of a building in a distressed area to be used for manufacturing or research and development (R&D) depends, among other things, on whether the building or portions thereof are used for manufacturing or R&D upon completion of the construction project.

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:

Dressel, A.L.J. – . . . building constructor appeals partial denial of its tax deferral application for a new office building. Denial upheld.¹

ISSUE:

If a manufacturer builds an office building for its own use and applies for a distressed area tax deferral on its construction, may the Department pro-rate the deferral because part of the building, immediately after construction, was not used for manufacturing?

FACTS:

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410. Nonprecedential portions of this determination have been deleted.

. . . (taxpayer) is a designer and fabricator of . . . building siding and roofing panels. Its books and records were examined by the Department of Revenue (Department) for the period March 9, 1995 through December 31, 1997. As a result a tax assessment, identified by the above-captioned numbers, was issued for \$ The taxpayer has paid the assessment but brings this action for a partial refund.

In March of 1995, the taxpayer applied for a retail sales and use tax deferral and exemption certificate for its new manufacturing plant and office building. Its application was accepted in the same month, and the taxpayer was issued Certificate # Actual construction of the facilities started around December 1995, and the project was completed December 31, 1997. For part of the project the taxpayer acted as a speculative builder, constructing on land that it owned. After the building commenced, the taxpayer sold the land and the partially-constructed building(s) to an affiliate entity. Thereafter, the taxpayer functioned as the general contractor for the affiliate and completed the building project.

In the subject audit, the Audit Division (Audit) of the Department assessed use tax/deferred sales tax on a portion of the new office building that, it claimed, did not qualify for the tax deferral under RCW 82.60. In its report, Audit wrote:

You have constructed a two story office building adjacent to, but separate and apart from the newly constructed manufacturing plant. At the time of project completion, and also the end of the tax deferral period, the first floor was put to use. The first floor houses all the engineers, designers, project managers, administrative and accounting personnel, sales people and all other nonessential manufacturing employees. Credit has been given in your deferral audit for construction costs directly related to this first floor based on the square footage used to directly support your manufacturing activities. Square footage used for administrative and sales support was not included in the deferral audit and is included in this schedule.² You are in agreement with this portion of assessed tax.

At the time of project completion (December 31, 1997) the second floor was not put to use to support your manufacturing activities. In February 1998, when this auditor commenced your deferral audit, one half of the second floor was totally empty except for a couple of tables. The other half of the second floor was used as a storage area for used furniture, company records, and various other items. When this auditor returned in mid May 1998, nothing had changed and the second floor still was unused. It is the department's position that this second floor is not being used as an essential or an integral part of your manufacturing facility and therefore does not qualify as a qualified building or portion thereof under RCW 82.60.020. Tax has been assessed on the second floor based on square footage and construction costs.

You are in disagreement with the tax assessed on this schedule and plan to appeal the issue. Your position is that the office building was built with the future in mind and that the second floor will eventually be used as support space to house employees that are

² Schedule 4 of the audit.

essential and integral to your manufacturing operation. While this audit can accept your outlook for the future, there are still no guarantees that this will ever happen and as an auditor I must audit for present facts and not future expectations.

(Footnote added; [emphasis original.]) In its petition for refund, the taxpayer opines that the Department cannot partially disallow the deferral unless a portion of the subject premises are, actually, being used for a purpose other than manufacturing or research and development. The taxpayer characterizes the second floor as “unused capacity” at the time of the audit. The taxpayer writes, “. . . where the portion of the building is initially unused and held for reasonably anticipated production needs, as opposed to being held for rental or unrelated uses, it must be allowed.” The taxpayer continues by saying that, while there was unused space on the second floor for a year or two, production demands have increased to the point where all the space is now utilized.

At the hearing the taxpayer got more specific as to how the second floor is now being used. Immediately after construction, the second floor was utilized, primarily, for storage. The taxpayer built the facility so it would have some room to grow. The second floor was, essentially, empty for about the first five months. At the time of the hearing, however, the second floor included a conference room, photocopier, blueprints, lunch room, classroom, three offices for estimators, a project administration office, the office of the company president, the sales manager’s office, offices for salesmen, and a computer room. This occupation is consistent with what the company envisioned when it constructed the building. Early on, the taxpayer used the second floor for storage of accounting records, blueprints, contracts, and other paper files. As of the time of the hearing, about 30 employees populated the building. These included 10 engineers and draftspersons, 10 contract administrators and estimators, and 10 in sales and administration, including the receptionist and two owners. Presently,³ the second floor is fully utilized. It looks considerably different than it did when Audit saw it in May of 1998. The second floor was converted from a “big cavern” to finished offices with walls in mid-2000. None of the space on the second floor has been rented out. The taxpayer believes it was “short-sighted” of the Department in not allowing them to grow into their building.

Audit pro-rated the tax deferral or, effectively, disallowed part of it, because the second floor of the building was not used for a “qualifying purpose” at the time the building was completed in December 1997.

ANALYSIS:

WAC 458-20-24001A (Rule 24001A) reads, in part:

Sales and use tax deferral -- Manufacturing and research/development activities in distressed areas -- Applications filed prior to August 1, 1999. Introduction. [Chapter 82.60 RCW](#) establishes a sales and use tax deferral program. The purpose of the program is to promote economic stimulation, create employment opportunities, and reduce poverty

³ As of the hearing date, that is.

in certain areas of the state. The legislature established this program to be effective solely in those areas and for those circumstances where the deferral is for investments that result in the creation of a specified minimum number of jobs or investment for a qualifying project.

The program applies to sales and use taxes on materials and labor and services rendered in the construction of qualified buildings or acquisition of qualified machinery and equipment and requires the recipient of the deferral to maintain the manufacturing or research and development activity for an eight-year period.

What constitutes a "qualified building" is explained in § 1(n) of Rule 24001A, which reads, thusly:

(n) "Qualified buildings" means construction of new structures, and expansion or renovation of existing structures for the purpose of increasing floor space or production capacity, used for manufacturing and research and development activities. "Qualified buildings" are limited to structures used for manufacturing and research and development activities. "Qualified buildings" include plant offices and warehouses if such facilities are essential or an integral part of a factory, mill, plant, or laboratory. "Office" means space used by professional, clerical, or administrative staff. For plant office space to be a qualified building its use must be essential or integral to the manufacturing or research and development operation. Office space that is used by supervisors and their staff, by technicians, by payroll staff, by the safety officer, and by the training staff are examples of qualifying office space. "Warehouse" means facilities used for the storage of raw materials or finished goods.

Consistent with this definition, Audit allowed the tax deferral for some, but not all, of the first floor of the subject office building.⁴ As to the second floor, it denied the deferral, entirely, on the basis that this floor was not being used for manufacturing or research and development at the time construction of the building was operationally complete. That time, which is not disputed by the taxpayer, is said by Audit to be December 31, 1997. Section 9(b) of Rule 24001A states:

The certificate holder must notify the department in writing when the construction project is operationally complete. The department will certify the date on which the project was

⁴ WAC 458-20-24001A(4) calls for the apportionment of building costs for tax deferral purposes in some situations. It reads, in part:

The deferral is allowable only in respect to investment in the construction of a new building or the expansion or renovation of existing buildings used in manufacturing and research and development. (a) Where a building(s) is used partly for manufacturing or research and development and partly for purposes that do not qualify for deferral under this rule, the deferral will be determined by apportionment of the total project costs. The applicable tax deferral will be determined by apportionment according to the ratio the construction cost per square foot of that portion of the building(s) directly used for manufacturing or research and development purposes bears to the construction cost per square foot of the total building(s).

operationally complete. The recipient of the deferral *must maintain* the manufacturing or research and development activity for eight years from this date. (Italics ours.)

Not only was such activity not maintained in the second floor office space in question, it was not even *initiated* for up to two years after the date the project was operationally complete.

Section 11(c) of Rule 24001A reads:

(c) **Failure of investment project to satisfy general conditions.** If, on the basis of the recipient's annual report or other information, including that submitted by the department of employment security, the department finds that an investment project is not eligible for tax deferral for reasons other than failure to create the required number of qualified employment positions, the department will declare the amount of deferred taxes outstanding to be immediately due. For example, a reason for disqualification would be that the facilities are not used for a manufacturing or research and development operation.

From this we see that the deferral can be revoked, after it has been granted, in the event the premises are not used for the qualified activity. Thus, had it been granted in the first place, the taxpayer's deferral could have been rescinded, based on the last two quoted portions of Rule 24001A. This leads us to believe that the administrative rule contemplates that the manufacturing or research and development activity be ongoing or, at least, ready to go at the time the project is operationally complete.

...

DECISION AND DISPOSITION:

The taxpayer's petition is denied.

Dated this 21st day of April 2003.