Cite as Det. No. 04-0004, 24 WTD 283 (2005)

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. 04-0004
. . .	)	
	)	Registration No. . . .
	)	Document No. . . .
	)	Audit No. . . .
	)	Docket No. . . .
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RULE 170; RCW 82.04.050: CUSTOM CONSTRUCTION -- SPECULATIVE BUILDER – INDICIA OF OWNERSHIP OF LAND. The issue of ownership of property is determined by an analysis more rigorous than a simple search of record title. Looking at all the attributes of ownership contained in Rule 170(2)(9) we conclude that Taxpayer 1 performed construction activities on real property owned by Taxpayer 2 and thus acted as a custom contractor.

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.

[Taxpayer 1] protests the retailing business and occupation ("B&O") tax and retail sales tax assessed on the income it received to remodel a commercial building. Similarly, [Taxpayer 2] protests the deferred sales tax/use tax assessed on the payments it made to [Taxpayer 1] for the building remodel. [Taxpayer 2] purchased a commercial building for remodel and lease. Prior to the remodel, [Taxpayer 2] quit claimed its interest in the property to [Taxpayer 1], which was formed by the members of [Taxpayer 2] to act as the prime contractor. [Taxpayer 1] was paid for the construction work it performed from construction loan proceeds obtained by [Taxpayer 2]. The deed was never recorded and REET was never paid on the property transfer to preserve the appearance that the property remained under the ownership of [Taxpayer 2]. Taxpayers maintain that because [Taxpayer 1] performed construction work on property it owned, the work was speculative construction and not custom construction as the Audit Division maintains. We

disagree. [Taxpayer 2] retained all the attributes of ownership and paid [Taxpayer 1], a third party, to perform the construction work. Accordingly, we conclude that [Taxpayer 1] performed custom construction and was correctly assessed retailing B&O tax and retail sales tax on its billings.[12]

ISSUE:

Did [Taxpayer 1] remodel a commercial building for [Taxpayer 2], making it a custom contractor liable for payment of retailing B&O tax and collection of retail sales tax on all of its billings, or was it a speculative builder remodeling a building that it owned?

FINDINGS OF FACT:

Lewis, A.L.J. – [Taxpayer 1] and [Taxpayer 2] are separate entities owned by [Owners]. The [Owners], members of both LLCs, are experienced real estate developers.

[Taxpayer 2] purchased a commercial building in . . . , Washington. The building required remodeling before it could be leased. [Taxpayer 2] hired a contractor to perform demolition work. [Taxpayer 2] fired the demolition contractor after a dispute.

According to Taxpayers, the primary tenant of the building required [Taxpayer 2] to hire an outside contractor to do the remodel. To keep the tenant, the [Owners] formed [Taxpayer 1], as a separate LLC, to act as the general contractor and complete the building remodel. Both LLCs registered with the Secretary of State and operated as separate entities. Each LLC maintained its own separate business records and filed federal income tax returns.[3]

The Department of Revenue ("Department") audited the books and records of both entities.[4] The assessments represented the Audit Division's conclusion that [Taxpayer 1] performed custom construction remodel work on a building owned by [Taxpayer 2]. Taxpayers disagreed. On November 20, 2002, Taxpayers filed petitions for correction of the assessments, maintaining that

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

[2] [Taxpayer 2] was assessed deferred retail sales tax/use tax on the amounts it paid [Taxpayer 1] as a protective assessment. The assessment against [Taxpayer 2], being complimentary, will be reduced by the amount of retail sales tax paid by [Taxpayer 1].

[3] [Taxpayer 1's] Profit and Loss Statement for calendar year 1999 show construction income of $ . . . . [Taxpayer 1] paid for the materials and subcontracting labor it purchased and billed [Taxpayer 2] as the work progressed.

[4] The Department's Audit Division audited [Taxpayer 1's] books and records for the period March 22, 1999 through December 31, 2000. On August 29, 2002, the Department issued a $ . . . assessment, representing retailing B&O tax and retail sales tax assessed on unreported construction income received from [Taxpayer 2] for the building remodel. Similarly, the Department's Audit Division audited [Taxpayer 2's] books and records for the period January 1, 1999 through December 31, 2000. On September 5, 2002, the Department issued a $ . . . assessment representing mostly the deferred retail sales tax/use tax on the payments it made to [Taxpayer 1] for the building remodel.

the tax assessments were made in error. Taxpayers explained that the construction work was actually speculative construction because [Taxpayer 2] allegedly quitclaimed the property to [Taxpayer 1] prior to the beginning of the construction.[5] The deed, dated March 12, 1999, was never notarized or recorded. When asked why the deed was never recorded, Taxpayers explained that [Taxpayer 2] had obtained construction financing from a bank and, had the deed been recorded, the lender would have withdrawn the financing commitment, thus delaying the project. Similarly, Real Estate Excise Tax was not paid on the property transfer.

In sum, [Taxpayer 1] was allegedly formed to satisfy the requirements of the primary tenant. The experienced members were well aware of the substantial tax benefits that speculative builders enjoy. To avoid the additional tax required of a custom contractor, a quit claim deed was prepared to transfer ownership of the property to [Taxpayer 1],[6] thus, allowing [Taxpayer 1] to argue that it remodeled the building as a speculative builder. However, if legal title was in fact transferred to [Taxpayer 1], then [Taxpayer 2] not only made false representations to the bank, but also avoided payment of REET by not filing the deed.

On April 29, 2003, well after the audits were begun, [Taxpayer 1] and [Taxpayer 2] filed amended Federal Tax returns. Prior to the amendment, [Taxpayer 2's] federal tax return identified the real estate as an asset and [Taxpayer 1's] federal tax return reported construction income. The amendments, removed the real property from [Taxpayer 2's] asset list and added it to [Taxpayer 1's] asset list. Similarly, the amendment to [Taxpayer 1's] federal tax return removed the construction income.

ANALYSIS:

As a general rule, retail sales tax applies on each retail sale. RCW 82.08.020. "Retail sale" is defined in RCW 82.04.050 to include construction activities. RCW 82.04.050(2)(b) states:

> (2) The term "sale at retail" or "retail sale" shall include the sale of or charge made for tangible personal property consumed and/or for labor and services rendered in respect to the following: . . .
> (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, including the installing or attaching of any article of tangible personal property therein or thereto, whether or not such personal property becomes a part of the realty by virtue of installation . . . .

WAC 458-20-170 (Rule 170) implements RCW 82.04.050, providing guidance and instructions to taxpayers on the subject of contractors, construction, and their state tax responsibilities. Rule

[5] The quit claim deed was not presented to the Audit Division during the course of the audit. Rather, it was presented during the September 9, 2003 in-person hearing.
[6] The [Owners] are members of both LLCs. Thus, while the deed was never recorded it is presumed that the deed was delivered.

170 distinguishes between "speculative" construction and "custom" construction. The distinction is based upon the identity of the consumer of the construction services. The central issue is whether or not the construction was done on "real property of or for consumers" and specifically, whether [Taxpayer 2], at the time the construction occurred, was the "consumer."

RCW 82.04.190(1) defines "consumer" as:

> Any person who purchases, acquires, owns, holds, or uses any article of tangible personal property irrespective of the nature of the person's business and including, among others, without limiting the scope hereof, persons who install, repair, clean, alter, improve, construct, or decorate real or personal property of or for consumers . . . .

Rule 170 does not define "custom" construction *per se*; however, it provides a definition of "prime contractor":

> The term "prime contractor" means a person engaged in the business of performing for consumers, the constructing, repairing, decorating or improving of new or existing buildings or other structures under, upon or above real property, either for the entire work or for a specific portion thereof.

Rule 170(2)(a) defines "speculative builder" to mean:

> As used herein the term "speculative builder" means one who constructs buildings for sale or rental upon real estate owned by him. 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, RCW 82.04.190(1), 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. Looking at the attributes of ownership contained in Rule 170(2)9a), we conclude that [Taxpayer 1] was not the owner of the land, even if we assume legal title was transferred to [Taxpayer1].

1. What were the intentions of the parties in the transaction under which the land was acquired? During the in-person hearing, [Owner] stated that [Taxpayer 2] was formed to

purchase, remodel, and rent the real estate. The formation of [Taxpayer 1] was not contemplated at the time the real estate was purchased. It was only to satisfy the requirements of the major tenant that [Taxpayer 1] was formed.

2. Who paid for the land? [Taxpayer 2] purchased the real estate. Although the land was allegedly quit claim deeded to [Taxpayer 1] by [Taxpayer 2], the evidence is incomplete in this regard. There is no record of any consideration given; the deed was not notarized; the deed was not recorded; and, there is no evidence the deed was delivered.[7]

3. Who paid for the improvements to the land? [Taxpayer 2] paid for improvements to the land. [Taxpayer 2] had a construction loan and used the proceeds to pay [Taxpayer 1] for the remodel work.

4. In what manner did all parties, including financiers, deal with the land? Without exception, all the interested parties dealt with the land as if it was owned by [Taxpayer 2].

- [Taxpayer 2] represented to the lender that it owned the real estate, even after it allegedly quitclaimed its interest in the property to [Taxpayer 1]. [Taxpayer 2] stated that it feared that the lender would withdraw its financing commitment if it learned that the property had been deeded to another entity. Thus, [Taxpayer 2] never recorded the quitclaim deed, wanting the lender to continue believing that it owned the real estate.

- [Taxpayer 2] represented to the State that it owned the real estate. [Taxpayer 2] neither recorded the quit claim deed nor paid REET on the transfer. Thus, [Taxpayer 2] allowed the State to continue believing it owned the real estate.[8]

- [Taxpayer 2] represented to the building's primary tenant that it owned the real estate. [Taxpayer 1] was formed to satisfy the building's primary tenant's requirement that the remodel work be done by an independent contractor.

- [Taxpayer 2] represented to the Federal Government that it owned the real estate. [Taxpayer 2's] federal tax returns recorded it as the owner of the property.[9]

Based upon the criteria identified in Rule 170(2)(a), we conclude that [Taxpayer 1] acted as a custom contractor and that the Audit Division correctly assessed tax.

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[7] RCW 64.04.020: "Every deed shall be in writing, signed by the party bound thereby, and acknowledged by the party before some person authorized by this act to take acknowledgements of deeds." Additionally, RCW 65.08.070 provides that an unrecorded deed is void as against any subsequent purchaser or mortgagee in good faith and for a valuable consideration from the same vendor, his heirs, or devisees, whose conveyance is first duly recorded.

[8] RCW 82.45.090 requires that REET be paid on sale before the county auditor can accept the deed for recording.

[9] After the Department's audit, Taxpayer filed amended returns consistent with [Taxpayer 1's] ownership of the property.

DECISION AND DISPOSITION:

Taxpayers' petitions are denied. However, because two complimentary assessments have been issued, the [Taxpayer 1] assessment will be reduced to the extent that the deferred sales tax/use tax assessed against [Taxpayer 2] on the building remodel is paid.

Dated this 15th day of January 2004.