NO. 46689-9

COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

DEPARTMENT OF REVENUE, STATE OF WASHINGTON,

Appellant,

v.

MORPHO DETECTION, INC.,

Respondent.

BRIEF OF APPELLANT

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I. INTRODUCTION

States cannot tax the federal government directly. But they can and do tax contractors that work for the federal government. *Washington v. U.S.*, 460 U.S. 536, 546, 103 S. Ct. 1344, 75 L. Ed. 2d 264 (1983). One such tax is Washington's use tax on contractors that construct, repair, decorate, or improve buildings for the United States.

As part of a federal overhaul of airport security operations after 9/11, the United States paid Morpho Detection over $48 million to manufacture and install explosive detection systems at two Washington airports. Therefore, the Department of Revenue imposed use tax on Morpho as the contractor that improved the airports for the United States. This outcome was required by Washington's statutory scheme, which imposes use tax on contractors in situations where Washington cannot tax the United States directly.

In a ruling that is flatly inconsistent with both the language of RCW 82.04.190(6) and the purpose of that statute to tax contractors doing business with the United States, the trial court granted Morpho's request for a tax refund of more than $5 million. Based on an application of the plain meaning rule that our Supreme Court has repeatedly rejected, the court interpreted the words "of or for" as they appear in RCW 82.04.190(6) to limit the use tax to construction work only on land in

which the United States has a property interest. As a result, the court carved out a tax exemption for the broad category into which Morpho's work fell—work paid for by the United States on land the United States does not own. Creating a single type of building improvement work that entirely escapes taxation cannot possibly be the legislative intent behind the statute. This Court should reverse the order granting summary judgment to Morpho, direct the trial court to grant partial summary judgment to the Department, and remand for resolution of the remaining issues.

II. ASSIGNMENTS OF ERROR

1. The trial court erred in granting Morpho Detection's motion for summary judgment.

2. The trial court erred in denying the Department's request for partial summary judgment.

3. The trial court erred in ruling that the United States must have a beneficial interest in the real property where buildings are improved for the use tax to apply.

III. ISSUE PERTAINING TO ASSIGNMENTS OF ERROR

"Consumers" of personal property owe use tax on the value of that property if they have not paid retail sales tax. RCW 82.12.020. The definition of "consumer" includes persons "engaged in the business . . . of improving . . . buildings . . . upon, or above real property of or for the United States . . . ." RCW 82.04.190(6). Morpho Detection installed

explosive detection systems under contract with the United States and was paid for that work by the United States. Did the trial court err when it ruled that Morpho improved buildings neither "of" nor "for" the United States under RCW 82.04.190(6) and thus did not owe use tax on the value of the personal property it installed? (Assignment of Errors 1-3)

IV. STATEMENT OF THE CASE

A. Overview

In the wake of September 11, 2001, Morpho Detection[1] won two national contracts to manufacture and install explosive detection systems at airports for the Transportation Security Administration (TSA). CP 176-367. TSA determined that the 46 systems at issue in this case would be installed at Washington airports, specifically the Seattle-Tacoma and Spokane International Airports. *See* CP 36-54. At these airports Morpho performed various tasks assigned by TSA, including assembly and assuring the systems functioned properly. *E.g.*, CP 450-70 (various invoices); CP 511; 544-45. Sea-Tac received 41 units, with the five remaining units installed in Spokane. CP 36-54.

For its manufacture and installation of the Washington systems, Morpho received over $48 million from the federal government. Because

[1] During periods relevant to this case Morpho went through various name changes, including names associated with General Electric. The company is now called Morpho Detection, LLC, owned by the French corporation Safran. For ease of reference, the brief will refer to the Respondent's various iterations as "Morpho."

Morpho had installed the systems in Washington and its work was for the United States, the Department assessed Morpho use tax totaling $4,191,799, in addition to other tax, interest, and penalties. CP 562.

B. Morpho's Bid And Contracts

After 9/11, Congress determined that it was necessary to overhaul security operations at our nation's airports in order to protect the citizenry. Part of the reform was the Aviation Transportation Security Act, which placed responsibility for airport security within the newly-created Transportation Security Administration. *See* 49 U.S.C. § 114.

One of TSA's duties was to acquire explosive detection systems and assure their installation at airports. Explosive detection systems use computer tomography to scan objects such as luggage and compare their density to known explosives. CP 40. Federal law required explosive detection systems be deployed as soon as possible, but no later than December 31, 2002. 49 U.S.C. § 44901(b).

TSA[2] issued a solicitation on November 23, 2001, for contractors capable of both manufacturing and installing explosive detection systems. The solicitation indicated the breadth of work to be performed by the contractor in addition to the actual manufacturing requirements. For example, the solicitation stated that "Contractor shall provide program

[2] The Federal Aviation Administration originally issued the solicitation, but shortly thereafter TSA took over the bidding process.

management, systems engineering, integrated logistics support, quality assurance, configuration management, training, materials and support to test, deliver, install and maintain [stand-alone] EDS [explosive detection systems] and supporting equipment/deliverables in accordance with this [Statement of Work]." CP 146.

Morpho, a relatively small company at the time, was in a prime position to expand its position in the market. *See* CP 509. Morpho was one of only two companies with an explosive detection product already certified by the federal government. *Id.* Morpho's systems contained several parts, generally including a computer tomography unit that scanned for explosives, an entrance conveyor, an exit slide, and a console. CP 40.

Morpho responded to the government's solicitation, touting not only its ability to manufacture explosive detection systems, but also the installation and other work it would perform at the destination airports:

> We have addressed needs beyond the device itself. Today, [Morpho] not only manufactures CTX scanners, but also offers site planning, integration services, installation services, maintenance services and a range of training courses for operators, instructors and maintenance personnel.

CP 158.[3]

Morpho was quickly awarded a "letter contract" to manufacture and set up explosive detection systems across the United States. CP 162-75. This began a flurry of manufacturing and site installation activity as Morpho sought to keep up with the exponentially increasing demand for its explosive detection systems leading up to the December 31, 2002, deadline. At the same time, Morpho continued to negotiate specific contract terms with the federal government. Eventually the parties entered into two complete contracts for the manufacture and "site installation support" of systems at airports across the country. CP 177-367 (site installation support provisions at CP 206, 299-300). The parties agreed to a price-per-system that included assembly at an airport of TSA's choosing. *See* CP 537-38 (assembly work included in contract price for machine). In addition, the government had the ability to order additional services and often did so. CP 450-70 (invoices to TSA for additional airport work).

C. The Explosive Detection Systems And Their Installation

The detection systems at issue in this case are used to screen checked baggage for explosives. The various installation processes Morpho used are detailed in "installation checklists" that Morpho

[3] "CTX" is one of Morpho's trademarked product lines. *See http://www.morpho.com/detection/see-all-products/ctx-explosives-detection/* (last visited January 25, 2015).

technicians completed. CP 473-505. The basic steps to deploying an explosive detection system are as follows:

a. *Manufacture*. Morpho manufactured the systems at its California facility. CP 33.

b. *Factory Acceptance Test*. Once a machine was manufactured, it was tested at Morpho's California factory. TSA could witness the test. *See* CP 519-20.

c. *Transportation*. After the factory acceptance tests, TSA-contracted trucks picked up the machines (at which point title to the machines passed to TSA) and moved them to other locations. The systems at issue in this case were taken to Texas before transport to Washington. *Id.*

d. *Airport Infrastructure Work*. Various contractors performed structural work at the airports to accommodate the explosive detection systems, some of which are the size of minivans. *E.g.*, CP 43.

e. *Transport to Washington*. For those systems that TSA determined would come to Seattle or Spokane, TSA arranged transportation to the Washington airport. CP 17, 33.

f. *Rigging and Seismic Anchoring*. When an explosive detection system arrived at an airport, "riggers" met the truck carrying the system. CP 518. The systems could be in more than one piece. CP 525-

26. The riggers unloaded and uncrated the systems, then moved them using a large forklift to a marked place inside the airport. CP 510-11, 522. In some cases, riggers "seismically anchored" systems to the floor, bolting them down with custom brackets. CP 45.

Around mid-2003, Morpho assumed responsibility for rigging and subcontracted that work to other companies. CP 88, 516. Morpho's contracts with TSA were modified to create a new billing category for "installation and rigging." CP 369-72. Morpho employees inspected systems for shipping damage and monitored the riggers. CP 518-19, 524.

g. *Assembly.* Once the systems were in place, Morpho assembled the internal components for each system. CP 34, 44-46, 206, 511. Because of delays such as requiring a replacement part or an infrastructure delay, the time between the beginning and end of assembling a system could be as much as a year. CP 544-45.

h. *Site Acceptance Test.* Once a system was assembled and installed, Morpho assisted Battelle in conducting a site acceptance test. This test assessed whether a system could adequately identify threats after assembly by scanning test bags. CP 530-31, 543.

i. *Baggage Handling Systems and Integration.* Some of the systems were "integrated" into baggage handling systems so that luggage moved directly through the explosive detection system on the baggage

handling conveyor belt. Proper integration ensured that the two systems could "communicate" with each other and that baggage would move smoothly through the CT scanner. Morpho handled the explosive detection system side of integration, and the baggage handling system contractor handled its side. *See* CP 548-57.

j. *Integrated Site Acceptance Test.* The integrated site acceptance test determined whether the completed system functioned correctly. Morpho assisted another contractor in performing these tests. CP 529-30.

k. *Multiplexing.* Morpho also designed and implemented a multiplex network, which allows TSA employees to monitor bag images from computer viewing stations in a "remote" room, separate from the explosive detection systems themselves. *See* CP 514-15, 527-28; 553.

D. Procedural Facts

The subject of Morpho's liability for use tax in Washington has been addressed in both state and federal venues.

1. The Department's audit

The Department audited Morpho's activities at the Sea-Tac and Spokane airports for the period January 1, 2002, through March 31, 2006. CP 39. The Department performed a meticulous audit, reviewing thousands of records Morpho provided to the auditor. The audit resulted

in a 16-page report entitled "Auditor's Detail of Differences and Instructions to the Taxpayer." CP 39-54.

Morpho received more than $48 million from the United States for manufacturing and installing these 46 systems. CP 36. Based on the information Morpho made available during the audit, the Department assessed Morpho a total of $5,423,645, including $4,191,799 in use tax, $237,293 in business and occupation tax,[4] a 5% assessment penalty of $221,455, and $773,098 in interest. CP 562. The Department imposed use tax because Morpho installed 41 explosive detection systems at Sea-Tac airport and five explosive detection systems at the Spokane airport, all for the United States. The Department calculated use tax based on the value of the personal property that Morpho installed. *See* CP 563.

2. Morpho's administrative appeal

Morpho appealed the assessment to the Department's Appeals Division. *See* WAC 458-20-100 (explaining Department's internal appeals process). In some of these appeals, members of the Department's executive leadership are involved in determining the outcome of an internal appeal, as was the case here. *See* WAC 458-20-100(6)(b).

Morpho submitted extensive evidence and legal argument to the Appeals Division. After considering that material, the Department issued

[4] Morpho does not dispute the business and occupation tax portion of the assessment. *See* CP 12.

its "Final Executive Level Determination," affirming that Morpho owed use tax for installing the explosive detection systems at Washington airports. CP 559-70. Most of the Determination is devoted to the issue of whether Morpho in fact "installed" the systems.[5] However, the Determination does address the issue of whether the property improved must be "of" the United States, or whether such improvement can be "for" the United States while located on non-federal land. The Department reasoned:

> The Department concludes that RCW 82.04.190(6) does not mandate that the real property at issue be of the United States. Rather, for purposes of RCW 82.04.190(6), business conducted can be for the United States on real property not of the United States, and those conducting such business can still be a "consumer." Since taxpayer assembled EDS machines in Washington on behalf of TSA, an instrumentality of the United States, on real property owned by the Port of Seattle, the Department concludes that Taxpayer's argument on this point is erroneous.

CP 564 (footnote 6).

3. Morpho's federal court litigation

While it was fighting its use tax assessment in Washington, Morpho also challenged its responsibility for the assessment through the

[5] This is likely the primary issue that will be litigated if the case is remanded. Despite contracts, statements of work, invoices, and testimony by Morpho employees stating that it installed the systems, Morpho makes the surprising contention that its work was not "installation" and therefore, that it is not a "consumer" under RCW 82.04.190(6). CP 13. However, for purposes of summary judgment, Morpho has conceded that it installed the systems and the issue is therefore not presently in dispute. CP 24 (footnote 6).

federal courts. Specifically, Morpho requested that TSA adjust its contract price to include the assessment, thereby effectively reimbursing Morpho for the use tax it would pay to Washington. Morpho argued that at the time it entered its contract, it did not know at which airports it would be installing its systems, and therefore it could not have known that it would owe use tax in Washington. *See* CP 592-93. It also argued that it could not have known that Washington would impose any tax at all in this situation. TSA refused to adjust the contract price. Morpho then litigated the issue in the Federal Aviation Administration's Office of Dispute Resolution for Acquisition (ODRA), which issued detailed findings and conclusions. CP 573-602.

One of Morpho's arguments to ODRA was that Washington's use tax was an "after-imposed tax"[6] under standard language that applies to federal contracts. Specifically, Morpho argued that the Department's use tax assessment was an after-imposed tax because the real property where the systems were installed is not owned by the federal government, similar to its argument here. CP 592-93.

ODRA disagreed with Morpho and instead agreed with the Department's interpretation of RCW 82.04.190(6). Citing the Department's Determination explaining that work can be "for" the United

[6] An "after-imposed tax" is a new or increased tax excluded on the contract date but whose exclusion was later revoked. *See* CP 92.

States in addition to being on or above real property "of" the United States, ODRA concluded that "[Morpho's] position is not supported by the canons of statutory interpretation or by demonstrating that contrary interpretations prevailed prior to the ALJ's Determination." CP 598. Rather, the Department "relied on the plain, simple, and singular interpretation that gives meaning to the complete language of the statutory definition of 'consumer.'" *Id.* ODRA also explained that Morpho would read the phrase "'or for' . . . out of the statute entirely." *Id.*

Morpho appealed the issue to the United States Court of Appeals for the District of Columbia Circuit. The U.S. Court of Appeals agreed with ODRA and denied the petition. *Morpho Detection, Inc. v. Transportation Sec. Admin.*, 717 F.3d 975, 976 (D.C. Cir. 2013). It held that Washington had not created an after-imposed tax because the law defining a "consumer" had not changed since 1975, and that "Morpho should have known it might reasonably be determined to be a 'consumer' whose business activities in Washington were subject to the use and B&O taxes." *Id.* at 982.

4. The state court litigation

After the Department issued its Determination in Morpho's administrative appeal, Morpho brought a tax refund claim in Thurston County Superior Court under RCW 82.32.180. The parties conducted

extensive discovery. Most of the discovery surrounded the factual issue of whether Morpho installed the explosive detection systems, as opposed to some other contractor. However that question was not the one upon which the trial court granted summary judgment.

Morpho moved for summary judgment, raising two issues related to whether or not it met the definition of a "consumer" under RCW 82.04.190(6) and was therefore subject to the use tax. In its response to Morpho's motion, the Department asked that partial summary judgment be granted in its favor on the two issues Morpho raised. *See* CP 60, 81. The first of these was Morpho's argument that, even assuming it installed the explosive detection systems at Washington airports, Morpho was not "engaged in the business" of improving buildings, and therefore was not a consumer. CP 23-25. The trial court found that there was an issue of fact on this issue. CP 646; RP 29.

The second issue resulted in summary judgment being granted to Morpho. Morpho argued that the definition of "consumer" in RCW 82.04.190(6) requires that the buildings being improved must be under, upon or above real property that is either owned by the United States or in which the United States has a beneficial interest such as a lease, an easement, or a license. CP 25-26; 630-32. The Department countered that no such property interest is required as long as the buildings are improved

for the United States, and that regardless, the United States had at least a license to inspect and operate security measures at the airports. CP 75-81.

The trial court agreed with Morpho that RCW 82.04.190(6) requires a property interest, and ruled that, as a matter of law, the United States had no such interest in Sea-Tac and Spokane airports. RP 30-31; CP 653. Accordingly, the trial court ruled that Morpho was not a "consumer" of the systems and, therefore, not subject to Washington's use tax. The Department timely filed a notice of appeal to this Court. CP 648-49.

V. ARGUMENT

Morpho meets RCW 82.04.190(6)'s definition of a "consumer" and the Department properly assessed use tax against Morpho based on the value of the systems it installed at Washington airports. The use tax is imposed on contractors that improve buildings above or upon real property "of or for" the United States. RCW 82.04.190(6) covers two situations: (1) contractors that improve buildings on real property "of" the United States, and (2) contractors that improve buildings "for" the United States. Because Morpho received $48 million for manufacturing and installing systems at Washington airports, it improved buildings "for" the United States, despite the fact that the United States does not own the Sea-Tac or Spokane airports.

The Department's construction of RCW 82.04.190(6) is the only reasonable one, particularly in light of the statutory scheme. Federal contractors are defined as "consumers" under the use tax because Washington cannot tax the United States directly. Therefore, the incidence of the tax is shifted to the contractor in federal contracting, unlike construction projects generally, where sales tax is imposed on the entity that purchases the work. Because Washington could not tax the United States for purchasing or installing explosive detection systems, Morpho is defined as a "consumer" and owes use tax.

Federal case law supports this result. The D.C. Circuit Court of Appeals held that Morpho should have known it might reasonably be determined to be a "consumer" and subject to Washington's use tax. *Morpho Detection*, 717 F.3d at 982. And the FAA's Office of Dispute Resolution for Acquisition found that Morpho's interpretation to the contrary was unsupported by the canons of statutory construction and read the words "or for" out of the statute entirely. CP 598.

A. Standard of Review and Legal Standards

The Court reviews orders granting summary judgment de novo. *In re Estate of Hambleton*, __ Wn.2d __, 335 P.3d 398, 406 (2014). A trial court properly grants summary judgment if there is no genuine issue of material fact and the party requesting summary judgment is entitled to

judgment as a matter of law. *Skagit Cnty. Pub. Hosp. Dist. Bd. 1 v. Dep't of Revenue*, 158 Wn. App. 426, 435, 242 P.3d 909 (2010).

The fundamental objective in construing a statute is to ascertain and carry out the Legislature's intent. *Dep't of Ecology v. Campbell & Gwinn*, 146 Wn.2d 1, 9-10, 43 P.3d 4 (2002). "When possible, the court derives legislative intent solely from the plain language enacted by the legislature, considering the text of the provision in question, the context of the statute in which the provision is found, related provisions, amendments to the provision, and the statutory scheme as a whole." *Cashmere Valley Bank v. Dep't of Revenue*, 181 Wn.2d 622, 631, 334 P.3d 1100 (2014) (citing *Campbell & Gwinn,* 146 Wn.2d at 9-10). Courts also consider the subject, nature, and purpose of the statute, along with the consequences of adopting one interpretation over another. *Burns v. City of Seattle*, 161 Wn.2d 129, 140, 164 P.3d 475 (2007). Statutory interpretation is a question of law subject to de novo review. *Cashmere Valley Bank*, 181 Wn.2d at 631.

The Department is charged with enforcing the tax code and has the authority to interpret it. *Id.* at 635. "While the ultimate authority for determining a statute's meaning remains with the court, considerable deference will be given to the interpretation made by the agency charged with enforcing the statute." *Impecoven v. Dep't of Revenue*, 120 Wn.2d

357, 363, 841 P.2d 752 (1992). Taxes are presumed valid, and the burden is on the taxpayer to show that the Department's assessment is incorrect. *Space Age Fuels, Inc. v. Dep't of Revenue*, 178 Wn. App. 756, 762, 315 P.3d 604 (2013).

B. The Department Properly Assessed Use Tax On The Value Of The Explosive Detection Systems Morpho Installed At Washington Airports.

The use tax is imposed on "every person in this state . . . for the privilege of using within this state as a consumer any: (a) Article of tangible personal property acquired by the user in any manner . . . ." RCW 82.12.020(1). Use tax is a companion tax to the retail sales tax and is imposed when a seller has not collected the retail sales tax. *See* RCW 82.08.020(1) (retail sales tax); RCW 82.12.020(1) (use tax); WAC 458-20-178(2); *Glen Park Assocs., LLC v. Dep't of Revenue*, 119 Wn. App. 481, 484 n.1, 82 P.3d 664 (2003). The intent of use tax is "to tax the privilege of using all tangible property within the state on which sales tax has not been paid." *Activate, Inc. v. Dep't of Revenue*, 150 Wn. App. 807, 814, 209 P.3d 524 (2009) (quoting *Sacred Heart Med. Ctr. v. Dep't of Revenue*, 88 Wn. App. 632, 638, 946 P.2d 409 (1997)). The use tax rate is determined by the applicable retail sales tax rate. RCW 82.12.020(4). The measure of the tax is the "value of the article used," which generally is its purchase price. RCW 82.12.010(7)(a); RCW 82.12.020(4).

For the following reasons, the Department properly assessed Morpho for use tax on the explosive detection systems that it installed or prepared for subsequent use by TSA.

1. Morpho "used" the explosive detection systems under RCW 82.12.010(6).

Whether use tax applies is governed in part by the statutory definition of "use." "Use" is given its ordinary meaning and includes in pertinent part, "the first act within this state by which the taxpayer takes or assumes dominion or control over the article of tangible personal property (as a consumer), and include[s] *installation*, storage, withdrawal from storage, distribution, or any other act preparatory to subsequent actual use or consumption within this state; . . ." RCW 82.12.010(6)(a) (emphasis added).

As noted above, Morpho has conceded for purposes of summary judgment that it installed the explosive detection systems in Washington. CP 24 (footnote 6). Because installation constitutes "use" under RCW 82.12.010(6)(a), this Court need only address whether Morpho's use of the systems was as a "consumer" under RCW 82.04.190(6).

2. Morpho used the explosive detection system "as a consumer" under RCW 82.04.190(6).

To have use tax liability, a taxpayer must "use" the item in question "as a consumer." In RCW 82.04.190, the Legislature has defined

"consumer" in numerous ways, giving the term a meaning much broader than what might commonly be understood as an individual household purchaser of goods. One subsection of that statute applies to the specific circumstances of this case, designating as "consumers" persons who construct, repair, decorate, or improve buildings upon or above real property "of or for" the United States.

> 'Consumer' means . . . [a]ny person engaged in the business of constructing, repairing, decorating, or improving new or existing buildings or other structures under, upon, or above real property *of or for* the United States. . . .

RCW 82.04.190(6) (emphasis added).

"Statutes must be interpreted and construed so that all the language used is given effect, with no portion rendered meaningless or superfluous." *Davis v. Dep't of Licensing*, 137 Wn.2d 957, 963, 977 P.2d 554 (1999) (citation omitted). To give all the words in this statute meaning, it must cover two situations:

1. Any person engaged in the business of constructing, repairing, decorating, or improving new or existing buildings or other structures under, upon, or above real property *of* the United States; and

2. Any person engaged in the business of constructing, repairing, decorating, or improving new or existing buildings or other structures *for* the United States.

This is the only logical construction of the statute that gives all the words their plain meaning. Morpho's work falls into the second situation as a matter of law because Morpho worked under contract with TSA, and TSA paid for installation of the explosive detection systems at the Washington airports. This holds true even though the federal government does not own the airports. In other words, regardless of whether Morpho installed the explosive detection systems in buildings on land "of" the United States, it certainly installed them in buildings on land "for" the United States.

The trial court reached a contrary conclusion, ruling that the definition of "consumer" in RCW 82.04.190(6) applies only when the federal government owns, or has some other property interest in, the real property on which the work is performed. RP 30-31. In doing so, the trial court failed to discern and give effect to the Legislature's intent. This intent is evident not only in the plain meaning of the words in RCW 82.04.190(6), but also in the statutory scheme, which deliberately shifts the incidence of the tax on construction-related activities to the contractor when the customer for those services is the United States.

C. Because Washington Cannot Impose Sales Taxes On The United States For Construction-Related Costs, The Legislature Imposes Use Tax On Federal Contractors For Those Materials.

The Supremacy Clause of the United States Constitution prohibits states from taxing the federal government directly. *U.S. v. New Mexico*, 455 U.S. 720, 733, 102 S. Ct. 1373, 71 L. Ed. 2d 580 (1982). This means that Washington's usual tax system imposing a retail sales tax on a person or business that hires a contractor to construct, repair, decorate, or improve buildings cannot be applied if it is the federal government that pays the contractor. As a result of this limitation, Washington enacted legislation that taxes a contractor who works for the federal government as the "consumer," rather than the actual purchaser of that work, the federal government. Even though the contractor will often pass the tax on to the federal government by including the costs in its bid price, the United States Supreme Court upheld this alternative tax system for government contracting against a Supremacy Clause challenge. *Washington v. U.S.*, 460 U.S. 536, 546, 103 S. Ct. 1344, 75 L. Ed. 2d 264 (1983).

The statutes accomplish this dual system for taxing construction through an interplay of the sales and use tax statutes and the definitions contained in those statutes. The analysis starts with the sales tax and the definitions of what is included and excluded from a "retail sale" subject to that tax. *See* RCW 82.04.050. A taxable "retail sale" generally includes

construction work. *E.g.*, RCW 82.04.050(2). Specifically, the term includes the "charge made for tangible personal property consumed and/or for labor and services" associated with:

> 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...

RCW 82.04.050(2)(b).

Despite the broad language of RCW 82.04.050(2)(b), work performed for the federal government is carved out of the sales tax by excluding it from the definition of "retail sale":

> The term [retail sale] does not include the sale of or charge made for labor and services rendered in respect to the constructing, repairing, decorating, or improving of new or existing buildings or other structures under, upon, or above real property of or for the United States. . .

RCW 82.04.050(12). This means that construction work "under, upon, or above real property of or for the United States" is not subject to retail sales tax on the labor and services like other construction work.

Because of the Supremacy Clause limitation on state taxation of the federal government, Washington imposed no sales or use tax on federally-funded construction projects from 1941 through 1975. *See Washington*, 460 U.S. at 538. But in 1975, the Legislature decided to

bring this work back into the tax system. And because the Legislature could not tax the federal government as a purchaser of the work, it chose to impose tax on the federal contractor. *Id.* at 538-540.

This federal contracting work is brought back into the tax scheme by defining a federal *contractor* as a "consumer" who owes use tax. RCW 82.12.020 imposes a use tax on "consumers" of personal property. In 1975, the Legislature added the definition of "consumer" in RCW 82.04.190(6), creating use tax liability for persons "engaged in the business of constructing, repairing, decorating, or improving new or existing buildings or other structures under, upon, or above real property *of or for* the United States . . . ." (Emphasis added.) Under the use tax, the federal contractor's use of materials in this work is subject to tax based on the value of the article used. RCW 82.12.020(4)(a).

This history regarding state taxation of federal construction projects demonstrates that starting in 1975, the Legislature intended to tax federal construction projects to the full extent allowed under federal constitutional limitations.

D. When The United States Pays A Contractor To Improve Buildings, That Work Is "For" The United States And The Contractor Is A "Consumer."

The trial court ruled that Morpho's work was not subject to use tax because Morpho performed it on land in which, the trial court assumed,

the federal government had no interest. RP 29-31; CP 653. In other words, the trial court ruled that Morpho was not working on land "of" the United States. This interpretation, however, reads the words "or for" out of RCW 82.04.190(6)'s "consumer" definition. *See* CP 598 (ODRA decision). The trial court erred by failing to take into account all the language of the statute, related statutes, and the context and purpose of the statute, as our Supreme Court requires. *See Campbell & Gwinn*, 146 Wn.2d at 9-10.

1. Morpho's interpretation of "for" in RCW 82.04.190(6) leads to an awkward and implausible result, contrary to the unambiguous language and statutory scheme.

Neither the trial court nor Morpho has ever offered a plausible meaning for the words "or for" that could support the result the court reached. Indeed, in its opening summary judgment brief arguing that its work was tax-exempt because it was not on federal land, Morpho made no effort whatsoever to explain this phrase. *See* CP 25-26. After the Department pointed out that shortcoming, Morpho suggested that perhaps the words "or for" mean some "beneficial interest" less than ownership. CP 631. Morpho did not identify precisely what this lesser interest might be, nor did it attempt to draw a line between what was and what was not a sufficient interest to trigger the use tax.

Morpho's reading of the statute is strained to say the least. It is difficult to imagine that the Legislature, immediately after using the phrase "real property of," which refers to ownership, would have used the phrase "real property . . . for" to describe some lesser property interest. It makes far more sense for real property to be "of" the federal government than for real property to be "for" the federal government.[7] The only plausible interpretation is that the word "for" links the earlier actions of "constructing, repairing, decorating, or improving new or existing buildings" with whom those actions are being done for—the federal government. In simple terms, contracting work is performed "for" the federal government; real property is not "for" the federal government.

If the Legislature intended that real property "for" the federal government mean property owned by someone else, but in which the United States has a lease, easement, or a license, it could easily have said so.[8] It did not, and Morpho's efforts to twist the statute into something

[7] Compare, for example, these sentences: "The contractor performed work on real property of the United States," and "The contractor performed work on real property for the United States." The first sentence plainly describes who owned the jobsite; the second sentence cannot coherently be interpreted to refer to a lease by the United States of the jobsite.

[8] In fact, the Legislature used such precision in another definition of activities constituting a retail sale. RCW 82.04.050(2)(c) imposes sales tax for "The constructing, repairing, or improving of any structure upon, above, or under *any real property owned by an owner who conveys the property by title, possession, or any other means* to the person performing such construction, repair, or improvement for the purpose of performing such construction, repair, or improvement and the property is then

else should be rejected. The Legislature intended "for" to address the constitutional problem of taxing the federal government directly if work is performed "for" the federal government, regardless of who owns the land where that work is performed.

Morpho's interpretation of the statutory language also causes an absurd result with respect to RCW 82.04.050(12), the portion of the "retail sale" definition that excludes government contracting from the retail sales tax. The language in RCW 82.04.050(12) mirrors the language in RCW 82.04.190(6)—one excludes work from the retail sales tax and the other defines the contractor performing the same work as a "consumer" under RCW 82.04.190(6), making the contractor subject to use tax. The two statutes should be read consistently, as they are related. *See Campbell & Gwinn,* 146 Wn.2d at 9-10.

Under Morpho's interpretation, because Morpho did not improve buildings "upon, or above real property of or for the United States," it is not a "consumer" under RCW 82.04.190(6) and, accordingly, is not subject to use tax. If "upon, or above real property of or for the United States" in RCW 82.04.050(12) is read the same way, the statute would not exclude from the retail sales tax construction work performed for the United States on non-federal land. But imposing sales tax on the United

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reconveyed by title, possession, or any other means to the original owner" (emphasis added).

States would have violated the Supremacy Clause, and the Legislature did not intend such a result.

2. Morpho's interpretation of "for" the United States is inconsistent with the rationale behind taxing federal contractors.

The policies that underlie imposing a use tax on government contractors apply squarely to Morpho's Washington installation of explosive detection systems for TSA. Because of the Supremacy Clause, Washington could not have imposed a sales or use tax on TSA for purchasing or using the explosive detection systems.

Imposing use tax when buildings are improved "for" the United States makes much more sense in constitutional terms than limiting the use tax to situations where contractors improve buildings on real property owned by the United States. It is clear that when the United States purchases work, Washington cannot impose sales or use tax on the United States. Therefore, to tax the improvement of buildings "for" the United States at all, a tax must be imposed on the contractor. Under Morpho's construction, Washington would essentially be taxing contractors only when buildings are improved on real property "of" the United States. But the constitutional problem of taxing the federal government has nothing to do with who owns the land. Washington could constitutionally impose retail sales tax on a private buyer of construction services on federal land.

U.S. v. New Mexico, 455 U.S. 720, 733, 102 S. Ct. 1373, 71 L. Ed. 2d 580 (1982) (Supremacy clause only prohibits tax directly on the United States). There would be no constitutional reason to shift the incidence of tax in these situations to the contractor.[9] Rather, the purpose of the use tax on federal contractors is to address the constitutional prohibition on taxing work *for* the United States.

3. The Legislature did not mean "and" when it used the word "or" in RCW 82.04.190(6).

The Department's interpretation of RCW 82.04.190(6) is the only reasonable interpretation that considers all the statute's language. In a sense, Morpho and the trial court have changed the Legislature's phrase "of or for" to "of *and* for." If the statute did say "and," then Morpho's work would be tax-free because it was not both on property "of" the United States *and* performed "for" the United States. But the word "or" does not mean "and" unless legislative intent clearly indicates that such a

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[9] The Legislature may have included the phrase "real property of" into the use tax scheme because of some older cases suggesting that states could not tax work on federal property. *U.S. v. Livingston*, 179 F. Supp. 9 (E.D.S.C. 1959) (sales or use tax on materials procured by Dupont for Savannah River Project, a U.S. facility, was invalid), *sum. aff'd* 364 U.S. 281 (1960); *U.S. v. Allegheny Cnty.*, 322 U.S. 174, 64 S. Ct. 908, 88 L. Ed. 1209 (1944) (state property tax imposed on value of federal machinery held by private party was invalid).

The more likely explanation of the language, however, is that the Legislature merely borrowed the "of or for" phrase from the statute imposing sales tax for construction generally, which taxes work "of or for" consumers. RCW 82.04.050(2)(b). The Court in this case need not determine the meaning of improving buildings above real property "of" the United States that do not involve payment from the federal government. Rather the Court needs only to determine whether Morpho's work was "for" the United States.

construction was intended. *Tesoro Ref. & Mktg. Co. v. Dep't of Revenue*, 164 Wn.2d 310, 319, 190 P.3d 28 (2008).

Tesoro is analogous. In *Tesoro*, Washington's hazardous substance tax was imposed on the first person or entity that had "the power to sell or use a hazardous substance or to authorize the sale or use by another." RCW 82.21.020(3). Tesoro argued that because the word "or" can be used interchangeably with the word "and," the statute was ambiguous. From this premise Tesoro argued that the tax did not apply to its operations because it had the power to sell, but not use, refinery gas.[10] *Tesoro*, 164 Wn.2d at 319.

The Court rejected Tesoro's argument. It explained that as a default rule, "or" does not mean "and." *Id.* The Court elaborated that the true test is legislative intent, to be understood by the statute's context, related statutory provisions, and the statutory scheme as a whole. *Id.* The Court proceeded to review the purposes of the hazardous substance tax, which were to (1) tax the first possession of all products designated

[10] There is a rule of construction that an ambiguous tax-imposing statute is construed in the taxpayer's favor. However, this rule of construction should only be used as a "tie-breaker" after considering not only the text, context, and purpose of a statute, but also legislative history and any other information we have about the statute. *See In re Estate of Hitchman*, 100 Wn.2d 464, 466, 670 P.2d 655 (1983) (rule that an ambiguous tax statute is construed in favor of taxpayer "has been generally overemphasized and exaggerated in scope . . . [T]ax laws ought to be given a reasonable construction, without bias or prejudice against either the taxpayer or the state, in order to carry out the intention of the legislature and further the important public interests which such statutes subserve."). Here, there is no "tie." The trial court erred and its decision should be reversed.

hazardous substances by the Department of Ecology, and (2) to tax the possession only once. *Id.* Neither purpose indicated that the Legislature "desired to narrow the scope of taxable possessions to persons with the power to both sell *and* use the hazardous substance." *Id.* at 320 (emphasis in original).

As in *Tesoro*, the Legislature here did not express a clear intent (or any intent) to mean "and" when it said "or" in RCW 84.02.190(6). The Legislature easily could have limited the tax to contractors performing work on real property owned by the United States. To do so it would simply have needed to eliminate the words "or for."

As in *Tesoro*, the taxpayer's statutory construction here is contrary to the purposes of the very statute it is construing. The use tax's purpose in general is to impose a tax on the use of all personal property for which sales tax has not been paid. *Activate, Inc.*, 150 Wn. App. at 814. And the use tax's purpose in government contracting specifically is to impose a use tax on a contractor where imposing sales tax on the federal government would violate the Supremacy Clause. *See Washington v. U.S.*, 460 U.S. at 537-40. Exempting federal contracting work from this tax simply because the work occurs on non-federal land is inconsistent with both these purposes. It would also make no sense. The Legislature would not enact a statute to capture tax on private contractor work on government contracts,

but exclude from that tax a host of situations–such as the federally-funded installation of explosive detection systems at Sea-Tac and Spokane airports—that did not involve a particular real property interest by the United States.

When RCW 82.04.190(6)'s language is read in context of the statutory scheme as a whole, and the statute's purpose is taken into account, legislative intent is clear. A "consumer" includes not only those who perform the specified types of work on real property owned by the United States or in which the United States has an ownership interest, but also those who perform such work "for" the United States, regardless who owns the real property that is improved.[11]

4. The legislative history further supports the interpretation that the Legislature sought to tax contractors for all personal property incorporated into building improvements for the United States.

Because the Legislature's intent is evidenced by RCW 82.04.190(6)'s language, the statutory scheme surrounding government

[11] There is additional historical support for reading "of or for" in the disjunctive rather than the conjunctive. As noted above at pg. 28 n. 9, the language in RCW 82.04.190(6) was likely drawn from the definition of "retail sale" that includes work above real property "of or for consumers." The retail sale definition statute previously had different language. A retail sale was defined in 1941 as the improvement of buildings above "real property of consumers or for consumers." *Klickitat Cnty. v. Jenner*, 15 Wn.2d 373, 379, 130 P.2d 880 (1942). The Legislature then simplified the statute by deleting the first reference to "consumers" in 1943. This change expressed the Legislature's apparent approval of the Court's interpretation in *Klickitat County*, rather than a change in the law. *See Earley v. State*, 48 Wn.2d. 667, 671, 296 P.2d 530 (1956). This supports a reading of the use tax definition as applying to work above real property of the United States or work for the United States.

contracting, and the purpose behind that scheme, this Court need not review the legislative history. But even if this Court were to find RCW 82.04.190(6) ambiguous, the legislative history supports the Department's interpretation.

The legislative history of the statute provides further evidence that the Legislature did not intend RCW 82.04.190(6) to apply only to property in which the United States government has a property interest. For instance, the fiscal note emphasizes work performed "for" the federal government:

> This measure broadens the sales and use tax base to include construction activity performed *for* the U.S. Government . . . . Consumer has been redefined to include persons engaged in constructing, repairing, or improving buildings *for* these same government entities.

CP 134 (emphasis added); *see also* CP 130 (Senate Committee report states statute "provides for the collection of the Sales and Use Tax upon the construction and maintenance of buildings *for* the United States . . .") (emphasis added). In contrast, there is no evidence in this history of any intention to limit the use tax to buildings improved *on* federal land. To the contrary, the history shows an intention to reach all work performed for the federal government that would otherwise be tax exempt under the Supremacy Clause. Therefore, even if this Court were to find the language of the statute ambiguous, the legislative history affirms the

legislative intent and purpose to reach all contracting for the federal government.

5. The federal courts agree that the Department's construction of RCW 82.04.190(6) is reasonable.

Washington courts have not construed RCW 82.04.190(6) with respect to this particular issue. But in Morpho's litigation with TSA, the Office of Dispute Resolution for Acquisition provided a logical and coherent analysis of the issue that is entirely consistent with the Department's construction of the statute.

In its federal litigation, Morpho raised a number of arguments as to why TSA should adjust its contract price to cover Washington's use tax assessment. Relevant here, Morpho asserted that Washington assessed an "after-imposed tax" that Morpho could not have anticipated.

ODRA flatly rejected Morpho's argument, observing that

> [Morpho's] position is not supported by the canons of statutory interpretation or by demonstrating that contrary interpretations prevailed prior to the ALJ's determination. The ALJ's footnote shows that he relied on the plain, simple, and singular interpretation that gives meaning to the complete language of the statutory definition of 'consumer.'

CP 598.[12]

ODRA continued by explaining that Morpho's reading of Washington's definition of "consumer" reads the phrase "or for" out of the

[12] The reference to "the ALJ's footnote" is to the Department's Executive Level Determination. *See* CP 564. That footnote is quoted above at p.11.

statute: "The ALJ gave meaning to the phrase 'or for' while [Morpho] would read it out of the statute entirely." CP 598. ODRA also found significant that neither Morpho nor its own research found any contrary interpretation in case law, tax guides, or even the press. *Id.* ODRA concluded its statutory analysis emphatically: "The plain meaning of the long standing statutory definition of 'consumer' spoke for itself for nearly three decades." CP 599.

Morpho appealed ODRA's decision to the United States Court of Appeals for the D.C. Circuit. Morpho again argued that Washington's assessment constituted an "after-imposed tax" because it involved a "novel interpretation" of Washington law. *Morpho*, 717 F.3d at 976, 980. The D.C. Circuit likewise rejected Morpho's argument.

The court expressed the view that the statute was ambiguous,[13] noting that sometimes statutes mistakenly use the word "or" when they really mean to use the word "and." *See, e.g.*, *Morpho*, 717 F.3d at 980. However, the context of the court's statements about the statute being ambiguous is significant. The court was rejecting Morpho's argument that Washington's interpretation was not foreseeable: "[W]e find unpersuasive Morpho's claim of unfair surprise." *Id.* at 981.

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[13] Even if the language were ambiguous, the surrounding use and sales tax statutes and purpose behind the statute indicate that the Department's construction is correct.

The court concluded that "Morpho should have known it might reasonably be determined to be a 'consumer' whose business activities were subject to the use and B&O taxes." *Id.* at 982. In a footnote, the court pointed out that the statute's construction was ultimately a matter for the Washington courts, but that the Department's construction was "a permissible interpretation. . . ." *Id.* at 982 n.10. Even if the Department's interpretation were merely "permissible," it would still be entitled to considerable deference. *Impecoven v. Dep't of Revenue*, 120 Wn.2d 357, 363, 841 P.2d 752 (1992) ("considerable deference will be given to the interpretation made by the agency charged with enforcing the statute").

E. Even If Morpho Is Correct That "For" Relates To Real Property Rather Than The Party Purchasing The Work, Morpho Remains A "Consumer" Subject To Use Tax.

Even under Morpho's interpretation of the term "or for," the trial court's decision should be reversed. Morpho made an effort to explain the phrase in its summary judgment reply brief:

> "Real property is for" the United States if the United States has a beneficial interest, easement, lease, license to use or other interest in the real property.

CP 631.

If the Legislature intended the phrase "or for" to mean a beneficial interest, easement, lease, or license in real property, TSA, as a matter of law possessed such a license in the airport properties. A license is merely

"an authority to do a particular act, or series of acts, upon another's land, without possessing any estate therein." *Black's Law Dictionary* 1060 (10th ed. 2009). Federal law required TSA to maintain security at the airports and therefore gave it a license to use real property at the airport to conduct such security operations. 49 U.S.C. § 44901 (providing, for example, that TSA shall supervise passenger screening at airports and has the power to order the dismissal of any individual performing such screening); 49 U.S.C. § 44916(b) (TSA "shall conduct periodic and unannounced inspections of security systems of airports . . . ."); *see generally* 49 U.S.C. § 114 (listing TSA responsibilities). Accordingly, even if the term "for" means a beneficial interest such as a license, as Morpho contends, the real property was improved for the United States.

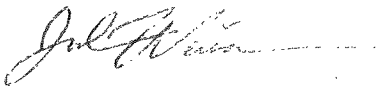
VI. CONCLUSION

The Legislature intends to impose a use tax on contractors who improve buildings for the federal government on any real property, whether owned by the federal government or not. Accordingly, the trial court erred by granting summary judgment to Morpho on the ground that the federal government does not own or have a property interest in the Sea-Tac and Spokane airports. This Court should reverse the order granting summary judgment to Morpho, rule that partial summary

judgment should be granted to the Department on this issue, and remand for trial on the remaining issues.

RESPECTFULLY SUBMITTED this 4th day of February, 2015.

ROBERT W. FERGUSON
Attorney General



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DATED this 4th day of February, 2015, at Tumwater, WA.

Susan Barton
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WASHINGTON STATE ATTORNEY GENERAL

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