NO. 44730-4-II

COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

BRAVERN RESIDENTIAL II, LLC,

Appellant,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

BRIEF OF RESPONDENT

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I. INTRODUCTION

This is a tax refund case involving retail sales tax owed on the construction of a residential apartment complex in Bellevue, Washington, commonly known as Bravern Residential Tower 4. PCL Construction Services, Inc. ("PCL Construction" or "PCL") constructed Tower 4 on land owned by the Plaintiff, Bravern Residential II, LLC ("Bravern II"). PCL Construction was a minority member of Bravern II during the time it constructed the apartment complex.

Under Washington law, construction services performed on land owned, leased, or possessed by another person are taxed as a "retail sale." RCW 82.04.050(2)(b); *Dep't of Revenue v. Nord Nw. Corp.*, 164 Wn. App. 215, 264 P.3d 259 (2011). This is so even if the contractor has an ownership interest in the entity that owns the land. *Nord Nw. Corp.*, 164 Wn. App. at 230; WAC 458-20-170(2)(f). Thus, when a member of an LLC performs construction services on land owned by the LLC, retail sales tax is owed on the "selling price" charged by the member.

In contrast, a person performing construction services on real property *it* owns is not engaged in an activity meeting the definition of a retail sale. *Rigby v. State*, 49 Wn.2d 707, 306 P.2d 216 (1957). Such person is commonly referred to as a "speculative builder." Because construction services performed by a speculative builder do not qualify as

a retail sale, retail sales tax is not owed on the value of those services. The tax advantage for a contractor that qualifies as a speculative builder can be significant.

Bravern II is seeking the tax advantage that applies to a speculative builder, arguing that it should be treated as if it were a construction contractor building on its own land. Under Bravern II's theory, the amount it paid PCL Construction to construct Tower 4 (over $121 million) is simply ignored because PCL Construction, as a minority member of a "construction joint venture," merely "contributed" its services to the "venture."

Bravern II's "construction joint venture" argument is not supported by the plain language of the excise tax statutes or the holding in *Nord Northwest Corp.* In short, PCL Construction (the contractor) and Bravern II (the land owner) are separate legal entities, and PCL's ownership interest in Bravern II does not make its construction activity exempt from Washington sales tax. Because the undisputed evidence establishes that PCL Construction performed construction activity for Bravern II on land owned by Bravern II for valuable consideration, retail sales tax is owed. Accordingly, this Court should affirm the superior court's order granting summary judgment in favor of the Respondent, Department of Revenue.

II. RESTATEMENT OF THE ISSUE

Bravern II is seeking a refund of retail sales tax under RCW 82.32.180, which authorizes a refund of excise tax when a taxpayer can "prove that the tax as paid . . . is incorrect, either in whole or in part, and [can] establish the correct amount of tax." The trial court granted summary judgment to the Department, holding that as a matter of law Bravern II is not entitled to the retail sales tax refund it seeks. This appeal presents the following issue:

> Did the trial court correctly conclude that Bravern II is not entitled to a refund of retail sales tax for the June 2009 tax period when the undisputed evidence establishes that (1) PCL Construction, not Bravern II, constructed Tower 4, and (2) PCL Construction performed the construction activity for Bravern II on land owned by Bravern II in exchange for valuable consideration?

III. STATEMENT OF THE CASE

A. Formation Of Bravern II, The Construction Of Tower 4, And PCL Construction's Role In The LLC.

Bravern II is a Washington limited liability company formed in May 2007. CP 43.[1] During its first year of existence, Bravern II was a

[1] Throughout its opening brief, Bravern II mischaracterizes itself as a "joint venture." A joint venture is "in the nature of a partnership." *Barrington v. Murry*, 35 Wn.2d 744, 752, 215 P.2d 433 (1950). While LLCs have some similarities to partnerships, they are a distinct type of business organization. *See Chadwick Farms Owners Ass'n v. FHC LLC*, 166 Wn.2d 178, 186-87, 207 P.3d 1251 (2009) ("A limited liability company is a statutory business structure that is like a corporation in that members of the company are generally not personally liable for the debts or obligations of the company and like a partnership in that it can be classified as a partnership for tax purposes . . . ."). Bravern II is a limited liability company formed under Washington law, not a partnership or joint venture.

single-member limited liability company owned and managed by Bravern Residential Mezz II, LLC ("BRM"). In April 2008, PCL Construction was admitted as a member of Bravern II. PCL Construction was (and is) a licensed Washington construction contractor. CP 109 at ¶ 30(a).

To become a member of Bravern II, PCL Construction agreed to make an initial capital contribution of $100 in exchange for a one percent ownership interest in Bravern II. CP 59 at ¶ 2.1; CP 60 at ¶2.2.1. BRM retained the remaining 99 percent interest. *Id.* BRM also retained control over the management of Bravern II. CP 68 at ¶ 5.1.1 (naming BRM as the managing member of the LLC).

1. PCL Construction built "Tower 4" in exchange for credits to its capital interest In Bravern II.

When PCL Construction became a one percent minority member of Bravern II, the LLC operating agreement was amended to reflect the rights and obligations of the two members. CP 53. That amended agreement ("Operating Agreement") specified that PCL Construction would contribute construction services and materials to the LLC pursuant to a "Services Addendum" executed at the same time as the Operating Agreement. CP 62 at ¶ 2.2.4; *see also* CP 86 ("Services Addendum"). The Services Addendum required PCL Construction to "fully perform and manage all of the work" pertaining to the "construction of Bravern

Residential Tower 4 in Bellevue, Washington." CP 90 at ¶ 4(a). Tower 4 was a planned high-rise residential condominium or apartment building being constructed as part of a larger development known as "The Bravern Development." *See* CP 90 at ¶ 2 (describing the Tower 4 project); CP 110-11 at ¶ 31 (describing The Bravern Development). The Services Addendum required PCL Construction to begin construction of Tower 4 on April 1, 2008, and to substantially complete the work by March 31, 2010. CP 93 at ¶ 9(a).

During the course of its construction work, PCL Construction submitted monthly progress billing statements to Bravern II. CP 118-145 (28 billing statements covering March 2008 through July 2010). After review and approval of the progress billing statements, PCL Construction received a credit to its Bravern II capital account equal to the amount billed. CP 104 at ¶ 23(c). Over the course of the construction project, PCL Construction received payments from Bravern II in the form of a credit to its capital account in excess of $121 million. *See* CP 145 (July 2010 billing statement showing "cumulative" contributed services of $121,022,756).

Under the terms of the Operating Agreement, PCL Construction received periodic cash distributions from its capital account during construction of Tower 4. CP 63 at ¶ 3.2. Bravern II made distributions to

PCL Construction at least monthly. The cash distributions were designed to prevent PCL Construction's capital account balance from exceeding one percent of the total capital of all members. CP 297-300.

Limiting PCL Construction's capital interest in Bravern II was important for two reasons. First, if PCL's capital account balance exceeded one percent for more than twenty days, PCL would have been entitled to an "accrued preferred return" on the excess amount at the rate of "prime plus 2.5%." CP 63-64 at ¶ 3.3 ("Accrued Preferred Return"). Second, if PCL's capital account balance exceeded two percent for more than fifteen days, PCL could exercise a "put" option requiring BRM to purchase PCL's entire interest in Bravern II at a specified price unless PCL received a cash distribution within thirty days reducing its capital account balance to one percent. CP 74 at ¶ 8.4.1 ("PCL Put Right"). These provisions required Bravern II and the members of the LLC to closely monitor PCL Construction's capital account balance and to make cash distributions to PCL within 20 days from the date PCL's capital account was credited. CP 297-300.

Bravern II had sufficient cash on hand to make monthly cash distributions to PCL Construction because BRM—the other member of Bravern II—was required to contribute cash to the LLC when necessary to enable Bravern II to pay its expenses. CP 61 at ¶ 2.2.3(a). BRM or

Bravern II may also have borrowed money to fund the Tower 4 construction project. *See* CP 212 (letter ruling request describing the proposed structure of Bravern II and asserting that Bravern "will acquire third-party financing as necessary to meet its cash requirements, including periodic distributions to Members"). Under the terms of the Operating Agreement, BRM was solely responsible for guaranteeing any construction loans. CP 63 at ¶ 2.5.

2. PCL Construction assigned its interest in Bravern II to BRM after completing construction of Tower 4.

PCL Construction had substantially completed construction of Tower 4 by March 2010, when the City of Bellevue issued a certificate of occupancy to Bravern II. CP 147. A few months later PCL Construction assigned its interest in Bravern II to BRM. CP 158. The assignment was completed on February 8, 2011. *Id.* After that date, PCL Construction had no ownership interest in Bravern II and received no income or profit from the lease of apartments in Tower 4.

B. The Department Determined That PCL Construction Was Not A "Speculative Builder" On The Tower 4 Project.

In August 2007 (several months before PCL Construction became a member of Bravern II), BRM, PCL Construction, and Bravern II submitted a joint letter ruling request to the Department of Revenue. CP 211. The three taxpayers submitted the request under authority of WAC

458-20-100(2)(b), which provides that taxpayers "may request an opinion on future reporting instructions and tax liability" from the Department. The letter ruling request explained the general facts of the planned Tower 4 construction project and asked the Department to conclude that PCL Construction would be "classified as a member of the joint venture performing speculative building and not as a prime contractor." CP 213. On February 29, 2008, the Department issued its ruling, holding that PCL Construction would not qualify as a speculative builder under the facts described in the ruling request letter. CP 221. Instead, the Department concluded that "PCL is a prime contractor with respect to construction services and tangible personal property provided to" Bravern II. CP 223.

The three taxpayers (BRM, PCL Construction, and Bravern II) filed an administrative appeal of the letter ruling with the Department's Appeals Division. On April 29, 2009, the Appeals Division issued a written determination denying the taxpayers' appeal and upholding the tax reporting instruction provided in the letter ruling. CP 225.

Prior to receiving the joint letter ruling request from BRM, PCL Construction, and Bravern II, the Department had issued two letter rulings to other taxpayers that had created limited liability companies similar to Bravern II, in which it erroneously granted the requested

"speculative builder" tax treatment. CP 384-85.[2] In one of those letter rulings, issued in 2006 to a client of KPMG LLC, the Department erroneously concluded that "Company B" (a construction contractor) received no compensation for construction work it performed "in its capacity as a member" of a joint venture. CP 205.[3] Consequently, according to the letter ruling, the "Construction Member" of the LLC was not required to pay retailing business and occupation (B&O) tax or collect retail sales tax on construction services it "contributed" to the LLC. *Id.* As discussed above, the Department issued different tax reporting instructions in response to the joint ruling request filed by BRM, PCL Construction, and Bravern II, concluding that under the facts described in the ruling request PCL Construction would owe B&O tax and would be required to collect retail sales tax on the full amount it received from the Tower 4 construction project. CP 221.

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[2] In its opening brief, Bravern II incorrectly asserts that the Department issued "*numerous* favorable rulings approving identically structured joint ventures as speculative builders." App. Br. at 7 (emphasis added). The Department searched its records and located only two letter rulings that had granted "speculative builder" treatment to LLCs structured similarly to Bravern II. CP 384-85.

[3] KPMG LLC is a multinational accounting firm. KPMG used the 2006 letter ruling to support a "construction joint venture" tax shelter it created and marketed to Washington construction contractors. CP 587-96 (KPMG marketing materials touting a "joint venture structure" as a way of avoiding retailing B&O tax and retail sales tax on the value of construction services). The other erroneous letter ruling, issued in 2005, is not part of the record in this appeal.

C. Bravern II Paid A Small Portion Of The Sales Tax Owed On The Construction Of Tower 4 And Filed This Refund Action.

After the Department determined that PCL Construction did not qualify as a speculative builder on the Tower 4 project, Bravern II filed a "consumer use tax return" with the Department for the month of June 2009 and paid sales tax for that month in the amount of $107,842. CP 177. Bravern II computed the tax based on a portion of the "total contributed services" PCL Construction had reported on the June 2009 billing statement it submitted to Bravern II. CP 180; *see also* CP 133 (June 2009 billing statement). After paying the sales tax it self-reported for the June 2009 tax period, Bravern II filed this refund action under RCW 82.32.180, claiming that it did not owe the tax. CP 7 at ¶ 16. The parties filed cross-motions for summary judgment. The superior court granted the Department's motion and denied Bravern II's cross-motion. CP 654. Bravern II then filed this timely appeal.

IV. ARGUMENT

A. Standard Of Review.

This Court reviews a grant of summary judgment de novo. *Seiber v. Poulsbo Marine Ctr., Inc.*, 136 Wn. App. 731, 736, 150 P.3d 633 (2007). Summary judgment is appropriate when no genuine issue of material fact exists and the moving party is entitled to judgment as a matter of law. CR 56. The material facts supporting the Department's

motion for summary judgment were not disputed. Rather, resolution of this case centers on how the excise tax statutes apply to the undisputed facts, which is a question of law that this Court reviews de novo. *See Wash. Imaging Servs, LLC v. Dep't of Revenue*, 171 Wn.2d 548, 555, 252 P.3d 885 (2011).

B. PCL Construction Performed Retail Construction Services When It Constructed Tower 4 In Exchange For A Capital Interest In Bravern II.

1. There is an important legal distinction between a "prime contractor" and a "speculative builder."

Washington imposes a retail sales tax on each retail sale in this state. RCW 82.08.020. In addition, Washington imposes a gross receipts tax on the gross proceeds derived from the business of making retail sales in this state. RCW 82.04.250(1).

The term "retail sale" is defined in RCW 82.04.050 and includes "the sale of or charge made for tangible personal property consumed and/or for labor and services rendered in respect to . . . [t]he constructing, repairing, . . . or improving of new or existing buildings or other structures under, upon, or above real property of or for consumers." RCW 82.04.050(2)(b). The term "consumer" is defined in RCW 82.04.190 and includes "[a]ny person who is an owner, lessee or has the right of possession to . . . real property which is being constructed, repaired, decorated, improved, or otherwise altered by a person engaged

in business." RCW 82.04.190(4). Applied together, these provisions provide that a person performing construction services on real property owned, leased, or possessed by another person is engaged in making retail sales. *Rigby v. State*, 49 Wn.2d 707, 709-10, 306 P.2d 216 (1957). The seller (i.e., the construction contractor) owes retailing B&O tax measured by the gross proceeds of the retail sale, RCW 82.04.250(1), and must collect retail sales tax from the consumer on the amount charged. RCW 82.08.020(1)(c). The B&O tax and retail sales tax apply even when the contractor and the consumer are affiliated entities. *Nord Nw. Corp.*, 164 Wn. App. at 229-30; WAC 458-20-170(2)(f). A person performing retail construction services is commonly referred to as a "prime contractor." *See* WAC 458-20-170(1)(a).[4]

In contrast, a person constructing buildings or other structures on real property *it owns* is not engaged in an activity fitting within the definition of a "retail sale." *Rigby*, 49 Wn.2d at 710. This is because a builder is not the "consumer" of construction services it provides to itself. *White-Leasure Development Co. v. Dep't of Revenue*, 2001 WL 1807636 (Wash. Bd. Tax. App. 2001). A person constructing buildings on real property it owns is referred to as a "speculative builder." *See* WAC 458-20-170(2)(a).

[4] A copy of WAC 458-20-170 is attached hereto as Appendix A.

A speculative builder enjoys two significant tax advantages over a prime contractor. First, a speculative builder is not required to pay B&O tax on the value of its construction services even though the value of the real property is increased. This is because a speculative builder does not charge itself for its own construction services, and amounts derived from the sale of real property are exempt from the B&O tax. RCW 82.04.390. Conversely, a person performing construction services for compensation on land owned, leased, or possessed by another person owes B&O tax on the gross amount received from the consumer of the services.

The second tax advantage relates to the measure of the retail sales tax. A prime contractor is required to collect and remit retail sales tax on the "selling price" charged to the consumer of the construction services. RCW 82.08.020(1); *see also* RCW 82.08.010(1) (defining "selling price"); *Klickitat Cnty. v. Jenner*, 15 Wn.2d 373, 382, 130 P.2d 880 (1942) (the measure of a retail sale is "the cost to the buyer or consumer, and not the cost to the seller").[5] Thus, the measure of the retail sales tax includes the amount charged for services performed by the contractor. In

[5] A contractor performing retail construction services normally charges and collects the retail sales tax from the purchaser and remits that tax to the Department. In the present case, PCL Construction did not collect retail sales tax from Bravern II. Instead, Bravern II self-reported a small amount of the retail sales tax owed on the construction project in order to bring this "test case" under RCW 82.32.180. Because the retail sales tax is imposed on the purchaser, RCW 82.08.050(1), and because the seller and the purchaser have joint and severable liability for the tax, RCW 82.08.050(10), it

contrast, a speculative builder pays retail sales tax only on its purchase of building materials and contract labor. *Riley Pleas, Inc. v. State*, 88 Wn.2d 933, 935, 568 P.2d 780 (1977).

The tax advantages enjoyed by a speculative builder are not the result of a legislatively-created tax exemption. Rather, they flow from application of the plain language of the statutory definitions of "retail sale" and "consumer." To obtain these tax advantages, the contractor *must* own the land. *See Nord Nw. Corp.*, 164 Wn. App. at 228 ("the builder must be the bona fide owner of the real property to qualify as a speculative builder"). A partner or LLC member that performs construction services on land owned by the partnership or LLC does not fit within this narrow gap and is taxed as a prime contractor, just as the Legislature intended when it enacted RCW 82.04.050(2)(b). *Id.* at 229 (citing WAC 458-20-170(2)(f)).

2. PCL Construction did not own the land on which it constructed Tower 4 and, therefore, was not a speculative builder.

The distinction between a prime contractor and a speculative builder turns on whether the person doing the construction owns the real property upon which the construction is performed. In the present case, there is no dispute that Bravern II owned the real property upon which

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was permissible for Bravern II to pay the retail sales tax directly to the Department and sue for a refund under RCW 82.32.180.

PCL Construction constructed Tower 4. CP 49; CP 55 at ¶ 1.3.6. PCL Construction clearly did not own the real property.

The undisputed evidence also establishes that PCL Construction, not Bravern II, constructed Tower 4. First, it is undisputed that PCL Construction is a licensed Washington construction contractor, CP 109 at ¶ 30(a), and is in the business of constructing large buildings. There is no evidence that Bravern II was a licensed contractor or that it was in the business of performing construction service.

Second, the Services Addendum entered into when PCL Construction was admitted as a one percent minority member of Bravern II required PCL to perform all construction activities pertaining to the Tower 4 project. Paragraph 1 of the Services Addendum specified that PCL Construction was to provide construction services and materials in exchange for a credit to its Bravern II capital account. CP 90. Likewise, paragraph 4 of the Services Addendum acknowledged that PCL Construction "shall fully perform and manage all of the work of and set forth in" the Services Addendum, which "is generally described as *construction of Bravern Residential Tower 4* in Bellevue, Washington." CP 90 at ¶ 4(a) (emphasis added). Paragraph 7(a) of the Services Addendum explained that PCL Construction "agrees to perform the Work and pay the Cost of the Work and, for providing such services, shall

receive a credit" to its capital account in an amount not to exceed $116,226,420. CP 92. The other provisions of the Services Addendum are consistent with the fact that PCL Construction was the entity required to perform the construction services pertaining to the Tower 4 project. *E.g.*, CP 93 at ¶ 9(a) (outlining the "Commencement and Completion Dates and Schedules"); CP 97 at ¶ 17 (describing "Cost of the Work"); CP 116 (exhibit "F" to the Services Addendum listing anticipated construction costs).

The course of dealing between PCL Construction and Bravern II also confirms that PCL performed the construction activity pertaining to the Tower 4 project. After PCL Construction began constructing Tower 4 in early 2008, it submitted monthly progress billing statements to Bravern II. CP 118-145. Each billing statement (entitled "Statement of Value of Member's Activity" or "SVMA") set out the value of the materials used and services performed by PCL Construction for that month. *E.g.*, CP 119 (SVMA # 02, showing "Current" charges for April 2008). The project architect reviewed these monthly progress billing statements to substantiate the accuracy of the charges. *Id.* (SVMA # 02, showing "Architect's Certificate Confirming Contributed Services). PCL Construction then received a credit to its Bravern II capital account equal to the amount of the verified charges. From this course of dealing, it is

evident that PCL Construction billed Bravern II, and was paid by Bravern II, on a monthly basis for the construction activity it performed for Bravern II. This was verified by Garth Hornland, a Senior Manager with PCL Construction, who explained that "as PCL provided construction services" to Bravern II it would receive a credit to its capital account "associated with the progress of the job." CP 297-98.

PCL Construction received consideration for its construction activities in the form of a credit to its Bravern II capital account rather than through cash payments. That, however, does not make the services it provided to Bravern II exempt from B&O tax or retail sales tax. A contractor performing retail construction is taxed on the gross proceeds from the sale, RCW 82.04.250(1), which is the "value proceeding or accruing from the sale." RCW 82.04.070. The term "value proceeding or accruing" is defined in RCW 82.04.090 as "the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued." The Supreme Court has explained that the Legislature broadly defined "value proceeding or accruing" in RCW 82.04.090 so as to include in the measure of the tax "everything of value in money, or which can be measured in terms of money, received or taken in payment or exchange." *Engine Rebuilders, Inc. v. State*, 66 Wn.2d 147, 150-51, 401 P.2d 628 (1965).

The receipt of an ownership interest in a business in exchange for services or property is generally considered a "sale" of the services provided or property conveyed. *See, e.g., Christensen v. Skagit Cnty.*, 66 Wn.2d 95, 98, 401 P.2d 335 (1965) (taxable sale occurred when owner of real estate conveyed it to a corporation in return for stock in the corporation). Moreover, a capital interest in an LLC is personal property. RCW 25.15.245(1). Thus, PCL Construction received consideration in the form of "property expressed in terms of money, actually received" when Bravern II credited PCL's capital account each month in an amount equal to the materials it used and services it performed in constructing Tower 4 for Bravern II on land owned by Bravern II.[6]

Finally, it is immaterial in this case that PCL Construction was a member of Bravern II during the time it constructed Tower 4. Under Washington law, a limited liability company is a separate legal entity from its owners. RCW 25.15.070(2)(c). Moreover, it is well settled that affiliated business entities, such as a parent and its subsidiary corporations, are treated as separate persons for B&O tax and retail sales

[6] Not all credits to a partner or member's capital account are "consideration" for the sale of services or property to the partnership or LLC. For example, a credit to a partner or member's capital account resulting from the sharing of profits from the business venture—the partner/member's "distributive share" in accounting terms—is not consideration for the sale of services or property by the partner or member to the venture. However, in this case, PCL Construction received a credit to its capital account as a result of services it provided *directly to* the LLC, not from the distributive share of profits from the LLC. In this circumstance, the credit constitutes consideration for the sale of construction services by PCL Construction to Bravern II.

tax purposes. *Simpson Inv. Co. v. Dep't of Revenue*, 141 Wn.2d 139, 154, 3 P.3d 741 (2000) (citing *Wash. Sav-Mor Oil Co. v. Tax Comm'n*, 58 Wn.2d 518, 364 P.2d 440 (1961)). The same is true of a limited liability company and its members. *See Nord Nw. Corp.*, 164 Wn. App. at 230. Because a business entity is a distinct "person" from its owners, an owner performing construction services for the business entity on land owned by the business entity is not a speculative builder.

PCL Construction performed construction services on land owned by Bravern II. As the consumer of the construction services, Bravern II owed retail sales tax measured by the selling price. Bravern II has self-reported and paid a small portion of the tax owed. CP 177. Because Bravern II has not established that it overpaid the tax owed on the retail construction services performed by PCL Construction, its refund claim should be denied. *See* RCW 82.32.180 (in a refund action, the taxpayer must prove that the tax it paid was incorrect "in whole or in part," and prove the correct amount of tax); *Texaco Ref. & Mktg., Inc. v. Dep't of Revenue*, 131 Wn. App. 385, 398, 127 P.3d 771 (2006) (a taxpayer seeking a tax refund under RCW 82.32.180 must show the tax paid was incorrect and establish the correct amount of tax owed).

3. The "casual and isolated sale" exemption discussed in WAC 458-20-106 does not apply.

Bravern II argues that the credit it made each month to PCL Construction's capital account does not qualify as a "taxable event" under WAC 458-20-106 (Rule 106). App. Br. at 6. Bravern II also argues that "[c]ontributions of capital are not subject to sales tax." App. Br. at 13 (citing WAC 458-20-106, example 5). Bravern II misreads Rule 106 and the examples provided in that Rule.[7]

Department administrative Rule 106 pertains to the retail sales tax exemption for "casual and isolated sales" that is codified at RCW 82.08.0251. That code section provides in relevant part that retail sales tax "shall not apply to casual and isolated sales of property or services, unless made by a person who is engaged in business activity taxable under" the Washington B&O tax or public utility tax. A casual or isolated sale is defined in RCW 82.04.040(2) as "a sale made by a person who is not engaged in the business of selling the type of property involved."

PCL Construction is in the business of selling construction services. CP 109 at ¶ 30(a). Because PCL Construction is in the business of selling construction services, the tax exemption for casual and isolated sales does not apply. Consequently, Rule 106 does not apply. That rule

[7] A copy of Rule 106 is attached as Appendix B.

cannot expand a tax deduction or tax exemption beyond what is provided by statute or required by the constitution. *Coast Pac. Trading, Inc. v. Dep't of Revenue*, 105 Wn.2d 912, 917-18, 719 P.2d 541 (1986).

Moreover, by its very terms Rule 106 does not apply to the sale of goods or services by a person engaged in the business of selling the type of property involved. Rule 106 explains that "retail sales tax applies to all casual or isolated retail sales made by a person who is engaged in . . . business activity" subject to Washington tax. WAC 458-20-106 (5th paragraph). Only persons "not engaged in any business activity" are exempt from sales tax on casual or isolated sales. *Id.* Because PCL Construction is engaged in business as a construction contactor, it is not exempt from retail sales tax when it performs that business activity on land owned by another.

Rule 106 goes on to provide several examples involving the transfer of capital assets to or by a business, including the transfer "of capital assets to a partnership or joint venture in exchange for an interest in the partnership or joint venture." WAC 458-20-106, example 5.[8] However, the Rule neither states nor implies that providing *services* to a partner or joint venture in exchange for an interest in the partnership or

[8] A capital asset is "[a] long-term asset used in the operation of a business or used to produce goods or services, such as equipment, land, or industrial plant." Black's Law Dictionary 126 (8th ed. 2004).

venture is exempt from tax. This is consistent with the purpose of the six examples provided in Rule 106, which explain that a change in the "mere form of ownership of property" does not result in a taxable sale. *See* Det. No. 93-240, 13 WTD 369 at p. 16 (1994). The examples provided in Rule 106 are "grounded on the recognition that sales tax should not, through technical interpretation of the law, be imposed to impede business reorganizations when the ownership of a business remains essentially the same and the change was merely one of form." *Id.* (quoting Det. No. 87-212, 3 WTD 259 (1987)).[9] No similar justification exists for excluding from the definition of "sale" the contribution of *services* to a business entity in exchange for an ownership interest in the entity. Services are not "property," and the contribution of services does not result in a change in the "mere form of ownership of property."

Rule 106 should be read "as a whole, giving effect to all the language and harmonizing all provisions." *Nord Nw. Corp.*, 164 Wn. App. at 230 (quoting *Cannon v. Dep't of Licensing*, 147 Wn.2d 41, 57, 50 P.3d 627 (2002)). It must also be read in context with the statute it is interpreting. When read as a whole and in context with RCW 82.08.0251, Rule 106 does not permit a seller of retail construction

[9] Tax determination number 93-240 is available on-line at <http://taxpedia.dor.wa.gov/documents/current%20wtds/13wtd369.doc>. Determination number 87-212 is available at <http://taxpedia.dor.wa.gov/documents/current%20wtds/3wtd259.doc>.

services to avoid tax simply by contributing those services to a partnership or joint venture in exchange for an interest in that partnership or venture.

Rule 106 does not apply to the facts of this case and does not create a retail sales tax exemption for the construction services PCL Construction provided to Bravern II in exchange for a capital interest in Bravern II. Thus, Rule 106 does not support Bravern II's refund claim.

C. The Controlling Tax Statutes Are Not Ambiguous. But If They Were, WAC 458-20-170 Would Be Entitled To Considerable Deference.

The court's goal in construing a statute is to determine and give effect to the Legislature's intent. *TracFone Wireless, Inc. v. Dep't of Revenue*, 170 Wn.2d 273, 281, 242 P.3d 810 (2010); *Dep't of Ecology v. Campbell & Gwinn, LLC*, 146 Wn.2d 1, 9-10, 43 P.3d 4 (2002). "If the statute's meaning is plain on its face, we give effect to that plain meaning as the expression of what was intended." *TracFone Wireless*, 170 Wn.2d at 281. In the present case, the controlling statutes are unambiguous. Applying the undisputed facts to the plain language of RCW 82.04.050(2)(b) and RCW 82.04.190(4), Bravern II was the consumer of the retail construction services PCL Construction performed for Bravern II on real property owned by Bravern II.

Even if there were some ambiguity in the controlling tax statutes—which there is not—WAC 458-20-170 (Rule 170) pertaining to construction services would be entitled to "considerable deference" in determining the proper construction of the statutes. *Nord Nw. Corp.*, 164 Wn. App. at 229. Under Rule 170, Bravern II is not entitled to the refund it is seeking.

1. Bravern II is not entitled to a refund under Rule 170 or the Department tax determinations applying that Rule.

Department administrative Rule 170 explains, among other things, the tax consequences that flow from the legal distinction between a "prime contractor" performing construction services on land owned by another person and a "speculative builder" performing construction services on its own land. To qualify for the tax advantages of a speculative builder, the contractor must own the land. WAC 458-20-170(2)(a). It is not enough for the construction contractor to be a "member" or "owner" of the entity that owns the land. WAC 458-20-170(2)(f); *see also Nord Nw. Corp.*, 164 Wn. App. at 215 ("[W]e agree with the Department's interpretation of the rule it enforces and conclude WAC 458-20-170(2) unambiguously requires real property ownership to qualify as a speculative builder.").

Rule 170(2)(f) explains that a business entity is a distinct person from its owners and that "[p]ersons . . . who perform construction upon land owned by their corporate officers, shareholders, partners, owner, co-venturers, etc., are constructing upon land owned by others and are taxable as sellers under this rule, not as 'speculative builders.'" In construing this administrative rule, the Department has historically looked at the manner in which the person performing the construction services is compensated for the services. If the person performing the services has an absolute right to payment for its services, the transaction is considered a retail sale. By contrast, if the person performing the construction services has no right to payment for those services, but merely "contributes" those services to a business venture in exchange for the right to share in the profits of the venture, the Department has treated the contractor as a speculative builder. This analysis was explained by the administrative law judges that decided Bravern II's administrative appeal:

> In construing [Rule 170(2)(f)] our determinations have looked to the manner in which the "person" performing the construction services at issue is compensated, and specifically whether such payments may be characterized as "absolute." The language most frequently used to articulate this inquiry, focuses on whether the person performing the construction services "has an absolute right to payment for services rendered. . . , that is, [if] the payment is not based on any right to profit or gain, the[n the] payment is subject to tax."

CP 248 (quoting Det. No. 02-0123, 22 WTD 206 (2003)).

This application of Rule 170(2)(f) is consistent with other published tax determinations. In effect, the Department will look at the substance of the transaction to determine whether the payment received by a member of a joint venture was (1) consideration in exchange for services or property provided to the joint venture (a taxable retail sale) or (2) merely the sharing of profits from the venture. For instance, in Determination No. 87-254, the Department addressed a claim by a taxpayer that amounts it received from a joint venture it had created were profits from the venture, not proceeds from the lease of assets to the venture, even thought the payments were characterized as "rent" in the joint venture agreement. *See* CP 538 (copy of Det. No. 87-254). In analyzing the taxpayer's claim, the Department looked at the substance of the transaction and determined that the payments were profits from the activities of the venture, not taxable rent payments. The Department explained that the payments were not "absolute" because the taxpayer would receive no payment unless the venture generated profits. CP 539.

Likewise, in Determination No. 89-290, the Department addressed a claim by a taxpayer that amounts it received from a joint venture it created to develop and sell real estate were distributions of profit from the venture, not the payment of interest on money advanced by the taxpayer.

See CP 542. In analyzing the taxpayer's claim, the Department looked at the substance of the payments and determined that they "were dependent on the sale of the property" being developed by the joint venture. CP 545. The taxpayer had no right to the payments absent "the existence of a profit" from the venture. *Id.* Based on these facts, the Department concluded that the payments were akin to the sharing of profits in the venture and not interest on loans to the venture.

In Determination No. 90-74, the Department addressed a claim by a construction contractor that argued it was acting as a speculative builder with respect to three construction projects. *See* CP 548. The taxpayer, a partner in the partnerships that owned the land on which the construction took place, claimed that it had no right to any payments from the partnerships for its construction activities other than the distribution of profits. In analyzing the claim, the Department explained that "partners are considered as third party service providers to the partnership of which they are a member when the obligation of the partnership to pay for such services is 'absolute' or fixed, and exists independently of any right to profit or gain" from the partnership. CP 551. As construed by the Department, an "absolute" or fixed payment would include any amount received from the partnership other than the distribution of profits from the partnership. *Id.*

These published tax determinations, and others, reflect the Department's application of Rule 170(2)(f). If a contractor receives no consideration for construction services it performs as a member of a joint venture other than a share of profits from the venture, the Department will treat the contractor as a speculative builder. In the typical case, a contractor and a land owner create a joint venture to build houses for sale to the public. The contractor receives no compensation for its services other than the right to share in the profits recognized by the joint venture when the venture sells the improved real property. In that circumstance, the Department does not treat the right to receive future profits from the venture as valuable consideration for the construction services performed by the contractor-member. *See, e.g.,* CP 555 (copy of Det. No. 99-176, explaining that where a true joint venture was created between a contractor and a land owner involving a 50-50 split of the proceeds from the venture and no other consideration, the contractor was treated as a speculative builder).

The Department's treatment of services provided in exchange for the right to share in the profits of a venture is similar to the tax treatment the federal courts and the Internal Revenue Service follow when determining whether a "service partner" has received taxable income in exchange for services provided to the partnership. Under the federal

income tax code, the receipt of a capital interest in a partnership in exchange for services constitutes gross income to the service partner at the time of receipt. As explained in *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), "[w]hen a service partner receives an interest in partnership capital, the cases clearly hold that a taxable event has occurred. The receipt of the capital interest must be included in the service partner's income. . . . There is little, if any, dispute that such a transaction involves the recognition of income." *Id.* at 820.

While the receipt of a capital interest in a business entity in exchange for services is universally recognized as income to the service provider, the same is not true of a *profits* interest.[10] The seminal case to analyze the issue is *Campbell*. In that case, the Eighth Circuit explained why receipt of a *profits* interest is distinguishable from the receipt of a *capital* interest. "When one receives a capital interest in exchange for services performed, a shift in capital occurs between the service provider and the [other] partners. The same is not true when a service partner receives a profits interest." *Id.* at 822. When a partner receives only a profits interest, "prior contributions of capital are not transferred from

[10] A "profits interest" in a partnership gives a partner a share of future partnership profits but no interest in partnership capital on the date of the grant. For a detailed explanation of the distinction between a capital interest and a profits interest, see Bradley T. Borden, *Profits-Only Partnership Interests*, 74 Brook L. Rev. 1283, 1295-1298 (2009).

existing partners' capital accounts to the service provider's capital account." *Id.* Stated somewhat differently, the receipt of a profits interest in exchange for services "does not create the same concerns" as the receipt of a capital interest "because no transfer of capital assets is involved. . . . Thus, some justification exists for treating service partners who receive profits interest differently than those who receive capital interests." *Id.* at 822.[11]

Although not a perfect analogy, the Department employs a similar approach to determine whether a contractor that contributes services to a joint venture is making a retail sale of its construction services. In effect, the Department—in applying Rule 170(2)(f)—does not treat the receipt of *profits* flowing from the business entity as consideration for services provided to the joint venture. On the other hand, when a contractor-member receives a *capital* interest in the venture, or receives other valuable property in exchange for the services it provides to the venture, the contractor-member has received consideration in exchange for performing construction services on land owned by another. That is a retail sale under RCW 82.04.050(2)(b).

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[11] In 1993 the IRS acquiesced to the *Campbell* decision. *See* Rev. Proc. 93-27, 1993-2 C.B. 343 (1993). Thus, for federal income tax purposes, the IRS generally does not treat the receipt of a profits interest in exchange for services as gross income to the partner at the time of receipt.

In the present case, PCL Construction received a capital interest, not a mere profits interest, in Bravern II in exchange for the construction services it provided to Bravern II. None of the cash distributions that Bravern II paid to PCL Construction were tied in any way to profits generated by Bravern II. This is confirmed by the undisputed evidence. Under the terms of the Operating Agreement, PCL Construction received periodic cash distributions from its capital account during the construction of Tower 4. CP 63 at ¶ 3.2. Bravern II made these periodic distributions within twenty days after PCL Construction had received a credit to its capital account in the amount of the "current" construction services it provided to Bravern II. CP 297-99; *see e.g.*, CP 119 (SVMA # 2 showing amount billed to Bravern II for PCL's "current" construction activity for the month of April 2008). The cash distributions were not based on any sharing of profits from the Tower 4 "venture." In fact, PCL Construction never received any distribution of profits from its minority ownership interest in Bravern II. By the time Bravern II was ready to generate income from the lease of apartments in Tower 4, PCL Construction had already transferred its interest in Bravern II to the majority owner. *See* CP 158 (PCL Construction assigned its interest in Bravern II to BRM effective February 8, 2011).

The federal "Schedule K-1" forms issued to PCL Construction for the 2008 through 2011 tax periods also confirm that PCL Construction did not share in the profits of the Tower 4 project. *See* CP 185-199. Those tax forms show that PCL Construction received no income from Bravern II's business operations. CP 185 at Part III, lines 1-11; CP 189 at Part III, lines 1-11; CP 193 at Part III, lines 1-11; CP 197 at Part III, lines 1-11. Thus, it is undisputed that PCL Construction did not contribute construction services to Bravern II in exchange for the right to share in the profits of the venture. Instead, PCL Construction built Tower 4 for Bravern II, on land owned by Bravern II, in exchange for a capital interest in Bravern II equal to the cash value of the services it performed and materials it used. Under both the plain language of the relevant statutes and the Department's application of administrative Rule 170(2)(f), that was a retail sale.

2. The Department's construction tax guide is consistent with its treatment of construction joint ventures and does not support Bravern II's refund claim.

Bravern II relies primarily on the Department's "construction tax guide" as support for its refund claim. App. Br. at 12-22. The tax guide is not law. It is a publication issued by the Department to summarize the tax law as it applies to the construction industry. *See* CP 487 ("This publication is a guide to help those engaged in construction activities

determine their state tax liabilities"). The guide includes a section summarizing the law pertaining to "speculative building." *Id.* (listing "Speculative Building" as third primary topic under the table of contents).[12] Bravern II takes portions of that section of the guide out of context in an effort to claim a tax refund to which it is not entitled.

The Department's construction tax guide explains, among other things, that a joint venture can qualify as a speculative builder if the venture owns the land and performs the construction. "To be treated as a speculative builder, a joint venture entity must actually exist and the joint venture entity must own the land **and** perform the construction itself." Appendix C at p. 2. This is a correct statement of the law. *See Nord Nw. Corp.*, 164 Wn. App. at 215 ("WAC 458-20-170(2) unambiguously requires real property ownership to qualify as a speculative builder").

The guide also explains that when construction services are performed by a member of the joint venture and the member is "guaranteed a fixed amount as compensation for construction services independent of any right to profit or gain," the member is taxable as a prime contractor. Appendix C at p. 2. As discussed above at pages 26

[12] CP 487-488 is an excerpt from a past version of the construction tax guide. The entire guide as currently updated is available on-line at <http://dor.wa.gov/content/doingbusiness/businesstypes/industry/construction/default.aspx>. A copy of the updated portion of the guide involving "speculative building" is attached as Appendix C.

through 28, this statement is consistent with Rule 170(2)(f) and the Department's published tax determination applying that rule.

Conversely, when the member is granted only the right to share in the profits of the venture, the member is not treated as engaging in a taxable sale of construction services to the joint venture. In that circumstance, the member is not "performing construction services as a separate entity," and the venture can qualify as a speculative builder. *Id.* Again, when read in context, the construction tax guide is entirely consistent with the Department's application of Rule 170(2)(f).

Bravern II's efforts to use the construction tax guide to expand speculative builder treatment to a joint venture or LLC that is purchasing construction services from a member should be rejected. The guide does not support such a broad application of the law.

3. The letter ruling issued to Bravern II was consistent with the Department's treatment of construction joint ventures.

Bravern II also argues that the Department mishandled a letter ruling request jointly submitted by BRM, PCL Construction, and Bravern II. *See* App. Br. at 8-10. The ruling request submitted by the three taxpayers explained the basic facts pertaining to the planned construction of Tower 4. CP 211. After considering the facts presented by the taxpayers, the Department issued its ruling explaining that the proposed

construction of Tower 4 would not qualify as speculative construction. CP 221.

Bravern II argues that the analysis contained in the Department's letter ruling was inconsistent with tax reporting instructions the Department provided to similarly structured joint ventures. However, Bravern II has not raised an estoppel claim. CP 497. As a result, its argument that the letter ruling is inconsistent with other Department informal guidance is immaterial.

But in any event, the analysis in the letter ruling *is* consistent with the manner the Department has historically treated construction joint ventures. As discussed above, when analyzing a claim that a payment is not subject to tax the Department will look at the substance of the transaction to determine whether the payment received by a member of a joint venture was (1) consideration in exchange for services provided by the construction-member to the joint venture or (2) merely the sharing of profits from the venture. The key factor is whether the payment flows from the income or profits of the business venture. If the payments to the construction-member do not flow from the profits of the venture, those payments are consideration for services provided to the venture and taxed as retail construction.

The joint letter ruling issued to BRM, PCL Construction, and Bravern II applies that exact analysis. *See* CP 221 ("A contribution of services is properly treated as a sale of services when the distribution is made without regard to profit or risk."). Under the facts described in the joint ruling request, this key factor was missing. CP 222 (summarizing provisions in the Operating Agreement and concluding that the periodic cash distributions payable to PCL Construction "appear substantially certain to occur without regard to the risk of the venture and with little or no effect on the members' rights to profits or proceeds"). Therefore, consistent with its prior application of Rule 170(2)(f), the Department found that PCL Construction would not qualify as a speculative builder on the proposed Tower 4 project. CP 223 ("PCL is a prime contractor with respect to construction services and tangible personal property provided to Bravern.").

Bravern II argues that the Department has historically allowed a construction contractor to avoid the retail sales tax and retailing B&O tax by creating a joint venture with the land owner and specifying in the agreement that distributions to the members are discretionary and conditioned on the availability of cash. App. Br. at 20-21. In effect, Bravern II argues that the Department allows parties to a joint venture to use clever contracting schemes to avoid paying taxes that would

otherwise apply when a contractor performs construction services on land owned by another person.

Nothing in Rule 170(2)(f) or the Department's application of that rule supports Bravern II's contention that parties may contract around the retail sales tax that is owed on construction services performed on land owned by another person. Bravern II's broad reading of Rule 170(2)(f) conflicts with the controlling statutes and with the Department's long-standing interpretation of its rule. Under both the controlling statutes and Rule 170(2)(f), Bravern II owed the retail sales tax it reported on the construction services that PCL Construction provided to Bravern II in building Tower 4 on land owned by Bravern II.

D. Bravern II's Refund Claim Should Also Be Denied Pursuant To RCW 82.32.655.

In addition to the fact that PCL Construction was not a speculative builder on the Tower 4 project under the plain language of the relevant excise tax provisions, Bravern II's refund claim should also be denied pursuant to RCW 82.32.655. That statute provides that the Department of Revenue "must disregard, for tax purposes" tax avoidance transactions similar to the KPMG "construction joint venture" tax shelter that Bravern II has employed here.

1. RCW 82.32.655(3)(a) is designed to curb the precise tax avoidance transaction at issue here.

The Department of Revenue is charged with the duty to enforce the excise tax laws of this state. RCW 82.01.060. In exercising that duty the Department, from time to time, becomes aware of tax avoidance schemes that are inconsistent with the general responsibility of taxpayers to voluntarily report and pay taxes that are lawfully owed. In 2007 the Department became aware that the accounting firm KPMG LLP was marketing a tax shelter to real estate developers and construction contractors that was based on the erroneous Department letter ruling issued in 2006 to a KPMG LLP client. Using that letter ruling as support, KPMG explained to potential clients that a land owner and construction contractor could avoid many thousands or millions of dollars of retail sales tax and retailing B&O tax if the land owner contributed the land to an LLC in exchange for a 99 percent interest in the LLC and the construction contractor invested $100 in the LLC in exchange for a one percent minority interest and then "contributed" its construction services to the LLC. CP 587 (marketing materials prepared by KPMG LLP to explain how The Bravern could save over $9 million in state and local taxes under the "Joint Venture Structure" proposed by KPMG). According to KPMG, this tax strategy would result in construction

services being "re-characterized from those of a Prime Contractor to those of a Speculative Builder." CP 592.

After some internal discussion, the Department concluded that the tax shelter being marketed by KPMG was not effective because it was inconsistent with the Department's historic application of Rule 170(2)(f). However, the Department was interested in developing administrative rules that addressed the misuse of joint ventures in general. As explained by former Department Assistant Director Russ Brubaker, while the Department was certain that the tax shelter marketed by KPMG would not qualify for the beneficial tax treatment enjoyed by a speculative builder, it was not entirely certain Rule 170(2)(f) would work "with somewhat different fact patters in different industries." CP 571. The Department was also concerned about other types of tax avoidance transactions involving the use of limited liability companies or other business entities. CP 395.

In 2007, the Department commenced stakeholder work with the goal of developing an administrative rule pertaining to various "abusive tax avoidance transactions." CP 395-96. Due in large part to the lack of consensus among stakeholders, the Department ended its stakeholder work in September 2008 without finalizing an administrative rule. CP 439. Instead, the Department brought the issue to the attention of the

Legislature. CP 618-19. In 2010, the Legislature enacted RCW 82.32.655 in an effort to curb certain abusive tax shelter, including the KPMG "construction joint venture" tax shelter at issue in this case.

2. The members structured the Bravern II Operating Agreement to limit PCL Construction's right to share in the profits of the venture and to limit its risk of loss.

RCW 82.32.655 sets out "the legislature's intent to require all taxpayers to pay their fair share of taxes. To accomplish this purpose, it is the legislature's intent to stop transactions or arrangements that are designed to unfairly avoid taxes." RCW 82.32.655(1). The statute goes on to provide that the Department "must disregard, for tax purposes, the tax avoidance transactions or arrangements that are described in subsection (3) of this section." RCW 82.32.655(2). For example, the Department is required to disregard for tax purposes joint ventures or similar arrangements "that are, in substance, substantially guaranteed payments for the purchase of construction services characterized by a failure of the parties' agreement to provide for the contractor to share substantial profits and bear significant risk of loss in the venture." RCW 82.32.655(3)(a). This provision is retroactive, applying to tax avoidance transactions occurring on or after January 1, 2006. *See* Laws of 2010, 1st Sp. Sess., ch. 23, § 1703.

Bravern II argues that the business arrangement entered into in April 2008 between BRM and PCL Construction does not fit within the statutory language of RCW 82.32.655(3)(a). App. Br. at 26-30. Bravern II is incorrect. A careful reading of the Operating Agreement shows that the members carefully structured Bravern II to significantly limit PCL Construction's right to share in the profits of the venture and to limit its risk of loss.

Under the terms of the Operating Agreement, BRM agreed to "contribute the Property and the Development Rights" in the Tower 4 project to Bravern II in exchange for 99 percent ownership of the LLC, and PCL Construction agreed to contribute its construction materials and services in exchange of the remaining one percent ownership of the LLC. CP 60 at ¶ 2.2.2(a) (BRM agrees to contribute property and development rights); CP 62 at ¶ 2.2.4 (PCL agrees to contribute construction materials and services); *see also* CP 59 (defining "Property"); CP 60 at ¶ 2.2.2(b) (defining "Development Rights"); CP 83 (describing the "Property" BRM agreed to contribute). Thus, even though Bravern II was not a true joint venture, it was a "similar arrangement between a construction contractor and the owner or developer of a construction project" that falls within the ambit of RCW 82.32.655(3)(a).

The Operating Agreement and other evidence in the record also establishes that PCL Construction did not share substantial profits and did not bear significant risk of loss from the Bravern II business venture. First and foremost, PCL Construction had only a small ownership interest in Bravern II and was not required to contribute any cash to the LLC other than its initial $100 contribution. CP 59-60 at ¶ 2.1; CP 60 at ¶ 2.2.3(b). While the Operating Agreement obligated PCL Construction to contribute construction materials and services to the LLC, it also required Bravern II to make cash distributions to PCL Construction in order to avoid an additional "accrued preferred return" payable to PCL and to avoid triggering a "put" option that would allow PCL to sell its interest in Bravern II to the other member of the LLC at a set price. CP 63 at ¶ 3.3 ("Accrued Preferred Return"); CP 74 at ¶ 8.4.1 ("PCL Put Right").

As anticipated under the terms of the Operating Agreement, Bravern II made periodic cash distributions to PCL Construction within twenty days from the date PCL's capital account was credited for the cash value of the materials and services contributed. Consequently, PLC Construction's ownership interest in Bravern II never exceeded one percent for more than 20 days at a time.

Other provisions of the Operating Agreement also limited PCL Construction's ability to share in the profits of the venture and limited its risk of loss. For example, paragraph 8.4.2 of the Operating Agreement permitted PCL Construction to leave the business venture upon finishing construction of Tower 4. CP 74 at ¶ 8.4.2 ("Exit Right Sale"). Thus, once Tower 4 was fully constructed and ready to generate income through the sale of condominium units or the lease of apartments, BRM had the right to purchase PCL Construction's minority interest and effectively take all of the profits from the venture for itself.

That, in fact, is what occurred. After PCL Construction finished constructing Tower 4 it transferred its interest in Bravern II to BRM pursuant to paragraph 8.4 of the Operating Agreement. CP 158; CP 160-62. Thus, as the parties intended under the terms of the Operating Agreement, PCL Construction did not share in any of the profits derived from Bravern II.

When viewed objectively and in light of the business venture as a whole, PCL Construction's right to share in the profits of the Bravern II was not "substantial." Additionally, PCL Construction's risk of loss was limited solely to its *undistributed* capital contributions, which was insignificant in relation to the Tower 4 project as a whole. Because PCL Construction received cash distributions from Bravern II within twenty

days from the date Bravern II credited its capital account, PCL was "at risk" at any given time for only a small portion of the $121 million it cost to build Tower 4. *See* CP 629 at ¶ 14 (during construction of Tower 4, PCL Construction's undistributed capital account balance averaged $6,759,296, which is less than 6% of the total cost of Tower 4). BRM assumed virtually all the risk that the project would fail.

The purpose of RCW 82.32.655(3)(a) is to prevent construction contractors from avoiding the Washington tax on transactions that are in substance the sale of retail construction services. In the present case, PCL Construction—in form and in substance—performed retail construction services when it constructed Tower 4 for Bravern II on land owned by Bravern II. The fact that PCL Construction was a one percent minority member of Bravern II does not change the underlying substance of the transaction. Moreover, because PCL Construction did not share substantial profits or bear significant risk of loss in the venture, the transaction is deemed by the Legislature to be a tax avoidance transaction that the Department must disregard. Consequently, Bravern II is not entitled to a refund of the retail sales tax it reported for the June 2009 reporting period.

3. Retroactive application of RCW 82.32.655(3)(a) is not unconstitutional.

Bravern II is also incorrect when it claims that retroactive application of RCW 82.32.655 is unconstitutional because it imposes a "new" tax. Br. App. at 30. RCW 82.32.655 codifies the substance over form doctrine as it applies to construction services. The substance over form doctrine has been applied in Washington tax cases since at least 1971. *See Time Oil Co. v. State*, 79 Wn.2d 143, 147, 483 P.2d 628 (1971). Moreover, the retail sales tax at issue has been imposed in Washington since the 1930s. Thus, contrary to Bravern II's claim, RCW 82.32.655 does not impose any "new" tax.

More importantly, the retroactive application of RCW 82.32.655 does not violate the Due Process Clause. In *United States v. Carlton*, 512 U.S. 26, 114 S. Ct. 2018, 129 L. Ed. 2d 22 (1994), the Supreme Court held that the substantive due process standard as applied to retroactive tax legislation "does not differ from the prohibition against arbitrary and irrational legislation that applies generally to enactments in the sphere of economic policy." *Id.* at 30 (internal quotations and citation omitted). If a statute's retroactive application "is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and

executive branches." *Id.* at 30-31. Thus, the Court clarified that a retroactive tax statute violates substantive due process only if its intended application to the past periods at issue is wholly unrelated to any legitimate legislative purpose. *See id.* at 40 (Scalia, J., joined by Thomas, J., concurring in the judgment).

The Washington Supreme Court has also rejected the notion that retroactive tax legislation is subject to heightened scrutiny under the Due Process Clause. *See W.R. Grace & Co. v. Dep't of Revenue*, 137 Wn.2d 580, 602-03, 973 P.2d 1011 (1999). In *W.R. Grace*, the Court explained that due process is met when "retroactive application of the legislation is itself justified by a rational legislative purpose." *Id.* (quoting *Carlton*, 512 U.S. at 31).

Statutes enacted by the Legislature are presumed to be constitutional and will not be overturned unless the statute so clearly contravenes constitutional limits as to leave no reasonable doubt as to its unconstitutionality. *Wash. State Grange v. Locke*, 153 Wn.2d 475, 486, 105 P.3d 9 (2005). Bravern II has not met that burden here. As a result, RCW 82.32.655(3)(a), which was specifically designed to curb tax avoidance involving retail construction services, provides an alternative basis for denying Bravern II's refund claim.

4. Retroactive application of RCW 82.32.655(3)(a) is not barred by RCW 82.32.660(1)(a).

Although RCW 82.32.655(3)(a) applies retroactively to January 1, 2006, the Legislature provided an exception where a taxpayer could prove that it "reported its tax liability in conformance with either specific written instructions provided by the department to the taxpayer, a determination published under the authority of RCW 82.32.410, or other document made available by the department to the general public." RCW 82.32.660(1)(a). That exception does not apply here.

Bravern II claims that it is not required to remit retail sales tax on the $121,022,756 it paid PCL Construction to construct Tower 4 on land owned by Bravern II, and that *not reporting* or paying tax "conforms to the requirements established by DOR's published documents." App. Br. at 23. In making this argument, Bravern II ignores the specific written instructions it received from the Department that advised Bravern II that the Tower 4 construction project would not qualify as speculative construction. *See* CP 221 (letter ruling). Instead, Bravern II relies on its reading of the Department's construction tax guide. App. Br. at 24-25. But, as discussed above, Bravern II reads the construction tax guide out of context. That tax guide, when read in context and consistent with the law it is summarizing, does not support Bravern II's claim of tax immunity.

To the contrary, the guide explains that in circumstances where, as here, the "contractor member" of a joint venture receives consideration in excess of the right to share in the profits of the venture, the member is engaged in retail construction. *See* Appendix C at p. 2.

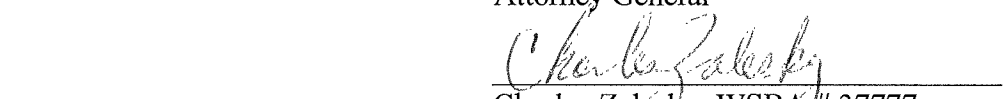
The statutory exception provided in RCW 82.32.660(1)(a) does not apply in this case. Consequently, RCW 82.32.655(3)(a) *does* apply and provides an alternative reason to uphold the trial court's grant of summary judgment to the Department.

V. CONCLUSION

For the reasons set forth, the Department respectfully requests that the Court affirm the superior court's order granting summary judgment to the Department.

RESPECTFULLY SUBMITTED this 25th day of November, 2013.

ROBERT W. FERGUSON
Attorney General



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I certify under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DAT-D this 25th day of November, 2013, at Tumwater, WA.

Carrie A. Parker

Carrie A. Parker, Legal Assistant

APPENDIX A

WAC 458-20-106
Casual or isolated sales—Business reorganizations.

A casual or isolated sale is defined by RCW 82.04.040 as a sale made by a person who is not engaged in the business of selling the type of property involved. Any sales which are routine and continuous must be considered to be an integral part of the business operation and are not casual or isolated sales.

Furthermore, persons who hold themselves out to the public as making sales at retail or wholesale are deemed to be engaged in the business of selling, and sales made by them of the type of property which they hold themselves out as selling, are not casual or isolated sales even though such sales are not made frequently.

In addition the sale at retail by a manufacturer or wholesaler of an article of merchandise manufactured or wholesaled by him is not a casual or isolated sale, even though he may make but one such retail sale.

Business and Occupation Tax

The business and occupation tax does not apply to casual or isolated sales.

Retail Sales Tax

The retail sales tax applies to all casual or isolated retail sales made by a person who is engaged in the business activity; that is, a person required to be registered under WAC 458-20-101. Persons not engaged in any business activity, that is, persons not required to be registered under WAC 458-20-101, are not required to collect the retail sales tax upon casual or isolated sales.

However, persons in business as selling agents who are authorized, engaged or employed to sell or call for bids on tangible personal property belonging to another, and so selling or calling, are deemed to be sellers, and shall collect the retail sales tax upon all retail sales made by them. The tax applies to all such sales even though the sales would have been casual or isolated sales if made directly by the owner of the property sold.

A transfer of capital assets to or by a business is deemed not taxable to the extent the transfer is accomplished through an adjustment of the beneficial interest in the business. The following examples are instances when the tax will not apply.

(1) Transfers of capital assets between a corporation and a wholly-owned subsidiary, or between wholly-owned subsidiaries of the same corporation.

(2) Transfers of capital assets by an individual or by a partnership to a corporation, or by a corporation to another corporation in exchange for capital stock therein.

(3) Transfers of capital assets by a corporation to its stockholders in exchange for surrender of capital stock.

(4) Transfers of capital assets pursuant to a reorganization under 26 U.S.C Section 368 of the Internal Revenue Code, when capital gain or ordinary income is not realized.

(5) Transfers of capital assets to a partnership or joint venture in exchange for an interest in the partnership or joint venture; or by a partnership or joint venture to its members in exchange for a proportional reduction of the transferee's interest in the partnership or joint venture.

(6) Transfer of an interest in a partnership by one partner to another; and transfers of interests in a partnership to third parties, when one or more of the original partners continues as a partner, or owner.

The burden is upon the taxpayer to establish the facts concerning the adjustment of the beneficial interest in the business when exemption is claimed.

Use Tax

The use tax applies upon the use of any property purchased at a casual retail sale without payment of the retail sales tax, unless exempt by law. Uses which are exempt from the use tax are set out in RCW 82.12.030.

Where there has been a transfer of the capital assets to or by a business, the use of such property is not deemed taxable to the extent the transfer was accomplished through an adjustment of the beneficial interest in the business, provided, the transferor previously paid sales or use tax on the property transferred. (See the exempt situations listed under the retail sales tax subdivision of this rule.)

[Statutory Authority: RCW 82.32.300. WSR 83-07-034 (Order ET 83-17), § 458-20-106, filed 3/15/83; Order ET 75-1, § 458-20-106, filed 5/2/75; Order ET 74-1, § 458-20-106, filed 5/7/74; Order ET 70-3, § 458-20-106 (Rule 106), filed 5/29/70, effective 7/1/70.]

APPENDIX B

WAC 458-20-170

Constructing and repairing of new or existing buildings or other structures upon real property.

(1) **Definitions.** As used herein:

(a) 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. The term includes persons who rent or lease equipment to property owners for use in respect to constructing, repairing, etc., buildings or structures upon such property, when the equipment is operated by the lessor.

(b) The word "subcontractor" means a person engaged in the business of performing a similar service for persons other than consumers, either for the entire work or for a specific portion thereof. The term includes persons who rent or lease equipment to prime contractors or subcontractors for use in respect to constructing, repairing, etc., when such equipment is operated by the lessor. When equipment or other tangible personal property is rented without an operator to contractors, subcontractors or others, the transaction is a sale at retail (see RCW 82.04.040 and 82.04.050).

(c) The terms "prime contractor" and "subcontractor" include persons performing labor and services in respect to the moving of earth or clearing of land, cleaning, fumigating, razing, or moving of existing buildings or structures even though such services may not be done in connection with a contract involving the constructing, repairing, or altering of a new or existing building or structure. The terms also include persons constructing streets, roads, highways, etc., owned by the state of Washington.

(d) The term "buildings or other structures" means everything artificially built up or composed of parts joined together in some definite manner and attached to real property. It includes not only buildings in the general and ordinary sense, but also tanks, fences, conduits, culverts, railroad tracks, tunnels, overhead and underground transmission systems, monuments, retaining walls, piling and privately owned bridges, trestles, parking lots, and pavements for foot or vehicular traffic, etc.

(e) The term "constructing, repairing, decorating or improving of new or existing buildings or other structures," in addition to its ordinary meaning, includes: The installing or attaching of any article of tangible personal property in or to real property, whether or not such personal property becomes a part of the realty by virtue of installation; the clearing of land and the moving of earth; and the construction of streets, roads, highways, etc., owned by the state of Washington. The term includes the sale of or charge made for all service activities rendered in respect to such constructing, repairing, etc., regardless of whether or not such services are otherwise defined as "sale" by RCW 82.04.040 or "sales at retail" by RCW 82.04.050. Hence, for example, such service charges as engineering fees, architectural fees or supervisory fees are within the term when the services are included within a contract for the construction of a building or structure. The fact that the charge for such services may be shown separately in bid, contract or specifications does not establish the charge as a separate item in computing tax liability.

(2) **Speculative builders.**

(a) 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.

(b) Where an owner of real estate sells it to a builder who constructs, repairs, decorates, or improves new or existing buildings or other structures thereon, and the builder thereafter resells the improved property back to the owner, the builder will not be considered a speculative builder. In such a case that portion of the resale attributable to the construction, repairs, decorations, or improvements by the builder, shall not be considered a sale of real estate and shall be fully subject to retailing business and occupation tax and retail sales tax. It is intended by this provision to prevent the avoidance of tax liability on construction labor and services by utilizing the mechanism of real property transfers. (RCW 82.04.050 (2)(c).)

(c) Amounts derived from the sale of real estate are exempt from the business and occupation tax. (RCW 82.04.390.) Consequently, the proceeds of sales by legitimate speculative builders of completed buildings are not subject to such tax. Neither does the sales tax apply to such sales, since such a sale involves no charge made for construction for a consumer, but the price paid is for the sale of real estate.

(d) However, when a speculative builder sells or contracts to sell property upon which he is presently constructing a building, all construction done subsequent to the date of such sale or contract constitutes a retail sale and that portion of the sales price allocable to construction done after the agreement shall be taxed accordingly. Consequently, the builder must pay business and occupation tax under the retailing classification on that part of the sales price attributable to construction done subsequent to the agreement, and shall also collect sales tax from the buyer on such allocable part of the sales price.

(e) Speculative builders must pay sales tax upon all materials purchased by them and on all charges made by their subcontractors. Deductions for such tax paid with respect to materials used or charges made for that part of the construction done after the contract to sell the building should be claimed by the speculative builder on his tax returns in accordance with WAC 458-20-102, under the subheading PURCHASES FOR DUAL PURPOSES.

(f) Persons, including corporations, partnerships, sole proprietorships, and joint ventures, among others, who perform construction upon land owned by their corporate officers, shareholders, partners, owners, co-venturers, etc., are constructing upon land owned by others and are taxable as sellers under this rule, not as "speculative builders."

(3) **Business and occupation tax.**

(a) Prime contractors are taxable under the retailing classification, and subcontractors under the wholesaling classification upon the gross contract price.

(b) Where no gross contract price is stated in any contract or agreement between the builder and the property owner, then the measure of business and occupation tax is the total amount of construction costs, including any charges for licenses, fees, permits, etc., required for the construction and paid by the builder.

(4) **Retail sales tax.**

(a) Prime contractors are required to collect from consumers the retail sales tax measured by the full contract price. Where no gross contract price is stated, the measure of sales tax is the total amount of construction costs including any charges for licenses, fees, permits, etc., required for construction and paid by the builder.

(b) The retail sales tax does not apply to charges made for janitorial services nor for the mere leveling of land used in commercial farming or agriculture. The tax does apply, however, in respect to contracts for cleaning septic tanks or the exterior walls of buildings, as well as to earth moving, land clearing and the razing or moving of structures, whether or not such services are performed as incidents of a contract to construct, repair, decorate, or improve buildings or structures.

(c) Sales to prime contractors and subcontractors of materials such as concrete, tie rods, lumber, finish hardware, etc., which become part of the structure being built or improved are sales for resale and are not subject to the retail sales tax. Sales of form lumber to such contractors are sales for resale provided that such lumber is used or to be used first by such persons for the molding of concrete in a single contract, project or job and the form lumber is thereafter incorporated into the product of that same contract project or job as an ingredient or component thereof. Sales of form lumber not so incorporated as an ingredient or component are sales at retail.

(d) The retail sales tax applies upon sales and rentals to prime contractors and subcontractors of tools, machinery and equipment, and consumable supplies, such as hand and machine tools, cranes, air compressors, bulldozers, lubricating oil, sandpaper and form lumber which are primarily for use by the contractor rather than for resale as a component part of the finished structure.

(e) The retail sales tax applies upon sales to speculative builders of all tangible personal property, including building materials, tools, equipment and consumable supplies and upon sales of labor, services and materials to speculative builders by independent contractors.

(5) **Use tax.**

The use tax applies generally to the use by prime contractors and subcontractors of tools, machinery, equipment and consumable supplies acquired by them primarily for their own use and upon which the retail sales tax has not been paid. This includes equipment and supplies purchased in a foreign state for use or consumption in performing contracts in this state. The use tax applies generally to the use by speculative

builders of all tangible personal property, including building materials, purchased or acquired by them without payment of the retail sales tax (see also WAC 458-20-178).

[Statutory Authority: RCW 82.32.300. WSR 87-19-007 (Order ET 87-5), § 458-20-170, filed 9/8/87; WSR 83-07-033 (Order ET 83-16), § 458-20-170, filed 3/15/83; Order ET 71-1, § 458-20-170, filed 7/22/71; Order ET 70-3, § 458-20-170 (Rule 170), filed 5/29/70, effective 7/1/70.]

APPENDIX C

Construction

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Speculative building

Speculative builders construct residential or commercial buildings on land they own. Speculative builders are subject to real estate excise tax on the selling price of the land along with all attachments including buildings, roads, and other structures. The sale of real estate is not subject to the B&O tax or retail sales tax.

A speculative builder is the consumer of all material incorporated into the real estate. A speculative builder may not use a reseller permit to purchase materials used in speculative building. Any construction contractor hired by a speculative builder is a custom prime contractor for tax purposes and not a subcontractor. Hence, any contractor performing construction services for a speculative builder must charge sales tax on the total contract price.

Payment of Sales Tax on Goods Delivered to Job Site
Effective July 1, 2008, speculative developers that have materials and supplies delivered to the job site pay sales tax based on the job site delivery location. Previously, the sales tax rate was determined by the vendor's location.

Land Ownership

As explained above, the definitions of custom and speculative building and the resulting tax consequences are based upon who owns the land. Building on land owned by another is prime construction (unless specifically defined otherwise) and building on your own land is speculative construction. Therefore, land ownership must be established to determine the proper tax application to the construction work performed.

The owner of real property is generally the holder of the recorded title. However, it is possible for a person to hold title to real property which he/she does not own. Therefore, attributes of ownership, other than mere title to the property, may determine the tax application.

WAC 458-20-170 identifies four criteria that can be used in determining who holds the attributes of real estate ownership (other criteria may be used as well). They are:

1. The intentions of the parties in the transaction under which the land was acquired;
2. The person who paid for the land;
3. The person who paid for improvements to the land; and
4. The manner in which all parties, including financiers, dealt with the land.

The attributes of ownership establish who has the rights and liabilities of a property owner. That is, who has the ownership rights and liabilities to the extent that a court would call that person the owner of real property, despite the fact that someone else may hold mere bare title to the property. Holding documentation which, by itself, labels a party to the transaction as landowner does not override the other attributes of ownership if those attributes are held by another person.

For example:

Party A - Original Landowner/Seller

Party B - Contractor/Nominee

Party C - Customer/Purchaser

Party A wishes to sell its land. Party C wishes to purchase Party A's land and have Party B construct a house on it. For financing purposes, title is first transferred to Party B as nominee for Party C. At this point, the title will show Party B as "Grantee and Nominee." Then Party B constructs the home. Afterwards, Party B transfers title to Party C.

Although Party B is shown as title holder during construction of the home, he/she does not have the attributes of ownership. Therefore, Party B is not a speculative builder of the home, but is a custom prime contractor to Party C.

Certain Title Transfers will be Disregarded

When an owner of real estate sells to a builder who improves the property and then resells the improved property back to the original owner, the builder is not taxable as a speculative builder. The total activities are taxed as custom prime construction.

Pre-sales Agreements

Additionally, a prospective buyer will not be the owner of land by merely executing a purchase and sale agreement or pre-sale agreement with the contractor (even if a substantial amount of money is paid). In this case, there has not been a transfer of ownership rights and liabilities until the closing has taken place.

Selling a Speculative Home During the Course of Construction

When a speculative builder sells or contracts to sell property upon which there is a building under construction, all construction completed subsequent to the date of such sale or contract constitutes custom prime contracting.

The "retail sale" does not take place until the purchasers have the "right of possession" to the real property being constructed. Typically, the right to possession is transferred on the date of closing the property conveyance. Therefore, retail construction on what was originally a speculative house does not occur until after closing.

Joint Ventures

The formation of a joint venture is a common way to accomplish the development of real estate. Many times the members of the joint venture include a person that owns property (landowner member) and a general contractor (contractor member). The formation of a joint venture is the creation of a third entity. When construction takes place on the property, tax consequence is determined by the answers to the following questions:

1. Which entity owns the land? Does a member or joint venture entity own the land?
2. Which entity is providing the construction services? Is a member performing the construction services as a separate entity (prime contractor for the joint venture or landowner) or is the joint venture performing the construction services itself (contractor is performing service as a member of joint venture)? The answers to these questions will determine the tax liabilities of the joint venture entity and specific members.

If construction services are performed by a member as a separate entity on land owned by one of the other entities (the joint venture entity or landowner), the construction services are taxable as custom prime contracting. The contractor must collect retail sales tax on the full contract price (labor and materials) from the landowner. This is true even if the contractor is a member of the joint venture.

When a joint venture owns the land and the contractor performs construction services as a member of the joint venture (versus a separate entity), the joint venture is a speculative builder. In this case, the work performed by the contractor is a contribution to the capital of the joint venture. The joint venture entity must pay retail sales tax or use tax on materials purchased or produced for incorporation into the real estate.

To be treated as a speculative builder, a joint venture entity must actually exist and the joint venture entity must own the land **and** perform the construction itself.

Land ownership is established by the attributes of ownership as discussed above. The following factors are significant in determining whether construction activities are performed by a joint venture or by other parties involved in the construction:

1. Was the joint venture specifically formed to perform the contract work?
2. Did the formation of the joint venture begin prior to construction?
3. Was the construction work actually performed by the joint venture (versus by a separate entity)?
4. Were the funds handled as joint venture funds rather than as separate funds of any party to the joint venture agreement?
5. Was there a contribution of money, property and/or labor so that any profit or loss incurred by the joint venture is proportionately shared by all members?

Where a member is guaranteed a fixed amount as compensation for construction services independent of any right to profit or gain, such amount is taxable as custom prime contracting.

Road Building on Speculative Projects

Generally, the construction of roads on private property by a prime contractor is a retail sale subject to retail sales tax on the full contract price (labor and materials). However, when the road will be deeded to a city or county, the construction is taxable as public road construction. In this case, the road contractor's charges to the speculative builder are not subject to retail sales tax. A road contractor is the consumer of all materials it incorporates into the roads. This means the road contractor must pay retail sales tax or use tax on such materials. This includes materials provided by the speculative builder. However, if the speculative builder (landowner) has paid retail sales tax or use tax on the materials, the tax is not due again from the road contractor.

The speculative builder remains a consumer with regard to all materials purchased or produced for incorporation into the road. Therefore, the speculative builder must pay retail sales tax or use tax on materials provided to the road contractor. In this case, both contractors are consumers with liability for payment of retail sales tax or use tax on materials. However, the value of the

materials is only subject to the tax once. Therefore, when one contractor has paid the tax, the tax liability has been satisfied with regard to those materials.

If the road is not finally dedicated to the public body within a reasonable period of time after the work is completed, the speculative builder will be liable for use tax on the charges of the road contractor. A reasonable period of time has generally been limited to one year or less.

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