Ruling 94-01

Vermont Department of Taxes

Date: January 25, 1994

Written By: Danforth Cardozo, III, Attorney for the Department

Approved By: Emily B. Tartter, Deputy Commissioner of Taxes

You have requested a formal ruling on the application of Vermont's sales and use tax exemption under 32 V.S.A. § 9743(3) and (4) as it relates to your client, [Corporation]. This ruling relies on the representations contained in your letter to Commissioner Joyce H. Errecart dated April 20, 1993; our telephone conversation of July 27, 1993; the letter from [Name], of your firm dated August 30, 1993, and my telephone conversation with [Name] of September 9, 1993.

Facts: The [project] (the "Project") is to be a [type of project] with related facilities located on a [#] acre site in [Town], Vermont. Construction of the project began in [Date] and is scheduled to be completed by [Date].

The [Corporation] (the "Corporation") is a Vermont not-for-profit corporation and is exempt from taxation under Section 501(c)(3) of the Internal Revenue Code. [Partnership] (the "Partnership") is a [State] limited partnership.

Prior to [Date], the Corporation held a purchase option with respect to the real property upon which the construction activities at issue are being conducted. In order to obtain the financing required for construction of the facilities, the Corporation approached [Financing Corporation], a [State] corporation ("[Financing Corporation]") for assistance in this regard. [Financing Corporation] has significant expertise in the development, marketing and operation of [type of project]. [Financing Corporation] has been involved in the development of a number of [type of projects] throughout the United States. [Development Corporation], a wholly owned subsidiary of [Financing Corporation], is the general partner of the Partnership, formed in [Date] for the purpose of performing certain development functions and obtaining pre-construction financing for the [project]. The Partnership, while sharing a similar name, is not an affiliate of the Corporation nor is it within the direct or indirect control of the Corporation.

On [Date], the Corporation and the Partnership entered into an Agreement to Lease, which provides that the Corporation would assign its purchase option to the Partnership. The Partnership would in turn acquire the property through the exercise of the option and then proceed to obtain construction financing and otherwise assist the Corporation in the development of the [project]. Upon completion of the construction, the parties agreed to enter into a fifteen year lease of the property from the Partnership to the Corporation (the "Lease").

The financing and development activities undertaken by the Partnership pursuant to the Agreement to Lease were undertaken in return for a development fee. All costs incurred by the Partnership (primarily the construction costs) were to be directly or indirectly reimbursed by the Corporation pursuant to the Lease. During the term of the Agreement to Lease and even prior to construction, the Corporation had significant responsibilities for obtaining regulatory approvals for project operations as well as certain obligations with respect to marketing the [project]. In addition, the Corporation had continuing oversight over the development and construction plans.

The Agreement to Lease provides that the Partnership was responsible for obtaining construction financing from an institutional lender on terms no less favorable than set forth in a pre-approved budget. The Corporation agreed to cooperate with the Partnership and to obtain and provide to the Partnership any information requested by a construction lender and to execute any document necessary to obtain the construction loan.

The Lease provided for a fifteen year term. The rent due under the lease was to be determined at the time of execution pursuant to a formula. The formula provided that in the aggregate, the rent was to be sufficient to pay all debt service incurred by the Partnership in completing the project, pay all real estate taxes not required to be paid by the Corporation under the Lease, and provide a specified rate of return to the Partnership. In addition, there were certain equitable adjustments in the rent payable in order to insure that the Partnership received its rate of return, notwithstanding the occurrence of certain events. In other words, the rent was not based on comparable fair market rents, but rather, upon the actual costs incurred by the Partnership in developing the [project] along with an "interest" factor. In addition, the Lease required the Corporation to pay the Partnership its costs of procuring and maintaining insurance and all taxes and assessments on the property.

Under the Lease, repairs and insurance were to be provided by the Corporation and in the event of major destruction to the property, the Partnership would be required to make repairs if such damage did not make all or a substantial portion of the leased premises untenantable, except that such obligations to repair would not be in excess of the proceeds of insurance recovered with respect to the casualty. Furthermore, if the property was rebuilt, rent would not be abated unless the restoration took more than two years to complete. Similar rules would apply in the case of a condemnation.

The Lease contained a right on the part of the Partnership to offer the property for sale to the Corporation each year following the tenth year of the Lease. In addition, in each of those years the Corporation would have a purchase option with respect to the property. While the purchase option would nominally be exercised at fair market value, the term "fair market value" as used in the Lease is actually defined to be something other than an arms-length price. Rather, in rough terms, the price is based upon the fair market value less the amounts paid under the Lease as rent. At the expiration of the term of the Lease, the "fair market value" would have most likely been relatively nominal. Subsequent to the Agreement to Lease, the Partnership, working directly with the Corporation and its advisors, provided consulting services in order to guide the [project] through the extensive approval process at the State and local levels in order to obtain the required permits and approvals; prepared the Project budgets; assisted the Corporation in selecting and negotiating a fixed price contract with a construction contractor; and oversaw the design and engineering work. The Corporation was at all times intimately involved in this process and the nature of the services provided by the Partnership was akin to consulting and advisory services which were necessary given the Corporation's relative lack of experience in a project of this type and the Partnership's much greater experience.

A construction contract dated as of [Date], as amended, was entered into between the Partnership and the general contractor, ["General Contractor"] for a fixed price of [price]. Preliminary site work was begun [date].

Due to various financial concerns, the Corporation decided to fund the project through tax-exempt bonds. This made it necessary to restructure the project so that the Corporation would be the owner, and not just a lessee with an option to purchase. On [date], at approximately the same time as the site work was begun, the Partnership and the Corporation entered into an "Agreement to Proceed with Tax-Exempt Financing" (the "Agreement to Proceed"; the Agreement to Lease, Lease and Agreement to Proceed are sometimes hereinafter referred to collectively as the "Agreements") in which both the Partnership and the Corporation agreed to pursue a revision of their prior contractual arrangements so as to allow for tax-exempt financing of the [project]. The essence of the Agreement to Proceed was that the development of the [project] would be financed by the proceeds of tax exempt bonds issued by the Vermont Industrial Development Authority and lent to the Corporation. The property would be conveyed to the Corporation at the time of closing on the bonds. Prior to closing, the Partnership would ensure that construction on the project was begun and at closing on the bond financing, the Corporation would reimburse the Partnership for all expenditures it incurred. In the interim, the Corporation would become a co-signatory to the construction contracts.

It was anticipated by the Corporation and Partnership that the tax exempt financing would be available prior to the start of building construction (other than site work) for the project. This did not turn out to be the case because of certain requirements imposed by the issuer of the tax exempt-financing and constraints in the capital market applicable to tax-exempt financing. However, the Corporation considered an early start of construction of the project buildings to be critical in meeting the needs of the [project] residents, and construction began prior to the bond closing.

The Corporation required that the Partnership obtain an agreement from the construction contractor to start construction of the buildings in the project pending completion of the tax-exempt financing, with an understanding that the Corporation would become a party to the construction contract and pay the contractor out of proceeds of the tax-exempt financing. Prior to commencement of building construction, the Partnership agreed to this approach and an existing contract between the Partnership and the contractor was to include the Corporation as a co-signatory. The Partnership gave the project contractor a promissory note, secured by a mortgage on the project, evidencing the obligation to pay requisitioned amounts out of the proceeds of the tax-exempt financing.

The Partnership did not make any payments to the contractor and the contractor was looking solely to the bond proceeds to be paid by the Corporation at closing. Construction was actually halted in [date] pending issuance of the bonds.
The Partnership agreed to take the risk of the early commencement of building construction only because of the agreement with the contractor that the contractor would be paid out of the proceeds of the tax-exempt financing being arranged by the Corporation, and with the further understanding that no commencement of use by the Corporation could occur until the completion of the tax exempt financing. Additionally, other parties connected to the project, including the contractor, sub-contractors, architects and consulting engineers have been willing to proceed with the understanding and expectation that as soon as the tax-exempt financing was in place, the Corporation would be in a position to purchase the land and improvements completed thus far from the Partnership, and to then pay the general contractors, who in turn would pay the subcontractors, suppliers and materialmen.

The bonds were issued as of [date] and title to the project lands and improvements was conveyed from the Partnership to the Corporation. The Corporation paid all outstanding contractor invoices so that construction could resume at about the same time.
Discussion: As a general rule, contractors are considered as any other purchaser of taxable tangible personal property. Sales of building materials and supplies to contractors and subcontractors are considered to be retail sales subject to the sales and use tax. 32 V.S.A. § 9701(5). Consequently, a contractor must pay the sales and use tax as a consumer on the purchase of materials and supplies used in the fulfillment of the construction contract. Regulation § 226-7 (III).

However, both 32 V.S.A. § 9743(4)(B) and Regulation § 226-7(IV) provide that the sale of building materials and supplies to a contractor to be used in the construction of any building owned by or held in trust for the benefit of a Section 501(c)(3) organization and used exclusively for the conduct of its exempt business is not subject to the sales and use tax. Regulation § 226-7(IV) further provides that in such a case the contractor purchases such materials and supplies tax free and should not charge any exempt entity sales and use tax thereon.

To take advantage of the above exemption, the exempt organization must obtain an Exemption Certificate from the Commissioner of Taxes. 32 V.S.A. § 9743(4). The organization must furnish its Exemption Certificate number to the contractor, who in turn must provide its own Exemption Certificate (containing the exempt organization's number) to its suppliers in order to buy material and supplies free from tax. Regulation § 226-7(IV).

"While exemptions for a public use are not construed with the same degree of strictness as those applicable to property used for gain or profit, they are still construed strictly, and no claim of exemption can be sustained unless within the express letter or necessary scope of the exempting clause." Pizzagalli v. Department of Taxes, 132 Vt. 496, 499 (1974). To take advantage of the exemption, the plain and explicit words of both the applicable statute and regulations require that the sale of building materials and supplies to a contractor must be used in the construction of a building "owned by or held in trust for the benefit of" a Section 501(c)(3) organization. 32 V.S.A. § 9743(4)(B), Regulation § 226-7 (IV).

The Partnership undertook development and construction of the project while it owned the project. It was the initial intention of the parties that title to the project would remain in the Partnership even upon completion of the construction. The project was to have been leased to the Corporation by the Partnership. Due to financing constraints, the agreement of the parties was changed to provide vesting of legal title in the Corporation when the bond financing was obtained. It was understood, however, that no commencement of use by the Corporation could occur until the bond financing was obtained.

The Partnership entered into the construction contract while it owned the project. Later, the contract was modified to include the Corporation as a co-signatory before legal title passed to the Corporation, but both before and after this time the Partnership maintained ultimate control over the project. The Partnership gave a mortgage and a promissory note to the contractor. There is no question that legal title to the land and improvements did not pass from the Partnership to the Corporation until [date].

It is apparent from the facts that a clear decision was made to keep ownership in the project in the Partnership for as long as possible without jeopardizing the bond financing. Under these circumstances, to hold that the Corporation was the owner of the project before conveyance by the Partnership would be incorrect. The Department cannot be confined to the labels that the parties place on their transactions. See Wetherbee v. State, 132 Vt. 165, 168 (1974).

In the Pizzagalli case, the court analyzed a situation similar to the facts here and found no exemption from the sales and use tax. There, a construction company and its wholly owned subsidiaries financed and owned buildings which they constructed and then deeded to housing authorities exempted from federal taxation under I.R.C. Section 501(c)(3). The court held that the construction company and subsidiaries, and not the housing authorities, were the owners of building materials used in construction and thus the materials were not exempt from sales and use tax under 32 V.S.A. § 9743(4). The court found that the interest of the housing authority as a vendee under an executory contract of sale was insufficient "ownership" upon which to base the exemption, particularly in the absence of a vendee taking possession or some sort of beneficial interest short of legal title passing to the vendee. "(T)o meet the ownership requirement of an exemption properly construed legal title must be in the claimant, and...the interest of a vendee does not qualify." Id. at 499. The court also found that the contract to convey property did not create a trust whereby the vendor-contractor held in trust for the vendee-housing authorities, and that the building materials were not thereby held in trust for the housing authorities who were to purchase the finished buildings. Id., at 500. The court specifically found that the fact that the tax might be borne by the government or the exempt organization did not impel a different result. Id.

The Corporation argues that the Corporation should be treated as the owner of the Project for tax purposes at all relevant times, and cites federal cases dealing with the issue of federal tax ownership. These cases are irrelevant. The determination at issue here is simply whether the project was owned by a Section 501(c)(3) organization as required to qualify for the exemption from sales and use tax under 32 V.S.A. § 9743(3). The cases cited analyze whether certain periodic payments should be treated under federal tax law as rent or installment sale payments. They have no bearing on the state law analysis of whether an entity is a true owner of property.

On the facts presented, the Partnership was the owner of the property until the [date] transfer of title to the Corporation. Accordingly, any purchase or use of materials and supplies by the contractor or subcontractors on this project is taxable insofar as the Partnership is or was the owner of the project at the time of the sale or use.

This ruling is issued solely to your firm and is limited to the facts presented as affected by current statutes and regulations. Other taxpayers may refer to this ruling to determine the Department's general approach, but the Department will not be bound by this ruling in the case of any other taxpayer or in the case of any change in the relevant statute or regulations.