WAC 458-20-28001  Construction joint ventures and similar arrangements described in RCW 82.32.655 (3)(a).  (1) Preface. This rule includes a number of examples that identify a set of facts and then state a conclusion. The examples should be used only as a general guide. The department will evaluate each case on its particular facts and circumstances and apply both this rule and other statutory and common law authority. An example that concludes an arrangement or transaction is not unfair tax avoidance under this rule does not mean that the arrangement or transaction is approved by the department under other authority.

The tax consequences of all situations must be determined after a review of all facts and circumstances. Additionally, each fact pattern in each example is self-contained (e.g., "stands on its own") unless otherwise indicated by reference to another example. Examples concluding that sales tax applies to the transaction assume that no exclusions or exemptions apply, and the sale is sourced to Washington.

(2) Required elements.
(a) A construction joint venture or similar arrangement is a potential tax avoidance arrangement or transaction when it:
   (i) Provides substantially guaranteed payments to the construction contractor for construction services rendered;
   (ii) Does not provide the construction contractor with the right to share substantial profits in the venture; and
   (iii) Does not require the construction contractor to bear significant risks of loss in the venture.

The construction joint venture is considered a sale of construction services and potential tax avoidance if (a)(i) through (iii) of this subsection elements exist and the arrangement is also determined to be unfair tax avoidance under WAC 458-20-280(3). If none of these elements exist, then it is not potential tax avoidance and cannot be unfair tax avoidance.

(b) Form of the arrangement. A joint venture or similar arrangement includes a joint venture, partnership, limited liability company, or any similar arrangement between a construction contractor and an owner or developer. This rule applies even if the arrangement includes additional participants. The term "construction contractor" includes any person providing construction services or services in respect to construction. The term "owner or developer" includes, without limitation, a landowner, a lessee of land, a project manager, or a construction manager. An arrangement that fails to meet all elements of a joint venture at common law may still be an arrangement that is considered a joint venture or similar arrangement under this subsection.

(c) Substantially guaranteed payments. A "substantially guaranteed payment" is a payment that is guaranteed, secured, or otherwise protected so as to be substantially guaranteed to occur. The determination is based on all relevant facts and circumstances including, without limitation, the terms of any operating agreement or other applicable instrument, common trade practice, and the course of dealing of the parties. The fact that a payment reduces the value of the payee's capital account is not determinative. Whether or not a payment is a guaranteed payment for purposes of Sec. 707(c) of the I.R.C. is not relevant.

(d) Substantial profits. A construction contractor is entitled to substantial profits only when it has a vested and unconditional right to receive income earned by the venture in the ordinary course of the venture's business to which the construction contractor's contributed property and/or services relate, after costs of the venture are paid.
in full or otherwise provided. If the receipt of income is guaranteed, secured, or otherwise protected so as to be substantially guaranteed to occur, it is a substantially guaranteed payment, not a right to share in substantial profits. For purposes of determining substantial profits, a right is unconditional even though dependent on venture profitability. To be "substantial," the right to profits must be substantial when compared to the right to guaranteed payments under the arrangement.

(e) **Significant risks.** A construction contractor bears significant risks when its right to substantial profits is not guaranteed, secured, or otherwise protected so as to be substantially guaranteed to occur. A significant risk of loss to the contractor is deemed to occur when at least one-half of the fair market value of contributed services is at risk.

(3) **Examples.**

Example 1. A construction contractor and a developer create a joint venture under which the developer contributes land, and the construction contractor contributes labor and materials. All contributions and distributions are reflected in adjustments to the value of the parties' capital accounts. The construction contractor's capital account contributions are valued at out-of-pocket cost of labor and materials plus 12% designated as overhead. The venture agreement provides that the venture will obtain a bank construction loan and will use the construction draws to periodically pay down the construction contractor's capital account. The terms of the construction loan require that construction loan proceeds be used to pay the construction contractor and remove applicable liens. Under this arrangement, payments to the construction contractor are substantially guaranteed to occur because the terms of the construction loan require payments to the construction contractor. Because this arrangement provides for substantially guaranteed payments, no substantial right to profits and the loan terms assure no risk of loss to the contractor, it is a potential tax avoidance arrangement or transaction under WAC 458-20-280(2). However, it is not unfair tax avoidance unless it is determined to be tax avoidance in accordance with WAC 458-20-280(3).

Example 2. Assume the same facts as in Example 1, but the value of the construction contractor's contributions of labor and materials are credited to its capital account at out-of-pocket cost plus 3% for overhead. Assume that all of the items credited to capital account are substantive credits. Under this arrangement, payments to the construction contractor are substantially guaranteed to occur because the terms of the construction loan require payments to the construction contractor. If the arrangement contains other provisions that also provide the contractor with the right to share substantial profits and require the contractor to bear significant risk of loss in the venture, then the arrangement is not an unfair tax avoidance arrangement or transaction.

Example 3. Assume the same facts as in Example 2, except that nothing in the loan documents or any other agreement require that payments be made to the construction contractor. If the arrangement also provides the contractor with the right to share substantial profits and requires the contractor to bear significant risks of loss in the venture, then the arrangement is not a tax avoidance arrangement or transaction.

Example 4. A construction contractor and a developer create a joint venture under which the developer contributes land and the construction contractor contributes labor and materials. All contribu-
tions and distributions are reflected in adjustments to the parties' capital accounts. The value of the construction contractor's capital account contributions include out-of-pocket costs of labor and materials plus 12% designated as overhead. If at any point, the value of the construction contractor's capital account exceeds a specified percentage of the total capital account balances of all members combined, and that percentage is not reduced within 30 days, the construction contractor has the right to require a buy-out by the venture (a "put option"). The purchase price of the put option is equal to the value of the unpaid balance of the construction contractor's capital account. The agreement requires the developer to guarantee the venture's payment obligation under the option. The construction contractor is also entitled up to 5% of the profits of the venture once the improved land is sold. In this example, payments to the construction contractor are substantially guaranteed as a result of the put option and the developer guarantee. In addition, the construction contractor is not entitled to substantial profits of the venture. Therefore, the arrangement is a potential tax avoidance arrangement or transaction under WAC 458-20-280 (2)(a). However, it is not unfair tax avoidance unless it is determined to be tax avoidance in accordance with WAC 458-20-280(3).

Example 5. Assume the same facts as Example 4, but the construction contractor is entitled to 50% of the profits of the venture. However, the developer has the power under the joint venture agreement to issue a call option and buy all of the construction contractor's interest in the venture at any time prior to the sale of the improved property. Under this example, the construction contractor is also not entitled to a substantial share of the profits of the venture because the construction contractor's right can be terminated by unilateral act of the developer. It does not matter whether the developer's call right is discretionary or is limited to a termination "for cause." Because the arrangement provided for guaranteed payments and does not provide the construction contractor with a vested and unconditional right to profits of the venture, the arrangement is a potential tax avoidance transaction. However, it is not unfair tax avoidance unless it is determined to be tax avoidance in accordance with WAC 458-20-280(3).

Example 6. Assume the same facts as Example 4, but the value of the construction contractor's capital account contributions includes only allowable cost of labor and materials plus 3% overhead. However, the purchase price of the put option is equal to the unpaid balance of the construction contractor's capital account plus 8% of the profits of the venture, determined as of the date the put option is exercised. The arrangement is still a potential tax avoidance arrangement. In this example, the price under the put option right is a guaranteed payment because it is guaranteed by the developer.

Example 7. A construction contractor and a developer create a joint venture to build a house, under which the developer contributes land and the construction contractor contributes labor and materials. All contributions and distributions are reflected in adjustments to the parties' capital accounts. Upon sale of the house, the venture will wind up its business, pay or provide for all debts of the venture, and distribute all funds in the following order: (i) A distribution to the construction contractor in an amount equal to the value of its capital account; (ii) a distribution to the developer equal to the value of the amount of its capital account; (iii) substantial profits as defined in subsection (2)(d) of this rule to the construction con-
tractor; and (iv) all remaining funds to the developer. Assume the construction contractor's rights to receive the value of its capital account and the final profits distribution are vested and unconditional, but that neither of the payments are guaranteed, secured, or otherwise protected. In this example, the construction contractor is not entitled to any guaranteed payments. In addition, the construction contractor has a right to substantial profits that are at significant risk of loss. Because none of the elements identified in subsection (2)(a) of this rule above are present, this is not a potential tax avoidance transaction.

**Example 8.** A construction contractor and a developer create a joint venture under which the developer contributes land and the construction contractor contributes labor and materials. Assume the construction contractor is not entitled to any guaranteed payments. Upon sale of the house, the venture will wind up its business, pay or provide for all debts of the venture, and distribute all funds X% to the developer and Y% to the construction contractor. Assume that the construction contractor's right to receive this Y% of venture profits is vested and unconditional and that the construction contractor is not entitled to any guaranteed payments. Under this example, the construction contractor is entitled to a substantial share of profits earned by the venture in the ordinary course of its business to which the construction contractor's contributions relate. This arrangement is not a potential tax avoidance arrangement or transaction because no payments, including payment of the Y% profit, are guaranteed. Therefore, the right to profits is substantial and the construction contractor also bears significant risk in the venture.

**Example 9.** Assume the same facts as Example 8, but the developer and an affiliate of the construction contractor enter into a separate contract for project management services. The affiliate will provide all project management and similar services through the contract, under which payment for the services is substantially guaranteed. The arrangement is not potential tax avoidance under this subsection. The project management contract will be subject to tax according to the substance of the arrangement, assuming the affiliate is responsible for construction.

(4) **Related guidance.** Nothing in this rule affects the application of WAC 458-20-170 or other department-published guidance on differentiating between speculative builders and prime contractors. Therefore, an arrangement or transaction may be considered the sale of construction services under WAC 458-20-170 or other guidance, irrespective of whether the arrangement or transaction is potential or unfair tax avoidance under this rule.

(5) **Reserved.**