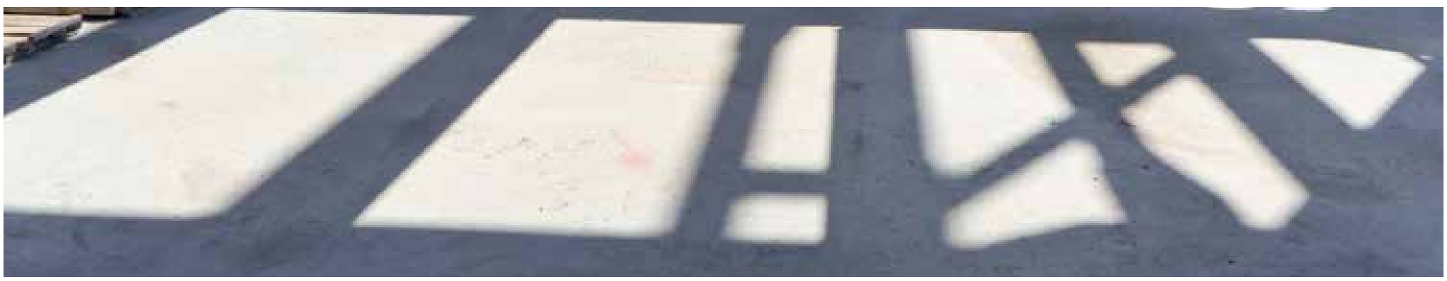
by Nathan M. Nickolaus, Esq.

Hidden Trap In Chapter 100 Could Cost Cities



Chapter 100 Bond financing is one of the most popular tools in the municipal economic development toolbox.[1] It is popular for a number of good reasons. On the surface, it seems fairly easy to do, and in most cases the bond counsel and the company do all of the heavy lifting. It does not require the consent of any of the other taxing jurisdictions, although they do get notice. It doesn't carry the controversy that tax increment financing (TIF) does. Most importantly, it is known to carry no risk to the city. However, that last statement turns out not to be completely true. It turns out, that some risk may be involved after all.

The basics of Chapter 100 are relatively straightforward.[2] The city purchases land and builds a facility for a prospective company. In most cases, this is actually done by the company in the name of the city. Since the real property is owned by the city, and a city does not pay property taxes, the company effectively receives a property tax abatement.[3] The city does not pay tax on the building regardless of the use.[4] Since the purchases for construction were made in the name of the city, there is no sales tax charged on those purchases.[5] Certain equipment and machinery can also be purchased sales tax free. The company then leases the property, building and equipment from the city and the lease payments are used to retire the bonds that paid for it all.

Many believe that this is where the process ends with the entire project having been completed tax free. However, the lease payments from the company to the city are potentially subject to the imposition of sales tax found at §144.020.1(8) of the Missouri statutes. This is a sales tax, although it functions in many ways like a use tax. It imposes sales tax on any lease of personal property, unless sales tax was paid on the property when the lessor acquired it. This tax would only be applicable to the tangible personal property portion of the lease, as there is no sales tax on real property transactions. It would also not apply to construction materials since they become part of the real property and therefore not subject to sales tax. However, other tangible personal property, even if acquired using the city's sales tax exemption, could be taxable when it is leased to the company by the city.

Recently, Missouri Department of Revenue (DOR) audits have begun looking for this potentially unpaid sales tax. This has resulted from audits of the company rather than the city. DOR has pressured companies to pay this tax; however, ultimately it is the city, as the "seller" who is responsible to see that the tax is paid. It is not clear whether DOR will continue this policy or not. City officials should not assume that just because they have had a Chapter 100 project in place for many years that this danger is not out there. Since the department of revenue has pursued the companies to pay the tax, the city may not be immediately aware of the problem.

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Cities and the companies they work with can avoid this hidden tax. First, if the company paid sales taxes on the tangible personal property when purchased, there is no liability for tax on the lease. It is not uncommon, particularly in small transactions, that the city does not offer its sales tax exemption. Second, if the property was exempt from sales tax, no tax liability occurs as a result of the lease. For example, materials used in construction of the building are not subject to sales tax, and would likewise not be an issue in the tax on the lease.

The third method is probably the least understood, but offers the greatest protection. Section 144.054.3 of the Missouri statutes allows an exemption to the sales tax on the lease of tangible personal property if the project is eligible under Chapter 100 and it receives a certification from the Missouri Department of Economic Development (DED). There are, of course, a number of requirements that must be met in order to receive such a certificate.

Obviously, the lease must be part of a Chapter 100 project. It must also be what is determined to be an eligible project. Missouri law contains two different definitions of projects eligible for Chapter 100. The Missouri Constitution states that applicable uses include "manufacturing, commercial, warehousing and industrial development purposes, including the real estate, buildings, fixtures and machinery."[6] This is a very broad definition of eligible projects, with the term "commercial" potentially including almost anything. Missouri statutes however, provide a much narrower definition that includes only "warehouses, distribution facilities, research and development facilities, office industries, agricultural processing industries, service facilities that provide interstate commerce, and industrial plants." While this may seem broad, it is not. The term "office industries" is specifically defined to include only national headquarters for telecom, IT and insurance companies. The term "service facilities that provide interstate commerce" has been interpreted narrowly by DOR to include only companies that sell services exclusively out-of-state.[7] Thus, a hotel that would clearly fit under the constitutional definition of "commercial" would not be an eligible project under the statutory definition, as traditionally interpreted by DOR.

Missouri's courts have on occasion addressed this discrepancy between the Constitution and the enabling statute. For example, in *StopAquila v. City of Peculiar,* the Missouri Supreme Court upheld the use of municipal revenue bonds to finance the construction of a privately-owned utility, Aquila.[8] The Court found that because Aquila was in the business of selling electricity that meant it was engaging in commerce, it was a commercial facility; therefore, the City was authorized to participate under the Missouri Constitution.

Assuming that the project meets the definition of eligible projects, the actual tangible personal property must be defined as machinery. Machinery is the only tangible personal property listed in § 100.010 that is not otherwise exempt already (the other two being fixtures and building materials). Machinery is not clearly defined; however, DOR in the past has indicated that it must be directly used in the production process. Thus, a wool spinner in a thread factory would be machinery, but the blender in the employee lounge would not. DOR also has traditionally included office furnishings such as desks, chairs and computers within the definition of machinery. Art, foosball tables and workout equipment, for example, have not been included in the past, even though it is perfectly acceptable to purchase them through Chapter 100 funding.

The DED exemption is discretionary. Thus, even if a project falls within the statutory definitions of an eligible project and the property meets the definition of machinery, there is no guarantee that DED will award the exemption certificate. The parties must submit an application for the exemption to DED.[9] DED also encourages parties contemplating a Chapter 100 project to meet with them as early as possible to discuss eligibility.

An additional area of concern in regards to Chapter 100 projects is whether normal municipal construction rules apply. Arguably, because the project is being constructed in the name of the city, prevailing wage (§ 290.210 et seq. RSMo), competitive bidding, and payment bond requirements (§ 107.170 RSMo) should apply. However, in most cases the courts have not applied those rules. Largely this is determined by how the project is structured. In many instances, the municipality is only indirectly involved in the construction process. The company itself acts as the developer; building the facility as the agent of the city. In such a structure, the construction company is contracting with the company and not the city. As a result, the courts have held, based on specific factual scenarios, that competitive bidding was not required;[10] that prevailing wage did not apply;[11] and that payment bonds might not be required.[12] The court also pointed out in the *Septagon* case that a subcontractor can obtain a mechanics lien against the company's leasehold interest. The court found that the purpose of payment bonds is to protect contractors on public projects where ordinarily mechanic's liens cannot be used; where a mechanic's lien can be used, there is no requirement for a payment bond. While it may appear then that Chapter 100 projects are exempt from all of these requirements, that is not necessarily so. It will depend on how directly involved the city is in the construction process. A city may wish to protect itself by requiring a payment bond or prevailing wage.

Chapter 100 remains one of the most valuable and easily-used tools for local economic development. City officials should be aware of exactly how it works and where the traps are located. Cities should seek out knowledgeable and independent legal guidance during the process to insure success.

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