

**THE CITY SPECULATIVE BUILDER TAX –
A HIDDEN LAND TRANSFER TAX**

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STEPTOE & JOHNSON LLP

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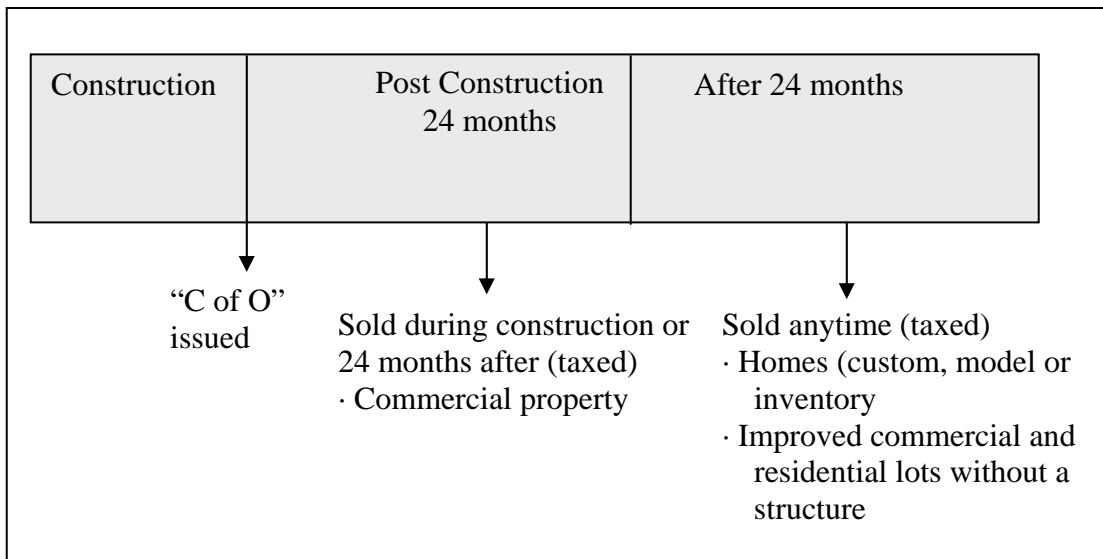
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1. THE CITY SPECULATIVE BUILDER TAX.

The speculative builder tax is imposed on the sale of “improved real property” if the improved real property is sold prior to completion or before the expiration of 24 months after the improvements are substantially complete. If custom, model or inventory homes or improved residential or commercial lots without a structure are involved, then the tax is imposed when sold, without any time limitation. See Model City Tax Code Section –416 and definition of “Speculative Builder” contained in Model City Tax Code Section –100.



1.1 The Structure of The Speculative Builder Tax.

(1) *The Tax Imposition Section.* Section –416(a) of the Model City Tax Code imposes a city privilege license tax under the “speculative builder” classification as follows:

The tax shall be equal to ____ percent (___%) of the gross income from the business activity upon every person engaging or continuing in business as a *speculative builder* within the City. (Emphasis added).

(2) *The Taxable Gross Income of a Speculative Builder.* “The gross income of a speculative builder considered taxable shall include the total selling price from the sale of improved real property at the time of closing of escrow or transfer of title.” See Model City Tax Code Section –416(a)(1).

(3) *Definition of a “Speculative Builder.”* Speculative builder is defined by the Model City Tax Code as follows:

“*Speculative Builder*” means either:

- (1) an *owner-builder* who sells or contracts to sell at anytime, improved real property (as provided in Section –416) consisting of:
 - (a) custom, model, or inventory homes, regardless of the stage of completion of such homes; or
 - (b) improved residential or commercial lots without a structure; or
- (2) an *owner-builder* who sells or contracts to sell improved real property other than improved real property specified in subsection (1) above:
 - (a) prior to completion; or
 - (c) before the expiration of twenty-four (2) months after the improvements of the real property sold are *substantially complete*. (Emphasis added).

See Model City Tax Code Section –100.

(4) *Definition of “Owner-Builder.”* An “owner-builder” is defined to mean “an owner or lessor of real property who, by himself or by or through others, constructs or has constructed or reconstructs or has reconstructed any improvement to real property.” See Model City Tax Code Section –100.

(5) When is the Project “Substantially Complete.” For speculative builders other than residential homebuilders, the 24 month period is measured from the date that the improvements were “substantially complete.” That term is defined as follows:

“*Substantially Complete*” means the construction contracting or reconstruction contracting:

- (i) has passed final inspection or its equivalent; or
- (ii) certificate of occupancy or its equivalent has been issued; or
- (iii) is ready for immediate occupancy or use.

See Model City Code Section –100.

(6) *The Trigger for the Imposition of Speculative Tax is the “Sale of Improved Real Property.”* The term “sale” has been broadly defined by the Model City Tax Code as follows:

“*Sale of Improved Real Property*” includes any form of transaction, whether characterized as a lease or otherwise, which in substance is a transfer of title of, or equitable ownership in, improved real property and includes any lease of the property for a term of thirty (30) years or more (with all options for renewal being included as a part of the term). In the case of multiple unit projects, “sale” refers to the sale of the entire project or to the sale of any individual parcel or unit.

See Model City Tax Code Section –416(a)(3).

(7) *Definition of “Improved Real Property.”* The trigger for the imposition of the tax is the “sale” of improved real property. Improved real property is defined by the Code as follows:

“*Improved Real Property*” means any real property:

- (A) upon which a structure has been constructed; or
- (B) where improvements have been made to land containing no structure (such as paving or landscaping); or
- (C) which has been reconstructed as provided by Regulation; or
- (D) where water, power, and streets have been constructed to the property line.

See Model City Tax Code Section –416(a)(2).

1.2 Exclusions and Deductions.

The following exclusions and deductions are allowed in computing the speculative builder tax:

Standard 35% Deduction. The total selling price from the sale of improved real property, which is the tax base for the speculative builder classification, is reduced by a flat statutory deduction amount of 35%. See Model City Tax Code Section –416(c)(2).

Land Deduction. Most cities do not allow a deduction for either the cost or the fair market value of the underlying land. That is the case with the major cities in the Phoenix area. The Model City Tax Code provides local options which may be adopted by a city, for a deduction for the cost of the land, which is local option M, and a deduction for the fair market value of the underlying land, which is local option N. The Master Version of the Model City Tax Code should be consulted as to which cities offer the land deduction. A good number of the smaller, outlying cities and towns allow a deduction for the fair market value of the land (local option N). They include the following:

Deduction for fair market value of land.

Bullhead City	Pima
Camp Verde	Pinetop-Lakeside
Colorado City	Prescott
Douglas	Prescott Valley
Eloy	Quartzsite
Flagstaff	Safford
Kingman	Sahuarita
Lake Havasu City	Sedona
Mammoth	Show Low
Parker	Thatcher
	Wilcox

A limited number of cities provide a deduction for the cost of the land (local option M). They include:

Deduction for cost of land.

Duncan
Nogales
Patagonia
Tucson
Winslow
Youngtown

Reconstruction Contracting. Cases involving “reconstruction contracting,” the speculative builder may exclude from its gross income the prior value allowed for

reconstruction contracting in determining the speculative builder's gross income. Model City Tax Code Sec. __ - 416(b)(1). Reconstruction of real property is defined by Model City Tax Code Regulations to mean "the subdividing of real property and, in addition, all construction contracting activities performed upon said real property; provided, however, that each of the following conditions are met:

- (1) A structure existed on said real property prior to the reconstruction activities; and
- (2) The "prior value" of said structure exceeds fifteen percent (15%) of the "prior value" of the integrated property (land, improvement and structure); and
- (3) The total cost of all construction contracting activities performed on said real property and the twenty-four (24) month period prior to the sale of any part of the real property exceeds fifteen percent (15%) of the "prior value" of the real property; and
- (4) The structure which exists on the real property prior to the reconstruction activity still exists in some form upon the property, and is included, in whole or in part, in the property sold." Model City Tax Code Reg. -416.2(a).

An example of reconstruction contracting would be the conversion of apartments into condominiums with the sale of the individual condominium units.

"Prior value" is defined by the regulations to mean "the value of the total integrated property, with improvements, as existing immediately prior to any reconstruction activity. A property's full cash value for secondary tax purposes is to be used as the property's "prior value." Additionally, a taxpayer may use the "alternative prior value" in lieu of the full cash value of the property for secondary property tax purposes. The "alternative prior value" is the "actual cost of the reconstruction property prior to reconstruction, provided that evidence of such cost is presented to the tax collector and is determined by the tax collector, in his sole discretion, to be satisfactory." Such evidence may consist of an arms length acquisition price accompanied by a full appraisal of all property involved which appraisal shall have been performed by the real estate broker or MAI appraiser. See Model City Tax Code Reg. -416.2(b) and (c).

Labor for Installation of Income-Producing Capital Equipment. There is a deduction for the gross proceeds of sales or gross income derived from the installation, assembly, repair or maintenance of income-producing capital equipment as defined in Section -110 of the Model City Tax Code, as long as that equipment does not become permanently attached to a building or other structure. The installation labor deduction does not include any income from contracting activity which consists of the development of or modification to real property in order to facilitate the installation, assembly, repair, maintenance or removal of the income-producing capital equipment. Additionally, permanent attachment is defined by the Code to mean at least one of the following:

- (i) to be incorporated into real property.
- (ii) to become so affixed to real property that becomes a part of the real property.
- (iii) to be so attached to real property that removal would cause substantial damage to the real property from which it is removed.

See Model City Tax Code Section –416(c)(2)(B).

1.3 Exemptions.

The Model City Tax Code also provides a number of exemptions from the speculative builder classification. They are:

Purchase of Income-Producing Capital Equipment and Tangible Personal Property Sold to “Qualifying Hospitals.” An exemption is provided for the gross proceeds of sales or gross income attributable to the purchase by a speculative builder of machinery, equipment or other tangible personal property that is exempt from or deductible from the privilege or use tax under:

(1) Section –465(g) (the income-producing capital equipment exemption) and (p) (the sales tax exemption for sales of tangible personal property to “qualifying hospitals”).

(2) Section –660(g) (the use tax exemption for income producing capital equipment) and (p) (the use tax exemption for sales of tangible personal property to “qualifying hospitals”).

Construction of Egg Production Facility. Gross income from the construction of an environmentally controlled facility for the raising of poultry for the production of eggs and the sorting, or cooling and packaging of eggs is exempt.

Clean Rooms. Revenue derived from the installation, assembly, repair or maintenance of clean rooms is exempt where the clean room equipment qualifies for deduction under Section –465(g) relating to income producing capital equipment. Both the cost of the clean room equipment and its installation is exempt.

Agricultural Pollution Control Equipment. Revenue derived from a contract entered into with a person engaged in the commercial production of livestock, livestock products or agricultural, horticultural, viticultural or floricultural crops or products in Arizona for the construction, alteration, repair, improvement, etc. of any building or other structure, or project used directly and primarily to prevent, monitor, control or reduce air, water or land pollution is exempt.

1.4 Tax Credits.

After the speculative builder tax liability has been determined, a speculative builder is allowed the following tax credits against its tax liability:

Tax Credit for Purchase of Building Materials. A tax credit is allowed in an amount equal to the city privilege or use tax, or the equivalent excise tax, paid directly to a taxing jurisdiction or as a separately itemized charge paid directly to the vendor with respect to the tangible personal property incorporated into the structure or improvement to real property which is the subject of the speculative builder tax.

Tax Credit for Taxes Paid by Prime Contractor. A tax credit is allowed in an amount equal to the privilege taxes paid to the particular city, or charged separately to the speculative builder, by a construction contractor, on the gross income derived by that contractor from the construction of any improvements to the real property, which are subject to the speculative builder tax.

These credits, though, cannot be claimed by the speculative builder until such time that the gross income against which those credits apply is reported. This means that the speculative builder must first report its speculative builder revenue to the city (or be assessed in an audit situation) first before it is entitled to the credits. *See* Model City Tax Code Section –416(c)(3).

The common credit which is given is the credit for the sales taxes paid by the prime contractor on the job. This prevents a double taxing of the actual cost of the construction. With this prime contracting credit, the speculative builder tax is essentially imposed on the land value and overhead and profit of the developer.

1.5 Exclusion For The Sale Of Partially Improved Residential Real Property To Another Speculative Builder.

A speculative builder is not taxable on the sale of “partially improved residential real property” to another speculative builder if, and only if, the following conditions are met.

(1) The speculative builder purchasing the partially improved residential real property has a valid city privilege license for construction contracting as a speculative builder; and

(2) At the time of the transaction, the purchaser provides the seller with a properly completed written declaration that the purchaser assumes liability for and will pay all privilege taxes which would otherwise be due the city at the time of sale of the partially improved residential real property (See City of Phoenix Privilege Tax Speculative Builder’s Certificate, attached as Tab A); and

(3) The seller also:

- (i) maintains proper records of such transactions in a manner similar to the requirements relating to sales for resale; and
- (ii) retains a copy of the written declaration provided by the buyer for the transaction; and
- (iii) is properly licensed with the city as a speculative builder and provides the city with the written declaration attached to the city privilege tax return where the speculative builder claims the exclusion.

See Model City Tax Code Section –416(b)(4).

Definition of “partially improved residential real property.” This term is defined to mean:

Any improved real property, as defined in subsection (a)(2) ..., being developed for sale to individual homeowners, where the construction of the residence upon such property is not substantially complete at the time of the sale. (Emphasis added).

See Model City Tax Code Section –416(a)(4).

1.6 Homeowner’s Bona Fide Non-Business Sale of a Family Residence.

An individual will not be subject to the speculative builder tax if the individual builds the home and sells it within 24 months from substantial completion if the following requirements are met:

- (1) The property was actually used as the principal place of a family residence or vacation residence by the immediate family of the seller for the 6 months next prior to the offer for sale; and
- (2) The seller has not sold more than two such family or vacation residences within the thirty-six months immediately prior to the offer for sale; and
- (3) The seller has not licensed, leased, or rented the sold premises for any period within 24 months prior to the offer for sale.

Construction Contractors Taxable On Work Done For Homeowner. If a homeowner of a family residence contracts with a licensed construction contractor for improvements to the residence, the construction contracting on a family residence is presumed to be for the owner’s bona fide non-business purpose and all construction contractors are required to report and pay the tax imposed on the construction of those improvements (under the construction contracting classification).

Homeowner's Purchase of Tangible Personal Property. A homeowner's purchase of tangible personal property for inclusion in any construction, alteration or repair of his or her residence is subject to tax under the retail sale classification (the homeowner is treated as the ultimate consumer).

Homeowner Must Be An Individual. The homeowner must be an individual and no other entity, association or representative may qualify for the homeowner's bona fide non-business sale of a family residence. The only exceptions are that an administrator, executor, personal representative, or guardian in guardianship or probate proceedings, for the estate of a deceased or incompetent person or a minor, may claim the "homeowner" status for that person if that person would have otherwise qualified with respect to the residence involved.

1.7 Opportunities?

Contract to Sell the Improved Real Property but Do Not Transfer Title Until After the 24-Month Period? Does It Work? No. *See* definition of "Speculative Builder" (an owner-builder who sells or "contracts to sell").

A Long Term Lease Rather Than a Sale? Will not work if the lease is for a term of 30 years or more (with options for renewal being included as a part of the term). *See* Model City Tax Code Section –416(a)(3), definition of "Sale of Improved Real Property."

Short Term Lease With Option to Buy? Rather than selling the property, it would be leased for a short term to get past the 24-month period with the lease providing a purchase option that could only be exercised after the expiration of the 24-month period. Would this work? Probably not. *See* the definition of "Sale of Improved Real Property," which is defined to include "any form of transaction, whether characterized as a lease or otherwise, which in substance is a transfer of title of, or equitable ownership in, improved real property" *See also* the definition of "Speculative Builder" which includes the reference "or contracts to sell." Could that language cover a lease with a purchase option? What if the lease were only a short term lease with no purchase option, with there being no contractual obligation to sell or to purchase the property. That may work.

Transfer Property to L.L.C. and Sell Membership Interests. Put the property in a limited liability company (or corporation) and sell the membership interests in the LLC or stock in the corporation. Is this situation covered by the "Definition of Improved Real Property" which includes "any form of transaction ... which in substance is a transfer of title of, or equitable ownership in, improved real property..."

Allocation of Purchase Price. The speculative builder tax classification applies only to the "sale of improved real property." What if the sale transaction

includes both real property and personal property, such as equipment or intangibles? Many times, an apartment complex or office building will be sold within the 24-month trigger period but by that time it is fully leased up, or close to being fully leased up. Those in-place leases certainly have a value and they are assigned by the seller to the purchaser of the building. Should the value of the assigned leases, which is an intangible, be subject to the speculative builder tax? See City of Phoenix CAP No. 1394. (March 2, 1999) (value of assigned leases not subject to speculative builder tax).

To the extent that assets other than a building and land are transferred, as a planning technique it is recommend that the purchase price be allocated among land, building, personal property (such as equipment, etc.) and intangibles (such as the value of any assigned leases). To the extent that any income producing capital equipment is involved, there is a specific deduction for that equipment and there should be a purchase price allocation to it.

1.8 The *Estancia* Case.

In *Estancia Development Associates LLC v. City of Scottsdale*, 291 Ariz. Adv. Rptr. 45 (3/23/99) (attached as Tab B), the court held that the speculative builder provision of the Model City Tax Code does not apply to sale of real property that is unimproved at the time of sale, even though the sales contract requires subsequent improvements to be made by the seller. Estancia owned real property in Scottsdale and entered into contracts to sell the individual lots into which the property had been subdivided. Under the contract, the purchaser agreed to buy the property and Estancia agreed to set up an escrow for the transaction. Estancia's contracts also obligated it to make improvements to the property. Those improvements were to be paved roads, sewers, water, telephone, cable television, natural gas and electric service. As of the close of escrow, no structure had been erected on any parcel that Estancia sold. It was also not disputed that Estancia later completed the off-site improvements contemplated by the purchase contractor.

The speculative builder tax of the Model City Tax Code taxes the sale of "improved real property" within 24 months from the date of substantial completion of the improvements. Improved real property is further defined to include land "where water, power and streets *have been constructed* to the property line." The Court of Appeals held that since there had been no improvements made to the property at the time of the close of escrow, which was the time of sale, the speculative builder tax did not apply, although it was contemplated and Estancia was obligated to make off-site improvements after the sale. The court relied upon the plain language of the Model City Tax Code which makes it clear that the speculative builder tax only applies if improvements "have been made" or "constructed" at the time of sale.

1.9 Cities Response to *Estancia* Case: Proposal to Amend Model City Tax Code Sections 100 & 416 (03/20/03)

The following is a proposal from the cities to amend the model city tax code to reserve the *Estancia* decision. At this time, the proposed amendments have not been made.

Proposed Model City Tax Code Changes and Under lying Rationale:

Regarding our effort to close the loophole in MCTC Section 416 exposed in the *Estancia* decision, as well as to clarify the potential limitations of the current subsection (a)(2)(D), we propose following language to modify the definition of "Improved Real Property" in Section 416:

Sec. __-416. Construction contracting: speculative builders.

(a)(2) "Improved Real Property" means any real property:

- (A) Upon which a structure has been constructed; or
- (B) Where improvements have been made to land containing no structure (such as paving or landscaping); or
- (C) Which has been reconstructed as provided by Regulation; or
- (D) Where ~~water, power, and~~ streets OR ANY UTILITY SERVICE(S) have been constructed to the property line.; OR
- (E) WHERE THE SELLER HAS COMMITTED BY CONTRACT, TERMS OF SALE, OR OTHERWISE, TO MAKE OR HAVE MADE ANY OF THE ABOVE LISTED IMPROVEMENTS, REGARDLESS OF THE STAGE OF COMPLETION AT THE CLOSE OF ESCROW OR TRANSFER OF TITLE.

Discussion pertaining to changes in Section 416(a)(2)(D):

(D) Where ~~water, power, and~~ streets OR ANY UTILITY SERVICE(S) have been constructed to the property line.; OR

The change from "and" to "or" in subsection (D) addresses a grammatical oversight in the code intended to eliminate a potential argument that completion of all three stated improvements are required to qualify as improved real property. Both the ongoing actual treatment of property sales subject to this clause and the original intent of this subsection, was to treat a sale following the completion of any improvement as a taxable event, not only the instance of a sale following completion of all three of the specifically named elements: water, power, and streets.

The change from only mentioning "water" and "power" to "any utility service(s)" allows consideration of natural gas or other common utility lines, again in keeping with the original intent of taxing any improvement.

The practice and intent of subsection (a)(2)(D) has been and remains to hold transactions taxable if any of the listed improvements have been made to real property.

Note that we originally drafted this change to say, "Where streets or utilities have been constructed..." This version was changed to reference "any utility service(s)" rather than merely "utilities" to address a concern voiced by several cities that merely referring to "utilities" may have produced a potential argument that the extension of stubbed out lines to the property line are not technically "utilities" until they are actually attached and/or operating. We mention this here to make it clear that the intent has been and remains to impose tax on the sale of any property where any utility line has been constructed to the property being sold, without requiring determination of actual attachment to and/or operability on the property being sold.

Discussion pertaining to the addition of new subsection (E):

(E) WHERE THE SELLER HAS COMMITTED BY CONTRACT, TERMS OF SALE, OR OTHERWISE, TO MAKE OR HAVE MADE ANY OF THE ABOVE LISTED IMPROVEMENTS, REGARDLESS OF THE STAGE OF COMPLETION AT THE CLOSE OF ESCROW OR TRANSFER OF TITLE.

Regarding the addition of subsection (E), we refer to the Arizona Court of Appeals decision in *Estancia Development Associates, L.L.C. v. City of Scottsdale*, (196 Ariz. 87, 993 P.2d 1051).

In the *Estancia* case, the taxpayer sold vacant properties with a contractual promise to complete certain infrastructure improvements ("...paved roads, sewers, water, telephone, cable television, natural gas and electric service to the property by the date set forth in Public Report"). Although the selling price clearly reflected the added value associated with these future improvements, the completion of the improvements did not occur until after close of escrow and transfer of title.

The Taxpayer argued that since the improvements were not completed at the close of escrow, the property did not meet the definition of "Improved Real Property" and thus was not subject to the tax. The court found for the taxpayer, and explained their decision based on the current definition of "Improved Real Property" in the MCTC as follows:

In each description of the improvements, the past perfect tense is used. No provision is made for taxation of vacant land on which improvements are yet to be constructed. Thus, the S.R.C. (Scottsdale Revenue Code) does not tax the price of vacant land on which improvements were promised to be made but as of the time of sale have not been made. The taxpayer conceded at oral argument, however, that if any improvements had been made, the entire price of all improvements, including uncompleted ones, could be subject to tax.

We are aware that Estancia is unable to point to a policy reason for allowing transactions in which the improvements are deferred to escape the tax otherwise imposed. Nor are we able to discern one. However, it is enough that the S.R.C.'s plain language does not extend the tax to such transactions. Our duty is to apply the S.R.C. as written, not to judge whether the drafter's decision was wise.

We cannot determine an equitable rationale for favoring sales structured in this manner with an exemption that is not available on comparable sales where title passes after construction. Furthermore, we can neither think of, nor have we been offered a reasonable cause for structuring a sale in the manner described above, other than as a means of avoiding the tax.

We created the proposed subsection (E) to directly address the court's plain indication that, while the drafter's intent likely would have been to tax this type of transaction had they been able to foresee it, the code as written is not properly worded to anticipate a sale arranged in this way. Per discussions with the members of the UAC, including those involved in drafting the original version of the Model City Tax Code, the intent was clearly to capture and hold taxable all sales of improved real property as described. The original language was drafted based on "completed improvements" only with the intention of excluding sales of vacant land, failing to anticipate vacant land sales that included the value of future improvements in the selling price.

The drafter's did not contemplate the sale of a home, building, or other improvement where the selling price was based upon a promise to complete such improvements after the close of escrow or title transfer. If they had any comprehension that real property sales might be structured in this manner, the original drafters have indicated they would have included a passage similar to the proposed language in the original text.

Discussion pertaining to changes in the definition of "Owner-Builder" in Section 100:

"Owner-Builder" means an owner or lessor of real property who, by himself or by or through others, constructs or has constructed or reconstructs or has reconstructed any improvement to real property, INCLUDING AN OWNER OR LESSOR THAT HAS COMMITTED

BY CONTRACT, TERMS OF SALE, OR OTHERWISE, TO MAKE OR HAVE MADE ANY IMPROVEMENT TO THE REAL PROPERTY, REGARDLESS OF THE STAGE OF COMPLETION AT THE CLOSE OF ESCROW OR TRANSFER OF TITLE.

This change is being made to address a concern that the current definition of Owner-Builder is also based on language in the past perfect tense, with no provision for considering the possibility that an owner might enter into an arrangement for the sale of land that is vacant at the time that title transfers or escrow closes, but where the selling price is predicated on a improvements to be constructed after the transfer of title or close of escrow.

Again, this change simply levels the municipal tax playing field for like properties of comparable values, sold for comparable amounts, regardless of when the improvements that lead to those values and selling prices occur.

2. **TAXATION OF OWNER-BUILDERS WHO ARE NOT SPECULATIVE BUILDERS.**

The tax liability for an owner-builder who is not a speculative builder is imposed at the expiration of twenty-four months (24) after the improvement to the property is substantially complete. That tax is imposed on:

(1) The gross income from the activity of construction contracting upon the real property in question which realized by those construction contractors to whom the owner-builder provided written declaration that they were not responsible for the taxes as prescribed in subsection -415(c)(2); and

(2) The purchase of tangible personal property for incorporation into any improvement to real property, computed on the sales price. Model City Tax Code Section -417.

Exemptions. An owner-builder is generally provided with the same exemptions, deductions and tax credits as a speculative builder. See Model City Tax Code Section -417(b).

Example. If an owner provides subcontractors with the written owner-builder's declaration that the subcontractor is exempt, and the owner does not sell the property within twenty-four months of substantial completion (and the property involved is commercial property), then upon the expiration of that twenty-four month period, the owner will be considered to be a taxable owner-builder and subject to tax on the amount paid the various subcontractors as well as on the purchase price of building materials that the owner-builder purchased directly. The owner-builder provision would not apply to an owner that builds a residence because such a person would be considered to be a speculative builder and will be taxed on the sale of the residence no matter when it sold (during construction, within twenty-four months of completion of construction or anytime thereafter).