Cite as Det. No. 92-100, 12 WTD 349 (1992).

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 92-100
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .

[1] **RULE 118:** RENTAL OF OR LICENSE TO USE REAL ESTATE -- EXCLUSIVE POSSESSION AND CONTROL -- REQUIREMENTS. Arrangement whereby individual physicians rent single offices in a building owned, operated, and managed by their partnership will be deemed rental of real estate where a landlord-tenant relationship is shown to exist. The fact that other services are offered by the building owner to the doctors does not defeat the landlord-tenant relationship where various charges are separately contemplated in the rental agreement and separately accounted for by the partnership. Tacoma v. Smith, 50 Wn. App. 717 (Div. II, 1988); Det. No. 88-427, 7 WTD 35 (1988).

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

TAXPAYER REPRESENTED BY: . . .

NATURE OF ACTION:

Taxpayer protests assessment of service B&O tax on the portion of monthly charges to its building tenants for rent.

FACTS AND ISSUES:

Adler, A.L.J. -- Taxpayer is a partnership whose interests are owned equally by [several] physicians. The partnership was formed to own and operate an office building.

During the audit period, the partnership initially owned and managed the building. The . . . physicians had also formed a corporation, the shares of which were equally divided between them, to provide various services to the physicians. Beginning in 1989, the corporation became inactive. The partnership now performs all functions: it manages the building and provides the administrative services to the physicians.

Initially, also, the support staff was hired from a temporary agency. During the audit period, the staff became permanent and was hired and paid by the corporation. When the corporation was discontinued, the staff became employees of one of the partners. All [of the] physicians contribute equally for this and other administrative costs.

The taxpayer-partnership and the prior corporate entity were audited for the period from January 1, 1986, through June 30, 1990; and the above-captioned assessments were issued.

The auditor assessed use tax on certain purchases and service B&O on the income received by the building operator from its tenants. The portions of the assessments relating to use tax have been paid.

The auditor and taxpayer are in agreement as to the general facts relating to the rental income but disagree on the tax ramifications thereof.

The taxpayer believes the facts prove that two transactions occur: it rents real estate and it provides services to persons who happen to be its partners and the building's tenants. The taxpayer believes the rental income should be exempt under WAC 458-20-118 (Rule 118).

Pursuant to the lease agreement provided by the taxpayer, the monthly billings are divided into three categories:

> 1. "Basic rent" for an office space and location clearly defined in the agreement.
>
> 2. A prorata share (. . .) of "shared expenses" as defined in the agreement. These include clerical costs, telephone services, office supplies, and other items. Shared expenses do not include personal items. Additionally, the agreement states the prorata amount is based on number of offices rented. If a physician

> rented more than one office, his or her prorata share would become . . . per office rented.
>
> 3. Personal expenses for items not divided on a prorata basis. These include personal stationery, photocopies, and long-distance phone charges.

The taxpayer also provided a sample of a monthly billing confirming that the physicians receive a billing broken down by category.

The auditor contends that taxpayer is engaged in providing a comprehensive package of services to the physicians. Among these are administrative services, a license to use an office and common areas, and procurement of personnel, equipment and supplies. As such, she believed the entire amount received from each physician should be subject to service B&O tax.

DISCUSSION:

[1] WAC 458-20-118 (Rule 118) provides, in part, that

> A lease or rental of real property conveys an estate or interest in a certain designated area of real property with an exclusive right in the lessee of continuous possession against the world, including the owner, and grants to the lessee the absolute right of control and occupancy during the term of the lease or rental agreement. An agreement will not be construed as a lease unless a relationship of "landlord and tenant" is created thereby.
>
> . . .
>
> A license grants merely a right to use the real property of another but does not confer exclusive control or dominion over the same. Usually, where the grant conveys only a license to use, the owner controls such things as lighting, heating, cleaning, repairing and opening and closing the premises.

In Tacoma v. Smith, 50 Wn. App 717 (Div. II, 1988), the court stated that

> a lease is created if a tenant is granted exclusive possession or control of the parcel or a portion thereof. . . This is true even if the tenant's possession of the real estate is restricted by reservations. . . Such reservations can include the right to sell the leased property before the lease is over. . . and to designate from time to time the place

> on the premises to be occupied by the tenant. . . On the other hand, a license exists if a person is granted only the authority to do a particular act upon the owner's land.

(Emphasis supplied; citations omitted.)

In Det. No. 88-427, 7 WTD 35 (1988), the taxpayer showed that

> 1. The tenant had exclusive control of an office, which could be locked;
>
> 2. The tenant's control of the space was respected and maintained;
> 3. Although access was through common areas, the tenant had a key and freedom of access;
>
> 4. There was a written rental agreement formalizing the relationship; and
>
> 5. The invoice history showed that rent was charged.

In that case, the Department held that

> While the facts in this case are not the same as those in [a cited] BTA case, the principles remain the same. The taxpayer here has granted an associate the exclusive control of a separate office within its office suite. The associate can lock his door and can exercise exclusive possession and control over the space. Therefore the lease requirement of exclusive possession and control is met.

(Brackets supplied.) Det. No. 88-427, 7 WTD 35 (1988), page 37.

We believe that the same facts are present in this case.

Further, we find that this taxpayer is engaged in two businesses: renting office space in its building and providing business-management services. This dual business should not defeat taxpayer's right to a B&O tax exemption on the rental income where a true landlord-tenant relationship is created and where the facts indicate that the amount charged for rent is a reasonable charge for comparable office space in that location. To deny the exemption would result in unequal treatment of this taxpayer. A landlord providing only office space would clearly not be subject to B&O tax for the same transaction. Rule 118 and RCW 82.04.440 clearly contemplate just such a possibility:

> Persons who are involved in more than one kind of business activity are required to segregate their income and report under the appropriate tax classification based on the nature of the specific activity (see RCW 82.04.440)...

In assessing the tax, the auditor was persuaded, in part, that the total charge paid for the rent and for the services was all B&O taxable, because the rent paid exceeded expenses and the partners/ shareholders had to report the income on their federal tax returns.

We believe the auditor's reliance on the fact that the amount charged for rent is more than the building-owner's costs is misplaced and is partly caused by knowledge that the building owners were its tenants. That fact should not be determinative of the taxability of the separate legal entities' activities. There is no indication that the stated rent is excessive for office space in that location. Nor does the evidence indicate that the partners are abusing the system and sheltering income by charging themselves an exorbitant amount for "rent;" and receiving federal income tax deductions for those business expenses and/or receiving, through their other business venture, a state tax exemption for a dishonestly-high rental amount. We decline to use a "substance over form" analysis to deny taxpayer the exemption.

If the lessor had been a third party, the fact that the rental activities generated income in excess of expenses would not, of itself, be a factor in deciding whether this activity resulted in state B&O tax liability. Again, unless obvious abuse is present, the fact that a landlord makes a profit shows little more than good business sense and will not, by itself, turn an exempt rental into a taxable license to use. We believe most landlords calculate a profit margin into their rent charges; otherwise, there would be little incentive to be in that business.

DECISION AND DISPOSITION:

Taxpayer's petition is granted.

DATED this 20th day of April, 1992.