

Cite as Det. No. 92-304, 12 WTD 467 (1992).

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

In the Matter of the Petition	)	<u>D</u> <u>E</u> <u>T</u> <u>E</u> <u>R</u> <u>M</u> <u>I</u> <u>N</u> <u>A</u> <u>T</u> <u>I</u> <u>O</u> <u>N</u>
For Correction of Assessment	)	
of	)	No. 92-304
	)	
. . .	)	Unregistered
	)	Real Estate Excise Tax
	)	

- [1] RCW 82.45.035 -- REAL ESTATE EXCISE TAX -- MINING PROPERTY -- DEFINITION. The statute defines mining property as property which is sold or leased for the purpose of exploration or mining of minerals contained therein and no other purpose. Where the land owner grants the exclusive use of property including mining rights under a lease with an option to purchase the transaction is not one within the definition of mining property.
- [2] RCW 82.45.010 -- REAL ESTATE EXCISE TAX -- LEASE WITH OPTION TO PURCHASE. When a land owner enters into a long term lease of real property and includes therein an option for the lessee to purchase the property at some future time, the transaction is a sale for real estate excise tax purposes.
- [3] RCW 82.45.035 -- WAC 458-60-010 -- REAL ESTATE EXCISE TAX -- LEASE WITH OPTION TO PURCHASE -- WHEN TAX DUE. The determination of the time real estate excise tax is due is made based on the regulations that were in effect on the date the lease was entered. Under those regulations, real estate excise tax was due when and if the option was exercised unless there was a strong probability that the option would be exercised.
- [4] RCW 82.45.035 -- WAC 458-60-010 -- REAL ESTATE EXCISE TAX -- LEASE WITH OPTION TO PURCHASE -- WHEN TAX DUE. Where it was questionable whether the option to purchase would be exercised and where the exercise of the option would, in all likelihood, not be exercised, if at all, until the year 2036; the real estate excise

tax will not be due, if at all, until the option is exercised.

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: . . .

DATE OF HEARING: . . .

Conducted by A.L.J. Heller

#### NATURE OF ACTION:

The taxpayers protest the assessment of real estate excise tax on the purported sale of real property via a renewable lease of certain land and associated mineral rights. The lease contains the option to purchase the land for \$ . . . after the payment of \$ . . . in royalties.

#### FACTS:

Coffman, A.L.J. (successor to Heller, A.L.J.) -- The taxpayers are the owners of a nine acre tract of land . . . . They "leased" [in May 1981] the land, including the mineral rights. The Department reviewed the records of [the] County and determined that the lease was subject to Real Estate Excise Tax (REET). [In May 1990] the Department issued a notice and demand for REET for the periods of 1986 through April 1990. The taxpayers filed a timely appeal.

The lease included the following terms:

1. The taxpayers leased, let, and demised the exclusive use of the property to the lessee, "including all minerals in, upon and underlying said real property."
2. The lessee had the right to mine, remove, sell, or otherwise dispose of the minerals in the property. The lessee acquired total possession and use of the property including the surface, the subsurface, and all buildings, fixtures, etc.
3. The original term of the lease was for five years: [June 1981 through May 1986]. The lease was renewable for up to ten additional five year periods at the exclusive option of the lessee.

4. The lessee was required to pay the taxpayers royalties in the amount of . . . % net smelter.<sup>1</sup> The lessee was also required to pay the taxpayers an advance minimum monthly royalty. The advance minimum royalties were credited against the amount of net smelter royalties. When the advance minimum royalties were greater than the net smelter royalties, the lessee could carry the excess amount forward to apply to future net smelter royalties. The advance minimum monthly royalty was \$ . . . for the initial term of the lease and then increased by \$ . . . for each extension. Thus, the advance minimum monthly royalty for the first renewal period (June 1, 1986 through May 31, 1991) was \$ . . . . For the second renewal period it was \$ . . . .

5. Paragraph V. C. states:

Notwithstanding the payment requirements contained in Paragraphs IV [advance minimum royalties] and V [royalties] of this lease, Lessee shall be relieved of paying further minimum and percentage royalties when Lessee shall have paid and Lessors shall have received payments of \$ . . . pursuant to this Lease. At any time after said total sum has been paid, Lessee may, as its option demand and receive from Lessors a good and sufficient Warranty Deed to the demised property, free of liens and encumbrances except those arising from acts or omissions of Lessees, upon payment to Lessors of the sum of \$ . . . .

6. The only consideration which passed from the lessee to the taxpayer was in the form of royalty payments.

In addition the lease provided that:

1. The lessee has the right to terminate the lease at anytime by giving the taxpayers notice. If the lease is so terminated the lessee must give the taxpayers a quitclaim deed to the property; a copy of all exploration reports, drill logs, maps and other data on the property; and the lessee must remove all buildings etc. except underground ladders, timbers, or stulls.
2. The taxpayers have the right to terminate the lease only upon the lessee's default.

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<sup>1</sup> The term net smelter was defined as the amount received by the lessee for ore, concentrates, or precipitates less the cost of assay, smelting, transportation, etc.

The taxpayer stated that the \$ . . . was fully paid [around July 1989]. Further, the taxpayer stated that the lessee plans to shut down operations within the next five years.

The Department's notice of REET is based on the allegation that the taxpayer sold mineral rights as that term was defined in WAC 458-61-520(1). Further, the Department stated in the [May 1990] notice of REET:

Any additional monies received by you [taxpayer] in the form of Production Royalties or Advanced Minimum Royalties, will be subject to this tax, and will be payable on a schedule established by the Department of Revenue.

The calculation of tax was based on the taxpayers' receipt of \$ . . . during the period of 1986 through 1990.

#### ISSUES:

1. Is the "lease" of the property considered a sale of real property for REET purposes?
2. If the "lease" is treated as a sale of real property for REET purposes, when is the REET due?

#### DISCUSSION:

It should be noted that the original lease in this case was entered into during the month of May 1981. At that time the statutes controlling REET were codified in Chapter 28A.45 RCW. Effective September 1, 1981 Chapter 28A.45 was recodified into Chapter 82.45 RCW without significant change affecting this case. We will refer to the current codification of the REET statutes in this determination. Also, at the time of the lease the Department's only rules concerning REET were found in Chapter 458-60 WAC and only addressed leases with option to purchase. These rules were repealed on July 21, 1982. The Department simultaneously adopted Chapter 458-61 WAC which expanded the scope of the rules concerning REET to address the subject more comprehensively.

#### 1. Sale of Mineral Rights.

RCW 82.45.010 defines the term "sale" to "include any conveyance, grant, assignment, quitclaim, or transfer of ownership of or title to real property." The term also includes a lease with option to purchase real property. The Department based the

assessment on the theory that the lease was a sale of mineral rights.

[1] RCW 82.45.035 requires that the Department of Revenue provide a method for determining the selling price of mining property for REET purposes. Thus, if there is a sale of mining property, the legislature clearly intended that sale to be subject to REET. RCW 82.45.035 defines mining property as:

. . . property containing or believed to contain metallic minerals and sold or leased under terms which require the purchaser or lessor to conduct exploration or mining work thereon and for no other use. The term "metallic minerals" does not include clays, coal, sand and gravel, peat, gypsite, or stone, including limestone.

(Emphasis added.)

The lease in this case does provide the lessee with rights in addition to those listed in RCW 82.45.035. Specifically, the lessee was given exclusive use of the property's "surface, subsurface and all minerals therein contained and all buildings, mills, fixtures, equipment and any and all personal property situated thereon." Further, the lease did not require the lessee to conduct mining operations, rather, it merely authorized the lessee to do so. Therefore, the lease was not a sale of mining property and the Department erred in making the assessment based on WAC 458-61-520(1). That regulation did not exist at the time of the lease and therefore could not be controlling. This ruling does not, however, resolve the issue.

## 2. Lease with Option to Purchase.

[2] Was the "lease" a transfer of ownership? The parties referred to the agreement as a lease. The agreement contains a provision giving the lessee the right to purchase the property for a nominal price of \$ . . . after the payment of \$ . . . in royalties. The option provision causes the "lease" to be treated as a sale of real property under the statutory definition found in RCW 82.45.010.<sup>2</sup>

## 3. Timing.

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<sup>2</sup> Without the option provision the lease would have been a pure lease. Pure leases are specifically excluded from the definition of a sale found in RCW 82.45.010 and, therefore, the transaction would not have been subject to REET.

[3] That being the case, the question arises as to when the REET will be due. RCW 82.45.035 states:

The state department of revenue shall provide by rule for the determination of the selling price in the case of leases with option to purchase, and shall further provide that the tax shall not be payable, where inequity will otherwise result, until and unless the option is exercised and accepted.

WAC 458-60-010, which was in effect on the date the lease was entered, expressly addressed the question of when REET would be due on leases with options to purchase. WAC 458-60-010 stated:

The effect of this statute [RCW 82.45.035 as previously codified] is that the tax shall be imposed in all cases, when the option portion of the lease is exercised, unless it is otherwise equitable, under the surrounding circumstances, to impose the tax or require suitable security for the tax at an earlier stage in the transaction, i.e., at a time prior to the actual exercise of the option. The statute thus recognizes that certain lease-option agreements may be closer in nature to a lease than to a contract for the sale of real estate, while other lease-option agreements may be closer in nature to a contract for sale than to a lease.

(Emphasis added.)

WAC 458-60-020(2) stated:

If by the terms of the lease-option agreement, none of the lease payments apply on the ultimate sales price, the tax shall not be payable unless and until the option is exercised.

Here, the lease by its express terms fits within the conditions stated in WAC 458-60-020(2). Assuming that the lease falls within the terms of 458-60-020(2) the REET would only be due if and when the option was exercised. However, it is also clear that the option price is at best nominal.

[4] The basic premise of the regulations that existed at the time of the lease execution was to tax those leases with options to purchase at the time of execution only when there was a high degree of likelihood that the option would be exercised. If commercially viable amounts of ore on the property were not found, the lessee probably would not continue to pay the advance

minimum monthly royalties and abandon the lease. If commercially viable amounts of ore were found, the lessee would pay the royalties until a total of \$ . . . was paid. At that point no further compensation would be due the taxpayer for the remaining renewal periods. The lessee would still have the option to purchase the property in the year 2036 for \$ . . . . There would be no incentive for the lessee to exercise the option to purchase any earlier. The extent to which the property contained commercially viable quantities of ore was unknown at the time the lease was entered, therefore it was questionable whether the option to purchase would be exercised. Thus, we find that the REET is due only if and when the option to purchase is exercised.

DECISION AND DISPOSITION:

The taxpayer's petition is granted.

DATED this 29th day of October 1992.