Cite as Det. No. 98-019, 17 WTD 252 (1998)

BEFORE THE 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. 98-019
	)	
. . .	)	Registration No. . . .
	)	FY. . . /Audit No. . . .

[1] RCW 82.29A.020 -- LEASEHOLD EXCISE TAX -- LEASEH0LD INTEREST -- DEFINITION -- SALE OF PROPERTY -- RETAINED MINERAL RIGHTS. Where a landowner sells a tract of land but specifically retains the mineral rights in the sales contract, the landowner has legally retained ownership of those minerals and has not yet transferred them to the purchaser, even though the owner includes an option to require the purchaser to purchase the remaining mineral rights at a pre-determined price.

[2] RCW 82.29A.020 -- LEASEHOLD EXCISE TAX -- TAXABLE RENT -- CONTRACT RENT -- MAXIMUM ATTAINABLE -- LEASEBACK. Where the contract rent was negotiated as part of a sale and leaseback agreement and also provided for additional services being rendered to the lessor, the contract rent was not "negotiated under circumstances clearly showing that the contract rent was the maximum attainable by the lessor."

[3] RCW 82.29A.020 -- LEASEHOLD EXCISE TAX -- TAXABLE RENT -- SALE LEASEBACK -- RETAINED MINERAL RIGHTS. If a taxpayer sells a tract of land to a governmental entity and retains the mineral rights, those retained mineral rights are not included in the value of the leasehold interest subjected to the leasehold excise tax.

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.

NATURE OF ACTION:

A lessee of . . . County protests additional leasehold excise taxes assessed in excess of "contract rent". [1]

FACTS:

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

Okimoto, A.L.J. -- [Taxpayer] is a corporation that operates a sand and gravel mining operation on waterfront property in . . . , Washington. Although it owns the mineral rights to this property, it leases the surface area from . . . County (the County). The Audit Division (Audit) of the Department of Revenue (Department) examined Taxpayer's lease with the County for the period January 1, 1993 through December 31, 1995. The examination resulted in additional leasehold excise taxes and interest owing in the amount of $. . . , and Document No. . . . was issued in that amount on May 24, 1996. Taxpayer protested the entire amount and it remains due.

Taxpayer explained during the hearing that it had originally owned the . . . acres of waterfront and view property on which the gravel pit was located. Taxpayer had been mining minerals from the pit for many years. In the late 1980's, the County needed more land and initiated condemnation proceedings on [part] of Taxpayer's land. Taxpayer fought the proceedings and eventually prevailed when the court denied the County's public use permit. Because the County had lost in its initial proceeding, future condemnation proceedings by the County faced an uphill battle. The County, however, still needed to expand and Taxpayer's land remained the only viable solution. As a result, Taxpayer was in a very strong bargaining position.

After a series of lengthy and well-publicized negotiation sessions, Taxpayer entered into an agreement to sell the County its entire . . . tract of land for $. . . [2] . . . 1992. This agreement was debated by the County Council and ratified on . . . , 1992.

The original sales agreement transferred title to the [entire] tract to the County and allowed Taxpayer to leaseback the gravel pit area for a reasonable sum and provided that Taxpayer would pay the County a 50 cents-per-ton royalty for the removal of mined gravel. This provision was an essential part of the contract, because Taxpayer needed time to develop an alternate source of sand and gravel. The lease was to run for seven years.

Unfortunately, after the original sales agreement was executed and ratified by the Council, the County discovered that it was unable to sell enough bonds to finance the entire $. . . purchase price. Consequently, the County was put into the position of having to renegotiate the purchase price of the original contract. Under the renegotiated purchase agreement, the County paid Taxpayer a lower up-front price of $. . . for the land while Taxpayer retained the mineral rights to certain sand and gravel reserves. Since Taxpayer owned the reserves, it paid no royalty for their removal. The purchase agreement also clearly stated that Taxpayer would receive access to and the right to occupy surface areas for the purpose of mining the reserved minerals for a nominal fee of $10.

Under the terms of the contract, Taxpayer could also require the County to purchase the remaining untapped minerals at any time for an amount computed by a pre-determined formula. The formula was a sliding scale which reduced the value of the mineral reserves proportionately each month so that by the end of the seven-year lease, the minerals would be depleted. Taxpayer explained at the hearing that the purpose of the revised purchase agreement was simply to reduce the purchase price of the [entire] parcel to $ . . . while placing Taxpayer in the same position that it would have been in

[2] $. . . was the estimated fair market value of the property if used for waterfront residential purposes.

if it had received the original $ . . . sales price. Taxpayer states that it would not have sold the land to the County under any other conditions.

Section 3 of the contract also required Taxpayer to submit an operational plan for approval by the County. The operational plan described all activities anticipated to occur under the contract on the property during the lease year, and was required to take:

> "into consideration Lessor's goal of establishment of grades in conjunction with Lessor's ultimate development of the Property and Lessor's desire to utilize buffer and reclamation areas in connection with Lessor's ultimate development of the Property and Lessor's desire to utilize buffer and reclamation areas in connection with its . . . operations,"

In particular, the operational plan scheduled times and locations of mining, described measures to be taken to control environmental impacts, times and methods of reclamation in consideration of Lessor's plans for development of the Property following termination of Lessee's mining operation, and location of . . . , . . . , . . . , . . . and other facilities. Taxpayer stated that through approval of this operational plan the County was able to insure that mining activity during the lease was consistent with the County's plans for future land development. An example would be if a hill needed to be removed for the County's anticipated post-lease use, the County could require mining to be performed in that location.

Audit took the position that Taxpayer's occupancy of the property for the purpose of mining its sand and gravel reserves constituted a leasehold interest. Audit asserts that Taxpayer's use of the property was much more than a right to mine sand and gravel, but also included the rights to use the property for the following purposes:

1) Ingress and egress to and from the lessee's operation:
2) Stockpiling, washing, grading, sorting, cruising, loading and transporting sand and gravel mined from the property or transported to the property by train, barge or other vessel;
3) Construction and maintenance of buildings, excavations, road, power lines, pipelines, maintenance facilities, and other improvements reasonably necessary in the mining and processing and shipping of sand and gravel from the property;
4) Operation of a job-site office and related administrative and sales facilities;
5) Use of the docks and the rail facilities appurtenant to the property for loading, unloading and shipping of sand and gravel;
6) Operation of an asphalt plant;
7) Other historical uses of the property reasonably related to mining, processing, selling and shipping sand gravel;

Audit further contended that because the contract containing the $10 nominal payment for the use of the surface land and buildings was not put out for competitive bidding, that the "contract rent" was not "taxable rent". Using the previously assessed value of the property ($ . . .) and not the actual $ . . . million sales price, Audit computed "taxable rent" under the alternative method allowed by RCW 82.29A.020(2)(b) and based it on a fair rate of return.

Taxpayer argues that the substance of the transaction is simply a sale of the land to the County. Taxpayer states that even though it technically retained title to the minerals in the revised purchase agreement, because it can require the County to purchase the remaining mineral reserves at a pre-determined price at any time, in substance, the County owns the minerals. Therefore, Taxpayer argues that its lease with the County is simply an extracting lease and is specifically excluded from the definition of "leasehold interest" under RCW 82.29A.020.

Next, Taxpayer refers to RCW 82.29A.020 and argues that "taxable rent" should be "contract rent" because the contract was "negotiated under circumstances clearly showing that the contract rent was the maximum attainable by the lessor."

Finally, assuming arguendo, that the Department can re-compute taxable rent, Taxpayer argues that the $ . . . fair market value of the land used by Audit includes the value of both surface rights and mineral reserves. Since Taxpayer still owns the mineral reserves under the contract, Taxpayer states that their value should be excluded from the $ . . . base figure.

ISSUES:

1) Where a landowner sells a tract of land but retains the mineral rights and also includes an option to require the purchaser to purchase the remaining mineral rights at a pre-determined price, has the purchaser obtained ownership of those minerals?

2) Is "taxable rent" considered to be "contract rent" where a landowner sells a tract of land excluding sand and gravel reserves and also includes in the original sales contract the right to leaseback the surface areas for a nominal rate?

3) May a lessee exclude from the leasehold excise tax base the value of mineral reserves owned by the lessee?

DISCUSSION:

Although Taxpayer argues that the substance of its sale to the County is to transfer all rights and property to the County, including mineral reserves, we disagree. The second amendment to the Real Estate Purchase and Sale Agreement dated . . . , 1992 between Taxpayer and the County states:

> A. Purchaser and Seller desire to exclude . . . tons of sand and gravel reserves ("Excluded Reserves") from the Property which is being purchased by Purchaser pursuant to the Agreement and to adjust the Purchase Price accordingly.

(Underlining added.)

The amendment further states:

> 1. Property. Recital B, clause (ii), is amended as follows:

> (ii) appurtenances thereto including, without limitation, water and mineral rights appurtenant to the land . . . tons of sand and gravel reserves ("Excluded Reserves"), the ownership of which Excluded Reserves shall be reserved by Seller.

(Underlining added.)

The second amendment clearly excludes sand and gravel reserves from the property being sold by Taxpayer and purchased by the County. Title is specifically retained by the Taxpayer. Indeed, RCW 84.04.080 identifies things "in and under" land as "real property". WAC 458-12-010 further clarifies that definition to include:

> "(6) Title to minerals in place which belongs to someone other than the surface owner. Such a title to minerals in place is a "mineral right" but must be distinguished from mineral leases and permits, which do not give title to minerals in place and which are intangible personal property. Mineral rights, as defined herein, are realty regardless of whether they were created by grant or reservation.."

(Underlining added.)

Accordingly, based on the above language in the purchase contract and its amendments, we find that the substance of the sales/purchase agreement of the [entire] tract did not transfer ownership of the sand and gravel reserves to the County because they were specifically retained by Taxpayer. Taxpayer's petition is denied on this issue.

The leasehold excise tax is imposed by RCW 82.29A.030(1). It states:

> There is hereby levied and shall be collected a leasehold excise tax on the act or privilege of occupying or using publicly owned real or personal property through a leasehold interest . . . at a rate of twelve percent of taxable rent. . .

The measure of the tax is "taxable rent", to which the applicable tax rate is then applied. "Taxable rent" is defined in RCW 82.29A.020(2). It states:

> (2) "Taxable rent" shall mean contract rent as defined in subsection (a) of this subsection in all cases where [1] the lease or agreement has been established or renegotiated through competitive bidding, or [2] negotiated or renegotiated in accordance with statutory requirements regarding the rent payable, or [3] negotiated or renegotiated under circumstances, established by public record, clearly showing that the contract rent was the maximum attainable by the lessor: PROVIDED, That after January 1, 1986, with respect to any lease which has been in effect for ten years or more without renegotiation, taxable rent may be established by procedures set forth in subsection (b) of this subsection. All other leasehold interests shall be subject to the determination of taxable rent under the terms of subsection (b) of this subsection.

(Brackets and underlining added.)

RCW 82.29A.020(2)(a) lists three specific cases where "taxable rent" shall mean "contract rent." These are when the lease was established or renegotiated (1) through competitive bidding; (2) in accordance with statutory requirements regarding the rent payable; or (3) negotiated or renegotiated under circumstances, established by public record, clearly showing that the "contract rent" was the maximum attainable by the lessor. RCW 82.29A.020 then goes on to provide that "[a]ll other leasehold interests shall be subject to the determination of taxable rent under the terms of subsection (b) . . ."

In essence, RCW 82.29A.020 grants a "safe-harbor" to lessees for all leasehold contracts that are negotiated or renegotiated with governmental entities, in compliance with one of the three specifically sanctioned methods. In those instances, the Department is required to compute "taxable rent" based on "contract rent." In all other cases, however, the Department is required to determine "taxable rent" under subsection (b). We must now determine whether Taxpayer's lease meets one of the three sanctioned methods.

Taxpayer concedes that the lease rent was neither established through competitive bidding nor in accordance with statutory requirements for establishing rent payable. Instead, Taxpayer argues that the lease was "negotiated or renegotiated under circumstances, established by public record, clearly showing that the "contract rent" was the maximum attainable by the lessor".

A similar issue was addressed by the Board of Tax Appeals in Gunter Geismann v. Department of Rev., Docket No. 41980 (1992). In 1982 Gunter Geismann owned three dilapidated rental houses located in the middle of the University of Washington's (University) plans for expanding its campus westward. Geismann's houses had been targeted for acquisition and expansion. After protracted negotiations, Geismann sold his houses to the University for $330,000. Because expansion was still a long way off, the University and Geismann entered into a 5-year leaseback arrangement immediately after the sale closed. Under the terms of the lease Geismann paid the University $75 per month, an amount which the facts showed to be considerably below retail fair market value. Geismann argued that $75 was a fair rent "under the circumstances". In addition, Geismann submitted a letter from a University official clarifying that the low rent resulted from the University's reluctance to assume management of the property or to hire a professional property management firm and its desire that the houses should not remain vacant.

In finding that the $75 "contract rent" was not "taxable rent" the Board stated:

> We have no doubt that from the University's point of view, $75 per month may have been a fair price to induce Mr. Geismann to continue to manage the properties. The motives of the parties to the lease, however, are not the test. The evidence shows that Mr. Geismann was subleasing the properties to students at rates totalling up to $795 per month, which Mr. Geismann concedes is still below fair market rent for the properties. The University could have leased these properties to students at market rates and hired a professional property management firm. In that case, the measure of the leasehold excise tax would have been the rent paid by the students with no deduction for professional property management fees. We believe the same situation exists in Mr. Geismann's case.

> In effect, he is being paid to manage the properties by the device of a below-market lease. He is compensated for his time and efforts by receiving the difference between the rent he pays the University and the rent he receives from his lessees. The leasehold excise tax, as it currently exists, is designed to capture the ultimate fair market rent of the properties, and not be limited to "intermediate" rents entered into as compensation for property management.

Geismann at pp.4-5.

We believe that Taxpayer's case is very similar to Geismann. In both cases, the owner sold property to a governmental entity and immediately leasebacked the property for less than market rates; and the governmental lessor received some additional services in addition to the contract rent. We note that section 3 of the lease contract allows the County to influence or coordinate Taxpayer's mining activity so that it is consistent with the County's plans after the lease is terminated. In this respect the County may be able to obtain additional excavation services above and beyond the contract rent. In Geismann, the additional services received were property management services and in Taxpayer's case they are excavation services. Based on these factors, we cannot hold that the leasehold contract was ". . .negotiated or renegotiated under circumstances, established by public record, clearly showing that the contract rent was the maximum attainable by the lessor . . ." Accordingly, Taxpayer's petition is denied on this issue.

Because the lease contract was not negotiated under any of the three sanctioned methods, taxable rent must be computed under RCW 82.29A.020(2)(b). It states:

> (b) If it shall be determined by the department of revenue, upon examination of a lessee's accounts or those of a lessor of publicly owned property, that a lessee is occupying or using publicly owned property in such a manner as to create a leasehold interest and that such leasehold interest has not been established through competitive bidding, or negotiated in accordance with statutory requirements regarding the rent payable, or negotiated under circumstances, established by public record, clearly showing that the contract rent was the maximum attainable by the lessor, the department may establish a taxable rent computation for use in determining the tax payable under authority granted in this chapter based upon the following criteria: (i) Consideration shall be given to rental being paid to other lessors by lessees of similar property for similar purposes over similar periods of time; (ii) consideration shall be given to what would be considered a fair rate of return on the market value of the property leased less reasonable deductions for any restrictions on use, special operating requirements or provisions for concurrent use by the lessor, another person or the general public.

(Underlining added.)

The criteria contained in RCW 82.29A.020(2)(b) lists two separate factors to be considered in computing taxable rent: (1) rental paid to other lessors by lessees of similar property for similar purposes over similar periods of time, (comparable rentals); and (2) a fair rate of return on the market value of the property less restrictions on use (fair rate of return). The statute also uses the term "shall," which means that consideration of both criteria is mandatory.

We believe that Audit properly used the assessed value of the property which also corresponds to the value of similar tracts of land used for similar sand and gravel mining operations. This value, however, is based on the total value of the real property, including sand and gravel deposits. Taxpayer submitted documentation that it paid real property taxes on mineral deposits valued at $ . . . , $ . . . and $ . . . during the years 1993, 1994, and 1995, respectively. Taxpayer argues that these amounts should be excluded from the leasehold excise tax base. We agree. Taxpayer's petition is granted on this issue.

DECISION AND DISPOSITION:

Taxpayer's petition is granted in part. Taxpayer's file shall be remanded to Audit for the proper adjustment consistent with this determination.

Dated this 26th day of February, 1998.