

Cite as Det. No. 06-0122, 26 WTD 69 (2007)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Refund of)	<u>D E T E R M I N A T I O N</u>
)	
)	No. 06-0122
)	
...)	Registration No. . . .
)	FY. . . Audit No. . . .
)	Docket No. . . .
)	

RULE 118; RCW 82.04.390: SERVICE B&O TAX – EXEMPTION – SUBLEASE OF REAL ESTATE. Amounts derived from the lease of real estate are exempt from B&O tax. The exemption also applies to a sublease of real estate so long as there is a landlord – tenant relationship between the original tenant and the subtenant whereby the subtenant is given exclusive possession and control of the property conveyed. Whether a transaction is a sublease or a non-exempt license to use real estate is a question of fact to be determined under the principles set out in Rule 118.

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.

Zalesky, A.L.J. – Taxpayer protests assessment of business and occupation (B&O) tax on amounts received from two unrelated businesses for use of office space within taxpayer’s leased office suite. We conclude that the amounts received by taxpayer are from the lease of real estate. Because the B&O tax does not apply to the sale or lease of real estate, the petition is granted.¹

ISSUE

Are amounts received for use of office space correctly characterized as from the lease of real estate, which is exempt from the B&O tax under WAC 458-20-118 (Rule 118), or from a license to use real estate, which is not exempt from the B&O tax?

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

FINDINGS OF FACT

[Taxpayer] is a law firm that operates its business from a suite of offices located in a building in . . . Washington. Taxpayer leases the suite from the building owner. Taxpayer's suite is made up of a reception area located just inside the front entrance to the suite, six offices, a conference room, a work area containing a copy machine and other office equipment, and a hallway that loops from the reception area around the interior of the suite. The work area also functions as the office break room, with a refrigerator, microwave oven, coffee pot, and eating space. The front entrance has a lock, but is kept unlocked during business hours. During the period at issue none of the interior offices had locks on the doors.

Taxpayer's lease agreement allows it to sublet office space within the suite so long as it receives approval from the landlord. Taxpayer has entered into two sublease agreements. The first is with an unrelated business that allows that business to occupy one of the offices located within the suite. The agreement is on a month-to-month basis and may be terminated upon 30 days written notice from either party. The business pays monthly rent to the Taxpayer for use of this office space.

The second sublease agreement is also with an unrelated business. The agreement allows that business to occupy one of the offices located within the suite for a two year period This unrelated business also pays monthly rent to the Taxpayer for use of the office space it occupies.

Taxpayer treated the monthly rent payments as receipts derived from the lease of real estate. No B&O tax was paid on these amounts.

Taxpayer's business records were reviewed by the Audit Division of the Department of Revenue for the period January 2001 through June 2005. The Audit Division determined that the rents received by the Taxpayer were not from the lease of real estate but from the granting of a license to use real estate. Because proceeds from a license to use real estate are subject to B&O tax under the service classification, the Audit Division assessed B&O tax on Taxpayer's rental income.

The audit resulted in an assessment Taxpayer has paid the assessment and is seeking a refund of the B&O tax and related interest and penalty.

ANALYSIS

Amounts derived from the sale or lease of real estate are exempt from the B&O tax. WAC 458-20-118 (Rule 118). Amounts derived from the granting of a license to use real estate are not exempt. Rule 118; Det. No. 99-345, 19 WTD 618 (2000); Det. No. 92-213ER, 13 WTD 108 (1993). Whether a particular grant is a lease of real estate or a license to use real estate is a question of fact. *Tacoma v. Smith*, 50 Wn. App. 717, 722, 750 P.2d 647, 651 (1988). In making this determination, we are guided by the principles set out in Rule 118.

According to Rule 118(2), a lease of real estate “conveys an estate or interest in a certain designated area of real property with an exclusive right in the lessee of continuous possession . . . and grants to the lessee the absolute right of control and occupancy during the term of the lease . . . agreement.” By contrast, a license to use real estate grants the licensee the right to use the subject property “but does not confer exclusive control or dominion over the same.” Rule 118(3). “If exclusive possession or control of the premises, or a portion thereof, is granted, even though the use is restricted by reservations, the instrument will be considered to be a lease and not a license.” Det. No. 03-0118, 23 WTD 218, 221 (2004) (*quoting McKennon v. Anderson*, 49 Wn.2d 55, 59, 298 P.2d 492, 495 (1956)).

The lease of real estate involves the creation of a landlord – tenant relationship. Rule 118(2). “The essence of the relationship is that one person who has an estate in land gives another person permissive possession of the land at will or for a period of time” 17 Wash. Pract., *Real Estate: Property Law* § 6.2. In a landlord – tenant relationship, both parties hold an estate in the leased real property. The tenant holds a “leasehold” estate while the landlord holds a “reversion” (*i.e.*, the right to take back the land after the lease term is up). Generally speaking, a tenant has the right to sublease his or her leasehold estate absent an agreement to the contrary. A sublease is created when the tenant transfers some or all of the leased property to another person for a time that is shorter in length than the remaining balance on the original lease. *Id.* at § 6.64; Restatement (Second) of Property: Landlord and Tenant § 15.1, comment i.

The exemption from the B&O tax for income derived from the lease of real estate also applies in the context of a sublease. Det. No. 03-0118, 23 WTD 218 (2004). The exemption applies so long as there is a landlord – tenant relationship between the original tenant and the subtenant whereby the subtenant is given exclusive possession and control of the property conveyed. We find that such a relationship exists in the present case. Taxpayer conveyed to its subtenants the exclusive possession and control over the respective offices occupied by each. Our finding is based on the following facts and circumstances:

- The written agreements between the Taxpayer and its subtenants were in the form of a “Sub-Lease Agreement.”
- The written agreements specified that each subtenant had the right to occupy a specific office for a specific term in exchange for the payment of a monthly rent.
- Neither sublease can be terminated at will, and Taxpayer has no right to allow others to use the sublet offices during the term of the respective subleases.
- The subtenants were not employees, independent agents, or clients of the Taxpayer and were not engaged in the same or similar business as the taxpayer. As a result, we are not dealing with a “leased department” situation. *See* WAC 458-20-200 (Rule 200); Det. No. 99-345, 19 WTD 618, 623 (2000).
- Both subtenants were provided with keys to the building and to the front entrance of Taxpayer’s suite. As a result, the subtenants had unfettered access to their respective offices at all times.

- Taxpayer provided no clerical, accounting, or other business related services to either subtenant. The subtenants are allowed access to Taxpayer's copy machine, but must pay Taxpayer for any copies made.
- The services provided by the Taxpayer to the subtenants do not alter the nature of the relationship. For example, Taxpayer's receptionist will greet visitors arriving to see one of the subtenants, and the receptionist or another of Taxpayer's employees will sometimes escort visitors to the office of the subtenant that the visitor is there to see. Another example is that the subtenants are allowed access to the refrigerator, microwave oven, coffee pot, and eating space, that is set up in the work area. These services are not a significant aspect of the sublease. *Compare* Det. No. 04-0023E, 23 WTD 206, 213 (2004) ("[B]ased on the extensive array of services offered to . . . assisted living residents," the primary purpose of assisted living facilities is not the lease of real estate, but to "provide daily living assistance and care to the aged.").

The Audit Division points out that neither of the sublet offices had a lock on the door during the period under audit.² This, according to the Audit Division, is evidence of the lack of exclusive control over the sublet offices. We agree that the existence of, or lack of, a locking door is relevant evidence. *See* Det. No. 88-427, 7 WTD 35 (1988) (ability of associate to lock office door was an important consideration in finding that a lease had been created); . . . (Det. No. 04-0022E, 23 WTD 198 (2004)). However, a locking door is not by itself determinative. In the present case, considering all the facts and circumstances, the lack of a lock on the sublet offices is not sufficient to undercut the evidence that a landlord – tenant relationship existed between Taxpayer and its subtenants and that the subtenants had exclusive possession and control of the property conveyed.

"The taxpayer bears the burden of proving its receipts are from the exempt rental of real estate, rather than from a service B&O taxable license" Det. No. 04-0023E, 23 WTD 206, 210 (2004) (*citing Budget Rent-A-Car, Inc. v. Department of Rev.*, 81 Wn.2d 171, 174-75, 500 P.2d 764, 767 (1972)). Taxpayer has met its burden in the present case. The clear weight of the evidence supports the Taxpayer's assertion that the amounts received from its subtenants for the use of office space were derived from the lease of real estate. As such, those amounts are exempt from B&O tax.

DECISION AND DISPOSITION

Taxpayer's petition is granted.

Dated this 15th day of June, 2006.

² Taxpayer informs us that locks were installed on the sublet offices after the conclusion of the audit.