Cite as Det No. 09-0213, 29 WTD 75 (2010)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Refund of	)	D E T E R M I N A T I O N
	)	
	)	No. 09-0213
	)	
. . .	)	Registration No. . . .
	)	Document No. . . . /Audit No. . . .
	)	Docket No. . . .
	)	

RULE 118; RCW 82.04.390: B&O TAX – RENTAL OF REAL ESTATE - TENANT LATE FEES. The B&O tax exemption for the rental of real estate does not apply to tenant late fees because the purpose of the late fee is to compensate the taxpayer for losses it incurs when rent is not paid on time; the fees are not taken or received for the rental of real estate. Thus, they are not "derived from" the rental of real estate within the meaning of RCW 82.04.390.

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.

Klohe, A.L.J. – A commercial and industrial real estate developer protests the assessment of service and other activities business and occupation (B&O) tax on income received from . . . tenant late fees. We affirm the audit assessment.

ISSUE

Is income from tenant late fees exempt from B&O tax under RCW 82.04.390 or WAC 458-20-118(1)?[1]

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410. Nonprecedential portions of this determination have been deleted.

FINDINGS OF FACT

[Taxpayer] is a Washington Limited Liability Company headquartered [outside of Washington]. Taxpayer's business activities in Washington include . . . construction and leasing of . . . real estate. Taxpayer is part of a group of related entities owned by a common parent . . . .

The Audit Division of the Department of Revenue (Department) examined the Taxpayer's books and records for the period January 1, 2003, through June 30, 2007. . . .

. . . [T]he Department assessed service and other activities B&O tax on Taxpayer's receipt of tenant late fees that it collected during the audit period. [Taxpayer] received a total of $. . . in tenant late fees during the audit period, resulting in an assessment of service and other activities B&O tax of $. . . . Taxpayer disputes this assessment and argues that tenant late fees should not be subject to B&O tax because the fees are an amount derived from the rental or sale of real estate and are therefore exempt under WAC 458-20-118(1).

Taxpayer's lease agreements with tenants contain the following terms regarding the payment of rent and late payment fees:

> 4.1 Base Rent; Additional Rent. Tenant shall pay to Landlord the Base Rent for the Premises set forth in the Basic Lease Terms and all amounts other than Base Rent that this Lease requires ("Additional Rent") without demand, deduction or offset.
>
> 23.2 Interest; Late Charges. Rent not paid within ten (10) days of when due shall bear interest from the date due until paid at the rate of ten percent (10%) per annum. Landlord may at its option impose a late charge of $. . . for each $. . . of rent for rent payments made more than ten (10) days late in addition to interest and other remedies available for default.

ANALYSIS

Washington imposes B&O tax "for the act or privilege of engaging in business" in this state. RCW 82.04.220. "Engaging in business" in Washington means "commencing, conducting, or continuing in business." RCW 82.04.150; *see also* Det. No. 08-0128, 28 WTD 9 (2009). "Business" is defined as including all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or another person. RCW 82.04.140. B&O tax is assessed on the gross revenues received in the course of business; whether a profit is realized is immaterial. Det. No. 88-206, 5 WTD 395 (1988) (*citing Budget Rent-A-Car v. Dep't of Revenue*, 81 Wn.2d 171, 173 (1972)).

Taxpayers subject to service and other activities B&O tax must pay tax on the "gross income of the business." RCW 82.04.290(2)(a). "Gross income of the business" is defined as:

> [T]he value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

RCW 82.04.080.

Exemptions and deductions from B&O tax are narrowly construed. *Budget Rent-A-Car v. Dep't of Revenue*, 81 Wn.2d 171, 174 (1972)). As taxation is the rule, exemption is the exception. *Id.* RCW 82.04.390 provides an exemption for income derived from the sale or rental of real estate:

> This chapter shall not apply to gross proceeds derived from the sale of real estate. This however, shall not be construed to allow a deduction of amounts received as commissions from the sale of real estate, nor as fees, handling charges, discounts, interest or similar financial charges resulting from, or relating to, real estate transactions.

Washington law provides that the sale or lease of real property is not subject to B&O tax. *Lacey Nursing Home, Inc. v. Dep't of Revenue*, 103 Wn. App. 169, 174, 176, 11 P.3d 839 (2000). *See also* WAC 458-20-118 (Rule 118). Rule 118 is the Department's administrative rule promulgated to administer RCW 82.04.390.

Exemptions are not to be extended by judicial construction. *Pac. Nw. Conference of the Free Methodist Church v. Barlow*, 77 Wn.2d 487, 463 P.2d 626 (1969). "When we interpret exemption provisions, the burden is upon the taxpayer to show the exemption applies and any ambiguity is "construed strictly, though fairly and in keeping with the ordinary meaning of their language, against the taxpayer." Det No. 04-0147, 23 WTD 369, 375 (2004) (*quoting Simpson Inv. Co. v. Dep't of Revenue*, 141 Wn.2d 139, 150, 3 P.3d 741 (2000)).

Taxpayer argues that tenant late fees should not be subject to B&O tax because it is income derived from the sale or rental of real estate that is exempt from B&O tax under Rule 118, which provides in relevant part:

> Amounts derived from the sale and rental of real estate are exempt from taxation under the business and occupation tax. However, there is no exemption of amounts derived from engaging in any business wherein a mere license to use or enjoy real property is granted. Amounts derived from the granting of a license to use real property are taxable under the service B&O tax classification unless otherwise taxed under another classification by specific statute, *e.g.*, sale of lodging taxed under retailing. (See RCW 82.04.050 and 82.04.290.) Further, no exemption is allowed for amounts received as commissions for the sale or rental of real estate (RCW 82.04.390) nor for interest received by persons engaged in the business of selling real estate on time or installment contracts.

Rule 118(1).

Taxpayer claims that because the late fees are authorized by a lease agreement for the rental of real estate, the fees must be "derived from" from the rental of real estate within the meaning of Rule 118 and therefore exempt from B&O tax. The words "derived from" are not defined in the B&O tax statutes. In the absence of a statutory definition, we use the dictionary definition. "Words in a statute are given their ordinary and common meaning absent a contrary statutory definition." *John H. Sellen Constr. Co. v. Dep't of Revenue*, 87 Wn.2d 878, 882, 558 P.2d 1342 (1976). "Derived" means "to take or receive esp. from a source." *Webster's Third New International Dictionary* 1178 (2002).

In this case, the tenant late fees are not derived from the rental of real estate because they are not taken or received for the lease or rental of real estate (i.e., the tenant's right to quiet possession of the premises so long as the tenant pays rent). Rather, tenant late fees or charges are imposed when the tenant does not pay the rent on time. If the rent payment is made on time, there is no charge or fee. The purpose of the tenant late fee is to compensate Taxpayer for the losses it incurs when the rent is not paid on time. *See* Section 23.2 of the Lease Agreement quoted above. ("Landlord may at its option impose a late charge … for rent payments made more than ten (10) days late.") Thus, the tenant late fees are not derived from the rental of real estate within the meaning of the statute.

Taxpayer fails to recognize that the exemption language in Rule 118 originates in RCW 82.04.390. Reading the statute in its entirety, it is clear that the Legislature differentiated between amounts "derived from" real estate and those that merely "result from" or "relate to" the rental of real estate. In fact, the Legislature went so far as to state that certain financial charges "resulting from, or relating to, real estate transactions were not exempt." The second sentence in RCW 82.04.390 clearly states that the exemption shall not be construed to allow a deduction for interest, fees, or similar financial charges resulting from, or relating to, real estate transactions.

In *Clifford v. State*, 78 Wn.2d 4, 469 P.2d 549 (1970), the appellant argued that interest received by the sellers of real estate is exempt under RCW 82.04.290 because the interest received is "derived" from the sale of the real estate. The Court disagreed, stating that the second sentence of the statute made clear that the first sentence applied only to the selling price. *Id.* at 5. Therefore, the Court held that the interest received by the developer under a contract for the sale of real estate is subject to business and occupation tax. *Id.* at 6-7 ("The second sentence of the section removes any doubt that this was the legislative intent."); *see also* Det. No. 91-228, 11 WTD 403 (1992); Det. No. 89-146, 7 WTD 257 (1989).

Similarly, fees are listed in RCW 82.04.390 along with interest as a type of finance charge resulting from a real estate transaction that is not exempt. Based on the plain language in the statute, tenant late fees are a type of finance charge resulting from or relating to real estate transactions that are not allowed as a deduction or exemption.

Taxpayer argues that because the lease agreements characterize the late charges as "additional rent," they are amounts derived from the rental of real estate and should be exempt. How the late fees or charges are characterized for purposes of the lease agreement is not controlling. The Department has the ability to look beyond contract terms that purport to establish the nature of something, but do not in fact do so. *See e.g.,* Det. No. 06-0028, 26 WTD 97 (2007) (*citing City of Tacoma v. William Rogers Co.,* 148 Wn.2d 169, 178 60 P.3d 79 (2002) ("The existence of that agency relationship is not controlled by how the parties described themselves in their contract documents.")). If this were not the case, taxpayers would be able to avoid payment of taxes simply by defining goods or services in contracts with customers as items or transactions that are exempt from taxes by law.

We conclude that tenant late fees are not exempt from B&O tax. Accordingly, we rule that the Department correctly assessed service and other activities B&O tax on income from tenant late fees received by Taxpayer.

DECISION AND DISPOSITION

[Taxpayer's] petition is denied.

Dated this 12th day of August, 2009.

STATE OF WASHINGTON DEPARTMENT OF REVENUE