Cite as Det. No. 89-312, 8 WTD 29 (1989)

THIS DETERMINATION HAS BEEN OVERRULED OR MODIFIED IN WHOLE OR PART BY DET. NO. 99-316, 19 WTD 850 (2000)

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. 89-312
. . .	)	Real Estate Excise Tax Audit No. . . . Excise Tax

[1] REAL ESTATE EXCISE TAX, RCW 82.45.010, WAC 458-61-430(1)(2): LEASEHOLD INTEREST -- TRANSFER -- IMPROVEMENTS -- "SALE" CONSTRUED. The real estate excise tax will not apply to the transfer of improvements by the lessee of a ground lease when: (1) The ground lease contains no option to purchase and (2) the presumption of the lessor's ownership of the improvements has not been overcome. Under these circumstances the lessee only has a leasehold interest in the improvements, and their transfer will not be a "sale" subject to the real estate 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.

TAXPAYER REPRESENTED BY: . . .
. . .
. . .

DATE OF HEARING: January 11, 1984

NATURE OF ACTION:

Petition for cancellation of a real estate excise tax assessment.

FACTS:

Bauer, A.L.J. (as successor to Mastrodonato, A.L.J.) -- On May 2, 1983 the Department of Revenue assessed real estate excise tax, with a late payment penalty, on the alleged sale of a hotel building. The amount assessed, including penalty, was $265,660.

The property on which the hotel is located was leased in October 1973 by a joint venture. The joint venture subsequently assigned its leasehold interest to the taxpayer, with the approval of the lessor, by way of an amendment to the ground lease in April 1974. Under the terms of the lease agreements, the taxpayer was to occupy and use the premises during the term of the ground lease "for the purpose of constructing and operating thereon a first-class hotel ..." The ground lease documents contained no option to purchase, but instead provided that the lessor, upon expiration or termination of the ground lease, had the option to "assume ownership of any or all leasehold improvements or require Lessee ... to remove any or all such improvements..." at its own expense.

In 1979 the taxpayer, by then in financial difficulty, assigned its leasehold interest to a sole proprietorship (the "assignee"). The First Lease Assignment and Assumption Agreement executed in June 1979 contained the following pertinent language:

> WHEREAS, [the taxpayer] desires to enter into a refinancing of its debt structure with [a mortgage investor] and simultaneously assign all of its right, title and interest in the Lease Agreements and the improvements described ... to [the assignee], who in turn is assigning all of his right, title and interest in the Lease Agreements and Improvements to [a limited partnership] by separate instrument of even date herewith;
>
> NOW, THEREFORE, in consideration for the mutual promises contained herein, the parties agree as follows:
>
> 1. [The taxpayer] does hereby transfer, convey and assign all of its right, title and interest in the lease Agreements together with the Improvements to [the assignee].

The assignee in turn executed a "Deed of Trust and Security Agreement" in favor of the taxpayer, which document contained the following language:

> That [the assignee] ... in consideration of TEN DOLLARS ($10.00) in hand paid, and of the debt and trust hereinafter mentioned, ... do hereby irrevocably grant, bargain, sell and convey,...
>
> B. All buildings and all other above-ground improvements located upon or at the real property...

...

> 1. Note. This conveyance is made in trust, however, to secure the payment of that one certain promissory note... in the principal sum of ... $15,850,000 ...

The Department, in examining this deed of trust and other local news articles reporting the transaction, concluded that there had been a sale of real estate upon which real estate excise tax should be collected.

TAXPAYER'S EXCEPTIONS:

In its petition dated September 29, 1983, the taxpayer offered the following objections in its contention that the real estate excise tax assessment was invalid:

> 1. The "sale" to which the auditor is seeking to apply the tax was, in fact, a refinancing. This is evidenced by, and confirmed by his focus on, the deeds of trust that were recorded for security purposes. We contend that the tax is not applicable to deeds of trust given as security for debt. See RCW 82.45.010, WAC 458-61-630.
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> 2. The refinancing took the form of an assignment of the taxpayer's leasehold interest in the property in question. The real estate excise tax is not applicable to the assignment of a leasehold interest. See RCW 82.45.010, WAC 458-61-500.
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> 3. WAC 458-61-430(1) is invalid as a matter of law.
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> 4. WAC 458-61-430(1) was promulgated without adequate statutory authority and thus is an invalid exercise of administrative rule-making.
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> 5. WAC 458-61-430(1) was effective as of January 21, 1983. The Department cannot now retroactively apply this regulation. See, Hansen Baking Co. v. Seattle, 48 Wn.2d 737, 296 P.2d 670 (1956); Group Health Coop. v. Wash. State Tax Commission, 72 Wn.2d 422, 433 P.2d 201 (1968).

The taxpayer in a letter dated March 7, 1984 summarized the points made at the hearing as follows:

> Basically, we believe the real estate excise tax is inapplicable because this transaction was, in substance, a refinancing. (As you know, RCW 82.45.010 excludes from the definition of "sale" a "transfer of an interest in real property merely to secure a debt..") By the mid-70's, [the taxpayer] was in default in its obligations to ...[its first mortgagor] and to ... [its second mortgagor] and owed considerable amounts to trade creditors. It was obvious that additional financing was necessary.

Because neither [of the mortgagors] was interested in providing the necessary additional financing, [the taxpayer] was forced to look elsewhere. [The assignee] was willing to provide the refinancing through ... a related entity. The additional capital received as a result of this refinancing (approximately $1.9 million) was used to bring the [first mortgagor's] obligation current, to pay off the [second mortgagor's] obligation, and pay off a portion of the other creditors. As regards the transaction itself, its refinancing nature is evidenced by the following facts: The "purchase price" was more than double the appraised value. The "down payment" was disproportionately small ($50,000 on a total "price" of $15,900,000). The interest rate and payment schedule were established at a level to achieve a flow through to the holders of the underlying obligations ..., but also structured so that if the hotel's operating revenues were insufficient to cover the payments, no party except [the taxpayer] would have an obligation to make up the shortfall. (To cover shortfalls, as a condition of the transaction, [the taxpayer] was required to enter into a guaranty fund agreement, which has, in fact, been required to make up shortfalls.) The note to [the taxpayer] is nonrecourse, secured only by a deed of trust from [the assignee]. All of the "transfers" that made up this refinancing transaction (involving [the taxpayer], [the new mortgagor], [the assignee] and [the limited partnership to whom the assignee further assigned his interest]) were conditioned on each other and were effected simultaneously. When all was said and done, [the taxpayer] was effectively in the same place it had been before the refinancing, except that it had obtained an infusion of capital: it was (and is) in possession of and operating the hotel, it was (and is) obligated to pay the underlying indebtedness if hotel operating revenues were (or are) insufficient, and it was (and is) the only party with an equity of any significance.

Although we believe that the transaction was in substance a refinancing, we also believe that the form of the transaction precludes application of the real estate excise tax. In form this transaction was the assignment of a leasehold interest in improved property. (As you know, the assignment of a leasehold interest is also excluded from the definition of "sale" set forth in RCW 82.45.010). Because the hotel is an improvement that is permanent in nature, and would be completely destroyed by removal, under the holding of Pier 67 v. King county, 71 Wn.2d 92 (1967), it became a part of the realty as constructed. As such, it belongs to the lessor; [the taxpayer] could have no more than a lessee's interest. It is this lessee's interest that [the taxpayer] transferred. (Even if one thought that the improvements were meant to be the property of the lessee, under Pier 67 they can only be personal property. As such, their transfer is not subject to the real estate excise tax either.)

This brings me to a related point. The auditor applied WAC 458-61-430(1), which in turn is based on WAC 458-61-030(10). The later regulation defines "real estate" to include "improvements the title to which is held separately from the title to land to which the improvements are affixed." This expanded definition goes further than the statutory authority on which it depends, RCW 82.45.032. It is also contrary to

> Washington law, which recognizes that an improvement is only real property if it is owned by the owner of the underlying land. If not -- i.e., if it is owned by a lessee -- it is necessarily personal property. See Pier 67. Thus WAC 458-61-030(10) is an invalid exercise of the Department's rule-making authority. Furthermore, even if the regulation were valid, in this case title to the improvements is not held separately from title to the land.
>
> The defect in WAC 458-61-030(10) extends to WAC 458-61-430(1). Improvements can only be real property or personal property. If intended to be the property of the lessee, Pier 67 says that they are personal property, whose transfer is not subject to the real estate excise tax. If intended to be real property, Pier 67 says they can only be the property of the lessor. Thus when the lessee transfers its interest, it can only transfer a lessee's leasehold interest, and the real estate excise tax is again inapplicable.
>
> Finally, WAC 458-61-430(1) was adopted effective July 21, 1982, but is being retroactively applied to a 1979 transaction. We believe this regulation should not be retroactively applied in this case for two reasons. First, the Department's policy has been to apply new regulations prospectively only. This policy helps ensure even-handed and equitable administration of the tax laws. Second, the expanded definition of real estate contained in WAC 458-61-030(10) was not in effect, nor was its promulgation foreseeable, in 1979. If [the taxpayer] had known in 1979 that the tax would be applied, it could have planned accordingly. At this point, the damage that would occur by retroactive application cannot be mitigated.

ISSUE:

The issue for resolution is whether the alleged "sale" of the hotel was a sale of real estate taxable under the real estate excise tax.

DISCUSSION:

RCW 82.45.060(1) imposes an excise tax upon "each sale of real property."

The term "sale" is defined at RCW 82.45.010, which provides in part:

> As used in this chapter, the term "sale" shall have its ordinary meaning and shall include any conveyance, grant, assignment, quitclaim, or transfer of the ownership of or title to real property, including standing timber, or any estate or interest therein for a valuable consideration, and any contract for such conveyance, grant, assignment, quitclaim, or transfer, and any lease with an option to purchase real property, including standing timber, or any estate or interest therein or other contract under which possession of the property is given to the purchaser, or any other person by his direction, which title is retained by the vendor as security for the payment of the

> purchase price.
>
> The term shall not include a transfer by gift, devise, or inheritance, a transfer of any leasehold interest other than of the type mentioned above . . . . (Emphasis supplied.)

The ground lease in this instance does not include an option to purchase the real property. The assignment of the taxpayer's interest as lessee under the ground lease, therefore, was not a "sale."

Presuming that the real estate excise tax could apply to improvements located on leased land which the lessee does not have an option to purchase, the property interest in the improvements must be examined. Under Washington case law, unless the contract provides otherwise, improvements made by a lessee become part of the land upon construction and are owned by the lessor. Pier 67, Inc. v. King County, 71 Wn.2d 92, 94, 26 P.2d 610 (1967), rev'd on other grounds, 78 Wn.2d 48, 469 P.2d 902 (1970); Murray v. Odman, 1 Wn.2d 481, 485, 96 P.2d 489 (1939); Toellner v. McGinnis, 55 Wash. 430, 435-36, 104 Pac. 641 (1904). Even a provision in a lease requiring the lessor to pay the lessee for improvements erected on the property will not change the presumption of lessor ownership. See 2 Thompson, Real Property, § 1140.

We must therefore determine whether, under the terms of the taxpayer's lease, the taxpayer was holding an ownership interest in the improvements separate and apart from the underlying lease.
The terms of the ground lease require the lessee to build and operate the improvement (hotel) in accordance with certain objective standards enumerated in the lease documents. The lessee is therefore effectively prohibited from removing the improvements during the lease's term. The ground lease further provides that, upon expiration or termination of the lease, the lessor might elect to assume ownership of the improvements or require lessee to remove the improvements at its own expense.

The practical effect of these terms is that the lessee's interest in the improvements is no greater than the lessee's interest in the land. These terms, taken as a whole, support the presumption established in the case law that improvements added to the land by a lessee have become the property of the lessor.[1]

Further, we do not find that the "title ... to the improvements" language used in the 1979 Assignment and Assumption Agreement overcomes the presumption of the lessor's ownership of the improvements. This, and the "sell and convey ... [a]ll buildings and other above-ground improvements" language, when read in context, merely indicate an intention of surrendering the right of possession in the buildings during the term of the lease.

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[1] Parenthetically, and by contrast, we note that where a lessee is given the right to remove a building affixed to the land as part of the underlying realty, the lessee's interest is identified, in common law parlance, as a "chattel real." See, e.g., Newhoff v. Mayo, 48 N.J. Eq. 619, 23 Atl. 265 91891). The lessee's interest in the improvements under these circumstances may be distinguished from that which it holds in the underlying land. Whether such an interest would constitute an estate in property which can be subjected to the real estate excise tax upon transfer is a question which need not now be decided.

On this basis we conclude that the taxpayer's interest in the improvements was a leasehold interest.

WAC 458-61-430(1) and (2) does in fact address transfers of improvements. However, the rule must be read in conjunction with RCW 82.45.010.

WAC 458-61-430(1)(2) provides:

> (1) The real estate excise tax applies to the sale of improvements on leased land held in private ownership if terms of the sales contract do not require that the improvements be removed from the land.
>
> (2) The real estate excise tax does not apply to the sale of improvements on leased land held in private ownership if the terms of the sales contract require that the improvements be removed from the land. In this case, the improvements are considered personal property and their sale is subject to the use tax under chapter 82.12.RCW . . .

According to RCW 82.45.010, the only leased land subject to a real estate excise tax is land leased with an option to purchase. The "leased land" language in WAC 458-61-430(1) and (2) can thus be read to mean only leased land having an option to purchase. "Administrative rules may not amend or change enactments of the legislature." Fahn v. Cowlitz County, 93 Wn.2d 3689, 383, 610 p.2d 857 (1980); Kitsap-Mason Dairymen's Ass'n. v. State Tax Comm'n, 77 Wn.2d 812, 815, 467 P.2d 312 (1970).

The "sale of improvements" language in the WAC must thus be read to address a sale by the owner of the improvements. A lessee can only transfer the interests it has in the property and improvements to a third party.

[1] Thus, the real estate excise tax will not apply to the transfer of improvements by the lessee of a ground lease when: (1) The ground lease contains no option to purchase, and (2) the presumption of the lessor's ownership of the improvements has not been overcome. Under these circumstances the lessee has only a leasehold interest in the improvements, and their transfer will not be a "sale" subject to the REET.

The instant lease required the taxpayer, as lessee, to make and maintain specified improvements, and did not provide for an option to purchase. The taxpayer and its assignee thus had only a possessory interest in the improvements for the duration of the lease. The improvements, however, because there was nothing to the contrary in the lease, were owned by the lessor who had a reversionary interest in them. Upon construction, the hotel became part of the underlying property interest, and the lessee had no right to remove it. The subsequent transfer of the hotel to a third party, therefore, only transferred the taxpayer's existing interest, a leasehold interest with no option to purchase.

Accordingly, the transfer here at issue did not fall within the RCW 82.45.010's definition of "sale" and was not properly taxable.

Because we are resolving this issue in favor of the taxpayer, the remaining concerns raised by the taxpayer need not be addressed.

DECISION AND DISPOSITION:

The taxpayer's petition for correction of assessment is granted. The assessment will be cancelled.

DATED this 20th day of June 1989.