

Cite as Det. No. 00-210, 20 WTD 316 (2001)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 00-210
)	
...)	Registration No. . . .
)	FY. . . /Audit No. . . .

- [1] 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 that the tenant would assume the owner’s responsibility for repairing and maintaining the property, the contract rent was not negotiated under circumstances clearly showing that the contract rent was the maximum attainable by the lessor.
- [2] RULE 200; RCW 82.29A.020: LEASEHOLD EXCISE TAX – TAXABLE RENT – RECOMPUTATION OF – RATE OF RETURN OR SIMILAR SALES – RESIDENTIAL PROPERTY. When re-computing taxable rent for residential property, both the similar sales method and the rate of return method must be considered and the method that results in a more accurate tax assessment should be used.

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:

Lessees from the Port of . . . protest the assessment of additional leasehold excise taxes on the basis that their rent of one dollar per month was the maximum attainable.¹

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

FACTS:

Okimoto, A.L.J. --. . . (Taxpayers) rent residential property from the Port of . . . (Port) located on the north side of the . . . airport. The Audit Division (Audit) of the Department of Revenue (Department) examined Taxpayers' lease with the Port for the period January 1, 1994 through September 30, 1997. The examination resulted in additional leasehold excise taxes and interest owing in the amount of \$. . . and Document No. FY. . . was issued in that amount on February 2, 1999. Taxpayers protested the entire amount and it remains due.

Taxpayers explained during the hearing that their parents had given them a one-acre parcel located on the northern end of the . . . airport in the early 90's. The lot was located adjacent to their parents' . . . parcel Since they wanted to live near their parents, Taxpayers constructed a . . . house on the lot. In addition, Taxpayers built a double-car garage, carport, a shed and deck.

In early 1994, not long after construction was completed, the Port notified Taxpayers of its intent to acquire Taxpayers' property. The Port told Taxpayers that their house was in the "danger zone" of the . . . airport flight path. Because the Port had recently acquired some funding to obtain houses located in critical areas, the Port made an offer to purchase Taxpayers' property. Initially, the Port offered \$158,000 for the house or offered to purchase an aviation easement for \$4,740.

After researching the offer, Taxpayers determined that their newly constructed home was worth around \$200,000 and that an aviation easement would depress its value by at least 15%. Consequently, they rejected the Port's offer and counter-offered to sell their home to the Port for the remaining balance on their mortgage and 15 years of free-use. After further negotiation, Taxpayers and the Port eventually agreed to purchase the house for \$77,000² and to lease the house back to Taxpayers for \$1 per month rent. Taxpayers also agreed to assume the costs of maintenance and upkeep of the property.

Schedule 1: Leasehold Tax Due on Taxable Rent:

In this schedule Audit determined that the \$1 per month rent that Taxpayers paid to the Port for use of their residence was not determined through one of the three sanctioned methods. Therefore, Audit concluded that contract rent did not constitute taxable rent and needed to be recomputed pursuant to RCW 82.29A.020(2)(b). Audit recomputed taxable rent by utilizing the county's 1994 assessed valuation of the land and improvements of \$122,600. Audit then utilized a 10% rate of return factor to arrive at an annual taxable rental value for the property. Audit computed leasehold excise tax on rental amounts of \$1,021/mo. for 1994, \$1,150/mo. for 1995, \$1,215/mo. for 1996 and \$1,188/mo. for 1997.³ Audit relied on Det. No. 98-019, 17 WTD 252 (1998), and Gunter Geismann v. Department of Rev., Docket No. 41980 (Bd. of Tax Appeals, 1992) in support of its position.

² \$77,000 was the remaining balance owing on Taxpayers' mortgage.

³ Audit actually used annualized amounts, which we have converted to monthly rental rates.

Taxpayers object to Audit's recomputation of taxable rent. Taxpayers argue that the \$1/mo. rent paid to the Port for the residence and property was the "maximum attainable" based on information contained in the public record. Taxpayers simply state that they would not have sold their property to the Port if they had to pay a higher rent. Consequently, Taxpayers contend that their negotiated rent meets the safe-harbor provisions contained in RCW 82.29A.020 and that their \$1 per month contract rent is the appropriate taxable rent. Taxpayers submitted a letter from Port officials supporting their position that \$1 per month was the maximum rent obtainable under the circumstances.

In the alternative, Taxpayers argue that the monthly rent computed by Audit is more than the fair market rent of other similar residential properties located in the vicinity. Taxpayers estimated that the fair market rental value of their house at the time they negotiated the sale and leaseback arrangement was approximately \$800 per month. Taxpayers stated that they examined local rental rates contained in newspapers and other publications at the time and utilized that number to negotiate the sale and leaseback arrangement.

ISSUES:

- 1) Should "taxable rent" be considered "contract rent" where property owners sell residential property to a Port District on the condition that they be able to leaseback the same property for 15 years at a \$1 per month rental rate?
- 2) Should the rate of return or similar sales method be used when recomputing taxable rent of residential property?

DISCUSSION:

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 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 Taxpayers' lease meets one of the three sanctioned methods.

Taxpayers concede that the lease rent was neither established through competitive bidding nor in accordance with statutory requirements for establishing rent payable. Instead, Taxpayers argue 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."

We disagree. The material facts surrounding the lease negotiations suggest that the contract rent in the leasehold contract was far from the maximum attainable. The lease negotiations, which we will presume, *arguendo*, as being part of the public record, show that the \$1 per month contract rent was conditioned primarily upon a lower than market rate sales price for the underlying one-acre lot and residence. If the Port had agreed to pay a higher price for the lot and house, it could have easily negotiated a higher contract rent that would have reflected fair market value. We do not dispute that the Port has the authority to negotiate leases of below market contract rent in exchange for a below market purchase price of real property. In fact, we consider this to be a reasonable method of negotiations. We simply find that the leasehold contract rent negotiated under these types of sales and leaseback transactions does not result in the "maximum attainable" contract rent. See Det. No.98-019, 17 WTD 252 (1998).

In addition, we note that section 12 of the lease rental contract transfers the responsibility for performing interior and exterior leasehold repairs and maintenance to the tenants (Taxpayers). These responsibilities and their resulting costs would normally fall on the landlord and be recovered through monthly rental payments. The fact that these costs are transferred to Taxpayers also suggests that the \$1 per month contract rent was not the "maximum attainable." See Det. No. 98-019, 17 WTD 252 (1998); Gunter Geismann v. Department of Rev., Docket No. 41980 (Bd. of Tax Appeals, 1992). Based on these factors we cannot find 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"

We further note that the legislative intent of the leasehold excise tax was to replace property tax revenues that were lost when public entities became owners of the real property. RCW 82.29A.010 describes the legislative intent of the leasehold excise tax as follows:

The legislature hereby recognizes that properties of the state of Washington, counties, school districts, and other municipal corporations are exempted by Article 7, section 1 of the state Constitution from property tax obligations, but that private lessees of such public properties receive substantial benefits from governmental services provided by units of government.

The legislature further recognizes that a uniform method of taxation should apply to such leasehold interests in publicly owned property.

The legislature finds that lessees of publicly owned property are entitled to those same governmental services and does hereby provide for a leasehold excise tax to fairly compensate governmental units for services rendered to such lessees of publicly owned property.

In this case, Taxpayers received many significant services from the city and county, including police and fire protection, when they owned the land and residence. During that period Taxpayers' property taxes helped pay for those governmental services. Now that Taxpayers have sold the property to the Port of . . . , it has been taken off the property tax rolls, and the city and county no longer receive revenue to support these services from this property. This is true even though the city and county remain obligated by law to provide these essential services to Taxpayers. Furthermore, Taxpayers will continue to receive these governmental services throughout the term of their 15-year lease. Consequently, even though Taxpayers may perceive that it is unfair for them to be required to pay leasehold excise taxes on a value other than the negotiated contract rent, we find that it is a fair and reasonable determination. Taxpayers are simply contributing their fair share of taxes to support local governmental services that they have received in the past and will continue to receive throughout the 15-year lease. Accordingly, we find that Audit's recomputation of taxable rent on Taxpayers' lease contract is consistent with the legislature's intent as provided in RCW 82.29A.010. Taxpayers' petition is denied on this issue.

Because we have determined that 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) list 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, (similar rentals); and (2) a fair rate of return on the market value of the property less restrictions on use (fair rate of return).

WAC 458-29A-200 (Rule 200) implements RCW 82.29A.020(2)(b) and states in part:

(6) **Department's authority to establish taxable rent.** RCW 82.29A.020(2) authorizes the department to establish a "taxable rent" that is different from contract rent in some situations.

(a) If the department determines that a lessee has a leasehold interest in publicly owned property 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 under chapter 82.29A RCW. The department shall base its computation on the following criteria:

(i) Consideration shall be given to rent being paid to other lessors by lessees of similar property for similar purposes over similar periods of time; or

(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.

In recomputing taxable rent, Rule 200 allows Audit to consider either similar rentals or a fair rate of return method. In Taxpayers' leasehold tax assessment, Audit has considered a 10% rate of return factor based on the assessed value of the property. Although the fair rate of return method may be appropriate for determining the value of renting commercial business properties, it may not be the best approach for Taxpayers' case. Furthermore, we note that [it is not clear if Audit has] considered whether a recomputation of taxable rent on a similar rental basis would result in a more accurate tax assessment. Accordingly, we will remand Taxpayers' petition to the Audit Division to consider whether a recomputation of taxable rent based on the value of similar rentals of similar residential properties in the area is more appropriate or whether the fair rate of return method is more appropriate.

DECISION AND DISPOSITION:

Taxpayers' petition is remanded to the Audit Division for the proper adjustments consistent with this determination.

Dated this 22nd day of December, 2000.