Cite as Det. No. 00-154ER, 21 WTD 298 (2002)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	F I N A L E X E C U T I V E L E V E L D E T E R M I N A T I O N
	)	No. 00-154ER
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[1] WAC 458-20-135, WAC 458-20-118; RCW 82.04.320: B&O TAX – EXEMPTIONS – RENTALS – LICENSES. The labeling of payments as royalties or rents is not controlling in determining whether the payments are for the rental of real property or for a license or other right involving the use of real property.

[2] WAC 458-20-135, WAC 458-20-118; RCW 82.04.320: B&O TAX – EXEMPTIONS – RENTALS – LICENSES – MINERAL LEASES. In general, royalties received under a mineral lease are for the grant of the right to extract natural products and are treated as a license, a profit a prendre, or an incorporeal heriditament, not as the rental of real property.

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.

Mahan, A.L.J. – Owners of real property used in sand and gravel operations seek reconsideration of a decision affirming the assessment of service and other activities business and occupation (B&O) tax on royalty payments.[1]

ISSUES

1. Are some or all of the royalties received by the taxpayers under various leases considered payments for the rental of real property, which are not subject to B&O tax, or for the grant of rights to extract natural products, which are subject to service and other activities B&O tax?

2. Are the payments received under the mineral leases for the use of real estate as such and, therefore, not subject to excise tax?

FACTS

The four individual taxpayers are family members and each of them owns an undivided interest in one or more parcels of real property that are used by sand and gravel companies. The [individual] taxpayers also are principal shareholders in the sand and gravel companies. The gravel companies extract and sell sand and gravel from some of the properties as well as washing, crushing, and screening the gravel to create new products for sale. Taxpayer [the Rock Company] . . . is owned primarily by the same shareholders as the sand and gravel companies.

The Department of Revenue (Department) audited the records of the gravel companies. Following an audit of these records, the Department assessed service and other activities B&O tax on royalty payments the companies made to the taxpayers during the January 1, 1993 through December 31, 1996 period. The Department considered the payments as having been made for the intangible right to remove sand and gravel and not for the rental of real property. The taxpayers timely appealed the assessments and contended the royalty payments were rental payments for the granting of exclusive rights to possess the property. In Det. No. 00-154, we affirmed the Department's assessment of service and other activities B&O tax. On

[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.

reconsideration, the taxpayers presented evidence on the use of the various parcels of real property related to the royalty payments at issue.

According to the taxpayers, the gravel companies "lease" the taxpayers' properties for their operations. According to the taxpayers, "due to the close relationship" between the gravel companies and the taxpayers, these leases were never reduced to writing. According to the taxpayers, the parties have agreed to follow the terms of written leases that the gravel companies have with unrelated third parties.

On their books, the gravel companies identified the payments they made to each of the taxpayers as "royalties." The taxpayers further stated that each of the taxpayers reports the payments as royalty income, not rental income, on federal income tax returns.

According to the taxpayers, the properties subject to the mineral leases both had pre-existing buildings and the gravel companies constructed additional buildings during the term of the leases. The taxpayers further state that the predominate activity occurring on the premises is the processing and selling of the extracted materials and, therefore, the payments should not be characterized as royalties for the removal of natural resources.

At issue are royalty payments related to six different parcels of property: the [Rock Company] property (Parcel A); the [B] property (Parcel B); the [C] property (Parcel C); the [D] property (Parcel D); the [E] property (Parcel E); and the [F] property (Parcel F). Each parcel has different uses.

Parcel A:

Parcel A is part of three adjacent parcels of property used in a sand and gravel operation. One of the sand and gravel companies owns one of the parcels, on which sand and gravel is extracted and on which crushing, washing, sorting, and other equipment is maintained. Taxpayer [Rock Company] owns an adjacent parcel, Parcel A. During the audit period, no sand or gravel was extracted from Parcel A, although some sand and gravel was extracted prior to and after the audit period. Materials leaving the sand and gravel company's extracting and crushing operation pass over Parcel A. A truck scale is maintained on Parcel A. According to taxpayer [Rock Company], it is paid approximately $.35 per ton for all materials sold by the sand and gravel company and which cross [Rock Company]'s property. When materials were extracted from Parcel A, taxpayer [Rock Company] was paid approximately $1.00 per ton.

The other parcel is owned by a third-party. Under an Option and Material Purchase Agreement between the third-party and [the Rock Company], [the Rock Company] is entitled to extract sand and gravel from the property in exchange for payment of rents or royalties to the third-party. Under an oral agreement between [the Rock Company] and the gravel company, the gravel company extracts the sand and gravel from the third-party property on [Rock Company]'s behalf and processes it on the gravel company's property. According to the taxpayer, the gravel company pays it approximately $1.00 per ton for materials from the third-party property—of

which approximately $.65 per ton is used to pay the third-party for the extracted materials and $.35 per ton is for the right to move the materials across [Rock Company]'s property.

Parcel B:

Parcel B is owned by three of the taxpayers. One of the gravel companies operates a concrete batch plant on the property. No extracting activity takes place on this property and no permit to mine exists for this property. The gravel company pays a fee, identified in billing statements as an "access royalty," to the three taxpayers for each cubic yard of materials taken from the batch plant.

Parcel C:

Parcel C is owned by one of the taxpayers. The property is a depleted mining pit area from which extracting no longer takes places and for which a permit to mine no longer exists. One of the gravel companies owns and operates washing, screening, crushing, scaling, and ready mix equipment along with a sales office on the property. All materials used in the operation come from other locations. The taxpayers stated that, because of the high cost of transporting mined materials, it is very unusual for the processing of sand and gravel to take place at any distance from a pit. Because of the long history of this site as a source for materials for its customers, the gravel company continues to use this site using imported materials. For several years of the audit period, the owner of Parcel C was paid $ 900 in rent for the use of the property. According to the taxpayers, the owner is currently paid approximately $.30. per ton for materials processed and sold from the property.

Parcel D:

Parcel D is owned by two of the taxpayers. It and an adjacent parcel owned by one of the gravel companies are used in a sand and gravel operation. Extracting, washing, screening, and crushing of sand and gravel take place on Parcel D. Scaling, sales, and ready mix operations take place on the adjacent property. The gravel company pays the owners of Parcel D a royalty for each cubic yard of material extracted and sold by the gravel company from the properties.

Parcel E:

Parcel E is owned by three of the taxpayers. It and an adjacent parcel owned by one of the gravel companies are used in a sand and gravel operation. Extracting, washing, screening, and crushing of sand and gravel take place on Parcel E. Scaling and sale operations take place on the adjacent property. The gravel company pays the owners of Parcel E a royalty of approximately $.30 per ton for materials extracted and sold by the gravel company from the properties.

Parcel F:
Parcel F is owned by two of the taxpayers and an unrelated third-party, who is not a party to this appeal. One of the gravel companies owns and operates washing, screening, crushing, and

scaling equipment along with a sales office on the property. The gravel company pays the owners of Parcel F a royalty of approximately $.50 per ton for materials extracted and sold by the gravel company from the property.

ANALYSIS

To the extent a mineral lease transfers ownership of minerals prior to severance it is subject to real estate excise tax (REET). WAC 458-61-520. Conversely, under WAC 458-61-520(3), a mineral lease that does not transfer ownership of the minerals prior to severance from the real property is not subject to REET. Because the mineral leases at issue purportedly did not pass ownership in the sand and gravel prior to severance, they would not be subject to REET. Conversely, they would be subject to B&O tax, absent an applicable exemption, under the general principle the legislature intended to impose the B&O tax upon virtually all business activities carried on within the state. *See Impecoven v. Department of Rev.*, 120 Wn.2d 357, 363, 841 P.2d 752 (1992); *Time Oil Co. v. State*, 79 Wn.2d 143, 146, 483 P.2d 628 (1971).

The taxpayers contend that the mineral leases are exempt under RCW 82.04.320 and WAC 458-20-118 (Rule 118). RCW 82.04.390 exempts the "gross proceeds derived from the sale of real estate" from B&O tax. Rule 118 similarly states that amounts from the sale of “real estate” are exempt from B&O tax. It further identifies income from the rental of real estate as being subject to the exemption. Rule 118 further distinguishes between the rental of real estate and licenses to use real property, with the latter not subject to the exemption.[2]

. . .

[2] Rule 118 states:

> 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.
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> A lease or rental of real property conveys an estate or interest in a certain designated area of real property with an exclusive right in the lessee of continuous possession against the world, including the owner, and grants to the lessee the absolute right of control and occupancy during the term of the lease or rental agreement. An agreement will not be construed as a lease of real estate unless a relationship of "landlord and tenant" is created thereby.

Rule 118 is consistent with the distinctions between leases and licenses set forth in *McKennon v. Anderson*, 49 Wn.2d 55, 59, 298 P.2d 492 (1956).

Rule 118, however, does not identify whether, for purposes of that rule, a mineral lease should be considered a lease (which grants an exclusive right to possession of the property) or similar to a license (which grants a privilege to use the property).

The only departmental regulations that specifically characterize mineral leases appear to treat them as licenses, not leases. *See* WAC 458-12-005 and WAC 458-12-010. For ad valorem tax purposes, WAC 458-12-010 distinguishes between a sale of minerals in place (real property) and a mineral lease. It provides that 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." WAC 458-12-005 further distinguishes between tangible personal property interests (e.g., leases for less than the life of the lessee) and intangible personal property interests. The list of "intangible personal property" interests includes:

> (3) All mining or prospecting leases, whether on public or privately-owned land, except leases for the life of the lessee. RCW 84.04.080; TCR 4-22-36; *Walla Walla Oil, Gas & Pipe Line Company v. Vallentine,* 103 Wash. 359 (1918).

The *Vallentine* case cited in WAC 458-12-005 concerned whether the statute of frauds applied to an oil and gas mining lease.[3] Because oil and gas were believed to be migratory in nature, the court held that such interests did not create an encumbrance upon the land, but were only "a license entitling the licensee to search and dig for oil and gas according to the terms of the grant, and appropriate the produce to his own use on payment of the royalty or proportion without acquiring any property in the minerals until they are severed from the land. They create only an incorporeal hereditament – a right issuing out of or concerning the land." 103 Wash. at 363.[4]

Courts from other jurisdictions have also treated mineral leases as not involving a sale of real estate, but a grant of an exclusive right to explore and to reduce to possession the minerals extracted from the land:

> [U]nder controlling Oklahoma, Kansas, or federal law, an oil and gas lease is not realty, but a mere right or privilege to go upon the land to explore, produce and convert oil to the lessee's possession as personal property. . . .Indisputably, Oklahoma and Kansas,

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[3] Washington may be in the minority in not applying the statute of frauds in such situations. *See Norden v. Freidman*, 756 S.W.2d 158 (1988) ("Some jurisdictions, however, regard an oil and gas lease as a mere chattel interest and not within the statute of frauds. *See, e.g., Walla Walla Oil, Gas & Pipe Line Co. v. Vallentine*, 103 Wash. 359, 174 P. 980 (1918). Research indicates no Missouri case in point, but the majority rule holds oil and gas leases are an interest in lands and thus within the statute.").

[4] However, in a subsequent Washington inheritance case, the court held, with little analysis, that a coal mining lease with an option to purchase the land was a lease and not a license. *Hoover v. Ford's Prairie Coal Co.*, 145 Wash. 295, 259 P. 1079 (1927). That case has been criticized for failing to discuss or recognize the differences between a lease and a non-possessory right known as a profit a prendre. 2 *Washington Real Property Deskbook*, § 27.2(3)(a) (3d ed. 1996); *see also* 17 W. Stoebuck, *Washington Practice, Real Estate: Property Law* § 6.3, 295 n. 5 (1995) (hereinafter "*Stoebuck*"). Also, under current law a coal mining lease with an option to purchase is distinguished from a mining lease without an option to purchase. A coal mining lease with an option to purchase would generally be considered a sale of real property subject to real estate excise tax. RCW 82.45.035.

> without deviation have held an oil and gas lease is a chattel real, a profit a prendre, or an incorporated hereditament, which grants only the exclusive right, subject to legislative control, to explore by drilling operations; to reduce to possession, and thus acquire title to the oil and gas, which is personalty.

Phillips Petroleum Co. v. Jones, 176 F.2d 737, 739 (10th Cir. 1949); *see also Hinds v. Phillips Petroleum Co.*, 591 P.2d 697, 698, 1979 Ok 22 (1979) ("rather than a true lease, it [an oil or gas lease] is really a grant in praesenti of oil and gas to be captured in the lands described during the term demised so long thereafter as these substances may be produced").

A recent amendment to the Department's rule on extractors, WAC 458-20-135 [Rule 135], effective June 17, 2000, also treats mineral leases in a manner similar to how Rule 118 treats the rights and privileges granted under licenses. It states that royalties for the privilege or right to remove natural materials are subject to service and other activities B&O tax. It further makes it clear that the labeling of payments as royalties or rent is not controlling in determining the appropriate tax treatment. [Rule 135] provides:

> (5) Mining or mineral rights. Royalties or charges in the nature of royalties for granting another the privilege or right to remove minerals, rock, sand, or other natural product are subject to the service and other activities B&O tax. The special B&O tax rate provided by RCW 82.04.2907 does not apply because this statute specifically excludes compensation received for any natural product. Refer also to RCW 82.45.035 and WAC 458-61-520 (Mineral rights and mining claims) for more information regarding the sale of mineral rights and the real estate excise tax.
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> Income derived from the sale or rental of real property, whether designated as royalties or another term, is exempt of the B&O tax.

In Det. No. 00-154, we concluded that the Washington courts today would likely describe a mineral lease as a profit a prendre, an incorporeal hereditament, not a lease of realty:

> A profit, or profit a prendre, is "like an easement, a usufructrary right, but it gives the right to remove substances, commonly stone or minerals, from the soil." 2 *Washington Real Property Deskbook*, § 27.2(3)(a) (3d ed. 1996)*; see also Hoglund v. Omak Wood Products, Inc.*, 81 Wn. App. 501, 505 914 P.2d 1197 (1996) (a profit grants a right to use property as distinguished from a right of exclusive possession under a lease, citing *Stoebuck*, § 2.1, at 79 - 80).
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> In *Layman v. Ledgett*, 89 Wn.2d 906, 911, 577 P.2d 970 (1978), the Court discussed the nature and effect of a profit a prendre with respect to the grantee's rights in a contract for the sale of standing timber. The Court stated:
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> > These timber rights are considered as a profit a prendre, a right to take the profits of the land by entering onto it and cutting and removing the timber. This right is

> an interest in real property to which the timber grantee has title. The grantor has parted only with his right to appropriate that part of his land, i.e., timber, for a period of time; he has not parted with any part of his estate.

> Traditionally, the right to remove sand, rock, or timber is regarded as a profit, not a right of possession, such as is granted under a lease. *Stoebuck*, § 2.1, at 80 - 81 (citing *Layman*).

Whether described as a profit a prendre, an incorporeal hereditament, a license, or a chattel real, the Department's treatment of mineral leases in a manner similar to licenses, and not as leases of real estate, has a sound basis in the law. Accordingly, we conclude that mineral leases in general are not subject to the rental or sale of real estate exemption provided under Rule 118 or RCW 82.04.390. Further, because mineral leases are treated as similar to licenses, the imposition of B&O tax would not run contrary to the law prohibiting the imposition of excise tax on rentals of real estate, as discussed in *Lacey*, 103 Wn. App. 169.

In Det. No. 00-154, we also noted that it is not always easy to distinguish a mineral lease, which grants an exclusive right to use the property, from the grant of an exclusive right to possession and control of the estate under a lease:

> It is not always easy, however, to distinguish between a profit and a lease, because the use under a profit can be "exclusive" and the holder of the profit may make "some quite substantial uses that look much like possession. . . . the holder of a profit to mine minerals may install surface buildings and heavy equipment." *Id.* [*Stoebuck*, § 2.1, at 80.] Distinguishing between such property interests is further complicated by the "popular" use of the term "lease" to refer to mineral or coal mining profits. *Stoebuck*, § 6.1, at 295. It is, however, possible to enter into a true lease involving mineral rights. *Id.* ("A true mineral lease is possible if there is a transfer of a severed stratum of underground minerals, similar to a severance deed, but for the term of a leasehold.").

On reconsideration, with the presentation of evidence of how the different parcels are used, we must now consider for each parcel whether we are in fact dealing with mineral leases or the lease of real estate.

Parcel A:

The royalty income during the period at issue appears, at least in part, to have arisen from the taxpayer's grant of the right to the gravel company to transport across [Rock Company]'s property sand and gravel extracted from the sand and gravel company's land and sand and gravel extracted from the third-party's land. During the period at issue, no materials were extracted from the property owned by taxpayer [Rock Company], but it received a payment for all materials moving across its property for sale. One court in considering a similar agreement stated that such agreements are called a "wheelage clause" in the mining industry, and may involve the rental of the real estate, rather than the payment of royalties under a profit a prendre

for federal tax purposes. See *Logan Coal & Timber Assoc. v. IRS*, 42 BTA 529 (U.S. Bd. Of Tax Appeals 1940), *aff'd*, 122 F.2d 848 (3rd Cir. 1941), and cases cited therein. *See also Pleasanton Gravel Co. v. IRS*, 85 T.C. 839 (1985). In considering the wheelage issue, the Board in *Logan* concluded:

> From the above cases it would appear that, if provision is made in a coal lease for definite payments for the use of the land for transportation of coal from other lands under a "wheelage clause", such payments may be true rents and not a part of the royalties based upon the amount of coal mined from the lease involved. In the instant case, however, the only consideration provided in the lease was payment computed on the basis of coal mined . . . . No separate consideration on account of transportation of coal from other lands was provided in the lease. We think it obvious that the prime consideration for the contract was the payment based upon coal mined and we hold that such payment constituted royalties within the intent and meaning of the revenue statutes here being considered . . . . If we should assume that some part of the consideration for the payments made to petitioner was for the privilege of transporting coal from other lands, the record herein contains no evidence upon which to base a division between royalties and any rent for the transportation privileges, or to find error on the part of the respondent in treating the payments in question as royalties.

In the present case, the records may provide a basis [for the taxpayer to prove that a portion of the income was rental income under a wheelage clause, not] income related to the use of the property, and the taxpayer will be given the opportunity to provide the Audit Division with records [providing such proof. [5]]

[Also,] under the facts as presented, a portion of the income received by taxpayer [Rock Company] appears to be from the extraction of sand and gravel from the adjacent third-party parcel, in accordance with [Rock Company]'s agreement with the owner of that parcel. There was no assignment of the mineral lease from [Rock Company] to the gravel company and the gravel company appears to have extracted the sand and gravel on [Rock Company]'s behalf. As such, [Rock Company] appears not to be receiving income from the use of its real property either on a profit or on a rental basis, but from the sale or extraction of the materials from the adjacent property. Depending on whether the records adequately distinguish between the activities, such income may be taxed under the extracting or wholesaling B&O tax rate, a lower rate than the service and other activities rate. That issue is also remanded to the Audit Division with respect to Parcel A.

Parcels B & C:

Although designated as royalties, the taxpayer received rental income on Parcels B & C. Whether income is designated as royalties or rent is not controlling. *See, e.g.,* WAC 458-20-

[5] [We are remanding to allow the taxpayer to provide proof that its records show a wheelage clause and, if so, a previously negotiated value for the wheelage clause, and that the wheelage activity is not merely incidental to the primary activity of extraction.]

235(5). According to the taxpayers' statements, there was no mining or extracting of sand and gravel from these properties and no mining permit was in place for these properties. The payments were not for the exclusive right to explore and to reduce the sand and gravel to possession, and thus acquire title, as occurs with a profit a prendre. Rather, the payments were for the gravel company's exclusive possession and control of the property, for purposes unrelated to the extraction of sand and gravel from the properties. Accordingly, we reverse the Department's assessment with respect to Parcels B & C.

Parcels D, E, & F:

The objective evidence supports a finding that the royalty payments for Parcels D, E & F were in the nature of royalties under a profit a prendre rather than under a lease of real estate. The subject matter of the leases was the profit to be gained from depleting the natural resources, and the use of the property was in furtherance of the rights to extract the sand and gravel. It is obvious that the prime consideration for the contracts was the payment based upon the sand and gravel extracted and sold from the property, and not for any purported exclusive right to possess and control the property. The fact that the parties also referred to the payments as royalties, rather than rent, that payment was solely on a per ton or cubic yard basis, and that the agreements were also not reduced to writing, as might be expected with long-term leases of real estate, also support such a finding. The erection of buildings and the use of heavy equipment for extracting, crushing, processing, and transporting the sand and gravel is consistent with the use of the property under typical mineral leases and does not lead to a contrary finding. Further, no evidence was presented of any use by the mineral lessees of the property for purposes other than those related to the use of the property for the extraction, processing, and sale of the minerals.

Accordingly, we hold that such payments constituted royalties subject to the service and other activities B&O tax under the applicable revenue statutes and rules. We sustain the Department's assessment of service and other activities B&O tax on royalty payments the taxpayers received in exchange for granting the gravel companies the rights to remove minerals from and to use Parcels D, E, & F.

DECISION AND DISPOSITION

The taxpayers' petition for reconsideration is granted in part and denied in part. The case is remanded to the Audit Division for adjustment in accordance with this decision. The taxpayer will have 60 days following issuance of this determination to present records with respect to the division and nature of the income received for Parcel A.

Dated this 28th day of August 2001.