Cite as Det. No. 99-316, 19 WTD 850 (2000)

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. 99-316[1]
	)	
. . .	)	Real Estate Excise Tax Assessment

[1] RULE 458-61-430; RULE 458-61-080; RCW 82.45.060: REAL ESTATE EXCISE TAX ("REET") – SALE – TRANSFER OF IMPROVEMENTS ON LEASED LAND. Unless a specific exemption applies, transfers by lessees of lessee-owned improvements are subject to REET (regardless of who holds title). On the other hand, where the lessor owns the improvements, and the lessee is transferring only its leasehold interest in the improvements, REET does not apply.

[2] RULE 458-61-430; RULE 458-61-080; RCW 82.45.060: REAL ESTATE EXCISE TAX ("REET") – SALE – TRANSFER OF IMPROVEMENTS ON LEASED LAND – OWNERSHIP OF IMPROVEMENTS. The lessee is deemed to own the improvements on leased land where the lease was long-term, the lessee was required to construct the improvements, the lessee agreed to use the property exclusively in the manner specified in the lease, the lessee was required to restore any damaged improvements, the lessee was required to maintain insurance naming the lessors as insured, and the plain language of the lease provided that the improvements shall "become" the property of the lessor at the termination or expiration of the lease.

[3] RULE 458-61-430; RCW 82.45.030: REAL ESTATE EXCISE TAX ("REET") – SELLING PRICE. Where property is sold in an arm's length transaction between unrelated persons for a valuable consideration, a rebuttable presumption exists that the selling price is equal to the total consideration paid. If the selling price of the improvements on leased land was separately stated, then the tax is properly assessed based on the total consideration paid. On the other hand, if the selling price for the

[1] The reconsideration determination, Det. No. 99-316R, is published at 19 WTD 862 (2000).

> improvements was not separately stated, or cannot be reasonably determined, the market value assessment for the property maintained on the county property tax rolls at the time of the sale shall be used as the selling price.

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:

The taxpayer appeals a ruling from the Miscellaneous Tax Section, which held that a transfer of improvements on leased property is subject to the real estate excise tax. The taxpayer paid the tax and requests a refund.[2]

FACTS:

C. Pree, A.L.J. -- The taxpayer requested a ruling from the Miscellaneous Tax Section that a proposed transfer of improvements on leased property would not be subject to the real estate excise tax ("REET"). The taxpayer appeals the Miscellaneous Tax Section's adverse ruling. Based on the Miscellaneous Tax Section's adverse ruling, the taxpayer paid the tax and now requests a refund.

In 1986, the taxpayer leased a tract of commercial real estate ("the premises") under a ground lease. The taxpayer then developed the premises into a commercial site and subleased it to third parties. In its ruling request, the taxpayer recited the following terms of the ground lease as relevant to its request:

1. The Lessor conveys the possession of the Premises at the commencement of the lease free and clear of any encumbrances [2.2(b)].
2. The term of the lease expires 55 years after the commencement date [2.3(a)].
3. The Taxpayer agrees to pay all costs relating to demolition, site work, construction, landscaping and other construction costs.
4. The Taxpayer agrees to make lease payments to the Lessor based on a complex mix of minimum rent schedule and/or a percentage of net lease payments collected [4.2 through 4.5].
5. The Taxpayer agrees to use the Premises exclusively in the development and leasing of a "first class commercial" facility consistent with the terms of the <u>Ground Lease</u> [5.1]. No additional improvements may be made without the Lessor's consent.
6. The Taxpayer agrees to maintain at the Taxpayer's expense the premises "as a reasonable and prudent investor would. [8.1]."
7. If the Taxpayer fails to maintain the facilities, the Lessor may cause the necessary repairs at the expense of the Taxpayer [8.2].

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[2] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

8. At the termination of the Ground Lease, the Taxpayer must surrender the Premises to the Lessor [8.3].
9. At the termination date, "all existing improvements together with all the right, title and interest of Lessee in the then existing subleases shall unconditionally be and become the property solely of Lessor, and no compensation therefor shall be due or paid by Lessor to Lessee for any part thereof. . . . Lessee shall surrender to Lessor the Premises and any then existing improvements in good order, condition, and repair, reasonable wear and tear excepted, free and clear of all liens, claims and encumbrances . . . . Any then existing improvements to the Premises shall become the property of the Lessor without the payment of any consideration to the Lessee [10.1(1)].
10. The Taxpayer may not permit any liens, mortgages and encumbrances against its improvements in the Premises [11.1,3].
11. The Taxpayer may assign its interest in the Ground Lease [12.1].
12. The Taxpayer agrees to repair or restore the Premises in the event that the Premises are damaged or destroyed, subject to a right to terminate in certain instances [19.1,2,3].
13. The Lessor retains the right to subordinate the Taxpayer's interest in the Ground Lease with mortgages [20.1(a)].
14. The Lessor retains the right of first refusal and an option to purchase the Taxpayer's interest in the Ground Lease for a fair market value as determined by up to three appraisers.
15. The Taxpayer may invoke an election wherein the Lessor may either buyout the Taxpayer's leasehold interest or agree to sell the premises at fair value [23].

We note that the ground lease also provides under "basic lease provisions," after the lease term of 55 years, "OPTIONS: None." (Sec. 1.1.) Further, the lease requires the taxpayer to pay all taxes "as additional rent" (Sec. 9.1.) and to insure the improvements, with the lessor named as the insured (Sec. 14.1). Additional text in section 10.1, which was cited by the taxpayer above, provides:

> On the Termination Date . . . (i) all existing improvements . . . shall unconditionally be and become the property solely of Lessor, and no compensation therefor shall be due or paid by Lessor to Lessee for any part thereof **and this Lease shall operate as a conveyance and assignment thereof."**

(Emphasis added.)

On May 23, 1986, the parties amended the lease to provide, in part, as follows:

> Both lessor and lessee shall have the right, commencing on the first day of the twenty-fifth (25th) year of the Lease Term,[3] and continuing yearly thereafter during the remainder of the Lease Term, to elect to institute the procedure (the "Buy-Sell Procedure"). . . .
>
> [The electing party shall] state that the Electing Party will purchase the Offeree's Land Value interest (as defined below), if the Offeree is the Lessor, or the Offeree's Leasehold Value (as defined below), if the Offeree is the Lessee . . . .
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> [T]he term "Land Value" shall mean the fair market value of the real estate (exclusive of the building and improvements then constructed on the real estate. . . .[T]he term "Leasehold Value" shall mean the fair market value of the Lessee's leasehold estate and shall include (i) the current fair market value of the then existing buildings on a debt free basis and (ii) recognizing all of the rights and obligations of the Lessee under the terms of this Lease . . . .
>
> The purchase price of the Land or leasehold interest shall be the Land Value or the Leasehold Value, as the case may be . . . .
>
> If the Offeree is the Lessee, the Offeree shall be required to accept the offer in the Notice, and the Election shall state that the Offeree accepts the Electing Party's offer to purchase the Offeree's Leasehold Value . . . .
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> If the Offeree is the Lessor, then the Election shall state that:
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> (1) The Offeree accepts the Electing Party's offer to purchase the Offeree's interest at the value determined by the appraisers . . . or
> (2) The Offeree rejects the Electing Party's offer to purchase the Offeree's interest. . . but with the obligation that the Offeree shall purchase the Electing Party's interest at the value as determined by the appraisers . . . .

(Footnote added.)

In 1997, the taxpayer transferred its interests under the lease agreement to an unrelated third party for consideration. The Miscellaneous Tax Division held that this transfer was subject to REET. The Taxpayer argues that this transfer was not subject to REET.

Further, if we uphold the tax, the taxpayer argues that the REET was imposed on an inflated value. Specifically, the taxpayer argues:

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[3] This provision was subsequently amended to read "commencing on the first day of the 326th month after the Commencement date, and continuing on the anniversary of such date thereafter during the remainder of the Lease Term."

> [T]he appropriate method of determining the taxable value of that assignment is to refer to the value of the improvement as stated on the county tax roles.

In response, the Miscellaneous Tax Section stated:

> In all the documentation you have provided, I could find no identified price for the assignment of [your] interest in the improvement. From the filed affidavit, it appears that the price was $. . . . If this is the price paid for the assignment, then the tax was correctly paid. Only if the assignment price could not be reasonably determined, would the assessed value of the improvement be used as the selling price.

ISSUES:

1. Whether application of REET to a lessee's transfer of improvements on leased property depends on whether the lessee owns the improvements.
2. Whether the taxpayer owned the improvements at issue.
3. If the taxpayer's transfer is subject to REET, whether the tax should be based on the value of the improvements, as stated on the county tax roles.

DISCUSSION:

[1] RCW 82.45.060 imposes REET on "sales" of real property. RCW 82.45.010 defines "sale," for REET purposes, in pertinent part as follows:

> (1) 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 . . . 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[4] . . . or any estate or interest therein. . . . **The term also includes the grant, assignment, quitclaim, sale, or transfer of improvements constructed upon leased land.**
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> . . .
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> (3) The term "sale" shall not include:
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> . . .
>
> (b) A transfer of any leasehold interest other than of the type mentioned above.

(Footnote and emphasis added.) The highlighted language, which was added to the statute in 1993, is at the heart of this appeal.

[4]Neither the taxpayer nor the Miscellaneous Tax Division contends that the taxpayer had a lease with an option to purchase the property.

The taxpayer argues that the statute "includes some ambiguous language as it relates to the assignment of leasehold interests wherein a lessee makes improvements on behalf of a third party lessor of land." The taxpayer argues that, to the extent there is any ambiguity in the statute as to whether the legislature intended to tax an agreement of the type in question, the ambiguity should be resolved in favor of the taxpayer. However, in Washington Mutual Savings Bank v. Department of Revenue, 77 Wn. App. 669, 676 n.4, 893 P.2d 654 (1995), the court addressed the issue of whether a provision of the leasehold excise tax should be narrowly construed. The court reasoned:

> Both parties cite statutory interpretation principles which suggest that, in the event of doubt, the statute should be construed against the other party. See Ski Acres, Inc. v. Kittitas Cy., 118 Wn.2d 852 , 857, 827 P.2d 1000 (1992) (taxation statutes construed against [the] taxing authority); Corporation of Catholic Archbishop v. Johnston, 89 Wn.2d 505, 507, 573 P.2d 793 (1978) (tax exemptions construed against the taxpayer). Because this unique statutory framework is such that the taxation and exemption from taxation are to be construed coextensively with one another, these guidelines are not helpful or persuasive. Cf., MAC Amusement Co. v. Department of Rev., 95 Wn.2d 963 , 966, 633 P.2d 68 (1981).

Although Washington Mutual addressed the leasehold excise tax, rather than REET, we find the court's analysis persuasive here. Specifically, we note that the highlighted language in the statute is a part of a "taxation statute," which should be "construed against [the] taxation authority." However, section three of the statute is also at issue. This section provides an exclusion or exemption from tax, which should be "construed against the taxpayer." As such, we will give "effect to the words of the statute with reference to the context of the word and the general purpose of the statute." Washington Mutual, 77 Wn. App. at 676.

The legislative history to the 1993 amendments to the definition of "sale" provides guidance in determining the general purpose of the REET statutes. In 1993, in addition to adding the language at issue, the legislature amended the definition of sale to include certain transfers of ownership in certain entities. The legislature reasoned:

> The legislature finds that transfers of ownership of entities may be essentially equivalent to the sale of real property held by the entity. The legislature further finds that **all transfers of possession or use of real property should be subject to the same excise tax burdens**.

(Emphasis added.) We note that the legislature primarily addressed the extension of the REET to transfers of entity ownership in the legislative history. However, we find the legislature's overriding purpose in making the 1993 amendments, i.e., to subject "all transfers of possession or use of real property . . . to the same excise tax burdens," provides guidance in the resolution of this appeal. Specifically, unless an exemption applies, if the taxpayer's transfer of the improvements constitutes a "transfer of possession or use of real property," the transfer will be subject to REET.

The taxpayer construes the highlighted statutory language as follows:

> If a lessee creates a leasehold improvement to which, under Washington law, it retains title, and later transfers, sells or assigns such improvement to another, the later transfer will be subject to the REET. . . .

The Miscellaneous Tax Division, on the other hand, construes the highlighted language to encompass the transfer of **any** leasehold improvement, regardless of whether it is owned by the lessee/transferor. It states:

> In this case, there is an improvement constructed upon land, the lessee has a lease to that land and improvements, and they are transferring their leasehold rights to the land and improvements for consideration. Therefore, any assignment or transfer of an interest in an improvement constructed upon leased land would be subject to real estate excise tax.

We find the taxpayer's interpretation of the statutory language to be more persuasive. However, we find the taxpayer's use of the term "title," rather than "ownership," to be overly restrictive. In other words, unless a specific exemption applies, we hold that all transfers by lessees of lessee-owned improvements are subject to REET (regardless of who holds title).

The Miscellaneous Tax Section cites WAC 458-61-430(2) in support of its position. That rule provides: "The transfer of a lessee's interest in a leasehold for a valuable consideration is taxable to the extent the transfer includes any improvement constructed on leased land." However, this rule must be read in conjunction with RCW 82.45.010.[5] According to RCW 82.45.010, the "sale, or **transfer of improvements** constructed upon leased land" is subject to REET. (Emphasis added.) If the lessee does not own the improvements, it cannot "**transfer . . . improvements**," it can only transfer its leasehold interest in the improvements. Thus, to be consistent with the statute, the language in WAC 458-61-430 should be read to mean that REET applies only to the transfer of leasehold improvements where the lessee owns the improvements.

Our interpretation of WAC 458-61-430 is not only consistent with the statute, it is the only reading that is consistent with another rule, WAC 458-61-080, which sets forth the requirements for filing a REET affidavit. The rule, which was amended after the amendment to the statutory definition of "sale" to include transfers of improvements on leased land, provides:

> (3) When affidavit is required. Except for the transfers listed under subsection (4) of this section, the real estate excise tax affidavit is required for all transfers of real property including, but not limited to, the following:
>
> (k) A lease of real property that transfers lessee-owned improvements;
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> . . .

[5]Administrative rules may not amend or change enactments of the legislature. See, e.g., 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).

> (4) When affidavit is not required. The real estate excise tax affidavit is not required for the following and county treasurers shall not take affidavits for these specific types of transactions:
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> . . .
>
> (c) A lease of real property that does not transfer lessee-owned improvements. . . .

Thus, WAC 458-61-080 recognizes that REET applies when lessee-owned improvements are transferred. On the other hand, where the lessor owns the improvements, and the lessee is transferring only its leasehold interest in the improvements, REET does not apply.

[2] The next issue is whether the taxpayer owned the improvements at issue. The taxpayer argues:

> On the date of assignment, the Taxpayer only assigned its right to occupy the leasehold premises. The leasehold improvements had been assigned or transferred to the lessor upon construction over ten years prior to the assignment of leasehold rights. . . .
>
> In the present matter, the right that was assigned by the Taxpayer was only a possessory right. It is clear from the language of the ground lease that the Taxpayer did not have any ownership rights in the improvements and therefore could not transfer any ownership rights in the improvements. Accordingly, because the statute does not apply the real estate excise tax to the transfer of the right to possess an improvement, the tax is not applicable to the Taxpayer's assignment.

The court of appeals recently addressed the issue of whether the lessee or the lessor (a school district) owned improvements constructed on the lessor's property. Washington Mutual, 77 Wn. App. 669. If the lessee owned the improvements during the term of the lease, the improvements would be subject to personal property tax. See RCW 84.36.005. In contrast, if the lessor owned the improvements, the improvements would be subject to leasehold excise tax. See RCW 82.29A.020. In resolving the issue of who was the owner of the improvements, the court focused on the question of whether the parties intended the lessee or the lessor to be the owner. In answering this question, the court analyzed the terms of the lease. The court noted the following:

> As a contract, a lease can allocate who owns the improvements during and after the term of the lease, notwithstanding common law default rules. Cf. SSG Corp. v. Cunningham, 74 Wash. App. 708, 711, 875 P.2d 16 (1994) (modern rule is that intention of parties govern whether building constructed on leasehold is personal property of builder).

The court analyzed the parties' lease agreement to determine their intent and held:

> [B]y the plain language of the lease agreement the improvements here at issue are to remain the property of the lessee during the term of the lease and will not become the property of the lessor until the expiration or earlier termination of the lease.

77 Wn. App. at 671. Thus, the court held that the county properly imposed personal property tax on the improvements.

Similarly, the issue here is whether the lease agreement supports the taxpayer's argument that the parties intended the lessor, rather than the taxpayer, to own the improvements from the inception of the lease. As the court held in Washington Mutual, we also hold that the lessee (taxpayer) owned the improvements during the term of the lease. Thus, we find that the Miscellaneous Tax Division properly imposed REET on the taxpayer's transfer of the improvements.

The facts in Washington Mutual are similar to the facts here and support our conclusion. Both leases were long-term. In Washington Mutual, the lessee had a 99 year ground lease; in this case, the taxpayer has a 55 year ground lease. Further, both leases required the lessees to construct the improvements, subject to restrictions set by the lessor. Specifically, the Washington Mutual lease required the lessee to construct and operate office/retail space on the property. The buildings were to be constructed pursuant to a design approved by the school district, and the lessee could neither replace the improvements with improvements of lesser value nor make any changes to the plans without giving notice to the school district. In this case, the Taxpayer agreed to use the property exclusively in the development and leasing of a "first class commercial" facility; no additional improvements could be made without the lessor's consent.
In addition, in Washington Mutual, the lessee was required to restore any damaged improvements. Similarly, the taxpayer here is required to maintain at its expense the premises "as a reasonable and prudent investor would" and to repair or restore the property in the event it is damaged or destroyed. Both the taxpayer and the lessee in Washington Mutual were required to maintain insurance, naming the lessors as insured.

Perhaps most importantly, the plain language of both the lease at issue here and the lease at issue in Washington Mutual provides that the improvements shall "become" the property of the lessor at the termination or expiration of the lease. Specifically, in Washington Mutual, the lease agreement provided:

> During the term of this Lease, the Improvements constructed by Lessee . . . shall be the property of the Lessee. **At the expiration or earlier termination of this Lease, the Improvements . . . shall become the property of the lessor.**

(Emphasis added.) In this case, the lease agreement provides:

> **On the Termination Date . . . (i) all existing improvements . . . shall unconditionally be and become the property solely of Lessor**, and no compensation therefor shall be due or paid by Lessor to Lessee for any part thereof and this Lease shall operate as a conveyance and assignment thereof."

(Emphasis added.) The lessee in Washington Mutual argued that, because it already owned the right to use and occupy the land during the term of the lease, the above language should be interpreted to mean that the lessee acquired only the right to use and occupy the improvements during the term of the lease, and not the ownership of the improvements. The court disagreed. The court reasoned:

> [The lease provides] that the improvements "shall become the property" of the lessor after the lease expires or is earlier terminated. If the lessee only owns a right to use and occupy the improvements and does not own the improvements themselves, this provision is unnecessary. . . .
>
> A more harmonious interpretation of [the lease] is its plain meaning: that the lessee owns the improvements during the term of the lease and that the improvements shall become the property of the lessor at the expiration or earlier termination of the lease.

77 Wn. App. at 675. We find the court's reasoning applicable here. If the lessor were the owner of the improvements throughout the lease term, the highlighted language would be surplus. Specifically, if the lessor already owned the improvements, there would be no need to recite that the improvements "shall be and become" the property of the lessor.

In addition to the facts the court in Washington Mutual considered, we find the "buy-out" provisions in the taxpayer's lease to be probative of the parties' intent that the taxpayer would own the improvements during the term of the lease. Under the buy-out provisions, after a date specified in the lease, the lessor was required to respond to an offer by the taxpayer to purchase the lessor's property at "fair market value of the real estate (exclusive of the building and improvements then constructed on the real estate." The lessor was required to respond to the offer either by accepting the taxpayer's offer to purchase the land or by purchasing the improvements from the taxpayer at "the current fair market value of the then existing buildings on a debt free bases . . . recognizing all of the rights and obligations of the Lessee under the terms of this Lease." If the lessor were the owner of the improvements during the term of the lease, there would be no reason to require the lessor to purchase the improvements from the taxpayer at their "current fair market value." If the buy-out provision was intended to be a liquidated damages clause, it would seem reasonable that the lessor's payment would reflect the value of the taxpayer's use of the property for the length of time remaining in the lease, not the fair market value of the improvements.

The taxpayer argues that Det. No. 89-312, 8 WTD 29 (1989), supports its position. However, we note that the determination was decided prior to the amendment of the definition of "sale" in RCW 82.45.010. Further, the determination was decided prior to the court's decision in Washington Mutual, and it relies on reasoning that is inconsistent with that decision. Thus, to the extent Det. No. 89-312 is inconsistent with this determination, it is hereby overruled.

[3] The final issue is whether the selling price should be measured by "the value of the improvement as stated on the county tax roles," as the taxpayer contends, or the sales price, as the Miscellaneous Tax Section contends.

RCW 82.45.030 defines "selling price" as follows:

> (1) "[S]elling price" means the true and fair value of the property conveyed. If property has been conveyed in an arm's length transaction between unrelated persons for a valuable consideration, a rebuttable presumption exists that the selling price is equal to the total consideration paid . . . .
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> .
>
> (4) If the total consideration for the sale cannot be ascertained or the true and fair value of the property to be valued at the time of the sale cannot reasonably be determined, the market value assessment for the property maintained on the county property tax rolls at the time of the sale shall be used as the selling price.

WAC 458-61-430(3) explains, "If the selling price of an improvement [on leased land] is not separately stated, or cannot otherwise be reasonably determined, the assessed value of the improvement as entered on the assessment rolls of the county assessor will be used." This rule goes on to state:

> (10) "Selling price" means the true and fair value of the property conveyed. A rebuttable presumption exists that the true and fair value is equal to the total consideration paid or contracted to be paid to the transferor or to another for the transferor's benefit.
>
> (a) When the price paid does not accurately reflect the true and fair value of the property, one of the following methods may be used to determine the true and fair value:
>
> (i) A fair market value appraisal of the property; or
>
> (ii) An allocation of assets by the seller and the buyer made pursuant to section 1060 of the Internal Revenue Code of 1986, as amended.
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> (b) When the true and fair value of the property to be valued at the time of the sale cannot reasonably be determined by either of the methods in (a) of this subsection, the market value assessment for the property maintained on the county property tax rolls at the time of the sale shall be used as the selling price. (RCW 82.45.030)

The transaction at issue was "an arm's length transaction between unrelated persons for a valuable consideration." As such, under RCW 82.45.030(1), "a rebuttable presumption exists that the selling price is equal to the total consideration paid." However, it is unclear from the information we received whether the selling price of the improvements was separately stated. If the selling price of the improvements was separately stated, then the tax is properly assessed based on the total consideration paid. See RCW 82.45.030(1), (4). On the other hand, if the selling price for the improvements was not separately stated, or "cannot be reasonably determined," RCW 82.45.030(4) mandates that the "market value assessment for the property maintained on the county property tax rolls at the time of the sale shall be used as the selling price." See WAC 458-61-430(3).

This issue is remanded to the Miscellaneous Tax Division to allow the taxpayer the opportunity to provide information to support its argument that the selling price of the improvements cannot reasonably be determined. The taxpayer bears the burden of providing that the selling price was not equal to the total consideration paid. See RCW 82.45.030(1).

DECISION AND DISPOSITION:

The taxpayer's petition for refund is denied in part. The taxpayer's petition is remanded to the Miscellaneous Tax Division with respect to the valuation issue. The taxpayer has 60 days from the date of this determination to provide such information. If the taxpayer fails to provide this information, the taxpayer's petition will be denied.

Dated this 30th day of November, 1999.