Cite as Det.No. 96-098, 19 WTD 187 (2000)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment	)	D E T E R M I N A T I O N
	)	No. 96-098
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

[1] RCW 82.29A.020: LEASEHOLD EXCISE TAX -- RECOMPUTING TAXABLE RENT -- DUE PROCESS. It is not a denial of due process for the Department to retroactively recompute taxable rent in excess of contract rent when that authority is specifically granted by statute.

[2] RCW 82.29A.020: LEASEHOLD EXCISE TAX -- TAXABLE RENT -- RECOMPUTING TAXABLE RENT -- SANCTIONED METHODS. The Department may recompute taxable rent in excess of contract rent when the lease was not established pursuant to one of the three sanctioned methods.

[3] RCW 82.29A.020(2)(b): LEASEHOLD EXCISE TAX -- TAXABLE RENT -- RECOMPUTING TAXABLE RENT -- CRITERIA. When the Department recomputes taxable rent in excess of contract rent under RCW 82.29A.020(2)(b), it is required to consider both comparable sales and information on a fair rate of return.

[4] RCW 82.29A.020(2)(a): LEASEHOLD EXCISE TAX -- TAXABLE RENT -- RECOMPUTING TAXABLE RENT -- RENEGOTIATED LEASE. If a lease has been renegotiated within the last ten years, the Department may recompute taxable rent in excess of contract rent unless the renegotiated contract was established through one of the three sanctioned methods.

[5] RCW 82.32.105; RCW 82.32A.030; RULE 228: INTEREST -- WAIVER -- GROUNDS. Taxpayers are responsible for knowing their tax reporting obligations or to seek instructions from the Department when they are uncertain. The fact that the Department may not have specifically informed a taxpayer that it was reporting incorrectly is an insufficient reason to waive interest.

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:

A lessee of a port protests additional leasehold excise taxes assessed in excess of contract rent. [1]

FACTS:

Okimoto, A.L.J. -- Taxpayer is a partnership that leases real property from a Washington port (the Port). The Audit Division (Audit) of the Department of Revenue (Department) examined Taxpayer's lease with the Port for the period January 1, 1991 through December 31, 1994. The examination resulted in additional leasehold excise taxes and interest owing. Taxpayer protested the entire amount and it remains due.

In August 1976, Taxpayer entered into a lease with the Port for 2.316 acres located at an industrial park. The lease began in September 1976, and extended for a term of 30 years. It contained four successive five-year automatic renewal terms. The lease established a yearly rent of $750 per acre for the first 20 years of the lease. After the first 20 years, the annual rental payments were to be recomputed pursuant to a land rent formula contained in the lease (7% of fair market value less certain credits for investments).

The lease allowed Taxpayer to construct and rent leasehold improvements on the property. Title to the improvements remained with Taxpayer during the lease term and could be removed by Taxpayer. Title to all unremoved improvements would pass to the Port ninety days after termination of the lease.

In February 1982, the parties modified the lease to increase the amount of acreage to 2.73. The basic terms of the lease remained unchanged.

In its examination for the years 1991 through 1994, Audit determined that Taxpayer's lease payments to the Port were below market rate for comparable commercial property. In the alternative, Audit determined that the lease had been in effect more than ten years without being renegotiated. Based on these determinations, Audit recomputed the amount of leasehold excise tax due based on a fair rate of return on the market value of the property. To determine the fair rate of return, Audit used the Port's current annual rental guidelines of 10% of the appraised market value of the property. This information was supplied to Audit by the Port's Assistant Executive Director, who in turn based his opinion on a real estate appraiser's report. Audit computed the fair market

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

value of the acreage at sixty-five cents per square foot which converts to $28,000 per acre. Audit then applied a 10% rate of return factor to arrive at a fair market rental value of $2,800 per acre.

By multiplying 2.316[2] acres times $2,800, Audit concluded that the fair market rental of the property was $6,485 per year and assessed leasehold excise tax on that amount less amounts previously paid. Taxpayer had paid leasehold tax on $750 per acre for a total of $1,737 per year.

TAXPAYER'S EXCEPTIONS:

First, Taxpayer argues that it is an unjust denial of due process for the Department to retroactively compute taxable rent in excess of contract rent. Taxpayer relies on the Washington Supreme Court case of Japan Line v. McCaffree, 88 Wn.2d 93, 558 P. 2d 211 (1977) in support of its position.

Second, Taxpayer contends that RCW 82.29A.020(2)(b) requires, as a prerequisite to the Department's ability to establish any taxable rent in excess of contract rent, that the Department must make findings that the lease was not (1) established through competitive bidding; or (2) negotiated in accordance with statutory requirements regarding the rent payable; or (3) negotiated under circumstances clearly showing that the contract rent was the maximum attainable by the lessor. Taxpayer argues that the Department has failed to make such a finding.

Taxpayer points to RCW 53.08.080, which allows port districts great latitude in determining the amount of rent to be received from rental property. Taxpayer contends that the Port negotiated rent pursuant to those statutory requirements and therefore has complied with the second method. Taxpayer further disputes Audit's contention that the lease has been in effect for more than ten years without being renegotiated. Taxpayer argues that the lease was renegotiated in 1982 when the size of the parcels being rented was modified.

Taxpayer also contends that its lease with the Port reflected the fair market rental for the property at the time it was negotiated. Taxpayer contends that this satisfies the requirements stated in RCW 82.29A.020(2)(a).

Third, even assuming that taxable rent does not equal contract rent, Taxpayer believes that Audit computed taxable rent incorrectly. Taxpayer points to RCW 82.29A.020(2)(b) and states that the Department is required to consider both comparable rentals in addition to the fair rate of return on the market value of the property. Taxpayer further contends that this rate of return must be adjusted for any restrictions on the property's use. Taxpayer states that Audit considered neither comparable sales, nor restrictions on use in determining taxable rent. Taxpayer points out that the property was acquired from the United States Government and its deed restricts usage of the property to only "industrial facilities." If it is used for any other purpose, the federal government has the option to

[2]There appears to be a discrepancy between the 2.316 acreage used by Audit in computing the amount of leasehold taxes due and the 2.73 acreage covered by the 1982 lease revision. This issue is remanded to Audit for verification.

reclaim the property. Taxpayer states that this significant restriction was not considered by Audit. Taxpayer argues that Audit relied solely on rental guidelines which the Port had recently established for current newly-executed leases of unimproved raw land without restrictions.

Fourth, Taxpayer states that it has faithfully paid leasehold excise taxes based upon the rent provided in the lease. Prior to the assessment, Taxpayer had received no notice from the Department that additional leasehold taxes may be due. Now, over five years later, the Department is assessing interest in addition to back taxes which Taxpayer had no reasonable notice or opportunity to timely pay. Taxpayer believes that such action is arbitrary and capricious and seeks a waiver of interest.

Fifth, Taxpayer argues that the lease modification entered into in February 1982 which changed the amount of property leased from 2.316 acres to 2.73 acres constituted a renegotiation of the lease. Therefore, Taxpayer argues that since the lease had been renegotiated within the last ten years, the Department was precluded from establishing taxable rent in excess of contract rent for the years 1991 and 1992.

After the teleconference, Taxpayer filed supplemental information regarding the Port's efforts to obtain a fair market rental value for the properties involved. Taxpayer states in its letter of May 1, 1996:

> I have reviewed the minutes of the meetings of [the Port] Commission during the periods of time relevant to these leases, i.e. 1973-78. I attach to this letter the following documents from [the Port] which I believe establish the policy of the Port to obtain the fair rental value for its property.
>
> 1. Appraisal dated . . . 1978 of the Fair Market Rental value of [the Port's] property in [an industrial park]. Pages 1 and 6 of the appraisal give the appraisers conclusions. The property subject to the leasehold tax appeal falls primarily in the third column of the last category, i.e. $700.00 per acre per year.[. . .]
>
> 2. Minutes of [the Port's] meeting of . . . 1973 and Resolution . . . of the Commission agreeing to sell property at [an industrial park] for $4,000.00 per acre. Based upon the Port's formula for rents at 7% of the market value of the property this would establish a rental value of $280 per acre per year. (A 10% return would establish a value of $400 per acre per year.)
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> 3. Resolution . . . of the Port Commission dated . . . 1974 agreeing to sell an additional parcel of land at [an industrial park] for $4,000.00 per acre.
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> 4. Minutes of the . . . 1975 meeting of the Port Commission. Item No. 8 discusses the Commission's policy with regard to the lease of property at [an industrial park]. Item No. 12 approves the proposed sale of land to [. . .] for $8,000 per acre. (At 7% this

would establish a rental rate of $560 per acre per year and at 10% this would establish a rental rate of $800 per acre per year.)

5. Minutes of the Port Commission meeting of . . . 1976. Item No. 12, establishes the Port . . . policy to charge rent at the current market rates.

6. Minutes of the Port Commission meeting of . . . 1976. Item 4-A is the adoption by the Port of its rental policy. You will note that Item 4 was the approval of the [Taxpayer] lease and a copy of the rental formula was attached to the [Taxpayer] lease as Exhibit B (a copy of which was previously provided to you.)

7. Minutes of the Port Commission meeting of . . . 1976. Item No. 3 discusses the [. . .] lease and denies its request to modify the lease policy to cap the amount of any rent increases.

8. Minutes of the Port Commission meeting of . . . 1977. Item No. 5 approves the use of [. . .] Appraisals for the purpose of establishing the fair market rental value of the Port's property.

9. Minutes of the Port Commission meeting of . . . 1977. Item No. 11 adopted a policy for rental reviews every three years.

10. Minutes of the Port Commission meeting of . . . 1978. Item No. 5 authorizes the employment of a [. . .] Appraiser for the purpose of establishing the rental values of the property at [an industrial park].

(Brackets and underlining added.)

ISSUES:

1. Is it a denial of due process for the Department to retroactively recompute taxable rent in excess of contract rent in a leasehold excise tax audit assessment?

2. Under what circumstances may the Department recompute taxable rent in excess of contract rent?

3. What factors must the Department consider when it recomputes taxable rent in excess of contract rent under RCW 82.29A.020(2)(b)?

4. May the Department recompute taxable rent in excess of contract rent when the lease has been renegotiated within the last ten years?

5. May interest be waived in an audit assessment where the Department did not specifically notify a Taxpayer of its potential leasehold excise tax liability in excess of contract rent?

DISCUSSION:

[1] First, we believe Taxpayer's reliance on Japan Line, supra, is misplaced. In Japan Line, the Washington Supreme Court specifically recognized the legislature's broad powers to levy a retroactive tax. The holding of the court actually sustained the retroactive application of this very leasehold excise tax. We further note that Taxpayer's assessment does not involve the retroactive application of a new tax, but only involves recalculating the measure of an existing tax pursuant to specific statutory authority. In this way, it is no different from any audit assessment where the measure of a tax is in dispute. We find this tax assessment fully compatible with due process. Accordingly, Taxpayer's petition is denied on this issue.

[2] 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). Taxpayer recognizes this definition, but relies solely on the alternative language contained in RCW 82.29A.020(2)(b). We believe a more complete reading of the statute is required. In particular, we note that RCW 82.29A.020(2) states:

> (2) "Taxable rent" shall mean contract rent as defined in subsection (a) of this subsection in all cases where the lease or agreement has been established or renegotiated through competitive bidding, or negotiated or renegotiated in accordance with statutory requirements regarding the rent payable, or negotiated or renegotiated under circumstances, established by public record, clearly showing that the contract rent was the maximum attainable by the lessor: PROVIDED, That after January 1, 1986, with respect to any lease which has been in effect for ten years or more without renegotiation, taxable rent may be established by procedures set forth in subsection (b) of this subsection. All other leasehold interests shall be subject to the determination of taxable rent under the terms of subsection (b) of this subsection.

(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) under circumstances

wherein it can be established by public record 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) . . ."

Therefore, it is only where the contract was negotiated or renegotiated in compliance with one of the three specifically sanctioned methods that the Department is required to compute taxable rent based on contract rent. See Det. No. 87-112, 3 WTD 39 (1987). In all other cases where leasehold interests are established or renegotiated, the Department is required to determine taxable rent under subsection (b). We must now determine whether Taxpayer's lease meets one of the three sanctioned methods.

Taxpayer concedes that the lease was not established through competitive bidding. Therefore, that method is not applicable. Next, Taxpayer relies on RCW 53.08.080 as providing the statutorily required provisions for establishing rent payable. That provision states:

> A district may lease all lands, wharves, docks and real and personal property owned and controlled by it, for such purposes and upon such terms as the port commission deems proper; ...

While it is true that RCW 53.08.080 grants a port district the authority to set rental rates, it does not set out specific statutory procedures for determining the rent payable. Such contemplated statutory requirements normally set out procedural requirements and safeguards designed at assuring that the maximum or at least fair market rental was obtained for the use of public property. See Det. No. 87-111, 3 WTD 29 (1987). RCW 53.08.080 does not contain any such safeguards. Accordingly, we find that Taxpayer's lease does not meet the second method.

Finally, we consider whether 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." The evidence submitted by Taxpayer fails to prove the necessary facts.

The relevant contractual provisions are those set forth in the lease executed on . . . 1976. Taxpayer has submitted a fair market appraisal report and evidence of past sales of other industrial park properties in support of its position. All of the submitted information, however, is designed to show that Taxpayer's rent was comparable to fair market rent at the time the lease was established. Unfortunately, this is not the applicable standard. The third sanctioned method requires that Taxpayer establish through the use of information contained in the public record that the contract rent was the "maximum attainable by the lessor." Taxpayer's evidence fails to meet this standard. Accordingly, we find that the third sanctioned method is also not applicable.

[3] Because Taxpayer's contract rent was not negotiated or renegotiated under one of the three sanctioned methods, the lease falls under the "all other leasehold interests" portion of RCW 82.29A.020(2) and the Department is required to compute taxable rent under subsection (b).

RCW 82.29A.020(2)(b) 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.)

RCW 82.29A.020(2)(b) provides that where the Department determines that a lease has not been established or negotiated through one of the three sanctioned methods, the Department may establish taxable rent pursuant to the designated criteria. By use of the term "may" the Legislature has allowed the Department the discretion to either accept contract rent as taxable rent or recompute taxable rent pursuant to the stated criteria.

The Department has chosen to recompute taxable rent. The criteria contained in RCW 82.29A.020(2)(b) lists 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 (comparable rentals); and (2) a fair rate of return on the market value of the property less restrictions on use (fair rate of return). The statute also uses the term "shall," which means that the consideration of both criteria is mandatory.

Based upon the above facts, it is clear that Audit relied solely on fair rate of return value information supplied by the Port's Assistant Executive Director. This information was only based on the rate of return percentage being used by the Port at that time. It also appears that Audit did not adjust for the industrial use restriction placed upon the property by deed from the federal government.

Finally, we note that Audit has failed to properly consider evidence of comparable rentals. Audit contends that since the initial lease involved raw land, and that the leasehold improvements belonged to the lessees, that comparable rentals would only involve similarly unencumbered parcels

of raw land. Audit's position, however, fails to give effect to the phrase contained in RCW 82.29A.020(2)(b) which states:

> Consideration shall be given to rental being paid to other lessors by lessees of similar property for similar purposes over similar periods of time

(Underlining added.)

Waterfront property is not similar to landlocked property; land used for retail shopping is not similar to land used for industrial production; bare unencumbered land is not similar to restricted or encumbered land; and yearly leases are not similar to long term leases. In Taxpayer's case, we direct Audit to examine leases made to other lessors of land used for industrial purposes in similar locations for similar periods of time. We do not mean to imply, however, that all conditions must be identical before a determination of comparable rentals can be made, but only that some evidence involving comparable rentals should be considered. Once comparable rentals have been considered, each of the identified factors should be taken into account when evaluating the weight given each comparable lease. Since Taxpayer is engaged in the leasing of real property for industrial use, we believe that the information of comparable rentals paid to other lessors should be reasonably available. Therefore, we will allow Taxpayer until August 31, 1996 to provide the necessary information to Audit. Accordingly, this issue is remanded to Audit for consideration of comparable rentals and the effect of the federal government's industrial use restriction on the fair market rental value of the property.

[4] Next, we address Taxpayer's argument that the Department is precluded from recomputing taxable rent because its lease had been renegotiated in 1982. Taxpayer's argument is based on the proviso contained in RCW 82.29A.020(2)(a), which states:

> PROVIDED, That after January 1, 1986, with respect to any lease which has been in effect for ten years or more without renegotiation, taxable rent may be established by procedures set forth in subsection (b) of this subsection.

That proviso applies only to those leases that have been in effect for more than ten years and not renegotiated. See Det. No. 92-316, 12 WTD 477 (1993). For leases that have been renegotiated, the Department is not barred from recomputing taxable rent in excess of contract rent, unless that lease renegotiation process also satisfied one of the three sanctioned methods previously discussed. Each lease renegotiation is considered a newly established lease under RCW 82.29A.020(2)(a) and the method by which it was established must be evaluated separately. The 1982 alleged lease renegotiation, which merely added additional acreage to the existing lease, fails to conform to any of the three sanctioned methods for establishing a lease. Accordingly, Taxpayer's petition is denied on this issue.

[5] Next, we address Taxpayer's objection to being assessed interest on back leasehold taxes. RCW 82.32.050 provides that the assessment of interest is mandatory on audit assessments where the Department determines that taxes paid were less than those properly due.

Contrary to Taxpayer's assertion, the Department is not obligated to guarantee that all taxpayers know their proper reporting instructions. That responsibility must remain with each taxpayer. RCW 82.32A.030(2) clearly states that all taxpayers have the responsibility to:

> Know their tax reporting obligations and when they are uncertain about their obligations, seek instructions from the department of revenue.

In its effort to inform taxpayers of their proper tax reporting responsibilities, the Department has established a Taxpayer Information and Education Division in addition to the sixteen local field offices located throughout the state of Washington. All are available to answer Taxpayer's questions.

Although RCW 82.32.105 and WAC 458-20-228 (Rule 228) authorize the waiver of interest under certain limited circumstances, they do not apply to Taxpayer's case. Rule 228 states:

> (7) Waiver or cancellation of interest. The following situations will constitute circumstances under which a waiver or cancellation of interest upon assessments pursuant to RCW 82.32.050 will be considered by the department:
>
> > (a) The failure to pay the tax prior to issuance of the assessment was the direct result of written instructions given the taxpayer by the department.
> > (b) Extension of the due date for payment of an assessment was not at the request of the taxpayer and was for the sole convenience of the department.

Therefore, although we sympathize with Taxpayer's situation, we are unable to grant relief. Taxpayer's petition is denied on this issue.

DECISION AND DISPOSITION:

Taxpayer's petition is denied in part and remanded in part. The assessment is remanded to the Audit Division for adjustment if appropriate documentation is timely provided. If a new assessment is issued, it is due for payment by the date stated thereon.

DATED this 26th day of June, 1996.