

Cite as Det. No. 05-0343, 26 WTD 31 (2007)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Refund of tax)	<u>D E T E R M I N A T I O N</u>
paid by)	
)	
...)	No. 05-0343
)	
)	Registration No. . . .
)	Refund of REET
)	Docket No. . . .
)	

- [1] RULE 458-61A-211; RCW 82.45.060, RCW 82.45.010: REAL ESTATE EXCISE TAX – SYNTHETIC LEASE. The transfer of title from a lender to a taxpayer, under the terms of a synthetic lease, does not represent the satisfaction of a financing arrangement and as a result the transfer of title from lender to taxpayer is subject to REET.
- [2] RULE 458-61A-211; RCW 82.45.060, RCW 82.45.010: REAL ESTATE EXCISE TAX – SYNTHETIC LEASE. The transfer of title from a lender to a taxpayer, under the terms of a synthetic lease, represents a change in beneficial ownership and as a result the transfer of title to taxpayer is subject to REET.

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.

Lewis, A.L.J. -- Taxpayer used a lease agreement to finance the purchase of real property. Under the terms of the agreement, the lender took legal title to the property to secure its loan to Taxpayer. Taxpayer assumed responsibility for all costs and risks associated with the property. On satisfaction of the lease, the Department required payment of REET to transfer title from the lender to Taxpayer, maintaining that a taxable sales transaction occurred. Taxpayer paid the REET and requested refund maintaining that REET was collected in error. We deny Taxpayer's refund request, concluding that REET was correctly charged on the satisfaction of the synthetic lease. By the nature of a synthetic lease transaction, the transfer of property from the lender to the lessee is unable to qualify for exemption from REET as either the satisfaction of a financing

arrangement or of a mere change in identity or form of ownership of an entity where there is no change in the beneficial ownership.¹

ISSUES:

1. Does the transfer of title from a lender to Taxpayer, under the terms of a “synthetic lease,” represent the satisfaction of a financing arrangement and result in a transfer of title exempt from payment of REET?
2. Does the transfer of title from a lender to Taxpayer, under the terms of a “synthetic lease,” represent no change in beneficial ownership and result in a transfer of title exempt from payment of REET?

FINDINGS OF FACT:

Taxpayer is a . . . provider of telecommunications services. In early 2000, Taxpayer sought to acquire real property in Washington to serve as [a facility]. . . . Taxpayer wished to finance the property in a way that would provide it certain financial accounting benefits. Taxpayer planned to acquire the property through a structure known as a “synthetic lease.”

A synthetic lease is a financial structure that gives the tax benefits of ownership without the need to account for the purchase as would an owner. A synthetic lease has two main components, which qualify it as such. First, the lease is treated as an operating lease for Generally Accepted Accounting Principles (“GAAP”). Simply put, the lease does not show up on the company balance sheet and therefore positively impacts certain key financial ratios such as return on assets, debt to equity, return on equity, and interest coverage. Instead, the lease is recorded as an expense incurred on the company’s income statement. Second, for Internal Revenue Service purposes, the lease must transfer all tax benefits associated with ownership of the leased asset to the lessee. The lessee deducts the depreciation and interest expense in lieu of the rent expense under a typical lease. Such a structure allows the lessee the benefits of both worlds; to be viewed as the owner of the property for tax purposes, but at the same time, a lessee for financial reporting.

In structuring the purchase, Taxpayer arranged for the synthetic lease financing arrangement with a group of lenders . . . and [Limited Partnership]. Under the planned synthetic lease financing structure, [Limited Partnership] would hold nominal title to the . . . property in order to secure Taxpayer’s performance under the synthetic lease for the Lenders. The Lenders would finance the purchase . . . in consideration for receiving a return on their loan. [Limited Partnership] would also advance certain funds on which it would be entitled to monthly yield plus return of principal.

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

Taxpayer located suitable property in . . . Washington. Taxpayer negotiated and ultimately entered into a purchase agreement with the owner of the property. Just before close of the property purchase, Taxpayer assigned its rights in the purchase agreement to [Limited Partnership].

. . . a Real Estate Tax Affidavit” was completed. The Affidavit showed:

- . . . as the seller.
- [Limited Partnership] as the buyer.
- Gross sales price . . .
- \$. . . REET due.

The financing arrangement was documented in the terms of a Master Agreement and a Master Synthetic Lease The financing loan was evidenced by a Loan Agreement . . . and certain Promissory Notes payable to the order of the Lenders. The specific financing of the [facility] was also evidenced by a Washington Lease Supplement, a Washington Deed of Trust and Security Agreement, a Washington Assignment of Lease and Rents, and Assignment of Deed of Trust. The parties also entered into a Construction Agency Agreement that allowed Taxpayer to have complete control over the modification of the existing building required to meet Taxpayer’s needs.

Pursuant to the Construction Agency Agreement, Taxpayer demolished most of the interior of the existing structure and rebuilt the facility to its own specifications. The construction was financed by funds advanced by the Lenders. These construction loans were also secured by the facility pursuant to the transaction documents.

Under the terms of the synthetic lease, Taxpayer was required to make all payments associated with the financing . . . directly to . . . Bank, as agent for the Lenders. Taxpayer was also required to make a payment to [Bank] for the amount due to [Limited Partnership] on the funds it advanced. Taxpayer was responsible for payment of all amounts associated with the operation of the property, including taxes, insurance, and other charges. Furthermore, in order to induce the lenders and [Limited Partnership] to make advances under the Master Agreement, Taxpayer guaranteed full and prompt payment of all amounts due as provided in the transaction documents. Neither the Lenders nor [Limited Partnership] had any payment or operational responsibilities with respect to the property.

The Master Agreement provided that:

- It was the intent of the parties to the transaction that for federal, state and local tax purposes, Taxpayer was considered owner of the property.
- The synthetic lease was to be treated as a financing arrangement.
- [Limited Partnership] was to be treated as a Lender making loans to Taxpayer.
- Basic rent paid by Taxpayer was to be treated as interest.

- The payment made by the Lenders to fund the purchase was to be treated as principal of a loan.
- That other supplemental rent was to be treated as additional charges under a loan.

...

The Master Synthetic Lease provided that:

- For commercial and bankruptcy law purposes, the “lease” was to be treated as a financing transaction.
- The lease was to be treated as a mortgage and security agreement.
- [Limited Partnership] had all rights, powers and remedies available to a mortgagee.
- Taxpayer assumed all risk of loss associated with the purchased of the . . . facility.
- [Limited Partnership] made no warranties or representations regarding the condition of the property.
- If a casualty occurred . . . , Taxpayer was obligated to restore the facility to the original condition.
- All insurance proceeds resulting from any such casualty were to be paid to Taxpayer, unless default by Taxpayer had occurred.
- In the event of Taxpayer default after a casualty to the facility, all insurance proceeds were to be applied to payment of the loans and advances from [Limited Partnership] and the Lenders, with any excess proceeds going to Taxpayer.
- If the [Facility] could not be rebuilt after a casualty, Taxpayer was required to pay off the balances due to the Lenders and [Limited Partnership]. In such a case, title to the property would revert to Taxpayer.

The transaction was structured so that title would never revert to [Limited Partnership]. The synthetic lease was drafted to terminate by its own terms when Taxpayer paid the balance of the loans to the Lenders and [Limited Partnership]. Upon the termination of the lease, title to [The Facility] would revert to Taxpayer. Taxpayer also had the right, under the transaction documents, to pay off the financing and acquire clear title to [The Facility] at any time. In fact, Taxpayer’s only options for terminating the synthetic lease during its term were to immediately pay off the financing of the facility or to elect the “remarketing option.” Under the remarketing option, the property was to be marketed to third parties. Upon sale of the property, Taxpayer was obligated to pay [Limited Partnership] and the Lenders all amounts that they were due under the synthetic lease, with the remainder, if any, going to Taxpayer. If the proceeds did not cover the amounts due to [Limited Partnership] and the Lenders, Taxpayer was required to take the loss.

[In] 2003, Taxpayer sent a letter to the Department’s Taxpayer Services Division seeking a ruling on whether REET would be owed on the termination of the synthetic lease and the transfer of title to the property from [Limited Partnership] to Taxpayer. [In] 2003, Taxpayer exercised its right to pay off the amount owed and terminate the synthetic lease financing arrangement. Taxpayer paid [Limited Partnership] and the Lenders the remaining amounts due them under the

financing arrangement. The result of this action was that [Limited Partnership] and the Lenders no longer had a security interest in the property and clear title was transferred to Taxpayer. That same day [in] 2003, Taxpayer completed a Real Estate Excise Tax Affidavit and paid \$. . . in REET. The Affidavit showed:

- [Limited Partnership] as the seller.
- Taxpayer as the buyer.
- Gross sales price of \$. . .
- \$. . . REET due.

[The following day], Taxpayer Services answered Taxpayer's letter ruling request. The letter stated that if the September 2000 REET Affidavit stated that Taxpayer was the transferee, which it did not, "then the reconveyance of title from [Limited Partnership] to Taxpayer is exempt from REET." The letter ruling also stated that if Taxpayer was not the transferee, "then the reconveyance of title from [Limited Partnership] to taxpayer is subject to REET upon the termination of the synthetic lease." The letter had no practical effect as Taxpayer had already paid the REET.

[In] 2004, Taxpayer filed a Petition for Refund of REET. In making the Refund Request, Taxpayer argued that REET had been collected in error as the transfer of title from [Limited Partnership] to Taxpayer was not a sale under Washington law and thus no REET was due.

ANALYSIS:

RCW 82.45.060 imposes an excise tax upon the sale of real property. RCW 82.45.010(1) defines the word "sale" as:

Hav[ing] its ordinary meaning and shall include any conveyance, grant, assignment, quitclaim, or transfer of the ownership of or title to real property, including standing timber, or any estate or interest therein for a valuable consideration, and any contract for such conveyance, grant, assignment, quitclaim, or transfer, and any lease with an option to purchase real property, including standing timber, or any estate or interest therein or other contract under which possession of the property is given to the purchaser, or any other person at the purchaser's direction, and title to the property is retained by the vendor as security for the payment of the purchase price. The term also includes the grant, assignment, quitclaim, sale, or transfer of improvements constructed upon leased land.

However, under RCW 82.45.010's definition of sale, certain transfers are excluded from the definition of sale and thus exempt from payment of REET. Such exempt transfers include:

- (i) Any transfer of an interest made pursuant to a deed of trust or an order of sale by the court in any mortgage, deed of trust or an order of sale by the court in any mortgage,

deed of trust, or lien foreclosure proceeding or upon execution of a judgment, or deed in lieu of foreclosure to satisfy a mortgage or deed of trust.

(o) A transfer of real property, however effected, if it consists of a mere change in identity or form of ownership of an entity where there is no change in the beneficial ownership.

[1] Taxpayer argues that the transfer . . . of property from the lender is exempt from REET under one or more of sale exclusions found in RCW 82.45.010. Taxpayer maintains that a synthetic lease is a financing instrument and that the transfer from the lender to Taxpayer on satisfaction of the financing arrangement is an exempt transfer under RCW 82.45.010(i).

As a simple example, a home buyer pays REET when he purchases real property from the seller. If the transaction is financed by a third party, the third party will want a security interest in the property to protect its loan. When the buyer satisfies the loan, the lender will release its security interest in the property. No REET is due when the financing arrangement is concluded and the lender releases its security interest in the property. A purchase of real estate, so structured, is exempt from REET when the buyer satisfies the debt and the lender releases its security interest in the property. RCW 82.45.010(3)(i). Taxpayer argues that the transfer of title to Taxpayer by the lender/lessor on satisfaction of the synthetic lease is the equivalent of the lender releasing its security interest in the property on satisfaction of a mortgage or deed of trust. Taxpayer cites [the] Master Agreement

In support of its contention that a synthetic lease is a financing instrument Taxpayer has provided rulings from other jurisdictions, which conclude that a synthetic lease is a financing arrangement. *N.Y. Dep't Taxation and Finance Ruling*, FLR-014789-721, 2002, New York; *Massachusetts Department of Revenue Letter Ruling* 01-8, 2001 Mass. Tax Lexis 65 (Sept 11, 2001); *N.Y. Dep't of Taxation and Finance Adv. Op.* TSB A 01(7)R, 7/26/2001; *Florida Department of Revenue Technical Assistance Advisement* No. 00M-0002, 2000 TAX FALR 609, 2000 Fla. Tax Lexis 132 (August 15, 2000); *Florida Department of Revenue Technical Assistance Advisement* No. 00A-025, 2000 TAX FALR 272, 2000 Fla. Tax LEXIS 48 (May 15, 2000); *Florida Department of Revenue Technical Assistance Advisement* No. 96(M)-002, 96 TAX FALR 718, 1996 Fla. Tax LEXIS 173 (June 21, 1996).

As an example, the *N.Y. Dep't of Taxation and Finance Adv. Op.* TSB A 01(7)R, 7/26/2001 Opinion stated:

The synthetic Lease is substantively the same as the IDA financing discussed in the Transfer Tax Regulations. In both types of transactions the lender acquires fee title to the security and leases it to the borrower. The payments that are denominated rent constitute debt service, and the parties intend, and their agreements provide for, the conveyance of title to the security to the lessee as the owner of the asset that constitutes the lender's security. In the Synthetic Lease title is conveyed to [the lessor] to secure a debt, and at the end of the lease term [the lessor] conveys title to [the lessee] in release or satisfaction of its security interest.

Accordingly, neither the conveyance of title to [the lessor] nor the conveyance of title by [the lessor] to [the lessee] is subject to real estate transfer tax.

Taxpayer maintains that Washington should follow the lead of Florida, New York, and Massachusetts and treat the transfer of title to real property on the satisfaction of its synthetic lease as the equivalent of the satisfaction of a financing arrangement. Such treatment would exempt the transfer from REET, since a sale is necessary for REET to be triggered and RCW 82.45.010's definition of sale, excludes the satisfaction of a financing arrangement from the definition of sale.

Recently, the Department issued revised REET rules.² WAC 458-61A.-211 specifically discusses the application of transfers arising out of the satisfaction of a synthetic lease. Issuance of the Rule on synthetic leases represents an explanation/clarification of the Department's position and does not represent a change in the Department's position.³ The Rule makes clear that no exemption from REET is allowed for transfers resulting from the satisfaction of a synthetic lease. WAC 458-61A-211(4) states:

- (a) Where the ownership of real property is different for financial accounting purposes than for federal tax purposes, the beneficial ownership interest in the real property is deemed the entity which is the owner for financial accounting purposes. Any transfer from the entity that is the owner for federal tax purposes to the owner for financial accounting purposes, or vice versa, is subject to the real estate excise tax.
- (b) For example, Giant Company wants to expand its business. It identifies some real property, but is unable to finance the purchase through a normal loan. It contracts with Mega Loans, Inc. to enter into a "synthetic lease" for the purchase of the real property. Under the terms of the synthetic lease, Mega Loans will take title to the real property, and Giant Company will lease it from Mega Loans. Real estate excise tax is paid on the purchase of the real property by Mega Loans. The terms of the lease also provide that Mega Loans will be the owner for federal tax purposes and Giant Company will be the owner for financial accounting purposes [sic].⁴ Per the lease agreement, after a specified time Mega Loans will transfer title to the real property to Giant Company. The transfer of title from Mega Loans to Giant Company is subject to real estate excise tax. Here, as in the example, REET is due on the transfer of title from the lender to the lessee. Accordingly, we conclude that Taxpayer is not entitled to a refund of REET based on a claim that the satisfaction of the synthetic lease was an exempt transaction.

² Effective December 17, 2005.

³ While the new Rule becomes effect on December 17, 2005 it is applicable to taxpayer's case being an explanation/clarification of the Department's position. The Rule Revision's explanatory comment states "the amended chapter updates existing information, more clearly and completely explains department practices in administering the tax, and incorporates legislative amendments to chapter 82.45 RCW. The revised chapter also consolidates several of the prior rules, and updates and reorganizes the rule chapter in a more user-friendly manner."

⁴ An error was made in [editing] the example and, when read in context, it is clear it should have stated that Mega Loans was the owner for financial accounting purposes and Giant Company was the owner for federal tax purposes.

Consistent with the Rule, we conclude that transfer of property at the conclusion of the synthetic lease is not the satisfaction of a financing arrangement and exempt from REET. Next we address Taxpayer's second argument: that REET was not due on the transfer because there was no change in beneficial interest.

[2] RCW 82.45.010(3)(o), definition of sale, excludes from the definition of sale and thus from payment of REET:

A transfer of real property, however effected, if it consists of a mere change in identity or form of ownership of an entity where there is no change in the beneficial ownership.

WAC 458-61A-211(2) provides examples of such qualifying transfers:

- (a) The transfer by an individual or tenants in common of an interest in real property to a corporation, partnership, or other entity if the entity receiving the ownership interest receives it in the same pro rata shares as the individual or tenants in common held prior to the transfer. (See also WAC 458-61A-212, Transfers where gain is not recognized under the Internal Revenue Code.)
- (b) The transfer by a corporation, partnership, or other entity of its interest in real property to its shareholders or partners, who will hold the real property either as individuals or as tenants in common in the same pro rata share as they owned the corporation, partnership, or other entity. To the extent that a distribution of real property is disproportionate to the interest the grantee partner has in the partnership, it will be subject to the real estate excise tax.
- (c) The transfer by an entity of its interest in real property to its wholly owned subsidiary, the transfer of real property from a wholly owned subsidiary to its parent, or the transfer of real property from one wholly owned subsidiary to another.
- (d) The transfer by a corporation, partnership, or other entity of its ownership in real property to another corporation, partnership, or other entity if the grantee owner(s) receives it in the same pro rata shares as the grantor owner(s) held prior to the transfer.
- (e) Corporate mergers and consolidations that are accomplished by transfers of stock or membership, and mergers between corporations and limited partnerships as provided in chapters 25.10 and 24.03 RCW.
- (f) A transfer of real property to a newly formed, beneficiary corporation from an incorporator to the newly formed corporation, provided:
 - (i) The proper real estate excise tax was paid on the original transfer to the incorporator; and
 - (ii) It was documented on or before the original transfer that the incorporator received title to the property on behalf of that corporation during its formation process.

The examples of exempt transactions contained in the rule involve transfers between identical or closely related entities. Here the lender and Taxpayer are completely unrelated with the transfer from one entity to another unrelated entity.

The REET statute does not allow property to be transferred free from REET merely because one person has a beneficial interest in property and later acquires title. Instead it exempts from the definition of sale a transfer to an entity that is merely changing the form of the entity under which it operates, provided the entity has a beneficial interest in the property. There are no facts in this case regarding Taxpayer changing the form of its identity. We need not do an analysis of whether there was a change in beneficial interest when there was a change of ownership.

Based on the facts presented, we conclude that Taxpayer is not entitled to a refund of REET based on a claim that the transfer from the lender to Taxpayer on satisfaction of the synthetic lease consisted of a mere change in identity or form of ownership of an entity where there is no change in the beneficial ownership.

DECISION AND DISPOSITION:

Taxpayer's Petition for refund is denied.

Dated this 20th day of December, 2005.