

Cite as Det. No. 14-0260, 34 WTD 467 (2015)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Refund of) Assessment of))) . . .))	<u>D E T E R M I N A T I O N</u> No. 14-0260 Registration No. . . .
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RULE 118: BUSINESS AND OCCUPATION TAX – LICENSE TO USE REAL ESTATE – LEASE OR RENTAL OF REAL ESTATE – EXCLUSIVE RIGHT TO CONTROL OR DOMINION – EXCLUSIVE RIGHT TO CONTINUOUS POSSESSION. The Department properly found that Taxpayer granted a taxable license to use real estate rather than a non-taxable rental of real estate. The lessor had neither the right to exclusive control or dominion over the leased area; nor did the lessor have the exclusive right to continuous possession. Thus, the Department determined that the agreement at issue granted a taxable license to use real estate.

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.

Valentine, A.L.J. – [Taxpayer] appeals the assessment of service and other activities (Service) business and occupation (B&O) tax on payments received for allowing a related entity to use real property and improvements located at [the Port]. The Department of Revenue (Department) issued the assessment based on its opinion that the related entity’s use of the property and improvements constituted a taxable license to use real estate. Taxpayer contends the use constituted the tax-exempt rental of real estate We deny Taxpayer’s petition¹

ISSUES

1. Pursuant to WAC 458-20-118 (Rule 118), if a person enters into an agreement for the right to use real estate, but the agreement does not grant the person exclusive control and dominion over the real estate, nor the exclusive right of continuous possession, including against the owner, is the income generated from the agreement exempt from B&O tax as the lease or rental of real estate, or is the income subject to B&O tax under the Service classification as a license to use real estate?

. . .

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

FINDINGS OF FACT

The Department's Taxpayer Account Administration Division (TAA) completed a desk examination of Taxpayer's Washington business activities for the time-period of The result of the examination was an assessment, dated April 1, 2013, of \$² TAA describes Taxpayer's business activities as "providing the right to carry out certain international commerce, shipping, and navigation activities for maritime container vessel operations."³ Taxpayer paid the assessment face amount of \$. . . and asks for a refund.⁴

The facts leading up to the assessment are as follows. On August 14, 2012, the rights and obligations of an already-existing agreement (Agreement 1), dated January 9, 2003, were assigned to Taxpayer by an Assignment and Assumption of Lease Agreement (Agreement 2) between [Corporation] and Taxpayer.⁵ Taxpayer is a 100-percent owned subsidiary of Corporation.

Agreement 1 was between Corporation and [the Port].⁶ Agreement 1 gave Corporation the right to use 140 acres of real property and improvements owned by the Port. Agreement 1 identified the subject "Premises" as the Leasehold Area; the Preferential Use Area; and the Future Expansion Area, which was available for additional consideration. Agreement 1 specified that the Premises was available to Corporation for a fixed monthly fee for "all activities related to the loading and discharging of containers and/or non-containerized breakbulk cargos to and from Vessels involved in Lessee's operations, and for Lessee's operations incidental thereto."

The initial term of the agreement was for 20 years beginning with the commencement date, and the Port, at its sole discretion, could decide to renew the agreement for two, five-year extensions. The parties agreed to a rental amount for the Leasehold Area and a fee for the Preferential Use Area. Corporation was responsible for utilities and taxes, and Corporation and the Port shared responsibility for maintenance and repairs. Corporation could not assign its rights under the agreement to another party without the Port's consent unless the assignment was to an entity controlled by Corporation.

Subsection 1(b) of Agreement 1 specified that Corporation could use only the two berths located at the Preferential Use Area. Pertinent sections of Subsection 1(b) read as follows:

Non-Exclusive Preferential Use Area. Lessor hereby grants to Lessee the non-exclusive preferential use of the following area:

- (i) Effective from and after the Commencement date (as defined in Section 2(a) below), the 2 linear working berths of approximately 2,260 feet combined length and immediately adjacent area.

² The assessment consists of a credit for royalties B&O tax paid and the assessment of Service B&O tax, interest, and the 5 percent assessment penalty for the third and fourth quarters of 2012.

³ See Taxpayer's Exhibit G (Examiner's Detail of Differences and Instructions to Taxpayer).

⁴ A current balance due of \$. . . , for tax and interest, remains. Additional interest was added to the total due prior to Taxpayer's payment of the face amount.

⁵ See Taxpayer's Exhibit D.

⁶ See Taxpayer's Exhibit C.

The Term “preferential use” when used with respect to the berths and immediately adjacent area means the preferential right of Lessee to berth Vessels involved in Lessee’s operations at the two berths, for a combined total of up to two-hundred-sixty (260) calls of forty-eight (48) hours each per year.

...

If Lessee anticipates that more than two-hundred-sixty (260) calls will be made during any year of this agreement, then Lessee shall so advise Lessor in writing as early as possible during such year, and shall request permission for such additional calls from the Executive Director of Lessor in writing at least thirty (30) days prior to the date the number of vessel calls are expected to exceed such number. Such additional calls shall be subject to the Executive Director’s approval, which will not be unreasonably withheld, provided that notice is given and request for permission is made as herein provided. Whenever the berth is not in use by Lessee’s Vessels pursuant to the preferential use provisions of this agreement, it may be used by Lessor and Lessor’s other customers pursuant to section 5(b) below.

Subsection 5(b) of Agreement 1 reads in pertinent part:

Use of Premises by Lessor. Lessor reserves the right to use all or any part of the Preferential Use Area and Leasehold Area and improvements thereon for the berthing of vessels and loading or discharging of cargo and operations incidental thereto, and Lessee hereby grants a right of way to Lessor across the Premises to allow Lessor and its customers to reach the berth and loading/discharging areas; provided, however, that such use by Lessor shall not interfere with the operations of Lessee or Lessee’s customers without Lessee’s prior written consent.

Agreement 2, dated August 14, 2012, encompasses Taxpayer’s agreement to assume all of Corporation’s rights and obligations under Agreement 1.

On August 15, 2012, Taxpayer entered into a Service Agreement (Agreement 3)⁷ with Corporation for Corporation’s use of the Premises as described and outlined in Agreement 1. The income generated by Taxpayer from Agreement 3 is at issue in this appeal. Agreement 3 references Taxpayer as Party A and Corporation as Party B.

Pertinent sections of Agreement 3 read as follows:

RECITALS:

WHEREAS, Party A, has represented to Party B that Party A has all the rights of usage with respect to that certain real property located at [the Port] . . . and is willing and able to perform the services of providing the right to carry out certain international commerce, shipping and navigation activities for maritime container vessel operations on the Premises;

⁷ See Taxpayer’s Exhibit E.

WHEREAS, Party B, desires Party A to provide such services.

...

ARTICLE 2. SERVICE

Effective as of the Effective Date (as defined below), the Party A hereby agrees to invest the Party B and the Party B agrees to obtain the rights to carry out that certain commerce, shipping and navigation activities for maritime containership purpose on the Premises.

ARTICLE 3. EFFECTIVENESS, DURATION AND TERMINATION

This Agreement shall come into effect from August 15, 2012 (the “Effective Date”) and continue in full force and effect indefinitely until terminated by ninety (90) calendar days prior written notice from either party to the other.

ARTICLE 4. PAYMENT

During the currency of this Agreement, the Party B agrees to make the payment to the Party A for the Service performed under this agreement, in accordance with the Tariff Scheme and Payment Schedule set out more detailed in Schedule 1.

Under Schedule I of Agreement 3, Corporation agrees to make monthly payments to Taxpayer on the basis of the cost-plus method (Taxpayer’s cost plus a mark-up of 4.5 percent, “which shall be reviewed and adjusted annually”). A monthly rental payment is due Taxpayer for the Leasehold Area and a monthly fee is due Taxpayer for the Preferential Use Area.

Also under Schedule I of Agreement 3, Corporation agrees to the following:

Insurance, Taxes and Assessments: The Party B shall, *if demanded*, indemnify [Party A] for the fees and costs, including insurance premiums, property tax along with any and all present or future taxes, charges or similar levies, penalties, interest and expenses (hereinafter collectively referred to as the “**Fees**”), arising out of and relating to the Service as contemplated by this Agreement but excluding taxes imposed on the overall net income of the Party A. (Emphasis added.)

ANALYSIS

1. If a person enters into an agreement for the right to use real estate, but the agreement does not grant the person exclusive control and dominion over the real estate, nor the exclusive right of continuous possession, including against the owner, is the income generated from the agreement exempt from B&O tax as the lease or rental of real estate, or is the income subject to B&O tax under the Service classification as a license to use real estate?

In Det. No. 06-0122, 26 WTD 69 (2007), the Department provides instruction about distinguishing between a lease or rental of real estate and a license to use real estate:

Amounts derived from the sale or lease of real estate are exempt from the B&O tax. WAC 458-20-118 (Rule 118). Amounts derived from the granting of a license to use real estate are not exempt. Rule 118; Det. No. 99-345, 19 WTD 618 (2000); Det. No. 92-213ER, 13 WTD 108 (1993). Whether a particular grant is a lease of real estate or a license to use real estate is a question of fact. *Tacoma v. Smith*, 50 Wn.App. 717, 722, 750 P.2d 647, 651 (1988). In making this determination, we are guided by the principles set out in Rule 118.

Thus, the question of whether an agreement to possess or use real estate constitutes a lease or rental of real estate rather than a license to use real estate is a factual question, and the Department's Rule 118 provides guidance in reaching an answer.

Rule 118 explains the Department's tax treatment of a sale or rental of real estate versus a license to use real estate. Pertinent sections read as follows:

- (1) 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. (See RCW 82.04.050 and 82.04.290).
- (2) **Lease or rental of real estate.** 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.
- (3) **License to use real estate.** A license grants *merely a right to use the real property of another but does not confer exclusive control or dominion* over the same.

(Emphasis added.)

Det. No. 05-0304, 26 WTD 21 (2007) also provides guidance in distinguishing between the lease or rental of real estate and the license to use real estate. Pertinent sections read as follows:

Perhaps the most common vehicle conferring a right of possession absent fee ownership is through a leasehold interest. WAC 458-20-118 (Rule 118) defines a lease as conveying "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.” A lease carries a present interest and estate in the property involved for the period specified therein. It gives exclusive possession of the property, which may be asserted against everyone, including the lessor. *Conaway et ux. v. Time Oil Co.*, 24 Wn.2d 884, 210 P.2d 1012 (1949).

...

Rule 118 defines a license as “merely a right to use the real property of another but does not confer exclusive control or dominion over the same.” In discussing Rule 118’s distinction between a lease and a license, the appellate court, in *Lacey Nursing Home, Inc. v. Department of Rev.*, 103 Wn. App. 169, 11 P.3d 839 (2000), stated:

The common law distinction is similar. “A tenant’s primary right is to have exclusive possession and use” of real property. William B. Stoebuck, 17 Washington Practice: Real Estate: Property Law § 6.18, at 319; *see also* § 6.3 (1995). Possession “implies exclusive control of the area possessed.” Stoebuck, *supra*, § 6.3, at 295. A license merely grants the use of another’s land. Stoebuck, *supra*, § 6.3, at 295.

See also Det. No. 04-0022E, 23 WTD 198 (2004).

Thus, whether a lessee has exclusive control and continuous possession of the real estate to the exclusion of “the world,” including the owner or lessor, is a key element in differentiating between a lease or rental of real estate and a license to use real estate.

Taxpayer contends that a Washington State Supreme Court decision supports its position that the income at issue resulted from a lease or rental of real estate rather than a license to use real estate. *See Barnett v. Lincoln*, 162 Wash. 613, 299 P. 392 (1931).

The sole question in *Barnett* was whether the Port of Seattle had the legal right to enter into a contract with Salmon Terminals for the use and possession of certain of the Port of Seattle’s properties, including preferential use of berthing space. *Id.* The answer to the question rested on whether the agreement between the Port of Seattle and Salmon Terminals was a lease or a license to use real property. *Id.*

The Court concluded that the agreement between the Port of Seattle and Salmon Terminals was a lease:

In the present case, Salmon Terminals was given the exclusive right to the use and possession of 334,400 square feet of the warehouse space on pier 40, and was given the exclusive right to store its canned salmon. It was given the preferential use of the berthing space. The contract provides that the Salmon Terminals should repair the equipment, and that it should bear and pay all operating expenses. It further provides that the port shall receive, as compensation for the use of its premises, the established tariff on certain goods, and on others seventy-five percent of the tariff rates, and, in addition thereto, the Salmon Terminals bound itself to pay as rental for office space at the rate of

five cents per square foot; the agreement to be effective for a period of five years, with the option for an extension of an additional term of five years. It recites that the “privilege” granted may not be assigned or underlet without the written consent of the port having first been obtained. Despite the designation of the instrument as a preferential agreement or as a “privilege”, and the restrictions and reservations contained therein, we hold, *from a consideration of the entire instrument*, that it is a lease, and not a license or a mere privilege.

Id. (Italics added.)

We note that the Court, in *Barnett*, highlighted the importance of the exclusivity necessary to establish a lease by emphasizing the term “exclusive” in its discussion of the use and possession of the real estate at issue. We also note that the Court considered “the entire instrument” in reaching its decision rather than relying on a specific factor.

In the case at issue, a review of Agreements 1, 2, and 3 support TAA’s position that the Port always retained the right to occupy and use the Premises. The Agreements did not give Corporation exclusive possession, dominion, or control of the real estate at issue. The Agreements require only that the Port receive written permission to occupy and use the Leasehold Area if such occupation and use interferes with Corporation’s business activities. Otherwise, the Agreements do not limit the Port’s control or use of the Leasehold Area. Therefore, although the Court in *Barnett* found the presence of an actual lease even though the use of berths was preferential and not exclusive, the facts in this case are different because Corporation did not enjoy exclusive possession and control of the remainder of the Premises. Thus, Corporation did not enjoy exclusivity of the Premises, or any portion thereof, which is a component of establishing a lease. *McKennon v. Anderson*, 49 Wn.2d 55, 59, 298 P.2d 492 (1956).

Thus, we do not agree with Taxpayer that the income at issue in this appeal resulted from a lease or rental of real estate. The required exclusivity is not present in this set of facts. We conclude, therefore, that the income at issue in this appeal was obtained from a license to use real estate and is subject to Service B&O tax.⁸

...

DECISION AND DISPOSITION

Taxpayer’s petition for refund is denied.

Dated this 19th day of August, 2014.

⁸ Because we conclude that the issue of exclusivity is determinative in this case, we find it unnecessary to discuss additional elements of a landlord/tenant relationship.