

Cite as Det. No. 13-0394, 36 WTD 217 (2017)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for)	<u>D E T E R M I N A T I O N</u>
Refund)	
)	No. 13-0394
)	
...)	Registration No. . . .
)	

RULE 118; Rule 135; RCW 82.04.320: B&O TAX – EXEMPTIONS – RENTALS – LICENSES. The labeling of payments is not controlling in determining whether the payments are for the rental of real property or for a license or other right involving the use of real property.

RULE 118; Rule 135; RCW 82.04.320: B&O TAX – EXEMPTIONS – RENTALS – LICENSES – MINERAL LEASES. Evidence indicates that the rights conveyed were for the use of land for extraction and processing, which coupled with the fact that the Taxpayer did not identify or record the income received as rent, supports characterizing the income from the grant of the right to extract natural products, which is subject to B&O tax rather than amounts derived from the rental of real estate that would be exempt.

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.

Kreger, A.L.J. – A company protests assessment of service and other activities business and occupation (B&O) tax on income received for the grant of rights to remove minerals, rock sand, or other natural resource products, asserting that the income is exempt as amounts derived from the rental of real estate. We conclude that the income at issue is not exempt from B&O tax and deny the Taxpayer’s petition.¹

ISSUE

Does income from a lease, identified by the Taxpayer as a royalty, qualify for exemption from B&O tax under WAC 458-20-118 (Rule 118), as amounts derived from the rental of real estate?

FINDINGS OF FACT

[Taxpayer] is a Washington Limited Liability Company engaged in a variety of business activities. The Taxpayer’s Washington business activities include renting real estate, sales of

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

agricultural products, selling crushed rock that is extracted and manufactured by the Taxpayer, income from leasing mining property, and the operation of a golf range. The Audit Division of the Department of Revenue (Department) conducted an audit of the Taxpayer's business activities for the period of January 1, 2008, through September 30, 2011. This audit resulted in the assessment of additional tax in the amount of \$² The Taxpayer timely paid the assessment in full and filed an appeal protesting a portion of the tax assessed.

Specifically, the Taxpayer challenged the re-characterization of income, that it believes is derived from the rental of real property as income received for the grant of rights to remove minerals, rock sand, or other natural resource products, subject to service and other activities (Service) B&O tax.

The income at issue is derived from real property owned by the Taxpayer in . . . , Washington. In 1998, the Taxpayer sold a construction company to . . . [an out-of-state] corporation [(Tenant)]. In conjunction with this sale, the Taxpayer entered into a "Lease and Operating Agreement (. . .)" (Agreement) with [Tenant]. The Taxpayer had been extracting sand and gravel from this property for use in its construction activities, as well as for sale to others. The Taxpayer also operates a . . . farm on a portion of the property. The Taxpayer intends to eventually develop the property at the conclusion of the lease.

The Taxpayer records the income derived from Tenant under the Agreement as a royalty on its books and records and for federal tax purposes.

On appeal, the Taxpayer provided a full copy of the Agreement. The Agreement covers three elements, the real property owned by the Taxpayer – "The Property"; a lease from the State of Washington for real property adjacent to the Taxpayer's property to which the Taxpayer owned a Mining Contract – "The State Lease"; and another adjacent parcel of property leased by the Taxpayer "The . . . Parcel." Agreement, Recitals A-C.

The Agreement sets out an intent for the use of the property as:

The parties intend that Tenant use the Property in the manner it has been used in the past for stockpiling, selling and/or processing Sand and Gravel excavated from the State Land until the Sand and Gravel resource on the State Land is depleted, as described in this Lease. Thereafter, the parties intend that Tenant will extract Sand and Gravel from the Property and sell the material or process it on the Property, all in accordance with the terms of this Lease

Agreement, Recitals E. The Term of the Agreement is 30 years. Agreement Section 2.2.

Under the Agreement, the Taxpayer received basic rent and production royalties. The basic rent is set as a fixed amount increasing annually from \$. . . to \$. . . over a 20 year period.

² The assessment included \$. . . in additional tax due, comprised of: \$. . . in retail sales tax, \$. . . in retailing B&O tax, \$. . . in wholesaling B&O tax, \$. . . in service and other activities B&O tax, a credit of (\$. . .) for use tax paid in error, \$. . . in manufacturing tax, and multiple activities tax credit of (\$. . .) and \$. . . in extracting B&O tax; plus \$. . . in interest. No penalties were included in the assessment.

Agreement, section 8.1. The rent is to be paid monthly in equal installments. *Id.* No basic rent is due in the 21st through the 30th year of the lease. *Id.* Production Royalties are defined as additional rent. Agreement, section 8.2. The Production Royalties are based on the weight of materials shipped from the property on the first 500,000 tons of material shipped from the property. Agreement, section 8.2 & 8.3. The production royalties are paid as advance minimum royalties, which are absolute, and nonrefundable and additional production royalties if material is removed in excess of the assumed minimum tonnage. Agreement, section 8.6.

The Taxpayer also reserves the right to use a portion of the property. Agreement Section 4. The reserved rights include the right to use and develop a portion of the property, to remove topsoil, to purchase the Tenant's products, dispose of farm waste on the property, maintain a trailer residence on the property, reserves an access easement, the right to place backfill soil on excavated portion of the property, and reserves the right to all merchantable timber standing on the property. Agreement Section 4.

ANALYSIS

The Washington B&O tax is a gross receipts tax that is levied on the privilege of engaging in business in the state of Washington. RCW 82.04.220. The tax rate varies based on the type of business activity that a taxpayer engages in and the statute provides numerous classifications of activities. *See generally* RCW 82.04.260. RCW 82.04.290(2) provides for a "catch-all" classification for business or service activities not expressly enumerated in the statute.

WAC 458-20-135(5) ("Rule 135(5)") addresses the taxation of granting another the right to extract: "Royalties or charges in the nature of royalties for granting another the privilege or right to remove minerals, rock, sand, or other natural resource product are subject to the service and other activities B&O tax." The rule adds that "[i]come derived from the sale of rental or real property, whether designated as royalties or another term, is exempt of the B&O tax." *Id.* Taxpayer has granted Lessee the right to remove sand and gravel from its land. Thus, Taxpayer is subject to service and other activities B&O tax, unless a specific exemption applies.

WAC 458-20-118 ("Rule 118") provides that amounts derived from the sale and rental of real estate are exempt from taxation under the business and occupation tax. For purposes of determining whether an interest in real estate is a lease or rental, Rule 118 states:

A lease or rental of real property conveys an estate or interest in a certain designated area of real property with an exclusive right in the lessee of continuous possession against the world, including the owner, and grants to the lessee the absolute right of control and occupancy during the term of the lease or rental agreement. An agreement will not be construed as a lease of real estate unless a relationship of "landlord and tenant" is created thereby. Rule 118(1) (Emphasis added).

In distinguishing between the rental of real estate and a license to use real property, the latter of which is not entitled to the exemption from B&O tax, Rule 118(3) further provides:

A license grants merely a right to use the real property of another but does not confer exclusive control or dominion over the same. Usually, where the grant conveys only a

license to use, the owner controls such things as lighting, heating, cleaning, repairing, and opening and closing the premises.

Thus, under Rule 118, the principal difference between a lease and a license is the right of exclusive possession and control over the premises, including against the owner. *See also Lacey Nursing Home, Inc. v. Department of Revenue*, 103 Wn. App. 169, 11 P.3d 839 (2000). However, Rule 118 does not address whether a mineral lease should be treated like the rental of real property or a license to use real property.

The Department considered the taxation of a mineral lease in Determination No. 00-154ER, 21 WTD 298 (2002), in which it held that Washington courts would likely characterize a mineral lease as a profit a prendre, rather than a lease of real estate. A profit a prendre, or a profit, is the right to remove some substance from another's land, such as sand, rock, or minerals, and is traditionally regarded as a right of use (like a license), not a right of possession. 17 WILLIAM B. STOEBUCK ET AL., WASHINGTON PRACTICE, REAL ESTATE §6.3 (2d ed. 2004). A right of possession confers the legal right to exclude all persons from all parts of the land, while the holder of a profit may only prevent other persons from interfering with its limited purpose. *Hoglund v. Omak Wood Products, Inc.*, 81 Wn. App. 501, 505, 914 P.2d 1197, 1201 (1996) (citing 17 STOEBUCK, *supra*, at §2.1) (emphasis added). The limited purpose of the profit should be stated in the creating instrument or may be implied from the usage made. 17 STOEBUCK, *supra*, at §2.1.

As previously discussed, Rule 118(1) identifies the touchstone of a lease or rental of real estate for purposes of the B&O tax as the “exclusive right in the lessee of continuous possession against the world, including the owner, and grants to the lessee the absolute right of control.” While many of the provisions in the Agreement at issue may also appear in ordinary landlord-tenant leases, they do not address the fundamental question of exclusive and continuous possession required by Rule 118 and, therefore, are not determinative in resolving the issue of whether the Agreement creates a leasehold or a profit a prendre, or mineral lease.

In this case, we conclude that the Agreement at issue is closer to a mineral lease rather than the rental of real property.³ We note that the intent of the agreement addressed the use of the property primarily as the extraction and processing of sand and gravel from the property. Agreement, Recitals E. Additionally, the operating plan and majority of the terms of the Agreement relate to the extraction of sand and gravel. Finally, the significant and varied rights reserved to the Taxpayer under the Agreement are inconsistent with conveying an absolute right to control to the Tenant.

³ We note that many elements common in mineral leases, or profits a prendre, also contain elements common in the rental of real property. Mineral leases are frequently structured in a manner similar to triple net leases and the holder of the profit is customarily required to indemnify the landowner. And, profits are frequently assignable with the landowner's consent, which may not be unreasonably withheld. *See, e.g., Lang v. Walker's Paving, Inc.*, 121 Wn. App. 1015, 2004 WL 863679 (2004); *Adams v. Washington Brick, Lime & Mfg. Co.*, 38 Wn. 243, 80 P. 446 (1905). And finally, Lessee's right to a share of condemnation proceedings is consistent with other profits a prendre. *See* Determination No. 00-154ER, *supra* (citing *City of Phoenix v. South Bank Corporation*, 133 Ariz. 90, 649 P.2d 293 (1982) (finding that a contract in which the “buyer” in a sand and gravel “sales contract” was entitled to compensation upon a taking was a profit a prendre).

The Taxpayer notes that it cannot terminate the lease prior to the term of the Agreement absent default or breach. However, we find no authority for the proposition that having a fixed term for a mineral lease is sufficient to convert such an agreement to the rental of real property.

At a minimum, the Taxpayer asserts that the Basic Rent should be characterized as income from the rental of real property. We disagree. A set rental amount is not an uncommon element in mineral leases. [See, e.g., Det. No. 11-0080, 31 WTD 24 (2014) (“We find that [minimum annual rent] is not consideration for the occupancy or possession of real estate. The dual payment structure provided for in the Agreement is customary in many mineral lease agreements in which a landowner receives a royalty in exchange for granting the right to remove mineral deposits.” [String citation omitted].)]

. . . . Similarly, here, the basic rent component and absolute advance minimum are comparable to the minimum rental provisions common in mining leases. Such a dual payment structure, with both a fixed and variable component, is customary in many mineral lease agreements in which a landowner receives a payment in exchange for granting the right to remove mineral deposits. See *Orlandi v. Goodell*, 760 F.2d 78 (4th Cir. 1985); David L. Hallett, *Lease Bonuses, Advanced Royalties, and Delay Rentals—Federal Income Tax Consequences to Lessors and Lessees*, 18 Gonz. L. Rev. 101, 111 (1983).

We also note that in determining whether a transaction is a lease, a court is not bound by the characterization of the parties. See 25 AM. JUR. 2d *Easements and Licenses* §117 (2004). As the Washington Supreme Court stated, “while useful in interpreting the parties’ intent, the use of a lease or license label in the agreement will not be controlling.” *Barnett v. Lincoln*, 162 Wash. 613, 299 P.392 (1931).

Additionally, the Taxpayer generally asserts that there is value in the property irrespective of the presence of the sand and gravel, and notes that the Tenant is not required to remove any material from the property. We find this assertion inconsistent with the stated intent of the Agreement. Here, it is obvious that the Agreement would not have been entered into, but for the existence of sand and gravel on Taxpayer’s land.

An examination of the Agreement in its entirety reveals the foundation of the rights conveyed to the Tenant is the use of the land for extraction and processing of sand and gravel from the property. Furthermore, the Taxpayer’s own treatment of the income at issue in its books and records is consistent with the conclusion as the income was not recorded and identified as rental income. Accordingly, we conclude that the income at issue is not exempt from B&O tax under RCW 82.04.390 as amounts derived from the rental of real estate. We affirm the Audit Division’s assessment of Service B&O tax on this income. The Taxpayer’s petition for refund is denied.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 23rd day of December 2013.