Cite as Det. No. 98-080, 18 WTD 42 (1999)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 98-080
. . .	)	Registration No. . . .
	)	FY . . . /Audit No. . . .

RCW 82.29A.020: LEASEHOLD EXCISE TAX -- CONTRACT RENT -- LESSEE'S LEASEHOLD IMPROVEMENTS -- EXPENDITURES -- SUBSEQUENT GOVERNMENTAL ACTION. Costs for site relocation improvements paid by a lessee to bring a new site into compliance with the lessee's lease were found to be includable in the measure of "contract rent" when the relocation resulted from an option in the lease and the costs were clearly anticipated by both parties at the time the lease was executed.

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 port district protests additional leasehold excise taxes assessed on lessee's expenditures made for costs attributable to relocation leasehold improvements. [1]

FACTS:

Okimoto, A.L.J. -- The Port . . . (Port) is a municipal corporation located in Washington engaged in the business of operating a port district. The Port's books and records were examined by the Audit Division (Audit) of the Department of Revenue (Department) for the period January 1, 1992 through December 31, 1995. The audit resulted in additional taxes and interest owing in the amount of $ . . . and Document No. . . . was issued in that amount on November 27, 1997. The Port protested the assessment and it remains due.

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

Schedule 4: Proration of Lessor's Improvements Paid for by Lessee - . . . .

In this schedule, Audit assessed additional leasehold excise taxes on approximately $52,000 of site relocation expenses which . . . (lessee) was required to expend under the terms of the contract with the Port. Lessee conducted a sand reclamation operation on the property. The expenses included costs for site preparation, constructing berms, installing a de-watering retention area and fencing. The Port explained berms are 10-foot-high mounds of sand located around the area that isolate or buffer the sand reclamation operation from nearby tenants. The Port explained underground pipes were installed in the de-watering retention area so that water could be returned to the river after the sand had been removed. The fence performed both a safety and stabilizing function for the berms. Audit relied on the definition of "contract rent" contained in RCW 82.29A.020(a) and concluded these expenditures were incurred "for the protection of the lessor's interest" or were "expenditures for the improvements to the property" that became the property of the lessor. In accordance with RCW 82.29A.020, Audit assessed additional leasehold excise tax on these additional amounts of "contract rent."

Taxpayer concedes expenditures for leasehold improvements that subsequently become property of the lessor, fall within the original parameters of the definition of "contract rent," but argues the expenditures are later specifically excluded under RCW 82.29A.020(2)(a)(ii) as:

> . . . expenditures made by the lessee . . . for alterations or additions made necessary by an action of government taken after the date of the execution of the lease or agreement.

Taxpayer explains in its petition:

> [lessee] are tenants of the Port . . . . On or about September 15, 1992, the parties entered into a lease for a five year term. The lease provided that [lessee] could be required to move once, if necessary. With the construction of the project of what the Port terms as " . . . ", the Port mandated that [lessee] relocate its operations to a new site. [Lessee] paid an amount of $52,252 which was required to prepare the relocation site. The Washington State Department of Revenue has assessed a leasehold tax on the cost of the relocation site improvements. The Department prorated the improvements over the length of that five year lease.

Taxpayer argues:

> The Port . . . is, by definition, a governmental agency, in particular a municipal corporation under the laws of the State of Washington. The construction of a new terminal and replacement of [lessee] was the result of the passage of resolution by the . . . Commissioners . . . . , occurring after the date of the execution of the lease. Clearly, the relocation of [lessee] was "made necessary by the action of a government". The effect of the Port's governmental action was to require the expenditure by [lessee] of the improvements to the new site so they could relocate and continue their business. [lessee] spent over $50,000 to prepare the premises for the move.

ISSUE:

Are expenditures attributable to site improvements paid for by a lessee to bring a relocation site into compliance with the lessee's contract included in the measure of "contract rent" when the relocation resulted from an option in the lease and was clearly anticipated by both parties at the time of execution?

DISCUSSION:

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 applied. In Taxpayer's case, both Audit and Taxpayer agree that "taxable rent" means "contract rent." RCW 82.29A.020(2)(a) defines contract rent:

> (a) "Contract rent" shall mean the amount of consideration due as payment for a leasehold interest, including: The total of cash payments made to the lessor or to another party for the benefit of the lessor according to the requirements of the lease or agreement, including any rents paid by a sublessee; expenditures for the protection of the lessor's interest when required by the terms of the lease or agreement; and expenditures for improvements to the property to the extent that such improvements become the property of the lessor.
>
> . . .

(Emphasis added)

Audit contends this exclusion was meant to apply only to actions taken by governmental entities that were not a party to the leasehold contract and over which the parties of the contract had no control. In support of this Audit refers to a memorandum written by the legal counsel of a former Governor. Audit states:

> In looking at the summary of the leasehold excise tax statute in a memorandum written to then Governor Evans by his legal counsel, Chi-doo "Skip" Li, contemporaneous with passage of the leasehold excise tax, the purpose of the exemption was stated to be; "applies to facilities required to be built by the lessee by virtue of governmental action, such as pollution control devices, after execution of a lease. If the facilities are required already at the time the lease is entered into, this exemption does not apply."

Audit further contends the critical governmental action taken in Taxpayer's case was the execution of the original lease contract in 1992. Audit stresses this occurred well before the Lessee's eventual move in 1994. Furthermore, Audit points out the language in the contract indicates the move was anticipated by both parties at the time the contract was executed, was specifically negotiated for, and the anticipated site-relocation expenditures had been factored-into the monthly contract price.

We believe the intent of the legislature in enacting this particular provision was to exclude from the term "contract rent" only those additional expenditures over which the lessee had no control at the time the lease was entered into. The basis for this exclusion is that unexpected costs, such as pollution-control devices required by new legislation, should not be considered additional compensation to the lessor, because the expenditures were unforeseen and made primarily to maintain the existing business operation. Leasehold expenditures that only maintain and do not improve the leasehold are normally not inclusions to "contract rent." Det. No. 88-464, 7 WTD 85 (1988). Anticipated future costs borne by the lessee, however, such as costs associated with a relocation, would presumably have been considered in the negotiation process and reflected in lower negotiated monthly rental payments[2].

Furthermore, we disagree with Taxpayer's contention that the determinative governmental action under RCW 82.29A.020 was when the Port exercised its relocation clause under the contract. That action was merely the culmination of an ongoing program of development by the Port that was already in motion prior to the execution of the contract and clearly provided for at that time. To recognize that action as determinative under the statute would be an elevation of form over substance. Consequently, we believe the determinative governmental action, in this case, was the insertion of the relocation clause into the original lease. That action took place simultaneously with the execution of the contract and therefore does not qualify for the exclusion.

DECISION AND DISPOSITION:

Taxpayer's petition is denied.

Dated this 30th day of April, 1998.

[2] Indeed, the letter dated April 28,1994 from the Port to Taxpayer that notified Taxpayer of the Port's intention to exercise its option to require relocation indicates that the possibility of relocation was factored into the original lease agreement.