Cite as 3 WTD 39 (1987)

BEFORE THE INTERPRETATION AND APPEALS SECTION
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. 87-112
)	
)	Registration No. . . .
. . .)	(. . .)
)	Tax Assessment No. . . .
)	

[1] **CHAPTER 82.29A RCW:** LEASEHOLD EXCISE TAX. If a lease has not been negotiated in accordance with RCW 82.29A.020(2)(a), "taxable rent" is to be determined under 2(b) of that statute.

[2] **CHAPTER 82.29A RCW:** LEASEHOLD EXCISE TAX -- IMPROVEMENTS -- PERSONAL PROPERTY TAX. When a lessee makes improvements to publicly-owned property, and when the improvements remain the lessee's property at the lease expiration, the improvements are not taxable under the leasehold tax. They are taxable under the personal property tax, title 84 RCW.

[3] **CHAPTER 82.29A RCW:** CONSTITUTIONAL CHALLENGE. An administrative body does not have authority to determine the constitutionality of the law it administers; only the courts have that power.

[4] **WAC 458-20-100(12):** DEPARTMENT OF REVENUE PRECEDENT. Determinations by administrative law judges are to be "just and lawful and in accordance with the rules, principles and precedents established by the department of revenue."

[5] **RCW 82.29A.020:** LEASEHOLD INTEREST. When a private lessor sells real property to a county, the lessee is, thereafter, liable for leasehold excise tax.

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.

TAXPAYER REPRESENTED BY: . . .
. . .

DATE OF HEARING: October 23, 1985

NATURE OF ACTION:

The taxpayer petitions for a correction of a tax assessment concerning the leasehold excise tax.

FACTS:

Normoyle, A.L.J. (Successor to M. Clark Chandler, A.L.J.)--The taxpayer, an architect, entered into a real property lease covering the period from Mayá1, 1975 to May 1, 1985. The property was privately owned when the lease was signed. The lease, including two endorsements, provided as follows:

1. The base rent was $170.

2. The lessee intended to make improvements totaling $39,155.07.[1] The lessor agreed to allow the lessee, at his cost, to make the improvements. The lessor further agreed that:

a. Certain specific improvements would remain the property of the lessee (see attached Exhibit 1); and

b. The lessee had a diminishing interest in the real property in the original amount of $39,155.07. If the lease were cancelled by the lessor prior to its expiration, without the fault of the lessee, the lessor agreed to pay the lessee ten percent of this total for each year of the lease remaining at the time of cancellation.

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[1] The taxpayer has furnished before and after photographs of the building. Prior to the remodeling, the building was a concrete shell, formerly used for cleaning cars. The taxpayer turned it into a functional office.

The specific improvements referred to above, which were to remain the property of the lessee, consisted of improvements valued at $18,900.

On March 1, 1979, the lessor sold the real estate to the county. The taxpayer did not then enter into a new lease or any other contract with the county. Instead, he simply began to make his lease payments directly to the county. The taxpayer states that, after purchase by the county, he paid the leasehold excise tax each month, based on the lease rent of $170.

The Department of Revenue audited the county for the period from Januaryá1, 1981 to March 31, 1985. The auditor concluded that the taxpayer/architect had not fully paid his leasehold tax to the county and assessed back taxes directly against the taxpayer for that audit period. The auditor arrived at the tax by the following method:

$39,155.07 -- cost of lessee's improvements
- 3,719.07 -- lessee's own architect's fee
$35,436.00
-: 10 years (length of lease)
$ 3,543.60 annual "taxable rent"

The auditor then multiplied the "taxable rent" by the leasehold tax for each year of the audit.

The auditor did not credit the taxpayer with the lease tax payments that the taxpayer says that he made, which were based on an annual lease obligation of $2,040 (12 months x $170 rent). Instead, the auditor determined that the net cost of the improvements paid for by the lessee represented further consideration for the lease. In other words, under the analysis of the auditor, the total "taxable rent" on which the taxpayer should have paid the leasehold tax was a combination of the $170 per month rent and the prorated cost of the improvements ($3,543.60 per year).

When the lease expired, the taxpayer entered into a new lease with the county. That lease, effective May 15, 1985, provided for initial rent of $210 per month, increasing to $350 during the first year. The lease also recognized that the lessee-owned improvements, those listed in Exhibit 1, remained the property of the lessee.

The taxpayer's position is that he is being taxed for property that he, not the county, owns; that imposition of the tax is

unconstitutional; and that the leasehold tax doesn't apply in any event because, during the audit period, there was no lease between the county and the taxpayer.

ISSUES:

1. What is the "taxable rent," as defined in the leasehold excise tax statute?
2. Is imposition of the leasehold excise tax, under the facts of this case, an impairment of contract, in violation of the State Constitution?

3. Was there a lease or agreement between the taxpayer and the county?

DISCUSSION:

The pertinent parts of the leasehold excise tax statute, as it read at the time of this audit, are set out below.

> **RCW 82.29A.020:** . . . (1) "Leasehold interest" shall mean an interest in publicly owned real or personal property which exists by virtue of any lease . . . or any other agreement . . . between the public owner of the property and a person who would not be exempt from property taxes if that person owned the property in fee . . .
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> (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 . . . All other leasehold interests shall be subject to the determination of taxable rent under the terms of subsection (b) of this subsection.
>
> (a) . . .
>
> (b) If . . . a lessee is occupying or using publicly owned property in such a manner as to create a leasehold interest and . . . 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 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.
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> **RCW 82.29A.030:** (1) 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 on or after Januaryá1, 1976 . . . .
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> **RCW 82.29A.160:** Notwithstanding any other provision of this chapter, RCW 84.36.451 and 84.40.175, improvements owned or being acquired by contract purchase or otherwise by any lessee or sublessee which are not defined as contract rent shall be taxable to such lessee or sublessee under Title 84 RCW.
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> **RCW 82.29A.900:** This 1976 amendatory act . . . shall take effect immediately: . . .

The auditor incorrectly concluded that "taxable rent" in this case was "contract rent." She then applied the provisions of paragraph 2(a) of RCW 82.29A.020, instead of establishing taxable rent under 2(b) of that statute. The "contract rent" method of 2(a) is inapplicable because the lease was not, prior to or at the time of the audit, established through competitive bidding, negotiated in accordance with statutory requirements, or negotiated under circumstances, established by public record, clearly showing that the contract rent was the maximum attainable by the lessor. Believing that the "contract rent" did apply, the auditor assessed tax based on the total cost of the improvements less the architect's fee.

The tax should have been determined by application of paragraph 2(b). Under that part of the statute, the auditor is to consider 1) comparable leases, and 2) the fair rate of return on the market value of the leased property. The question of what was the taxable rent really boils down to this: During the audit period, what would the reasonable rental value have been, taking into account only those improvements owned by the lessor/county? That is, the rental value can only be determined by excluding the lessee-owned improvements (roughly one-half of the total remodel cost).

Further complicating the matter is the fact that the lessee retained a diminishing contract interest in the real property. For example, on Januaryá1, 1981, the beginning of the audit period, the lessee's interest was 40ápercent of the total cost of the improvements. We refuse, however, to elevate this diminishing contract interest into an ownership interest. The lessor owned the property, which included all improvements other than those which were specifically designated as being retained by the lessee. The lessee did not have legal title to those improvements not specifically designated. Rather, he merely had a diminishing contract interest which only would have gone into effect had the lessor terminated the lease.

We now turn to the threshold question: How is the "taxable rent" to be established under the unique facts of this case? As convoluted as it may seem, the only way to arrive at the taxable rent is to utilize one of the following methods during each year of the audit period, January 1, 1981, through Marchá31, 1985.

Method number one:

1. First, determine the reasonable rental value of the building without any of the improvements made by the lessee. From looking at the before and after photographs, it is doubtful that it would exceed the base rent of $170 per month.

2. Next, determine how much the total improvements increased the rental value.
3. Then, deduct that rental value attributable to the lessee-owned improvements.

4. Finally, deduct the amount of leasehold tax, if any, already paid by the taxpayer.

As an example only, this method would work as follows:

1. Under step 1, the "bare" rental value will be assumed to be $170.

2. Under step two, assuming that all of the improvements increased the rental value by $170, the total would be $340.

3. Under step three, the lessee-owned improvement (roughly one-half) would reduce the rental value by $85, making the total $255. The tax would be determined using this as the "taxable rent."

4. The tax is then reduced by the amount, if any, already paid by the taxpayer.

Unfortunately, the same four-step method must be employed for the other three years of the audit.

Method number two:

1. Determine what the reasonable rental value of the property would have been, had the lessee-owned improvements not been made.
2. Determine the leasehold tax on this value and then deduct the taxes, if any, already paid.

We note that the new lease between the taxpayer and the county, effective Mayá15, 1985, called for initial rent of only $210 per month. The lease also recognized that the specific lessee-owned improvements would be retained by the lessee. We take the rental provisions of this lease to be a strong indication of the reasonable rental value as of May 15, 1985, under method number two, i.e., $210 per month. It would, if rental values increased from 1981 to 1985, have to be reduced accordingly for the audit period.

Regardless of which method is used, because of the language of RCW 82.29A.160, the taxpayer is also liable for personal property tax for those improvements owned by him.

We now move to a brief discussion of the constitutional argument. The taxpayer argues strenuously and persuasively that imposition of this tax, under these facts, violates Article 1, Section 23 of the Washington State Constitution in that the tax impairs the obligation of a contract--the contract here being the original lease. The leasehold excise tax was effective Marchá1, 1976. The lease was entered into in 1975, and was for ten years. Neither the lessor nor the lessee contemplated the tax and no provisions were included in

the lease to cover the possibility of the lessor, during the lease term, selling to the county. The tax, the argument goes, imposes new conditions on the lessee and decreases the lease value.

As an administrative agency, we operate under certain constraints. One of them is that "An administrative body does not have authority to determine the constitutionality of the law it administers; only the courts have that power." Bare v. Gorton, 84 Wn.2d 380, 383 (1974). Therefore, we are unable to consider the taxpayer's constitutional challenge.

The last argument is that there was never, during the audit period, a lease "between the public owner" and the taxpayer, as required by RCW 82.29A.020(1). That is, the only lease or agreement was between the taxpayer and the original lessor.

Another constraint under which administrative law judges operate is that their determinations are to be "just and lawful and in accordance with the rules, principles and precedents established by the department of revenue. . . ." WAC 458-20-100(12). The precise issue raised by this taxpayer was argued numerous times by other taxpayers in other appeals. The Department's uniform position is that the tax commenced when the public body bought the property and assumed the lessor's interest. As was stated in an earlier Determination:

> When the city . . . purchased the building it succeeded to the interests of the prior owner including its interest as a lessor of space in the building. The city took the place of the prior owner in the lease and thus became a party to the lease. Therefore, the lease is between the taxpayer and the public owner of the property and met the statutory definition of a "leasehold interest."

While the taxpayer's argument is well taken--that the purchase by the county, without a novation of the lease or any other agreement between the county and the lessee, does not, ipso facto, transform the lease to one between the county and the taxpayer--we are bound by precedent established by the Department, in the absence of a court decision to the contrary.[2] Here, there is no such court decision.

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[2]See also, Board of Tax Appeals Docket No. 23543, where the Board of Tax Appeals upheld the Department's position.

DECISION AND DISPOSITION:

This appeal is referred back to the Audit section to determine, under RCW 82.29A.020(2)(b), what the "taxable rent" was during the audit period. If the taxpayer is able to verify to the auditor that he paid the leasehold tax to the county, based on the lease payments of $170 per month, the tax is to be reduced accordingly. Any interest due under RCW Chapter 82.32. is waived from February 28, 1986, to the due date of the corrected assessment to be issued by the Audit Section, because the delay in the issuance of this Determination was for the sole convenience of the Department.

Additionally, under RCW 82.29A.160, the specific improvements owned by the lessee, i.e., those listed in Exhibit 1, are subject to personal property tax under Title 84 RCW.

DATED this 17th day of April 1987.