

Cite as Det. No. 16-0283, 36 WTD 126 (2017)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Refund of) D E T E R M I N A T I O N
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 No. 16-0283
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 Registration No. . . .
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[1] RCW 82.45.030(1): REET – “SELLING PRICE” – TRUE AND FAIR VALUE – ARM’S LENGTH TRANSACTION. If a sale was an arm’s length transaction between unrelated parties, the amount actually paid for a commercial property is presumptively its “true and fair value,” and thus the correct tax measure; a retrospective appraisal that excludes the favorable leases in place, and values an occupied building using only the market value of leases (i.e., as if the building were empty), does not rebut the presumption.

[2] RCW 82.45.032(3)(c): REET – “SELLING PRICE” – TRANSFER OF A LEASEHOLD INTEREST. The seller of a commercial business does not have a leasehold interest in its own building that should be excluded from the “selling price.” Only tenants or renters can have “leasehold interests.”

[3] RCW 84.04.080: LEASEHOLD INTEREST – PERSONAL PROPERTY. Even though a tenant’s leasehold interest might be intangible personal property to a tenant, it is still an interest in real property to the owner of the property and must be included in the measure of the 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.

Bauer, T.R.O. – Taxpayer sold a two-story concrete Class B office building and paid Real Estate Excise Tax (REET) based on the total consideration paid. Taxpayer now petitions for a partial refund of the REET, claiming that the amount it paid exceeded the property’s “true and fair value.” We conclude that Taxpayer has failed to rebut the presumption that the total consideration actually paid was the property’s true and fair value. We deny Taxpayer’s petition.¹

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

ISSUE

Has Taxpayer rebutted the RCW 82.45.030(1) presumption that the total consideration Taxpayer received for the sale of an office building was its “true and fair value, because:

- a. An after-acquired appraisal as of the 2013 sales date calculated the value of the property to be \$. . . less than the total consideration paid; or
- b. The value of Taxpayer’s interests in the tenant leases should have been excluded from the measure of REET, either as “leasehold interests” under RCW 82.45.010(3)(c), or because they were intangible personal property excludable from the measure of the REET?

FINDINGS OF FACT

On April 12, 2012 (sale date), [Taxpayer] sold a . . . Class B office building . . . that was 90% leased and occupied by four tenants (Property), . . . , [an out-of-state] limited liability company (Buyer), in an arms’ length transaction for \$. . .² The credit status of the tenants was “excellent.”³ The sale, memorialized in a “Purchase Agreement” (Agreement), was for “the Property,” which included 6.7447 acres of land together with all of Seller’s right, title, and interest in all rights, easements, and interest appurtenant thereto including “the structures, personal property,” and “Seller’s interest in all leases and other agreements to occupy all or any portion of the Property that are in effect . . . (“Leases”).⁴

According to Taxpayer, as of the sale date, the four tenants’ rental rates ranged from \$. . . per square foot to \$. . . per square foot with increases in rent increasing annually by \$. . . per square foot. Market rent assumes typical renewal tenant improvement allowances, 5-10 year lease terms, and annual increases. Market rent is assumed on a triple net basis, with the tenants reimbursing 100% of their pro rata shares of NNN⁵ charges.

Taxpayer correctly asserts that intangible value is created when actual rents are above market rents or when the risk of the tenant defaulting on the lease is less than the average risk in the market place. Taxpayer states that, in this case, the buyer paid a premium over and above the fee simple value of the property because in addition to purchasing the property, it was also purchasing leases with above-market value.⁶

Tangible personal property included in the sale was valued at “0.”⁷

² Appraisal, “Summary of Appraisal,” p.2, “Property Description.”

³ Appraisal, “Introduction,” p. 9, “Ownership History.”

⁴ Agreement, “Purchase and Sale,” p.1, para 1

⁵ NNN refers to triple net lease wherein there are no landlord responsibilities. The tenants are responsible for taxes, insurance, and all maintenance (including roof and structure) exactly as if they were the owners of the building.

⁶ Appeal, Attachment, p.3, paras. 3-5.

⁷ Real Estate Excise Tax Affidavit.

According to Taxpayer, it did not perform an analysis of the real estate component of the transaction, but paid the (REET) on the full sales price. Taxpayer asserts it did not seek out professional guidance and did not know of the benefit of appropriate guidance and consideration of valuation techniques customarily considered by professional real estate appraisers.⁸

In 2014, Taxpayer hired an appraiser (. . .) to perform an appraisal of the Property as of its sale date to establish the Property's fee simple estate market value for use by Taxpayer in this real estate excise tax appeal.⁹ The Appraisal, dated May 12, 2014 (the Appraisal), considered two approaches to the Property's fee simple value—sales comparison and direct capitalization—in order to arrive at a final value:¹⁰

Approaches to Value & Final Value Conclusions	Comments
Sales Comparison Approach	\$. . . \$. . . /sq ft
Income Capitalization Approach	7.9% cap rate on projected NOI ¹¹
Retrospective Conclusion, Stabilized	\$. . . \$. . . /sq ft, 7.9% OAR
Less Shortfall ¹²	\$. . .
Retrospective Conclusion, As is	\$. . . \$. . . /sq ft

The appraisal noted:

The sales comparison approach is based upon comparable transactions. This approach is normally a strong indicator of value when adequate sales data are available. This approach is a good measure of market activity when recent sales are available and, like the income capitalization approach, this approach responds quickly to changes in the activity is somewhat muted. Given the lack of recent data, this method of analysis is only given minor emphasis in the overall correlation of value.

The income capitalization approach is generally considered a strong indicator of value for income-producing properties. The primary strength of this approach is income and operating levels respond quickly, if not immediately, to conditions in the market. Income information is based on market rent. Expenses were estimated using proforma expenses

⁸ Appeal of Refund Denial dated September 3, 2015, p. 1.

⁹ Appraisal, "Summary of Appraisal," Page 2.

¹⁰ Appraisal, "Summary of Appraisal," Approaches to Value & Final Value Conclusion," Page 3.

¹¹ NOI is the acronym for net operating income

¹² This "shortfall" was the vacancy shortfall. As to this shortfall, the Appraisal stated on p.76:

As noted, the subject was 90% leased at the retrospective date of value. In order to estimate the value of the property in its retrospective as-is fee simple condition, a typical purchaser (an investor) would make an adjustment to value to account for the cost of taking on the property in an unstabilized condition. The cost of the lease up includes both hard costs and opportunity costs. Hard costs include TIs [tenant improvements] and leasing commissions. Opportunity costs include lost rent and recoveries.

and various expense comparisons, along with investment parameters based upon sales used in the sales comparison approach. Based on fee simple valuation, only the direct capitalization method was considered.

Most emphasis is placed on the income capitalization approach. The subject is income producing and, from an investor's point of view, earning power is a critical element effecting [sic] property value. As a result, it is concluded the evidence best supports a retrospective market value of the fee simple estate in the subject property, as of June 20, 2012, of:

\$. . .¹³

On September 23, 2014, based on the Appraisal, Taxpayer applied to . . . County for a refund of a portion of the REET it had paid. Based on its assertion that "a leasehold interest in real estate for a term less than life is personal property," and the RCW 84.04.080 definition of personal property as including all leases of real property and leasehold interests therein for a term less than the life of the holder,¹⁴ Taxpayer reasons that it was due a refund because the REET on its original Affidavit # . . . should have been calculated as follows:¹⁵

Gross Selling Price	\$. . .
 Less Personal Property:	
Tangible Personal Property	(. . .)
Leasehold Interest	(\$. . .)
 Taxable Selling Price based on fee simple value of the property	
REET Due at .0178	\$. . .
REET Paid	\$. . .
 Refund Due	
	\$. . .

. . . County did not act on Taxpayer's refund request, but forwarded it to the Special Programs Division of the Department. On August 6, 2015, the Department's Real Estate Excise Tax Auditor denied Taxpayer's petition. On September 2, 2015, Taxpayer appealed that refund denial to this division.

Taxpayer's appeal is based on the argument that the Property's tenant leases were above market rent, and that Buyer thus paid a \$. . . premium for them: That \$. . . premium, argues Taxpayer, constituted the purchase of leasehold interests that constituted personal property based on the RCW 84.04.080 definition of "personal property" (includes all leases of real property therein for a term less than the life of the holder) and the cases *Andrews v. Cusing*, 65 Wn.3d 205, 396 P.2d 155

¹³ Appraisal, "Reconciliation & Final Value Opinions," p. 76. The \$. . . value, however, did not take into account the \$. . . shortfall, which then brought the retrospective value down to \$. . .

¹⁴ Ltr dated September 23, 2014 to the Fiscal Specialist, . . . County Records, p. 2.

¹⁵ Ltr dated September 23, 2014 to the Fiscal Specialist, . . . County Records, p. 3.

(1964) and *In re Barclay's Estate*, 1 Wn.2d 82, 85, 95 P.2d 393 (1939), both of which held that a lease of real estate for a term less than life is personal property. Thus, argues Taxpayer, because the REET is imposed on real property, and not personal property, the excess value of these leases in the amount of \$. . . must be subtracted from the measure of the REET.¹⁶

ANALYSIS

Washington's REET is imposed on the "sale of real property" measured by its "selling price." RCW 82.45.060. The term "sale" for REET purposes is defined by RCW 82.45.010(1):

As used in this [REET] chapter, the term "sale" has its ordinary meaning and includes any conveyance . . . or transfer of the ownership of or title to real property . . . or any estate or interest therein for a valuable consideration . . .

(Emphasis added.) "Selling price," for purposes of the REET, is defined by RCW 82.45.030(1):

As used in this chapter, the term "selling price" means the true and fair value of the property conveyed. If property has been conveyed in an arm's length transaction between unrelated persons for a valuable consideration, a rebuttable presumption exists that the selling price is equal to the total consideration paid

Thus, the "sale of real property" for REET purposes includes not only the transfer of ownership of or title to the physical land and structure, but also includes any "interest" or "estate" in that property. WAC 458-61A-101(2)(c) defines "true and fair value" as "market value, which is the amount of money that a willing, but unobligated, buyer would pay a willing, but unobligated, owner for real property, taking into consideration all reasonable, possible uses of the property."

If a sale was an arm's length transaction between unrelated parties, the amount actually paid for a property is presumptively its "true and fair value," and thus, the correct tax measure. In this case, Taxpayer and Buyer were unrelated and dealt with each other at arm's length. The parties agreed that the Property's true and fair value as of the date of the sale—taking into account the Property's actual and anticipated retail and office space leases—was \$. . . , and, ultimately entered into a Purchase and Sale Agreement for that amount. Accordingly, the weight of the evidence at this point strongly supports the conclusion that the property's true and fair value was equal to the consideration paid.

Taxpayer, however, seeks to rebut the RCW 82.45.030(1) presumption that the amount paid equaled the property's "true and fair value." To this end, Taxpayer presents (a) a retrospective appraisal, and (b) the argument that Taxpayer's "leasehold interests" should have been excluded from the tax measure, and the building appraised as if it were vacant.

a. Whether an after-acquired market value appraisal rebuts the presumption that the property's actual selling price was its "true and fair value."

¹⁶ Petition for Refund, dated September 3, 2015, Attachment, p. 3.

RCW 82.45.032(1) defines the term "real property," in relevant part, as:

"Real estate" or "real property" means any interest, estate, or beneficial interest in land or anything affixed to land, . . .

(Emphasis added.) This definition essentially [equates to] the "leased fee estate" of the interests in the property that Taxpayer sold – i.e., the value of the commercial building encumbered by the actual tenant leases.¹⁷

The Appraisal noted that when one establishes the market value of a fee simple interest, one "assumes the property is leased at market with normal rent schedule profiles."¹⁸ The Appraisal's reconciled value of \$. . . for a fee simple appraisal thus assumed that the Property was leased to only market or average quality tenants. The appraisal did not take into account the increased value of the tenants that actually occupied the Property.

A property value using an income capitalization method or income approach to establish a fee simple interest value is based on market rent at the time of the sale, and the estimate of market rent is based on a search of similar industrial properties throughout the competitive trade area.¹⁹ It provides a value indication for the property by estimating net income through an analysis of the market including past performance levels as well as projections for the future.²⁰ Stated another way, "market rent" is the rental income that a property would most probably command in the open market, indicated by the current rents paid, and asked for, for comparable space as of the date of the appraisal. When the value of leases actually in effect at the time of a property's sale deviates from the prevailing market rates, however, such leases will affect a property's actual value and selling price.²¹ Such was the case here.

¹⁷ A "leased fee estate" is defined as: "An ownership interest held by a landlord with the rights of use and occupancy conveyed by lease to others. The rights of the lessor (the leased fee owner) and the leased fee are specified by contract terms contained with the lease." THE DICTIONARY OF REAL ESTATE APPRAISAL 204 (3d ed., The Appraisal Institute 1993)

¹⁸ Appraisal, "Introduction," p. 62.

¹⁹ Appraisal, "Scope of Appraisal," p. 11, 6th bullet.

²⁰ Appraisal, "Income Capitalization Approach," p. 62, para 1.

²¹ See Jason J. Krentler, SRR Global Financial Advisory Services, Purchase Accounting Valuation for Various Real Property Assets, 21 Complex Real Property – Tangible and Intangible Assets and Liabilities, *Favorable/Unfavorable Leasehold Analysis (Above- and Below-Market Leases)*, at <http://www.srr.com/article/purchase-accounting-valuation-various-real-property-assets> (last visited Jun 17, 2015):

Favorable/Unfavorable Leasehold Analysis (Above- and Below-Market Leases) - Beyond the value of the lease contracts in place, there are also potential assets or liabilities in the presence of lease contracts that deviate from the market. From the acquirer's perspective, above-market leases are considered an asset in that income is attributable to the contract beyond what would be available in the market. To the contrary, below-market lease contracts would be considered a liability via the income impairment throughout the term of the lease.

To determine whether or not in-place leases are favorable or unfavorable, contract leases and current listings of comparable properties are analyzed to determine a rental rate and expense structure typical of the market. If the contract lease rate deviates from the concluded market rate, the annual contract rent is subtracted from the annual market rent to determine the difference in annual cash flows for the remainder of the lease term. For above-market leases, it is reasonable to assume the tenant would decline any options to extend. For below-market leases, the remaining lease term is typically projected to include all defined, favorable option terms.

- Contracts with above-market rents have a positive Fair Value (i.e., an asset exists)

In the Appraisal, only the direct capitalization analysis was used. The main reason for this was due to the interest appraised, which was the fee simple position.²²

Thus, the Appraisal, based on market rents and the direct capitalization approach, disregarded the actual value of the leases in effect as of the date of the sale. Using “market value rents,” the Appraisal established the property’s “As is Market Value – Fee Simple, as of sale date,” to be \$. . .

The actual total arms-length consideration paid for the property, as encumbered by existing leases, was \$. . . When commercial property is sold by a seller to an unrelated buyer, and when the property is encumbered by existing favorable leases, as was the case here, the seller may not later rebut the presumption that the price actually paid for a property was its fair value by producing an after-the-fact appraisal of the property as if it were empty (i.e., available for rent at market value). By doing so, Taxpayer is mischaracterizing the nature of the property as it actually was when sold. Accordingly, we give little weight to the Appraisal and hold that it does not provide evidence to overcome the presumption that the actual selling price of the property was its “true and fair value” and the correct measure of the REET.

b. Whether the value of Taxpayer’s interests in the tenant leases should have been excluded from the measure of REET as either “leasehold interests” in accordance with RCW 82.45.010(3)(c), or because such leasehold interests were intangible personal property.

RCW 82.45.010(3)(c) provides that, for REET, a “sale” does not include: (c) A transfer of any leasehold interest . . .”

- Contracts with below-market rents have a negative Fair Value (i.e., a liability exists)

See also Wikipedia, Real Estate Appraisal, at https://en.wikipedia.org/wiki/Real_estate_appraisal (last visited Jul 1, 2015):

Types of ownership interest

The type of real estate "interest" that is being valued must also be known and stated in the report. Usually, for most sales, or mortgage financings, the fee simple interest is being valued. The fee simple interest is the most complete bundle of rights available. However, in many situations, and in many societies which do not follow English Common Law or the Napoleonic Code, some other interest may be more common. While there are many different possible interests in real estate, the three most common are:

- **Fee simple value** (known in the UK as freehold) – The most complete ownership in real estate, subject in common law countries to the powers reserved to the state (taxation, escheat, eminent domain, and police power).
- **Leased fee value** – This is simply the fee simple interest encumbered by a lease. If the lease is at market rent, then the leased fee value and the fee simple value are equal. However, if the tenant pays more or less than market, the residual owned by the leased fee holder, plus the market value of the tenancy, may be more or less than the fee simple value.
- **Leasehold value** – The interest held by a tenant. If the tenant pays market rent, then the leasehold has no market value. However, if the tenant pays less than market, the difference between the present value of what is paid and the present value of market rents would be a positive leasehold value. For example, a major chain retailer may be able to negotiate a below-market lease to serve as the anchor tenant for a shopping center. This leasehold value may be transferable to another anchor tenant, and if so the retail tenant has a positive interest in the real estate.

²² *Id.* The appraiser went on to explain:

If the leased fee interest were being appraised, a property of this scale would be a good fit for a discounted cash flow analysis, and that would be the perspective of the most probable buyers, institutional investors. However, the fee simple interest assumes the property is leased at market with normal rent schedule profiles.

Taxpayer asserts that its leasehold interest in the property should therefore have been excluded from the taxable measure of the REET.

Only a tenant or a renter, however, can hold a leasehold interest.²³ Thus, when a tenant sublets or otherwise transfers its leasehold interest to another tenant, such a sale is not subject to the REET in accordance with RCW 82.45.010(3)(c). This is the type of “sale” that is intended to be exempt from the REET by RCW 82.45.010(3)(c).

The owner and landlord of a commercial property cannot own a leasehold interest in its own property. Instead of a leasehold interest, a landlord has a “leased fee estate,” which is basically an ownership interest in the property held by a landlord when the rights of use and occupancy have been conveyed by lease to another. Thus, a landlord’s “leased fee estate” is an interest in real property that is substantially different than that of a tenant’s leasehold interest.

The RCW 82.45.010(3)(c) exclusion does not apply in this case because Taxpayer did not own or sell a leasehold interest in the property that should be excluded from the taxable measure of the REET.

Taxpayer further asserts that the leasehold interest that was included in the sale should have been excluded from the REET’s taxable measure because leasehold interests are personal property.²⁴ Taxpayer’s argument, however, is misplaced.

Even if we were to concede that all leasehold interests in real property for a term less than the life of the holder constitute intangible personal property to the owner of the leasehold interest, the fact remains that only tenants can have leasehold interests, and Taxpayer was not a tenant. Taxpayer, therefore, could not own, or transfer, leasehold interests, but only its own interests in the tenant leases. Although the leasehold interests of Taxpayer’s tenants might have constituted intangible personal property to them, Taxpayer’s leased fee estate in those same tenant leases were an interest in real property to Taxpayer. Such an interest is not a leasehold interest that is intangible personal property, but an interest in real property that must be included in the measure of the REET.

Taxpayer’s arguments that Taxpayer’s leasehold interest should have been excluded from the measure of the REET under RCW 82.45.010(3)(c) or because a leasehold interest is intangible personal property is flawed. Taxpayer did not own, or sell, a leasehold interest. Taxpayer’s petition as to this issue is therefore denied.

²³ “Leasehold estate” is defined as:

The interest held by the lessee (the tenant or renter) through a lease conveying the rights of use and occupancy for a state term under certain conditions.

THE DICTIONARY OF REAL ESTATE APPRAISAL 204 (3d ed., The Appraisal Institute 1993)

²⁴ In support of Taxpayer’s argument that leasehold interests are intangible personal property, Taxpayer relies on RCW 84.04.080, which provides:

“Personal property” for the purposes of taxation shall be held and construed to embrace and include . . . all leases of real property and leasehold interests therein for a term less than the life of the holder” . . .

Taxpayer also cites the following cases for the proposition that leasehold interests are personal property. *Andrews v. Cusin*, 65 Wn.2d 205, 396 P.2d 155 (1964); *In re Barklay’s Estate*, 1 Wn.2d 82, 85, 95 P.2d 393 (1939); and *Arthur Gossan v. Scott Noble*, Docket No. 55469 (BTA, June 19, 2001).

DECISION AND DISPOSITION

Taxpayer's petition for refund is denied.

Dated this 1st day of September 2016.