Cite as Det No. 11-0080, 31 WTD 24 (2012)

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. 11-0080
. . .	)	
	)	Registration No. . . .
	)	Document Nos. . . .
	)	Audit Nos. . . .
	)	Docket No. . . .

WAC 458-20-135, WAC 458-20-118; B&O TAX – RENTALS – LICENSES – MINERAL LEASES. Royalties received under a mineral lease are for the grant of the right to extract natural products and are treated as a license or a profit a prendre, not as the rental of real property.

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.

Sohng, A.L.J. – Landowners protest the imposition of business and occupation tax, contending that payments received under a "Mineral Lease" are really exempt rental payments for granting exclusive rights to possess the property. The petition is denied.[1]

ISSUE

Are annual amounts received by landowners under a "Mineral Lease" considered payments for the rental of real property, which is exempt from B&O tax, or for the grant of rights to extract sand and gravel, which is subject to service and other activities business and occupation ("B&O") tax under RCW 82.04.290(2)?

FINDINGS OF FACT

[Taxpayer] is a partnership located in . . . Washington. Taxpayer owns . . . ranch land . . ., some of which contains sand and gravel deposits. [In] 1995, Taxpayer entered into a "Mineral Lease" (the "Agreement") with [a Company] for two parcels of land ("Parcel 1" and "Parcel 2") . . . for

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

a term of 30 years (for Parcel 1) and 20 years for (Parcel 2). On May 1, 1999, [the Company] assigned the Agreement to [Company 2], who is the current "lessee" ("Lessee").[2]

The Agreement calls for two forms of payments.

1. Minimum Annual Royalty. Section 2.2 requires Lessee to pay Taxpayer a "Minimum Annual Royalty" . . . .
2. Production Royalty. Section 2.1.1 of the Agreement requires Lessee to pay Taxpayer a "Production Royalty for all sand, gravel, rock and construction aggregates (the 'Minerals') consumed, produced, sold or shipped from the Premises" . . . .[3]

Both the "Minimum Annual Royalty" and the "Production Royalty" are subject to annual inflation adjustments under §2.3 of the Agreement. In 2010, the "Minimum Annual Royalty" and the "Production Royalty," after inflation adjustments, were $. . . and $. . ./ton, respectively. Section 2.1.3 provides for the recoupment of the "Production Royalty" as follows:

> All Production Royalties paid shall be credited against and deducted from payments of Minimum Annual Royalty, as required by § 2.2 of this Lease, which is to say: in the event Lessee pays a Minimum Annual Royalty of $. . . for an annual period, then payments of Production Royalties are not due until the amount of the Production Royalties due for said period exceeds the $. . . Minimum Annual Royalty amount, and then only in the amount in excess of said [Minimum Annual Royalty amount]. In the event the Production Royalty in an annual period is less than the Minimum Annual Royalty for that same period, the difference shall be a Production Royalty Credit. During any subsequent period, Lessee may apply the Production Royalty Credit to offset only Production Royalties in excess of Minimum Annual Royalties, it being the intent of the parties that, notwithstanding any Production Royalty Credit, the Minimum Annual Royalty due for each annual period of the term shall be paid when due.

Thus, any "Production Royalty" is payable only to the extent it exceeds the "Minimum Annual Royalty" in any given year. And the "Minimum Annual Royalty" is due regardless of the volume of mining activity that occurs.

Lessee's use and possession of the premises are addressed in the following provisions. Section 1.2 of the Agreement states:

> Lessee's right to possession and the obligations of possession shall begin as of the Commencement Date and shall end on December 31, 2024, as to Parcel 1 and December 31, 2014, as to Parcel 2, unless sooner terminated or extended as herein provided.

[2] Reference to [Company 2] as "Lessee" throughout this determination is for convenience only and does not indicate the Department's opinion that the Agreement is a lease or rental of real estate.
[3] Section 2.1.1.2 of the Lease provides for a discounted Production Royalty during the first five years of the term . . .

Section 3.1 of the Agreement, captioned "Lessee's Permitted Use," provides that Lessee may exclusively use the premises "only for the mining, processing, stockpiling and removal of the Minerals contained therein, by open-pit excavation." Section 3.1 also allows Lessee to construct and maintain "access roads, work shops, site offices and utilities required of a sand and gravel quarry," as well as a "concrete or asphalt batch plant processing Minerals. . . ."

Section 3.4 of the Agreement provides "[Taxpayer] may use the Premises for [Taxpayer's] own purposes without restriction, so long as Lessee's permitted use of the Premises is not impaired."

The Audit Division examined Taxpayer's books and records for the periods January 1, 2003, through December 31, 2005, and January 1, 2006, through December 31, 2009 (the "Audit Periods"). On August 4, 2010, the Audit Division issued assessments for each Audit Period in the amounts of $. . . and $. . ., respectively, for a total of $. . . .

On October 1, 2010 (after the audit had been concluded), Taxpayer and Lessee executed an addendum to the Agreement (the "Addendum"), which stated that it was made to "update and clarify the status, rights and obligations of the parties . . . ."[4] The Addendum further provides as follows:

> The term "Minimum Annual Royalty" is "Rent" for the exclusive use by Lessee of the real property. Lessee's interest in this property is contingent upon the payment of the "Annual Rent" as required in Section 2.2.
>
> All references to "Minimum Annual Royalty" are deleted and "Annual Rent" is substituted.

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]ncome derived from the sale or rental of 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.

In defining the term "lease or rental of real estate," WAC 458-20-118 ("Rule 118") states:

[4] Addendum to Mineral Lease, p.1.

> 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.

In the present case, the limited purpose was explicitly stated in §3.1 of the Agreement, which allows Lessee to use Taxpayer's land only for "mining, processing, stockpiling and removal" of minerals. And while §1.2 of the Agreement purports to grant Lessee the "right to possession," §3.4 of the Agreement effectively negates such right by Taxpayer's express retention of the right to use the premises "without restriction, so long as Lessee's permitted use of the Premises is not impaired." Lessee's inability to exclude all others, including the landowner, and its ability to only prevent impairment of its permitted use are wholly consistent with the rights customarily held by a profit holder, as enunciated in the *Hoglund* case. Thus, Lessee's right to mine Taxpayer's land under the Agreement is not a possessory interest in land which carries with it the

right to exclusive possession and control. Rather, such right is a profit a prendre and amounts received thereunder are royalties subject to B&O tax pursuant to Rule 135(5).

Moreover, our holding is consistent with Washington case law that recognizes the distinction between a "royalty lease," under which "royalties" are paid, and a "landlord-tenant lease," under which "rent" is paid. *See Fulle v. Boulevard Excavating, Inc.*, 20 Wn. App. 741, 582 P.2d 566 (1978); *Lang v. Walker's Paving, Inc.*, 121 Wn. App. 1015, 2004 WL 86379 (2004). The case of *Adams v. Washington Brick, Lime & Mfg. Co.*, 38 Wn. 243, 80 P. 446 (1905), involved a mineral lease of a clay deposit with a nearly identical payment structure to that of the instant case. The lessee in *Adams* was required to pay a $200 annual "minimum royalty," regardless of whether any clay was removed from the land, plus a royalty on all brick manufactured from the clay. The Washington Supreme Court found that the "principal impelling purpose" of the agreement was the clay on the premises:

> The 'lease' was a contract affording an authorization under which this clay could be made into brick, sold, and the desired profit attainted. It is inconceivable that this 'lease' would ever have been executed had it not been for the presence of this clay.

Id. at 247, 80 P. at 447. The landowner in the *Adams* case argued that the contract was in reality a lease of real property for a sum certain and that clay removal and brick-making were mere incidents to the lease. The Court disagreed, stating, "While the instrument is a lease in outline, yet its provisions show that brick-making, instead of being a mere incident, was the prominent purpose contemplated." *Id*. at 249, 80 P. at 448. With respect to the provision in the lease that prohibited use of the premises for a purpose other than removal of the clay for brick-making, the Court said, "How a certain purpose can be considered a mere incident in a lease, when the use of the premises is expressly confined to that one purpose, is somewhat difficult to comprehend." The court concluded that the contract in question did not give an unlimited right of possession; rather, it was an instrument giving possession for one purpose only, and as such, "must be deemed something other than an ordinary lease."

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. Coupled with the restriction against using the premises for any purpose other than mining, the Agreement clearly fails to grant Lessee an unlimited right of possession and therefore, cannot be a lease of real property under the rationale of the *Adams* case.

Nor are we persuaded by Taxpayer's argument that the Agreement is "overwhelmingly" a lease of real property by virtue of the existence of the following contractual provisions:

- It resembles a triple net lease, under which Lessee must pay taxes, insurance, and maintenance;
- Lessee may assign or sublease the premises with Taxpayer's consent, which may not be unreasonably withheld;

- Lessee is required to grant the state a right of way or easement on the premises for purposes of providing utility services;
- In the event the premises are condemned by right of eminent domain, Lessee is entitled to receive a "Leasehold Award," which represents the fair market value of Lessee's "leasehold estate"; and
- Lessee is required to indemnify Taxpayer from all liabilities asserted against Taxpayer in connection with Lessee's use or possession of the premises.

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, if not all, of the provisions cited by Taxpayer may typically 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.

Furthermore, many, if not all, of the provisions Taxpayer cites above frequently appear in "mineral leases" or other instruments creating profits a prendre and are not the exclusive province of true leases. Most profits a prendre are 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)).

Taxpayer further argues that the "Minimum Annual Royalty" (or "Minimum Annual Rent," as modified by the Addendum) is actually rent because it is paid whether or not mining activities occur. We find that it 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. *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). In *Weyerhaeuser Real Estate Co. v. Stoneway Concrete, Inc.*, 96 Wn. 2d 558, 637 P.2d 647 (1981), the Washington Supreme Court considered a mining lease that contained a provision for payment of minimum annual rental "irrespective of whether Lessee produces any minerals from the leasehold." The Court applied the doctrine of commercial frustration and held that the lessee was not obligated to pay the minimum annual rental where public opposition, litigation, and the enactment of environmental legislation made the lessee's planned strip mining operation unfeasible. The Court said:

> We believe that the purpose of that provision is to discourage idleness and procrastination when it is permissible to mine, not to allocate the risk of nonissuance of permits. As the dissenting judge of the Court of Appeals stated:
>
> > That language is not uncommon in mining leases. Its purpose is often "to insure a steady income to the lessor and to spur the lessee into a prompt and diligent development and operation of the property."
>
> 28 A.L.R.2d at 1015- 16. *Weyerhaeuser Real Estate Co. v. Stoneway Concrete Inc.*, [26 Wash. App. 882, 614 P.2d 249 (1980)] at 890-91. (Dore, J., dissenting).

Id. at 565, 637 P.2d at 651.

Likewise, Taxpayer requires Lessee to pay a minimum royalty to ensure that it makes productive use of its rights under the Agreement to extract sand and gravel, which in turn results in the "Production Royalty." The "Minimum Annual Royalty" is not in exchange for the occupancy or possession of real estate. Thus, the provisions of the Agreement actually support a finding that the arrangement between Taxpayer and Lessee is a profit a prendre, rather than a lease of real property.

Taxpayer also argues that reference throughout the Agreement to a "leasehold" and the revised language in the Addendum that changed the term "Minimum Annual Royalty" to "Annual Rent" cannot be ignored. Taxpayer has gone to great lengths to give the Agreement the appearance of a lease or rental of real estate. However, 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). An examination of the Agreement in its entirety reveals that it only conveys the right to use Taxpayer's land for mining activities. Accordingly, the royalty income at issue is not exempt from B&O tax under RCW 82.04.390 as amounts derived from the rental of real estate.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 7th day of March, 2011.