The following is a proposed draft Washington Tax Decision that is provided to the public for discussion purposes only. It has not been approved as a final Washington Tax Decision and cannot be relied upon as precedential under RCW 82.32.410

Cite as Det. No. 18-0105, Annual WTD Page (Year)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS 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. 18-0105
. . .	)	Registration No. . . .

[1] WAC 458-20-118: B&O TAX – LICENSE TO USE REAL ESTATE – LEASE OR RENTAL OF REAL ESTATE – AUTHORITY TO DO A PARTICULAR ACT – EXCLUSIVE RIGHT TO CONTINUOUS POSSESSION. A franchisor is not exempt from B&O tax on charges that it designates as rental charges when its franchisees are only granted the authority to do the particular act of operating a store subject to the franchisor's extensive and detailed restrictions, and do not have an exclusive right of continuous possession against the franchisor, who enjoys practically unfettered access to the stores.

[2] WAC 458-20-228; RCW 82.32.105: PENALTIES – GOOD FAITH. A taxpayer's good faith actions do not constitute a basis to waive penalties.

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.

Margolis, T.R.O. – A [retail] store franchisor (Taxpayer) protests (1) the assessment of service and other activities business and occupation (B&O) tax on grounds that it was assessed the tax on income related to real property leases, and (2) the assessment of delinquent penalty for failure to file a reconciliation return on grounds that Taxpayer exercised due diligence. We deny the petition.[1]

ISSUES

1. Whether, under WAC 458-20-118 . . ., amounts received by Taxpayer are income related to real property leases and exempt from B&O tax.

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

2. May the Department waive delinquent penalties under RCW 82.32.105?

FINDINGS OF FACT

Taxpayer operates an international network of [retail] stores through both franchise and corporate stores. The Department of Revenue's (Department) Audit Division (Audit) examined Taxpayer's records for the period January 1, 2010, through December 31, 2013, and on February 17, 2017, assessed Taxpayer $. . . . The assessment is composed of $. . . in service and other activities B&O tax, $. . . in use/deferred sales tax, $. . . in delinquent penalty, and $. . . in interest.

Taxpayer provided a report identifying all franchise operators in the state and highlighting specific charges collected as service revenues. Audit found a significant variance between this report and amounts reported on Taxpayer's returns. Taxpayer explained that the charges included equipment rental, which it later reported under the retailing B&O tax classification. Audit removed these amounts from the variance calculation. The remaining variance appeared because Taxpayer was deducting amounts as property lease charges. Audit reviewed [Taxpayer's] franchise agreement, determined that these charges are not based on a landlord/tenant relationship, but instead based on a "right to use" relationship, and assessed B&O tax on these amounts.

Specifically, Audit examined data for six sample months, which, per Taxpayer's report, showed $. . . in total service revenues after subtracting equipment rental. Taxpayer had reported $. . . . This is a variance of . . . %. Audit applied this variance to amounts reported for 2010-2013 to compute the measure of underpaid B&O tax. For example, Taxpayer reported $. . . subject to service and other B&O tax for 2010. Because . . . % of $. . . is $. . . , Audit assessed Taxpayer service and other activities B&O tax on $. . . ($. . . minus $. . .) for 2010. Audit also assessed Taxpayer a delinquent penalty on these amounts for 2011, 2012, and 2013, because Taxpayer failed to file reconciliation returns and true-up apportionable income by October 31 of the following tax year.

Taxpayer provided an unexecuted sample Individual Store Franchise Agreement. The agreement describes in detail the relationship between Taxpayer, the store, and its franchisee. . . .

[The agreement establishes that the franchisee receives from Taxpayer the right and license to operate a Taxpayer store and that Taxpayer agrees to lease the store location and equipment to the franchisee. Under the agreement, Taxpayer retains the right to use common areas of the lease location to install certain equipment, as well as any other areas Taxpayer deems necessary for installing, maintaining, repairing, and operating such equipment. The agreement also includes certain covenants through which Taxpayer exerts control over hours of operation and maintains access rights to the location, including inventory, financial records, and equipment. The franchisee pays Taxpayer under the agreement, but the agreement does not distinguish between charges for the license to operate and the cost of leasing the store location and equipment.]

Taxpayer explains that part of its [Taxpayer] Charge, which was subject to service and other B&O tax, is actually exempt rent, and provided an exhibit titled "Acknowledgement of [Taxpayer] Charge Allocation Washington," which states that the portion of the [Taxpayer] Charge that is equal to . . . % of the Net Sales represents base rental for the store.[2]

[2] . . .

ANALYSIS

Washington imposes B&O tax on every person for the act or privilege of engaging in business activities in Washington. RCW 82.04.220. The B&O tax is measured by applying particular rates against the value of products, gross proceeds of sales, or gross income of the business as the case may be. RCW 82.04.220.

The [Legislature] intended to impose the B&O tax on virtually all business activities carried on within the state. *Time Oil Co. v. State*, 79 Wn.2d 143, 146, 483 P.2d 628 (1971). Exemptions and deductions from B&O tax are narrowly construed. *Budget Rent-A-Car, Inc. v. Dep't of Revenue*, 81 Wn.2d 171, 174, 500 P.2d 764 (1972). As taxation is the rule; exemption is the exception. *Id.*

[*Rental of real estate exemption*]

. . . . WAC 458-20-118 (Rule 118) is the administrative rule that implements the [rental of real estate] "exemption."[3] It explains that amounts derived from the sale and rental of real estate are exempt, but there is no exemption for amounts derived from a license to use or enjoy real property, which is, in general, taxable under the service and other activities B&O tax classification. Rule 118(1).

Rule 118(2) and (3) contrast the lease or rental of real estate and a license to use real estate as follows (in pertinent part):

> 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. . . .
>
> 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.

The Department's distinction between a "lease" and a "license" is based on case law. The distinction between a lease and a license is often difficult to make. "In theory the distinction is clear: the holder of a license, easement, or profit has only the use of another's land, while a tenant has the right of possession." 17 Wash. Prac., Real Estate §6.3. *Conaway v. Time Oil Co*., 34 Wn.2d 884, 210 P.2d 1012 (1949) is a leading Washington case on the distinction between a lease and a license. In order to make the distinction, the Court wrote:

[3 Rule 118 interprets and applies *Apartment Operators Ass'n of Seattle, Inc. v. Schumacher*, 56 Wn.2d 46, 351 P.2d 124 (1960), in which the Washington Supreme Court held that rental income from real property is subject to the Washington Constitution's uniformity clause (article VII, section 1).]

> [W]hether a written instrument constitutes a lease or a license, the court must consider it in its entirety, together with the circumstances under which it was made and determined and the intention of the parties.
>
> A lease carries a present interest and estate in the property involved for the period specified therein, and requires a writing to comply with the statute of frauds. It gives exclusive possession of the property, which may be asserted against everyone, including the lessor. A license authorizes the doing of some act or series of acts on the land of another without passing an estate in the land and justifies the doing of an act or acts which would otherwise be a trespass. *Barnett v. Lincoln*, 162 Wash. 613, 299 P. 392; *Baseball Publishing Co. v. Bruton*, 302 Mass. 54, 18 N.E. 2d 362, 119 A.L.R. 1518; 32 Am. Jur. 30, § 5; 51 C.J.S., Landlord and Tenant, § 202(2), page 806.

Conaway, 34 Wn.2d at 893. *See also, Lacey Nursing Home, Inc. v. Dep't of Revenue*, 103 Wn. App. 169, 11 P.3d 839 (2000).

The case of *Tacoma v. Smith*, 50 Wn. App. 717, 722, 750 P.2d 647 (1988), affirms the differences between a lease and a license:

> A lease is created if a tenant is granted exclusive possession or control of the parcel or a portion thereof. *McKennon v. Anderson*, 49 Wn.2d 55, 58-59, 298 P.2d 492 (1956). This is the case even if the tenant's possession of the real estate is restricted by reservations. *Barnett v. Lincoln*, 162 Wash. 613, 618, 299 P. 392 (1931). Such reservations can include the right to sell the leased property before the lease is over, *Coates v. Carse*, 96 Wash. 178, 164 P. 760 (1917); and to designate from time to time the place on the premises to be occupied by the tenant. *See Barnett*, 162 Wash. at 620, 299 P. 392. On the other hand, a license exists if a person is granted only the authority to do a particular act upon the owner's land. *Barnett*, 162 Wash. at 619, 299 P. 392.

Taxpayer argues that a number of cases support its position that the receipts at issue qualify for the exemption. However, we find none of these cases determinative. For example, in Det. No. 01-015, 23 WTD 121 (2004), we applied WAC 458-20-200, the administrative rule regarding leased departments, and determined that the lease of premises for performing autopsies, office space, and evidence and body storage qualified for the exemption despite the lessor having limited access to the space. In this matter, Taxpayer is clearly not leasing a department, and it has extensive access to the stores. In Det. No. 16-0122, 26 WTD 69 (2007), we found that the exemption applied to subleases of office space by a law office to unrelated businesses. Here, Taxpayer is not collecting rent from leasing space to unrelated businesses, but is instead collecting a charge from its franchisees and designating a portion of that charge equal to . . . % of Net Sales as base rental for the store.

Taxpayer also argues that it was not assessed tax on these receipts in a prior audit, and in [a prior determination], the Department granted the allowance of a refund of taxes assessed on amounts the Taxpayer received for utilities and insurance that was paid as part of the rental of stores to the franchisee, indicating that the Department acknowledged the exemption. Audit did not challenge

whether Taxpayer was receiving income from the rental of real estate, and on review, the Department did not make a determination on the issue. The issue was whether, under WAC 458-20-205, charges for utilities were included in the measure of income from rental of real estate exempt from B&O tax. Because the Department is not barred from asserting a tax liability where its auditors failed to find errors in an earlier audit, and the determination does not decide the issue of whether Taxpayer is renting real property to its franchisees, this is not grounds for adjustment. *See Kitsap-Mason Dairymen's Ass'n v. Tax Comm'n*, 77 Wn.2d 812, 818, 467 P.2d 312 (1970); Det. No. 00-094, 21 WTD 58, 64 (2002); Det. No. 99-056, 19 WTD 54 (2000); Det. No. 93-191, 13 WTD 344 (1994); Det. No. 88-316, 6 WTD 299 (1988).

Taxpayer's gross receipts include income for providing its franchisee with a store where that franchisee must operate a Taxpayer store subject to a myriad of limitations and requirements on the property. The franchisee can *only* operate a store on the property. Taxpayer has reserved portions "as [Taxpayer] may elect" to use for the installation of specified equipment. Agreement, pages . . . . Taxpayer can remodel the store at any time, but the franchisee cannot remodel the store without prior consent. *Id*. Taxpayer dictates operating hours, and the franchisee must provide Taxpayer access to the store at any time and for any period of time during open hours. Agreement, page . . . . Taxpayer can perform maintenance whenever Taxpayer considers it necessary. Agreement, page . . . . Taxpayer can terminate the agreement for any number of reasons, including the franchisee not operating the store as a 24-hour operation, and making additions to the store or discontinuing use of equipment without advance written consent. Agreement, pages . . . . Taxpayer can take possession of the store if, in Taxpayer's opinion, the franchisee is involved in a divorce that jeopardizes the operation of the store or the [Taxpayer] Image. Agreement, page . . . .

The agreement states an intent to create a landlord-tenant relationship. Taxpayer reserves rights, and we recognize that this is common to lease agreements. However, because the franchisees are only granted the authority to do a particular act, namely operate a store subject to Taxpayer's extensive and detailed restrictions, and do not have an exclusive right of continuous possession against Taxpayer, who enjoys practically unfettered access to the stores, we conclude that Taxpayer is not leasing the stores to its franchisees. The income at issue is not from leases, and does not qualify for exemption under Rule 118 . . . .

[*Delinquent payment penalty*]

A taxpayer that does not timely file and pay its annual reconciliation is subject to the delinquent payment penalty in RCW 82.32.090(1). RCW 82.04.462(4). To avoid the penalty, a taxpayer that has apportionable income from "apportionable activities" must correct the reporting for the current tax year when the complete information is available, but not later than October 31 of the following tax year. *Id*. "Apportionable activities" specifically include those taxed under the service and other activities B&O tax classification. RCW 82.04.290; RCW 82.04.460(4)(a)(vi).

WAC 458-20-19402 [(Rule 19402)] is the administrative rule regarding the general application of apportionment under RCW 82.04.462. Rule 19402 Part 6 provides reporting instructions. The instructions are as follows:

(601) **General**.

> (a) Taxpayers required to use this rule's apportionment method may report their taxable income based on their apportionable income for the reporting period multiplied by the receipts factor for the most recent calendar year the taxpayer has available.
> (b) If a taxpayer does not calculate its taxable income using (a) of this subsection, the taxpayer must use actual current calendar year information.
> (602) **Reconciliation**. Regardless of how a taxpayer reports its taxable income under subsection (601)(a) or (b) of this rule, when the taxpayer has the information to determine the receipts factor for an entire calendar year, it must file a reconciliation and either obtain a refund or pay any additional tax due. . . . If the reconciliation is completed prior to October 31st of the following year, no penalties will apply to any additional tax that may be due.

Rule 19402 (bold in original).

The Department's authority to waive or cancel penalties is restricted to the authority granted by the Legislature. Otherwise, the assessment of penalties is mandatory when the conditions for imposing them are met. RCW 82.32.090; Det. No. 01-193, 21 WTD 264 (2002); Det. No. 99-279, 20 WTD 149 (2001). The Legislature has granted the Department limited authority to waive or cancel penalties pursuant to RCW 82.32.105. RCW 82.32.105(1) provides that the Department is required to waive penalties when it finds that the underlying act giving cause to the assessment of the penalty, i.e., delinquent payment, was due to circumstances beyond the control of the taxpayer.

WAC 458-20-228 is the administrative rule regarding penalties. Rule 228(9)(a) defines "circumstances beyond the control of the taxpayer." It states:

> The circumstances beyond the control of the taxpayer must actually cause the late payment. Circumstances beyond the control of the taxpayer are generally those which are immediate, unexpected, or in the nature of an emergency. Such circumstances result in the taxpayer not having reasonable time or opportunity to obtain an extension of the due date or otherwise timely file and pay.

Examples of what constitutes such circumstances are provided in Rule 228(9)(a)(ii), none of which apply to the situation here where Taxpayer asserts that penalties should be waived because it acted in good faith.[4] Rule 228(9)(a)(iii) gives examples of circumstances that are *not* considered to be a basis for waiving penalties.[5] Specifically, Example (B) includes "a misunderstanding or lack of

[4] Examples of circumstances beyond the control of the taxpayer in Rule 228(9)(a)(ii) include:
> (A) The return payment was mailed on time but inadvertently sent to another agency.
> (B) Erroneous written information given to the taxpayer by a department officer or employee caused the delinquency . . . .
> (C) The delinquency was directly caused by death or serious illness of the taxpayer, or a member of the taxpayer's immediate family . . . .

[5] Examples in Rule 228(9)(a)(iii) of circumstances that are generally not beyond the control of the taxpayer and will not qualify for waiver or cancellation of penalty include:
> (A) Financial hardship;
> (B) A misunderstanding or lack of knowledge of a tax liability;

knowledge of a tax liability," and Example (E) includes mistakes on the part of employees. Because the circumstances alleged in this matter are not immediate, unexpected, or in the nature of an emergency, and are unlike those circumstances described in Rule 228(9)(a)(ii), we conclude that the circumstances alleged by Taxpayer are not "beyond the control of the taxpayer" and are not grounds for waiver of penalties.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 19th day of April 2018.

(C) The failure of the taxpayer to receive a tax return form, EXCEPT where the taxpayer timely requested the form and it was still not furnished in reasonable time to mail the return and payment by the due date, as described in (a)(ii)(G) of this subsection;
(D) Registration of an account that is not considered a voluntary registration, as described in subsection (5)(a)(iii) and (b) of this section;
(E) Mistakes or misconduct on the part of employees or other persons contracted with the taxpayer (not including conduct covered in (a)(ii)(F) of this subsection); and
(F) Reliance upon unpublished, written information from the department that was issued to and specifically addresses the circumstances of some other taxpayer.