Cite as Det. No. 20-0041, 41 WTD 37 (2022)

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
	)	
	)	No. 20-0041
	)	
. . .	)	Registration No. . . .
	)	

WAC 458-20-118; RCW 82.04.290: SERVICE B&O TAX – LEASE VERSUS MERE LICENSE TO USE REAL ESTATE – COMPUTER EQUIPMENT COLOCATION SERVICE – COLOCATION SERVICE – CAGE FACILITY LICENSE. Taxpayer provided customers space in a secure facility in which to store computer equipment and pair it with internet access services. Taxpayer retained control over the space and how it was used. Because taxpayer did not grant its customers exclusive possession and control of the property, it granted a mere license to use the real estate, not a lease of the real estate. Gross income derived from the mere license to use real estate is generally subject to Service and Other Activities B&O 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.

LaMarche, T.R.O., successor to T.R.O. Roinila - A telecommunications company disputes the assessment of business and occupation (B&O) tax on gross income it received from certain co-location services, arguing that the income is real property lease revenue that is exempt from B&O tax.[1]

ISSUE

Under RCW 82.04.290(2)(a) and WAC 458-20-118, is the disputed colocation revenue taxable under the Service and Other Activities B&O tax classification, or is it real property lease revenue that is exempt from B&O tax?

FINDINGS OF FACT

. . . (Taxpayer) provides [colocation services] and related support services, to customers located inside and outside of Washington State.

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

The Department of Revenue's (Department) Audit Division (Audit) audited Taxpayer's business activities for the period of January 1, 2015, through June 30, 2018 (Audit Period). The Department issued an assessment on June 14, 2019, Document No. . . . totaling $. . . ,[2] which consisted of $. . . in Service and Other Activities B&O tax; a credit of $. . . in retail sales tax; $. . . in use tax; and $. . . in interest. Taxpayer paid the assessment in full and petitioned for a refund. At issue is certain gross income derived from Taxpayer's colocation services.

Colocation services generally consist of renting space in data center facilities for the purpose of providing power, cooling, and physical security for the server, storage, and networking equipment of customers.[3] Taxpayer's services include pairing its colocation services with a range of internet access services, including the use of specific telecommunications carriers.[4]

Taxpayer provided, as an example, a copy of an agreement . . . (Cage Facility License), dated January 20, 2016, between itself and a customer (Licensee) whose information is redacted. The "cage" referred to in the agreement is a "colocation cage," which is generally a dedicated server space within a data center or similar facility that is surrounded by mesh walls, which is accessed through a locking door.[5]

The agreement indicates that Taxpayer owns or leases premises within a certain building and agrees to license the right to use a certain space called Cage [number] located on those premises, in which the Licensee may "locate telecommunications computer/server systems, network hardware, and/or video equipment." Cage Facility License, paragraph 2, at 1. The Licensee agrees to pay Taxpayer a recurring monthly licensing fee. *Id.*, paragraph 5, at 1. The term of the license is three years. *Id.,* paragraph 4, at 1.

The Cage Facility License states that the Licensee's permitted use "shall be installation and operation of [Licensee's] telecommunications equipment for the purpose of interconnecting to [Taxpayer's] network in the building and no other uses." *Id.*, paragraph 7, at 2 (emphasis added).

Taxpayer agrees in the Cage Facility License to provide certain services, including maintenance of the licensed premises and the building, and maintenance of the fire suppression system, heating and ventilation system, and related electrical and mechanical systems. *Id.*, paragraph 13, at 3. Taxpayer also agrees to provide HVAC, lighting, and electricity to the licensed premises. *Id.*

The Cage Facility License allows Taxpayer to make periodic inspections of the licensed premises with due notice to the Licensee, with certain exceptions. *Id.*, paragraph 15, at 3. The agreement grants the Licensee "non-exclusive" access to the suite in which the licensed premises are located, and requires the Licensee to limit its presence to those areas where it has "legitimate business-related activities." *Id.*, paragraph 16, at 4 (emphasis added). Among other things, the Licensee may

[2] All figures are rounded unless otherwise noted.
[3] *See* definition of "colocation" provided in TechTarget, Essential Guide, *building a disaster recovery architecture with cloud and colocation*, Don Brancato and Davis S. Jones, posted by Margaret Rouse, August 2015, https://whatis.techtarget.com/definition/colocation-colo (last accessed January 21, 2020).
[4] *See* [information about Taxpayer's services from Taxpayer's website with web address] (last accessed January 21, 2020).
[5] *See* CyrusOne, *Colocation Cages*, https://cyrusone.com/solutions/data-centers/colocation-solutions/colocation-cages/ (last accessed January 21, 2020).

not use cameras, electro-magnetic devices, video equipment, tobacco, or flammable fluids on the premises, and Taxpayer has the right to prohibit other materials and equipment at any time, and in its sole discretion. *Id.*, paragraph 7, at 2.

ANALYSIS

RCW 82.04.220 imposes a B&O tax on the act or privilege of engaging in business activities in this state. RCW 82.04.290(2)(a) is a "catch all" provision that imposes a certain B&O tax rate "upon every person engaging within this state in any business activity other than or in addition to an activity taxed explicitly under another section in [chapter 82.04 RCW]."

WAC 458-20-118 (Rule 118) provides, in part:

> Amounts derived from the sale and rental of real estate are exempt from taxation under the business and occupation tax. However, there is no exemption of amounts derived from engaging in any business wherein a mere license to use or enjoy real property is granted. Amounts derived from the granting of a license to use real property are taxable under the service B&O tax classification unless otherwise taxed under another classification by specific statute . . . .

Rule 118(1).

Rule 118 distinguishes between a lease or rental of real estate and a license to use real estate. A lease or rental of real estate is described in Rule 118(2) as one that:

> [C]onveys 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, ...

In contrast, Rule 118(3) defines a license to use real estate as one that:

> [G]rants 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.[6]

[6] We note that WAC 458-20-205 (Rule 205) addresses, in part, sales of utility services to tenants by real estate lessors. It provides that B&O tax does not apply to charges made to tenants for costs to the lessor of the services provided, when the services are furnished as part of the "normal and customary landlord-tenant relationship," and are prorated among tenants based on their use of the services. Such charges are considered to be exempt from B&O tax as "incidental to and a part of gross income from the renting or leasing of real estate." Rule 205. However, "when the furnishing of utility services is not in accordance with the foregoing," the income is considered to be separate taxable business activity. *Id.* As we will discuss, under the facts of this case, Taxpayer's disputed income is not derived from the rental or lease of real estate, so under Rule 205, the charges for utilities are gross income subject to tax under the appropriate chapter of title 82 RCW.

Washington courts have recognized that exclusivity is a central element in differentiating between a lease or rental of real estate and a mere license to use real estate. *See Barnett v. Lincoln*, 162 Wash. 613, 618, 299 P. 392 (1931) ("A lease is a contract for the exclusive possession of lands or tenements for some certain number of years or other determinate period, and a contract for such exclusive possession is a lease although there may be certain reservations or a restriction of the purpose for which the possession may be used, and although it may be described as a license."); *McKennon v. Anderson*, 49 Wn.2d 55, 57-59, 298 P.2d 492 (1956) (exclusive possession of part of a barn); *Lamken v. Miller*, 181 Wn. 544, 44 P.2d 190 (1935) (food and sundry stands); *City of Bellevue v. Jacke*, 96 Wn. App. 209, 212-13, 978 P.2d 1116 (1999); *City of Tacoma v. Smith*, 50 Wn. App. 717, 721-23, 750 P.2d 647 (1988) (a reassignable boat slip). *See also*, *Regan v. City of Seattle*, 76 Wn.2d 501, 504, 458 P.2d 12 (1969) ("The critical question in determining the existence of [a landlord-tenant] relationship is whether exclusive control of the premises has passed to the tenant.")

Thus, the question of whether an agreement contemplates a mere license to use real estate, as opposed to a lease or rental of real estate, generally turns on the level of exclusive possession and control the grantee has under the agreement.

We previously addressed the taxability of colocation services similar to those of Taxpayer, in Det. No. 99-345, 19 WTD 618 (2000). In that case, the taxpayer entered into agreements with its customers allowing them to place their equipment in its building, which had sophisticated telecommunications access. We considered restrictions on the licensees' control over activities on the premises, their control of lighting and heating of the premises, and restrictions on their access to the premises. We found that the taxpayer in that case had not granted its licensees the "absolute right of control" over their assigned spaces that would constitute the rental or lease of real estate. *Id. See also* Det. No. 14-0260, 34 WTD 467 (2015) (addresses control and exclusivity as they pertain to the licensed use of boat slips and other port property).

Here, the Cage Facility License grants Lessee the right to use the area in Taxpayer's premises called Cage [number]. However, rather than conveyance of an exclusive right of continuous possession of the premises "against the world, including the owner," and granting of "the absolute right of control and occupancy during the term of the lease," the Licensee here only has a non-exclusive right to access the premises. Rule 118(2). The Licensee is also required to allow Taxpayer to make periodic inspections of the premises, and must limit its presence to those areas where it has "legitimate business-related activities." Cage Facility License, paragraph 16, at 4. Also, among other things, the Licensee may not use cameras, electro-magnetic devices, and video equipment on the premises, and the Taxpayer has the sole right at any time to disallow the use or presence of other items.

Importantly, the Licensee's use of the premises is narrowly limited to "installation and operation of [Licensee's] telecommunications equipment for the purpose of interconnecting to [Taxpayer's] network in the building and no other uses." Cage Facility License, paragraph 7, at 2 (emphasis added). The agreement thus contemplates a very limited use of the real estate, rather than the broader bundle of rights conveyed in a typical landlord-tenant relationship. Such rights would include "an exclusive right in the lessee of continuous possession against the world, including the owner," and "the absolute right of control and occupancy during the term of the lease or rental

agreement." Rule 118(2). The narrowly defined use allowed under the Cage Facility License indicates that the Licensee does not have such rights under the agreement.

Finally, similar to the description of a mere license to use real estate in Rule 118(3), Taxpayer provides electricity, lighting, heating, and HVAC, and maintains the premises and the building, including the fire suppression system, heating and ventilation systems, and related electrical and mechanical systems.

The facts here are similar to those regarding the colocation services in 19 WTD 618, and indicate that the Cage Facility License conveys a mere license to use the area of Taxpayer's real estate called Cage [number] for a narrow and limited purpose. The Cage Facility License does not grant the exclusive control or dominion over the licensed premises that would be found in a lease or rental of real estate. For these reasons, we find that the gross income in dispute is not from the lease or rental of real estate, but is instead derived from the licensing of real estate, as described in Rule 118(3) and 19 WTD 618.

Therefore, the gross income that Taxpayer earns from agreements like the Cage Facility License is subject to Service and Other Activities B&O tax, pursuant to RCW 82.04.220, RCW 82.04.290(2)(a), and Rule 118. Accordingly, we must deny the petition.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 6th day of February 2020.