05-1531
Audit
Signed 11/21/2006

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER,		
	ORDER	
Petitioner,	Appeal No.	05-1531
v.	Account No.	#####
	Tax Type:	Sales and Use Tax
AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION,	Audit Period:	05/01/01 – 09/30/03
	Judge:	Chapman
Respondent.		

Presiding:

Kerry R. Chapman, Administrative Law Judge

Appearances:

For Petitioner: PETITIONER REPRESENTATIVE 1, Attorney for Petitioner
PETITIONER REPRESENTATIVE 2, Attorney for Petitioner
PETITIONER REPRESENTATIVE 3, Vice President, PETITIONER
PETITIONER REPRESENTATIVE 4, Representative for Petitioner

For Respondent: RESPONDENT REPRESENTATIVE 1, Assistant Attorney General
RESPONDENT REPRESENTATIVE 2, from Auditing Division
RESPONDENT REPRESENTATIVE 3, from Auditing Division
RESPONDENT REPRESENTATIVE 4, from Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing, pursuant to the provisions of Utah Code Ann. §59-1-502.5, on September 12, 2006.

On September 27, 2005, Auditing Division ("Division") issued a Statutory Notice – Sales and Use Tax ("Statutory Notice") to PETITIONER ("PETITIONER"), relating to the period May 1, 2001 through September 30, 2003. In the Statutory Notice, the Division determined that the Petitioner should be refunded $$$$$ of tax that PETITIONER had overpaid for the audit period. The Petitioner contests, however, that part of the audit that imposed a deficiency of sales tax of $$$$$ on royalty and other payments, and asserts that

absent certain portions of this deficiency, PETITIONER would have received a greater refund than determined by the Division.

PETITIONER is in the business of producing sand and rock products, ready-mix concrete, and asphalt to sale to contractors and other purchasers, as well as for its own use in construction activities. A core ingredient in PETITIONER'S products and services is sand, gravel, and other aggregates that are taken from the ground (referred to herein as "sand and gravel"). To obtain sand and gravel PETITIONER either: 1) purchases the materials already in the form of tangible personal property, 2) purchases real property from which it removes the materials itself, or 3) enters into agreements with property owners for PETITIONER to remove the sand and gravel from the owners' property.

At issue in this appeal are royalty payments that PETITIONER paid to property owners under the third circumstance described in the above paragraph. PETITIONER asserts that the royalty payments it made under a number of its agreements relate to its purchase of an interest in real property, which would not be subject to sales tax. The Division, on the other hand, contends that the royalty payments are consideration paid for tangible personal property and, thus, are subject to sales tax.

The royalty payments at issue were made pursuant to five agreements, specifically: 1) the LEASE 1; 2) the LEASE 2; 3) the LEASE 3; 4) the LEASE 4; and 5) the AGREEMENT.[1] The Petitioner

1 Both parties stated in their respective pre-hearing briefs that the only issue in dispute concerned the royalties paid under these five agreements for sand and gravel that PETITIONER removed and, later, converted to real property while conducting its business activities. At the Initial Hearing, however, the Division stated that it was also asserting that PETITIONER owed additional Utah tax on sand and gravel taken from a PETITIONER pit located in STATE and subsequently used in Utah. As the Petitioner first became aware of the Division's intention to pursue this issue at the hearing, the parties were given an opportunity to conduct post-hearing discovery and submit briefs on the issue prior to an Initial Hearing decision being issued. On October 5, 2006, the Petitioner submitted a letter in which it agreed to pay the approximately $$$$$ in tax that would be due on sand and gravel taken from the STATE pit and was used in Utah. For this reason, the Commission will consider the STATE pit matter resolved and will not rule upon it in this Order.

asserts that the first four agreements at issue were leases for real property and that the royalties were paid as consideration for an interest in real property. The Petitioner further contends that even though its purpose in acquiring the real property interest was to convert the sand and gravel into tangible personal property and to remove it from the site, the agreement is, nevertheless, a transaction to acquire real property and, thus, nontaxable. Under the fifth agreement, the AGREEMENT, PETITIONER maintains that its royalty payments were made to purchase "either un-severed gravel which constituted real property, or a profit a prendre, which is an interest in real property[,]" and, in either instance, would constitute a sale of nontaxable real property.

The Petitioner contends that under all five agreements, it obtained an interest in real property prior to the sand and gravel being severed from the realty. For this reason, the Petitioner asserts that it acquired an interest in real property because the definition of "tangible personal property" in Utah Code Ann. §59-12-102(32) (2001) provides that tangible personal property includes "property severed from real estate" but excludes "real estate or any interest or improvements in real estate." As a result, the Petitioner argues that the royalty payments at issue were consideration it paid for real property (i.e., sand and gravel in place), not tangible personal property (i.e., severed sand and gravel), and, as such, are not subject to sales tax.

The Division argues, on the other hand, that the Petitioner purchased tangible personal property, not an interest in real property, under the five agreements. The Division argues that the royalties are taxable because each of the transactions at issue constitutes a "sale," as defined for sales tax purposes in Utah Code Ann. §59-12-102(25) (2001). Next, the Division argues that under the "essence of the transaction" test (i.e., the primary purpose for which PETITIONER entered into the five agreements), the Petitioner entered into each of the five agreements to obtain sand and gravel that PETITIONER would use as tangible personal property in its business activities. Moreover, the Division argues that the Petitioner neither acquired the "full

bundle of rights" necessary to obtain the real property at issue in fee simple nor obtained full possession of the land against the owner.[2]

For these reasons, the Division asks the Commission to find that the agreements constitute the sale of taxable tangible personal property, not the sale of an interest in real property. In the alternative, should the Commission find that the Petitioner obtained an interest in real property under the five agreements, the Division proffered in its Pre-Hearing Brief that the Petitioner should still be found responsible for use tax on the sand and gravel it removed from the realty and used in its business activities.

APPLICABLE LAW

During the audit period, Utah Code Ann. §59-12-103(1) provided that a tax is imposed on the purchaser for amounts paid or charged for the following transactions:

> (a) retail sales of tangible personal property made within the state
> . . . .
> (k) amounts paid or charged for leases or rentals of tangible personal property if:
> (i) the tangible personal property's situs is in this state;
> (ii) the lessee took possession of the tangible personal property in this state; or
> (iii) within this state the tangible personal property is:
> (A) stored
> (B) used; or
> (C) otherwise consumed;
> (l) amounts paid or charged for tangible personal property if within the state the tangible personal property is:
> (i) stored;
> (ii) used; or
> (iii) consumed[.]
> . . . .

2 The Division proffered, however, that in those instances where PETITIONER purchased real property in fee simple with the primary purpose to convert it into sand and gravel, i.e., tangible personal property, PETITIONER would not be liable for sales tax on its purchase price because it obtained the property in fee simple, acquiring the "full bundle" of property rights associated with the property. Furthermore, the Division proffered that under these circumstances, PETITIONER is also not responsible for use tax on its conversion of its real property into tangible personal property.

During the audit period, "tangible personal property" was defined in UCA §59-12-102(32) (2001). Subsection (a)(iv) of the definition provided that "tangible personal property" included "property severed from real estate." On the other hand, Subsection (b)(i) provided that "tangible personal property" did not include "real estate or any interest or improvements in real estate."

Also during the audit period, "sale" was defined, for sales and use tax purposes, in Section 59-12-102(25) to mean:

> any transfer of title, exchange, or barter, conditional or otherwise, in any manner, of tangible personal property or any other taxable transaction under Subsection 59-12-103(1), for consideration. It includes:
> . . . .
> (e) any transaction under which the right to possession, operation, or use of any article of tangible personal property is granted under a lease or contract and the transfer of possession would be taxable if an outright sale were made.

DISCUSSION

At issue is whether certain consideration paid by the Petitioner pursuant to five specific agreements is subject to sales tax. Pursuant to each agreement, a royalty was paid for each unit of sand and gravel that the Petitioner severed and removed from real property. Under each of the agreements, the Petitioner was granted the right to enter an identified tract of land and sever and remove sand and gravel for a specific number of years. In no instance, however, does it appear that that the Petitioner was given full possession of the land against the owner.

In each of the four agreements titled as "leases," (i.e., the LEASE 1, the LEASE 2, the LEASE 3, the LEASE 4"), the Petitioner is identified as the Lessee who, in consideration of a specified royalty paid for each unit of sand and gravel the Petitioner removes, leases the land, which is identified in the lease. Each lease also provides that the Lessor "leases" the land in return for the consideration (including royalties) paid by the Petitioner.

In the fifth agreement (i.e., the AGREEMENT), the Petitioner is referred to as the Buyer and agrees to pay the Seller a certain amount for each unit of gravel that the Petitioner removes from the Seller's real property. The agreement provides "[t]hat for the consideration . . . provided, the Seller agrees to sell . . . and the Buyer agrees to purchase . . . the gravel situated upon and consisting of the following described real property . . ."

The Division first argues that the royalties paid under these agreements are taxable because each agreement qualifies as a "sale," as defined in UCA §59-12-102(25) (2001). The Commission does not find this argument convincing. To qualify as a sale that is subject to sales tax, Section 59-12-103(1) requires that the transaction must also involve the purchase or lease of tangible personal property. Regardless of whether a transaction qualifies as a "sale," as defined in Section 59-12-102(25), the consideration paid is not subject to taxation unless the transaction also involves the transfer of title, exchange, or barter of *tangible personal property*. As a result, the Commission's decision in this matter is not solely dependent on whether each of the transactions at issue in this matter qualifies as a "sale."

The Division's second argument concerns the purpose for which the Petitioner entered into the five agreements. The Petitioner admits that its primary purpose in entering into the agreements was to obtain the rights to sever and remove tangible personal property (i.e., sand and gravel) from the real property. Given the Petitioner's primary purpose, the Division argues that under the "essence of the transaction" test, the royalties at issue were paid to purchase tangible personal property (i.e., the sand and gravel), not real property. For this reason, the Division argues that the Commission need not determine, for each contract, whether the Petitioner entered into a lease or a profit a prendre, which is an interest in real property, or whether the

Petitioner merely entered into a license, which is not an interest in land.[3] Instead, the Division contends that the Commission should sustain its assessment of tax on the royalties because the Petitioner's primary purpose in entering into the agreements was to obtain tangible personal property.[4]

The Commission recognizes the importance of the "essence of the transaction" test in determining sales taxability in many circumstances. However, the Commission is not convinced that the test is applicable in this matter. First, the Division admitted at the hearing that in those instances where the Petitioner purchased real property in fee simple for the primary purpose to sever and remove sand and gravel, the amount the Petitioner paid for the real property would not be subject to tax.

In addition, for purposes of sale and use tax, "tangible personal property" is defined in Section 59-12-102(32) (2001) to **include** "property severed from real estate," but to **exclude** "real estate or any interest or improvements in real estate." Because the purchase of real property or an interest in real property is, by definition, not the sale of tangible personal property, any consideration paid, including royalties, to obtain real property or an interest in real property would be nontaxable, regardless of the Petitioner's primary purposes in obtaining such property.

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3 In *Black's Law Dictionary* (8th ed. 2004), a "profit a prendre" is defined as "[a] right or privilege to go on another's land and take away something of value from its soil or from the products of its soil (as by mining, logging, or hunting)," while a "license" is defined as "[a] permission, usu. revocable, to commit some act that would otherwise be unlawful; esp., an agreement (not amounting to a lease or profit a prendre) that it is lawful for the licensee to enter the licensor's land to do some act that would otherwise be illegal, such as hunting game." The Utah Supreme Court has determined that a profit a prendre is an interest in real property, while a license is not. *See Wasatch Mines Co. v. Hopkinson*, 465 P.2d 1007 (Utah 1970); *Haynes v. Hunt*, 85 P.2d 861 (Utah 1939).

4 The Division proffers that its argument is supported by the Commission's ruling in *USTC Private Letter Ruling 92-011* ("PLR 92-011"). However, in that ruling, the Commission determined that the taxpayer "ha[d] not entered into a contract to purchase or own real estate." Furthermore, there is insufficient information about the characteristics of the contracts at issue in the ruling to determine whether the Commission's guidance in that letter has any applicability in this matter.

Moreover, the Utah Supreme Court and the Commission have both determined whether an interest in real property was acquired under similar circumstances. In doing so, they have reached their decisions by examining the documents associated with the transactions. For example, in *Rocky Mountain Energy v. Tax Comm'n*, 852 P.2d 284 (Utah 1993), the Court emphasized the need to examine the specific documents at issue in order to determine whether real property or personal property was sold. In that case, it sustained the Tax Commission's determination that the sale of slag (a waste product of the copper melting process) was the sale of tangible personal property, because there was no written document for the court to analyze and because of the uncertainty regarding the interest granted and the boundaries of the alleged interest.

In *Rocky Mountain*, the Court explained that the oral agreement between the parties was insufficient to show the transfer of an interest in real property because it did not meet the criteria set forth in *Wasatch Mines Co. v. Hopkinson*, 465 P.2d 1007 (Utah 1970). *Wasatch Mines* concerned the purchase of soil removed from real property. In that decision, the Court found that although a profit a prendre is an interest in land, the documents failed to transfer such an interest because they failed to "identify the grantor, the grantee, the interest granted, or a description of the boundaries in a manner sufficient to construe the instruments as a conveyance of an interest in land." The Court found, instead, that the documents appeared to be an arrangement for the defendant to act as a marketing agent for distribution of the soil.

In *Haynes v. Hunt*, 85 P.2d 861 (Utah 1939), the Court examined the wording of a deed that conveyed and warranted the right to remove fish from land and determined that the document was sufficient to grant an interest in real property instead of a "mere license." In that decision, the Court determined that a deed granted an interest in land because one of its provisions contained a granting clause (in that instance, "the words "convey and warrant") that pertained to land that was described. The Court also stated that the existence of a "reservation and exception" clause in the deed was "persuasive that the grant was more than a license."

Furthermore, in a 1986 Utah Tax Commission Decision From Informal Hearing [5] ("1986 Commission Decision"), the Commission sustained an assessment of sales tax after determining that the agreement lacked certain elements, as set forth in *Haynes*, that were necessary to convey a profit a prendre. Specifically, the Commission found that the agreement lacked a granting clause and did not contain a reservation and exception for the grantor, which were elements that the Court considered in *Haynes*.

For these reasons, the Commission finds that the five agreements at issue in this appeal must be reviewed to determine whether the royalties were paid to acquire an interest in land or merely a license to enter land. If the Commission finds that the royalties were paid to acquire an interest in land, it will find that the royalties are nontaxable and will overturn that portion of the assessment associated with them.[6] If the Commission finds that the royalties were not paid to acquire an interest in land, it will find that they were paid to purchase taxable tangible personal property and will sustain the Division's assessment.

The Utah Supreme Court stated in *Combined Metals Reduction Co. Industrial Comm'n*, 116 P.2d 929 (Utah 1941) that a mining lease may either be considered a lease of real property or a license to work the property, depending on the terms of the document. Accordingly, when analyzing the four "leases" at issue, the Commission must go beyond the title of each document to determine whether the royalties were paid to acquire an interest in real property. In *Wasatch Mines*, the Utah Supreme Court found that a profit a prendre

5 The decision that the Petitioner attached as Exhibit B to its Pre-Formal Hearing Brief has the appeal number and taxpayer's name redacted. The Tax Commission no longer has a record of this case to identify the appeal number.

6 The Commission disagrees with the Division's argument in its Pre-Hearing Brief (p.4) that the Petitioner would be responsible for a "use" tax on any gravel that it severed from a real property interest it acquired, then used in its business operations. First, Section 59-12-103(1)(l) only imposes a use tax when tangible personal property has been purchased and used, stored, or consumed. It does not impose a use tax on the purchase of real property where the purchaser converts its real property into tangible personal property that is then used, stored, or consumed. Furthermore, such a conclusion appears consistent with the Division's decision not to impose a use tax when the Petitioner purchased land in fee simple and converted the real property into tangible personal property for use in its business operations.

was not transferred because the documents failed to identify a grantor, a grantee, the interest granted, and a sufficient description of the land's boundaries. In *Haynes*, the Court was persuaded that a deed transferred an interest in real property because it contained a "granting clause" that identified the land at issue and also because it contained a "reservation and exception" clause. [7]

Each of the four lease agreements at issue in this appeal identify the grantor, the grantee and the interest granted. In addition, the land boundaries are adequately described in each lease to identify the land. Each document also contains a granting word (the word "lease") whereby the Lessor "leases" the described lands. Lastly, several of the leases contain a "reservation and exception" provision, with which the Lessor either reserves the right to extract a certain amount of sand and gravel from its own property, the right to graze cattle, or the right to operate its own business on the property. Based on the Utah cases discussed above, as well as cases from other jurisdictions,[8] the Commission finds that the Petitioner acquired, at the very least, a profit a prendre pursuant to the four leases at issue. Although the Division argues that the Petitioner did not obtain an interest in land because it did not obtain "exclusive possession of the premises against all of the world, including the owner," the Commission finds that the cases discussed above clarify that such possession

7 Although the existence of a "reservation and exception" clause may be one factor to indicate whether a document conveys an interest in land instead of a mere license, the Commission is not convinced that such a clause is necessary in order to convey an interest in land, even though it appeared to be a critical factor in the 1986 Commission Decision. For example, it is unlikely that such a clause would exist where a lessee leased real property and the lessor retained no right of possession during the duration of the lease. Furthermore, although this specific factor was mentioned in the 1939 *Haynes* decision to support the Court's finding, it was not discussed by Court in later cases, including *Wasatch Mine*, a 1970 case, and *Warburton v. Virginia Beach Fed. Sav. & Loan Ass'n,* 899 P.2d 779 (Utah Ct. App. 1995).

8 *See also Santa Clara Sand & Gravel Co. v. State Bd. Of Equalization*, 37 Cal. Rptr. 506 (Cal. Ct. App. 1964) (recognizing that a mining lease transfers an interest in land if it is a profit a prendre); *In re Lane Construction Co*., 1990 N.Y. Tax LEXIS 268 (NY Div. Tax App. 1990) (finding that a lease to remove sand, gravel and topsoil from the land gave the lessee a profit a prendre, which is not subject to tax); *Texas Taxability Requests No. 7711T0096E01* (11/01/1977) provides that a "properly executed 'lease' of land for the purpose of mining sand and gravel is considered a 'profit a prendre', and as such is treated as a lease of the land rather than a sale of personal property."

is not a requisite to obtain an interest in real property. For these reasons, the Commission finds that the royalties paid under the four leases are consideration to acquire an interest in real property, not tangible personal property, and, as a result, are nontaxable. Accordingly, the Commission overturns the Division's assessment of sales tax on the royalties the Petitioner paid as consideration under the LEASE 1, the LEASE 2, the LEASE 3, and the LEASE 4.

The last agreement at issue, the AGREEMENT, does not purport to be a lease. Nevertheless, the agreement identifies the Buyer (the Petitioner), the Seller, and the land at issue. The agreement also designates its duration to be a specific number of years. It also contains the following terms that clarify that the Petitioner has purchased the gravel prior to its being severed from the real property and that the Petitioner, not the property owner, will sever the gravel: 1) "the Seller agrees to sell . . . and the Buyer agrees to purchase . . . the gravel situated upon and consisting of the following described real property"; 2) the "Buyer agrees . . . to pay Seller . . . consideration for the purchase and removal of said gravel materials . . . for all gravel removed by Buyer from said property"; and 3) the "Buyer shall have free, unobstructed access to said property and gravel and that Buyer may remove such gravel at such times and under such conditions as Buyer may elect."

Not only does the AGREEMENT identify the Buyer, the Seller, the land at issue, and the specific duration of the agreement, it also provides that the Petitioner has acquired the gravel in its form as real property and that the Petitioner will sever the gravel from the realty and convert it into tangible personal property. For these reasons, the terms of the agreement appear sufficient, under the criteria set forth in *Wasatch Mines* and *Santa Clara*, to convey a profit a prendre to the Petitioner. As a result, the consideration paid under the agreement is the price paid to acquire a nontaxable interest in real property. Accordingly, the Commission also overturns the Division's assessment of sales tax on the royalties, or consideration, the

Petitioner paid under the AGREEMENT.

DECISION AND ORDER

Based upon the foregoing, the Commission overturns the Division's assessment of sales and use tax on the royalty payments the Petitioner paid pursuant to the five agreements at issue, specifically the LEASE 1, the LEASE 2, the LEASE 3, the LEASE 4, and the AGREEMENT. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission
Appeals Division
210 North 1950 West
Salt Lake City, Utah 84134

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this _____ day of _____, 2006.

_____
Kerry R. Chapman
Administrative Law Judge

BY ORDER OF THE UTAH STATE TAX COMMISSION.

The Commission has reviewed this case and the undersigned concur in this decision.

DATED this _____ day of _____, 2006.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

Notice: If a Formal Hearing is not requested as discussed above, failure to pay any remaining balance resulting from this order within thirty (30) days from the date of this order may result in a late payment penalty.

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