State of California **Board of Equalization**
Legal Division-MIC: 82

M e m o r a n d u m

To: Mr. Richard Johnson
Deputy Director

Date: May 4, 2000

From: Kristine Cazadd
Sr. Tax Counsel

Subject: ***<u>Issues Pertaining to Wetland Mitigation Banks</u>***

This is in response to your memorandum to Larry Augusta on February 3, 2000, requesting our opinion on the property tax consequences related to the development, change in ownership, and valuation of Wetland Mitigation Banks. Please accept our apologies for the delay.

The questions you submitted for purposes of our consideration are set forth below with a short summary answer, followed by a more in depth analysis thereafter.

1. Is the development of a Wetlands Mitigation Bank considered "new construction"?

Yes. The creation of new wetlands in the form of a wetlands mitigation bank site falls squarely within Section 70(a)(2) and Property Tax Rule 463(b)(2), as an "alteration of land or of any improvement (including fixtures) since the last lien date which constitutes a major rehabilitation thereof or which converts the property to a different use."

2. Should the transfer of "Wetlands Credits" be treated as an appraisable event?

No. "Wetlands credits do not represent the transfer of a present interest in real property, but are comparable to offsite improvements adding value to the land.

3. How should a Wetlands Mitigation Bank" be assessed once all credits are sold, i.e., does it have any value?

On any lien date, the taxable value of a wetlands mitigation bank should be the lower of (1) its adjusted base year value, including any value added for new construction completed in the process of forming the wetlands area, or (2) its current market value, taking into account the restrictions on use and the eventual depletion of revenues from the sale of credits. Once all credits are sold the owner's fee interest in the wetlands acreage would continue to be assessed.

<u>Legal Background</u>

The Statutory Parameters

"*Wetlands*" are defined by the U.S. Environmental Protection Agency (USEPA) regulations as "areas that are inundated or saturated by surface ground water at a frequency and duration sufficient to support, and that under normal circumstances do not support, a prevalence of vegetation typically adapted for life in saturated soil conditions. 40 C.F.R. sec. 230.41. Formal protection and "*mitigation*" of the adverse impacts on wetlands began in August 1991, when President Bush issued an Executive Order stating that the government's objective was "*no net loss*" of any wetlands. The continuation of this Order under the Clinton administration and the subsequent enactment of regulations by USEPA led to the following requirements on all property owners seeking to obtain the necessary permits from governmental agencies to develop their lands:

1) Avoid and or reduce to de minimis any impacts to comply with the "no net loss" objective; or
2) *Mitigate* any impacts that are unavoidable, by either *purchasing* existing wetlands nearby and preserving them into perpetuity, or by *creating nonexistent wetlands* nearby and similarly preserving them.

"*Wetland mitigation banking*" was developed under the Clean Water Act (33 U.S.C. Sections 1344 et seq.) to fulfill the second (alternative) requirement of mitigating any unavoidable impacts and was patterned after air pollution mitigation credits. Its purpose is to authorize (through permitting by the Army Corps of Engineers) government agencies and/or private entrepreneurs to place an approved amount of acreage or tracts of wetlands in "*banks*" and assign a corresponding number of "*credits*" to each bank, on a "*per acre of wetland basis*." One or more "credits" are then purchased by a landowner in the area, who, in order to obtain development permits, must mitigate the wetland loss caused by his project.[1]

The Statutory Process

Recognizing that the purchase of existing wetlands was a practical impossibility in most cases, the Legislature adopted the *Sacramento-San Joaquin Valley Wetlands Mitigation Bank Act of 1993*, codified in Fish and Game Code Sections 1775, et seq., in order to provide an additional alternative of creating new offsite mitigation banks. Its stated

[1] There are two types of wetland mitigation banks in this context. A *dedicated wetland mitigation bank* is a tract of wetlands approved as a mitigation bank for one specific user, such as Cal-Trans or the Department of Corrections, while constructing a large amount of new improvements in a particular area. A *commercial wetland mitigation bank* is a tract of wetlands approved as a mitigation bank for the purpose of selling its available credits to anyone.

purposes was to achieve the "no net loss" objective in the Sacramento-San Joaquin Valley region. Consistent with the federal law, Fish and Game Code Section 1777.2 provides that the *mitigation bank site*, or *bank site*, shall be a publicly or privately owned and operated site on which wetlands have been or will be created, not more than 40 miles from a *qualifying urban area.* (Section 1779.) Funding to cover the costs of the site is provided through the sale of *wetlands credits* to land owners (or government entities), which are required to mitigate a wetlands loss from their development. Section 1777.5 defines the *wetlands credit* assigned to any such site as "*a numerical value that represents the wetland acreage and habitat values of a mitigation bank site*."

Any person desiring to establish or create a wetland mitigation bank site must apply to the Department of Fish and Game for a determination that both the bank site and the operator qualify under numerous criteria found in all applicable statutes and regulations. Before any bank site may be created, the Department of Fish and Game must coordinate and execute a *memorandum of understanding* with the operator, (as well as other state, federal, and local agencies) which includes the following: 1) describes the site boundaries, 2) identifies the wetland acreage that qualifies to be credited against the development of any wetlands within 40 miles (i.e., identifying the number of credits), 3) states the maintenance requirements, 4) establishes a trust fund or bond in favor of the Department to provide funds for maintaining the bank site in perpetuity, and 5) sets forth the causes for breach of the agreement.

The Act provides no property tax exclusions or exemptions for the creation or maintenance of the bank sites. In fact, annual taxes are required to be included in the cost of any wetland credit even if the bank site owner is a government entity. Where the bank site owner is a public entity, it shall pay annually to the county where the property is located, an amount in lieu of the property taxes (including special assessments) levied on the property at the time the bank site is transferred to that entity. (Section 1787.)

Upon the successful completion of at least 20 acres of qualifying new wetlands, the operator may apply to the Department for its determination of the amount wetlands *credit* available for sale. (Section 1790.) The Department makes such determination based on established biological criteria listed in Section 1791, and may set a minimum price for wetlands credit sufficient to insure the financial integrity of that bank site, although the operator may charge a higher price. (Section 1792.) No credit shall be provided for wetland acreage that was already in existence prior to establishment of the bank. (Section 1790.)

Under Section 1792, the following factors must be used by the Department in verifying that the minimum value of the credit equals "the average cost for each wetland acre created":

- (a) land costs (including interest)
- (b) wetland creation costs
- (c) wetland administration, maintenance, protection costs
- (d) annual taxes, including the in-lieu payments for property taxes under Section 1787, if applicable
- (e) costs incurred by the Department in establishing and monitoring the bank site
- (f) any other costs for preserving the wetlands in perpetuity.

While the foregoing, factors constitute the minimum value of a credit, as indicated, Section 1792 also specifically provides that the operator may charge a higher price. The operator executes a separate agreement for the sale of wetland credits to a particular "*permittee*" (the public or private developer seeking a permit to remove or fill wetlands). Standard conditions of such agreements provide that the credits sold are non-transferable and non-assignable and do not transfer to the permittee any real property rights, i.e., rights to possess, own, use, lease, or hold a security interest in the actual bank site, to which the credits relate. Thus, once the "*permittee*" makes full payment for the purchase of credits in the bank site, there is no further obligation to the operator of the bank site, unless the permittee has contracted for an equity involvement in the bank. (Section 1796.)

Questions Addressed

1. Is the development of a Wetlands Mitigation Bank considered "new construction"? Yes.

Section 70(a) defines "new construction" as either (1) any **addition** to real property, whether land or improvement (including fixtures), since the last lien date; or (2) any **alteration** of land or of any improvement (including fixtures) since the last lien date which constitutes a major rehabilitation thereof or which converts the property to a different use. Rule 463 (b)(2) provides further that new construction means and includes "any substantial physical alteration of land which constitutes a major rehabilitation of the land or results in a change in the way the property is used." Examples of alterations to land to be considered "new construction" are land fill, retaining walls, site development for use under another purpose, altering rolling, dry grazing land to level irrigated cropland, etc. (See also examples in Assessors Handbook 502, *Advanced Appraisal*, p.118.) In subparagraph (A) of Rule 463 (b)(2), in any instance where the alteration is substantial enough to require reappraisal, only the value of the alteration shall be added to the base year value of the pre-existing land. Increases in value cause by appreciation (or a zoning change) rather than the new construction, shall not be enrolled. (Section 71.)

By definition, the creation of a wetland mitigation bank site falls squarely within the foregoing statute and rule as "a substantial physical alteration of land which constitutes a major rehabilitation of the land." The express purpose of the *Sacramento-San Joaquin Valley Wetlands Mitigation Bank Act* in Fish and Game Code Section 1781 is to increase the total wetlands acreage and values within this region. As noted, Sections 1778 through 1787 establish the approval process and criteria for obtaining a permit to create a bank site. Section 1792 lists cost items involved in the creation, construction, and maintenance of a bank. Moreover, Section 1790 states that no credit shall be provided for wetland acreage that was *already in existence*. Thus, wetland acreage created under the Act is "new construction," in that it was not a pre-existing wetland site, but was used for some other purpose (presumably undeveloped, agricultural, or open space). The creation of wetland acreage from such agricultural or open space acreage would also represent a change in use,

per Rule 463 (b)(2).[2] Fish and Game Code Section 1784 prescribes the type and extent of the "new construction" to be completed in order to preserve the site for use as wetlands acreage in perpetuity. For example, a reliable water supply, proper grades and soil preparation for vegetation and specified wildlife, ponds, foliage, and permanent conversion into a naturally occurring wetland system. Based on these parameters, the wetlands acreage created is assessable under Section 70(a)(2) and Rule 463 (b)(2).

In contrast, a bank site that was *previously* classified and protected by the Department, by USEPA, or by the Army Corp of Engineers as *wetlands* would not be considered newly constructed property, assuming there is no substantial alteration to the land or change in use. Based on the provisions in Fish and Game Code Sections 1775 through 1796, facts demonstrating that a specific bank site is newly constructed would be shown on the permit and the memorandum of agreement executed by the Department.

2. Should the transfer of Wetland Credits be treated as an appraisable event? No.

Based on both the federal and state statutory framework, wetland credits do not constitute taxable fee interest real property, the conveyance of which results in change in ownership and reappraisal. The issue is whether the purchase of a *credit* constitutes "a transfer of a present interest in the real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest", per Section 60. Quite obviously this is fact-driven determination requiring an analysis of the particular "right" (or "credit") being transferred in each case and whether it is part of the "bundle of rights" meeting the "test" of Section 60.

The seminal case is *Mitsui Fudosan v. County of Los Angeles*, (1990) 219 Cal.App.3d 525, dealing with the purchase of "development rights." The developer, Mitsui, purchased from adjacent landowners the right to construct additional 490, 338 square feet of building area, more than doubling the density that would otherwise have been permitted. The court held that this purchase of excess density in the form of *transferable development rights* (TDRs) constituted a transfer of a present "right" in real property. That is, the TDRs were a part of the "bundle of rights" arising from the ownership of the selling site and were added to the bundle of rights connected with the ownership of the Mitsui site. The court pointed out that excess development rights are similar to "air rights" (the right to build vertically), which Property Tax Rule 124 classifies as "land."[3] Like "air rights," the court held that TDRs should also be considered as part of the "fractional interests in the complex bundle of rights arising from the ownership of land." In so holding, the court recognized that

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[2] The legal opinion designated as Annotation No. 610.0051 concludes in a somewhat similar situation, that the reclamation of alkaline soil over a period of years, to convert unproductive land into viable use for agricultural purposes, constitutes new construction – as both an alteration and conversion of the land to a different use.

[3] See also Letter to Assessors No. 86/50 stating that "air rights" are those rights located directly above the land surface which establishes their description, but in a different horizontal plane.

> "As the density in urban areas increases, diminishing the number of sites available for new construction, the ability to exploit air space in various way to achieve vertical expansion becomes essential. Property rights which evolve as a means of furthering such goals are properly subject to taxation."

As a taxable real property interest, the conveyance of the TDR's from seller to Mitsui was held to be a "change in ownership" under Section 60. Per the court's holding, the full value of the sale of the TDR's was properly deducted from the donor property's assessment and added to the acquiring property is assessment. The court stated that the sale of the TDRs did involve the transfer "of a most significant present, beneficial property interest", and that the price paid supported an inference that the entire fee interest in the TDR's was actually transferred to Mitsui.

Here, there are several major differences between *wetland credits* and the TDRs conveyed under the facts of the *Mitsui* case. First, *wetlands credits* do not transfer to the permittee any part of the "bundle of rights" arising from the ownership of the wetland mitigation bank site (selling site). As noted above, Fish and Game Code Section 1795 provides that after payment for the credits to the bank site operator, "the permittee has no further obligations with respect to the bank site to which payment was made, unless the permittee has an equity involvement in the bank." Therefore, assuming no equity interest is contracted for in the particular transaction, the permittee neither acquires nor receives any rights to, or beneficial interest in the bank site.

Secondly, the price paid by the permittee for the wetlands credits is "a numerical value that represents the wetland acreage and habitat values of a mitigation bank site" per Section 1777.5. The full value of the sale of the credits would not be deducted from the bank site and added to the permittee's site as the *Mitsui* court did with the TDRs but rather, increased value would be added to the bank site as new construction under Section 70.

Thirdly, in contrast to *Mitsui*, nothing in the wetlands mitigation statutes indicates that the conveyance of wetlands credits to a permittee constitutes a transfer of surface or air space that would meet the change in ownership test of Section 60. If anything, the only real property interest defined or represented by a credit or given number of credits, is the offsite wetland acreage set aside at the bank site in exchange for the price paid by the permittee. The permittee is simply paying for an *offsite improvement* to real property owned by someone else (the bank site owner/operator) in order to meet governmental requirements to obtain a development permit for his site. The Board staff has long held that government exactions like zoning requirements or restrictions on use do not result in a change in ownership of that property.[4] Such exaction's and requirements may affect the value of the land upon a *future* sale or transfer, when change in ownership and reappraisal does occur. Board-approved language in Assessors' Handbook 502, *Advanced Appraisal*, page 131, states a similar conclusion, that impact fees, certain development fees, and off-site improvements may reflect only non-assessable enhancements of land value. In the example

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[4] See Annotation No. 220.0900, Milam letter 11/20/78, and Keeling letter on air emission reduction credits, 8/31/88, attached.

discussed, the builder/owner of a large industrial complex is required to (1) construct new freeway off-ramps leading to the site, (2) widen the streets adjoining the development, and (3) *purchase and dedicate a separate parcel of land for wildlife preservation*. The recommendation is that the costs associated with these offsite improvements should not be added to the new construction valuation of the improvements, but should be considered as enhancements to the complex's land value. When a change in ownership of the land occurs, the added value would be included in the sales price and reappraisal at that time.

3. How should a Wetlands Mitigation Bank" be assessed once all credits are sold, i.e., does it have any value?

On any lien date, the taxable value of a wetlands mitigation bank should be the lower of (1) its adjusted base year value, including any value added for new construction completed in the process of forming the wetlands area, or (2) its current market value, taking into account the restrictions on use and the eventual depletion of revenues from the sale of credits. Here, it should be noted that the sale price of the "wetlands credits" may be one of the indicators of value with respect to the full economic costs necessary to construct the wetlands and ready it for its intended use. Thus, some or all of the sale price of the wetlands credits may reflect portions of the direct costs, the indirect costs, or the entrepreneurial profit of the project, as discussed in AH 502, *Advanced Appraisal Manual*, pages 13-14.

Since the bank owner has agreed to permanent enforceable governmental restrictions in order to obtain approval to create the wetlands and to obtain wetland credits for the wetland acreage in the bank, quite obviously the provisions of Section 402.1 are applicable, and some adjustments to value necessary. Not only are these environmental restrictions enforceable in perpetuity, but the bank site is legally, physically, and financially bound by such restrictions, regardless of any change in operators. In the event of any breach or default by an operator, Fish and Game Code Section 1786 provides that the Department shall replace the operator, and/or that title to the property shall pass from the owner/operator to the Department. Therefore, the assessment of any bank site must take into account the effect of these restrictions, which effectively transfer to the Department the owner's right to ever develop the site or to convert it to another use. Presumably, the mitigation bank owner establishes the bank site under the burden of these restrictions based upon the knowledge that he will obtain a return of and on his investment through the number and the value of the wetlands credits the government allows for sale. Since the bank site itself can only be conveyed subject to the wetlands restrictions, the value of the wetlands acreage already sold becomes less as the available credits are sold and justifies a reduction in the taxable value when assessed.[5]

In *Mitsui Fudosan,* the court was not focusing on a restricted value, but applied a base year value reduction formula in which the TDRs were included in the base year value of the

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[5] Fish and Game Code Sections 1786, and 1790-1792 specifically anticipate that the credits will be sold relatively soon, and for this reason require the cost of a trust fund or bond in favor of the Department to be included in the value (price) assigned to the credits.

transferor's property so that when they were sold it was proper to reduce the base year value to reflect the fact that the TDRs were no longer part of that property.[6] In assessing wetland mitigation bank acreage, since the bank owner continues to hold all the existing fee interests, the focus is on the restricted value. Since the wetlands acreage will continue to be valued as *wetlands* based on the perpetual *enforceable restrictions*, its value should include an adjustment for these restrictions (representing the bank owner's anticipated loss of development rights over the remaining economic life of the property), as well as any "amenity value" as a wildlife, scenic, or wetlands preserve.

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Attachments

cc: Mr. David Gau, MIC:64
Mr. Charles Knudsen, MIC:62
Mr. Gary Platz, MIC:60
Ms. Jennifer Willis, MIC:70

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[6] With respect to the TDRs involved in *Mitsui Fudosan*, the Court of Appeal made the following statement at page 530: "Similarly, as the assessor's counsel acknowledged at oral argument, the base year value of the sellers' remaining properties should be reduced in the same proportion that the value of their TDRs bore to the fair market value of their land and improvements as a whole on the date ownership changed."