# STATE BOARD OF EQUALIZATION
# STAFF LEGISLATIVE BILL ANALYSIS

| | | | |
|---|---|---|---|
| Date Introduced: | **2/20/03** | Bill No: | **SB 451** |
| Tax: | **Property** | Author: | **Ducheny** |
| Board Position: | | Related Bills: | **SB 1631 (Morrow)** |

## BILL SUMMARY

This bill would specify that rental housing located on leased land on a military base, as specified, is not a possessory interest because it lacks the element of independence.

## ANALYSIS

### Current Law

Revenue and Taxation Code Section 107 sets forth the three essential elements that must exist to find that a person's use of publicly-owned tax-exempt property rises to a level of a taxable possessory interest. Those elements are independence, durability and exclusivity.

With respect to the element of independence, Revenue and Taxation Code Section 107(a)(1) defines "independent" to mean "the ability to exercise authority and exert control over the management or operation of the property or improvements, separate and apart from the policies, statutes, ordinances, rules, and regulations of the public owner of the property or improvements. A possession or use is independent if the possession or operation of the property is sufficiently autonomous[1] to constitute more than a mere agency."

Relevant case law and Property Tax Rule 20, a regulation, additionally require that a possessor derive "private benefit." "Private benefit" means "that the possessor has the opportunity to make a profit, or to use or be provided an amenity, or to pursue a private purpose in conjunction with its use of the possessory interest. The use should be of some private or economic benefit to the possessor that is not shared by the general public."

### Proposed Law

This bill would add Section 107.4 to the Revenue and Taxation Code to provide that a possession or use of land or improvements is **not independent** if that possession or use is pursuant to a contract, including, but not limited to, a long-term lease, for the private construction, rehabilitation, management, or maintenance of housing for active duty military personnel and their dependents, if all of the following criteria are met:

---

[1] Property Tax Rule 20 specifies that to be "sufficiently autonomous" to constitute more than a mere agency, the possessor must have the right and ability to exercise significant authority and control over the management or operation of the real property, separate and apart from the policies, statutes, ordinances, rules, and regulations of the public owner of the real property.

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.*

**Housing**

- The housing is on a military base under military control.
- The housing units do not use city or county services, which are instead purchased from the military base.
- The private contractor is not given the right and ability to exercise any significant authority and control over the management or operation of the military family housing, separate and apart from the rules and regulations of the military.
- The military sets the rents charged for the housing units.
- The military controls the distribution of revenues from the project to the private contractor.
- Tenants for the housing units are chosen by a base housing agency under military rules and regulations.
- Evictions from the housing units are subject to the military justice system.

**Initial Construction**

- The number of units, bedroom types, and the unit mix are set by the military, and may not be changed by the contractor without prior approval by the military.
- Costs of construction of the project are controlled by the military and are subject to federal regulation.
- The private contractor is allowed only a predetermined profit or fee for constructing the housing.
- The military sets the financing for the project.
- The construction of the housing is performed under military guidelines in the same manner as construction that is performed by the military.

An interest that is not "independent" fails to meet one of the three elements that must exist in order for the interest to be subject to property tax. Thus, the housing units would not be subject to property taxation.

**In General**

In certain instances a property tax assessment may be levied when a person or entity uses publicly-owned real property that, with respect to its public owner, is either immune or exempt from property taxation. These uses are commonly referred to as "possessory interests" and are typically found where an individual or entity leases, rents or uses federal, state or local government facilities and/or land.

Revenue and Taxation Code Section 107 establishes parameters within which assessors and judicial authorities are to determine the existence of taxable possessory interests. Generally, those determinations are made according to the facts and circumstances in each individual case.

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.*

## Background

Under the Military Housing Privatization Initiative (MHPI) Act authorized by Congress in 1996, the military has started to privatize on-base family housing units. The specifics of the implementation plans that were developed by the Army, Air Force, Navy, and Marine Corps vary in their details. However, the basic frameworks for these plans are similar:

- Lease military base land to private contractor/developer for 50 years.
- Convey existing family housing units and infrastructure to the contractor/developer for replacement or renovation.
- Contractor/developer to build additional family housing units, as required.
- Contractor/developer will assume responsibility for property management, including repairs and maintenance.
- Tenant costs including utilities may not exceed basic allowance for housing (BAH).
- At the end of the contract, ownership of the housing units will revert to the military authority.

The Military Housing Privatization Initiative is managed by the Competitive Sourcing and Privatization (CS&P) Office, in the Office of the Deputy Under Secretary of Defense (Installations and Environment). The Department of Defense maintains an extensive Web Site on the program at www.defenselink.mil/acq/installation/hrso.

Much of the existing military housing stock is in poor condition and housing has been identified as a source of retention difficulties faced by the military.

## COMMENTS

1. **Sponsor and Purpose.** This bill is sponsored by De Luz Family Housing. The author's background sheet explains the purpose of the bill as follows:

   **PROBLEM:** As a result of the long-term lease, which is necessary for the contractor to obtain financing, under the current interpretation of California law a possessory interest is created. This interest is taxable in the same manner as privately held property. The taxes, which can be substantial, reduce the amount of revenue from the project and hence reduce both the construction funds that can be financed and the funds necessary for maintenance. This appears to be an unintended consequence of the MHPI. The result is that contractors will not be able to build housing units to as high a standard as they otherwise would. And maintenance funds will suffer threatening the quality of life of residents.

   **SOLUTION:** The solution is to clarify existing law as to the definition of possessory interest. In order for a possessory interest to be created it must be deemed to be independent, durable and exclusive. While it can be argued that the interests created under the MHPI are none of these, the courts have said that legislative clarification is needed. Currently, based on an earlier military leasing act (Military Leasing Act of 1947), the courts consider such interests to be taxable. This bill redefines "independence" under the definition of

"possessory interest" to specifically address situations where the military has primary control over the project.

Additionally, the author states that this bill would not harm local government finances because, with respect to the existing housing stock that has been conveyed to private developers and will be replaced or renovated, that housing stock was not previously subject to property tax when owned directly by the military. With respect to the impact of new housing, the author states that local governments will not be negatively impacted because emergency services will be provided by the military base and schools would be compensated by Federal Impact Aid. The author states that, in fact, on-base housing will likely result in a positive impact to local governments because of reduced traffic congestion and reduced demand for other public services (police, fire, emergency medical, housing subsidies, etc.) by having fewer military families living off base.

2. **To date, four projects under the Military Housing Privatization Initiative have been awarded in California, with potentially three more projects to be awarded.** The awardee/developer/general partner of the projects have been

- Hunt Building Corp. (El Paso, Texas) for Camp Pendleton, Phase 1 (San Diego County)
- Lincoln Property Co. (Dallas, Texas) and Clark Realty Capital (Bethesda, Maryland), LLC for the Naval Complex. (San Diego County)
- The U.S. Army, U.S. Navy, and Clark Pinnacle Family Communities, LLC have formed a public-private partnership to operate and construct military family housing communities for the Presidio of Monterey (POM) and the Naval Postgraduate School (NPS) in Monterey Bay, California.
- The U.S. Army and Clark Pinnacle Family Communities, LLC have formed a public-private partnership to construct, renovate, and operate military family housing communities at Fort Irwin (San Bernardino County), Moffett Airfield (Santa Clara County), and Parks Reserve Forces Training Area (Alameda County).
  - Clark Pinnacle Family Communities, LLC is a joint venture between Clark Construction Company (Bethesda, Md) and Pinnacle Realty Management (Seattle, Washington).

3. **San Diego County has assessed a possessory interest in the Camp Pendleton project (De Luz Family Housing).** De Luz filed an appeal and the San Diego Assessment Appeals Board has found that a taxable possessory interest exists. It is unknown if the taxpayer will file suit in Superior Court.

4. **The original construction of the De Luz homes in the early 1950's was the focus of a landmark California Supreme Court decision on the valuation method applied to possessory interests**: *De Luz Homes, Inc. v. County of San Diego* (1955) 45 Cal.2d 546. In 1949, Congress approved the Wherry Housing Program that was intended to bring private homebuilders into the rental housing market for military personnel without using military construction funding. The original De Luz homes were constructed under this program. Under the program, a

developer acquired a land lease in 1952 and built housing rented to military families at Camp Pendleton which was subsequently subject to property taxation as a possessory interest. The *De Luz* possessory interest case was not about whether the developer had a taxable possessory interest in the property in the first instance, but rather how to properly value the possessory interest. Apparently, congressional concerns with "windfall" profits accruing to private developers under the program led to its effective termination in 1955, and beginning in 1957 the military began purchasing the homes constructed by private developers under the program. Thus, because Wherry housing was eventually purchased by the military (which is immune from state-imposed property tax), the military housing built under that program, including the De Luz homes, have not been subject to property tax in California until the recent conveyance to a private developer in 2000 under the 1996 Military Housing Privatization Initiative program. See CRS Report for Congress, "Military Housing Privatization Initiative: Background and Issues, July 2, 2001: http://www.defenselink.mil/acq/installation/hrso/refdoc.htm

5. **Other privately owned military housing on leased military property is currently subject to a possessory interest tax.** Since 1991, Ventura County has levied a possessory interest tax on 300 military residential housing units available for rent to military personnel on land leased by the Navy at Port Hueneme, California to the private contractor. This housing was built under the Section 801 Housing Program (a build-to-lease guarantee to the property developer) approved by Congress in 1984. In addition to the recent taxation of a possessory interest in San Diego County and the possessory interest in Ventura County, other counties may also have been assessing possessory interests in other privately-operated military housing located on military bases.

6. **Independence**. To qualify as a possessory interest, the right to use property must be sufficiently exclusive, durable and independent of the public owner to constitute **more than an agency**. *Pacific Grove-Asilomar Operating Corp. v. County of Monterey* (1974) 43 Cal.App.3d 675, 684. "If, in practical effect, one of the parties has the right to exercise complete control over the operation, an agency relationship exists;..." (*Nichols v. Arthur Murray, Inc*. (1967) 284 Cal. App.2d). Pacific Grove-Asilomar Operating Corp is a nonprofit corporation organized under the laws of the State of California solely for the purpose of managing for and on behalf of the Department of Parks and Recreation, State of California, the real property and all improvements on the "Asilomar Conference Grounds." In the *Pacific Grove* case, the Court found that an agency was created by the agreement there in question; the court concluded that Asilomar's management of the property was not independent, but subject to state control in every way. To date, that decision appears to be one of the few possessory interest cases in which an appellate court has concluded that an agency relationship existed.

7. **If it is determined that the contractor's interest rises to the level of a taxable possessory interest, then any restrictions, such as the restrictions on the rent that may be charged, must be reflected in the value of the possessory interest.** Section 402.1 provides that in the assessment of land, the assessor must consider

the effect upon the value of any enforceable restrictions to which the use of the land may be subjected. For instance, the military will restrict the contractor's use and possession of the land and improvements and will restrict the contractor's right to set rental fees on the land and the improvements. These restrictions must be considered by the assessor in valuing the land and improvements. See BOE Annotated Letter 660.0171: http://www.boe.ca.gov/proptaxes/pdf/660_0171.pdf

8. **Prior Constitutional Considerations.** Legislation to exempt various possessoy interests by statute has been often argued to be an "unconstitutional" exemption of real property. It is claimed that the appropriate course of action is to instead seek the approval of the voters of California by proposing a constitutional amendment to exempt the particular class of real property from property taxation. Therefore, some may argue that this legislation, if enacted, would similarly constitute an "unconstitutional" exemption of real property. However, in *City of San Jose v. Carlson (1997) 57 Cal.App. 4th 1348,* the court acknowledged the appropriateness of Legislative action to set parameters on the element of durability. A similar rationale could be made for this bill, with respect to the element of independence. The Sixth District Court of Appeals in *City of San Jose* invited the Legislature to establish some statutory standards in measuring durability, the court stated:

   "Although we agree that the element of durability seems to have been 'diluted to a degree of almost nonexistence' (*United Airlines, Inc. v. County of San Diego* (1991) [cite omitted]), the Legislature has not seen fit to reverse the growing trend toward finding taxable possessory interests in short-term uses, even in its most recent amendments to Section 107. If there is a sound basis for distinguishing between a second time user and a third time user of government-owned property for purposes of identifying a taxable possessory interest, **it is within the province of the Legislature to clarify the parameters of that interest in terms of frequency, duration, and length of time between uses."** [Emphasis added.]

9. **The MHPI provides advantages for the military and provides venture capital opportunities for the private sector.** There is a private or economic benefit to the private sector developers that ultimately seek and win the contract to build, rehabilitate, and manage the housing units on military bases. The Department of Defense notes: "Advantages For the Military, Venture Capital Opportunities for the Private Sector: The Military Housing Privatization Initiative helps to promote a mutually beneficial relationship between the Department of Defense and the private sector. For the Department of Defense, it results in the construction of more housing built to market standards, for less money than through the military construction process. Commercial construction is not only faster and less costly than military construction, but private sector funds significantly stretch and leverage the Department's limited housing funds. There are also significant venture capital opportunities in DOD housing for developers and financiers in the private sector. Privatization opens the military construction market to a greater number of development firms. It stimulates the economy through increased building activity.

And, DOD housing projects can provide a continuous inflow of capital to an investor over a long period of time."

http://www.defenselink.mil/acq/installation/hrso/about.htm

10. **This bill does not require that any property tax savings generated will ultimately inure to the benefit of the military personnel living in the residences.** Other sections of law extending a property tax exemption require that the savings inure to the worthy organization in question. See for example, Section 206.2 related to property leased to churches and Section 202.2 for property leased to free libraries and museums.

11. **If this bill passes and the possessory interest to the developer/operator is exempt from property tax, the military personnel that live in homes <u>would not</u> subsequently be assessed a taxable possessory interest directly.** Some governmental employees who reside in tax-exempt governmentally-owned property, for example forest service employees receive direct possessory interest assessments. However, active duty military personnel are not subject to such taxable possessory interests. In 1980, the 9th Circuit Court of Appeals in *United States v. Humboldt County* 628 F.2d 549 held that the occupancy of rent-free housing to military personnel on base at Beale Air Force Base in Yuba County and off-base near Centerville Beach Naval Facility in Humboldt County was not durable, nor did it confer a private benefit to the military personnel, and thus not a taxable possessory interest.

12. **Similar Legislation.** Similar legislation was contained in SB 1631 (Morrow) in 2002, which did not pass out of the Senate Revenue and Taxation Committee.

## COST ESTIMATE

The Board would incur some minor absorbable costs in informing and advising county assessors, the public, and staff of the change in law.

**REVENUE ESTIMATE**

**Background, Methodology, and Assumptions**

According to the Department of Defense, the privatization projects awarded or in planning for California are:

| Branch | Project | Scope | Award Date |
|---|---|---|---|
| Marine Corps | Camp Pendleton (Phase I) | 712 housing units<br>with 512 existing and 200 new | November 2000 |
| Navy | Naval Complex San Diego (Phase II) | 3,248 housing units<br>with 2,660 existing and 588 new | August 2001 |
| Army | Presidio of Monterey<br>*POM*<br>*Ord Military Community*<br>Naval Postgraduate School | 1,675 housing units<br>*87 including 37 historical and 50 apartments*<br>*1588*<br>601 housing units | February 2003 |
| Army | Fort Irwin<br>Fort Irwin<br>Moffett Federal Airfield<br>Camp Parks | <br>2,052 housing units<br>690 housing units<br>13 housing units | April 2003 |
| Air Force | Beale AFB | 1,444 housing units<br>with 1,553 existing; 109 demolished | April 2004<br>(projected) |
| Navy | Naval Complex San Diego (Phase 2) | 4,981 housing units | pending |
| Marine Corps | Camp Pendleton (Phase 2) | 3,595 housing units | pending |
| | **TOTAL** | **19,011 housing units** | **completed by 2010** |

The De Luz family housing area in Camp Pendleton was privatized during November 2000. According to the San Diego County Assessor's Office, the total 2001 assessed value for the taxable possessory interest for the 512 existing housing units amounted to $35 million. Families started moving into some of the 200 homes being built in the area during October 2001. The new homes that were completed in 2001, along with the Naval Complex San Diego project, comprising 2,660 housing units, were assessed as possessory interests on the 2002 roll. However, the housing units in the Naval Complex San Diego project utilize city and county emergency services and will continue to be treated as taxable possessory interests under this bill.

Similarly, among the Army projects, Presidio of Monterey (POM) and Moffett Federal Airfield (Moffett) would not be affected by this bill since the city of Monterey provides fire/emergency services to POM and the county of Santa Clara provides law enforcement to Moffett. However, it is possible that the Naval Postgraduate School (NPS) and Ord Military Community (OMC) would be treated as nontaxable under this bill if the services that NPS and OMC currently contract with local agencies continue to be charged to NPS and OMC (who then would presumably pass on the charges to the developer), instead of these services being provided directly to the developer.

For the purposes of this estimate, the initial valuation of the possessory interest for the De Luz/Pendleton homes will be used to estimate the valuation and revenue impact of all of the privatization projects currently planned for California. For De Luz, the average assessed value per privatized housing unit is $35 million/ 512, or $68,000.

The revenue impact for the De Luz/Pendleton homes can be estimated as follows:

712 x $68,000 = $48.4 million x 1% = $484,000

The **maximum number of housing units** that would be affected by this proposal is 10, 005 units (19,011– 3,248– 4,981– 87– 690 = 10,005). Adjusting for NPS and OMC, the maximum decreases to 7,816 units (10,005 – 601 – 1,588 = 7,816)

The annual revenue impact in 2010 can be estimated:

| | **Estimated Assessed Value** | **Tax Rate** | **Property tax** |
|---|---|---|---|
| Maximum | 10,005 x $68,000 = $680.3 million | x 1% | $6.80 million |
| w/o NPS and OMC | 7,816 x $68,000 = $531.5 million | x 1% | $5.31 million |

## Revenue Summary

The annual revenue impact at the basic one percent property tax rate under this bill is estimated to be $5.31 million to $6.80 million by 2010.

Assuming that this proposal would first be effective for the 2004 lien date, the number of housing units that would be affected in the first three years can be estimated as follows:

| Year | W/ NPS and Ord | w/o NPS and Ord |
|---|---|---|
| 2004 | DeLuz/Pendleton + Army<br>712 + 1,588+ 601 + 2,052 + 13 = 4,966 | 4,966 – 601 – 1,588 = 2,777 |
| 2005/2006 | 2004 + Air Force<br>4,966 + 1,444 = 6,410 | 2,777+ 1,444 = 4,221 |

| Year | Estimated Assessed Value | Tax Rate | Property tax |
|---|---|---|---|
| 2004 | [2,777 to 4,966] x $68,000 =<br>$188.8 to $337.7 million | x 1% | $1.89 to $3.38 million |
| 2005/2006 | [4,221 to 6,410] x $68,000 =<br>$287.0 to $435.9 million | x 1% | $2.87 to $4.36 million |

## Qualifying Remarks

This estimate measures the impact for the military housing privatized under the MHPI only. There are other housing projects that could be affected by this bill. For instance, the possessory interest in Ventura County has an assessed value of roughly $19.5 million resulting in property taxes of $195,000 at the 1% tax rate.

The impact of this bill may be smaller if any additional housing units currently scheduled for privatization under MHPI utilize city or county services, or are not situated on a military base under the control of the military. For example, the utility services in the Army's MHPI projects have been, or will be, privatized. MHPI deals only with the privatization of family housing units. Depending on the success of the MHPI privatization plans, the military may decide to privatize bachelor-housing quarters as well. The revenue impact of this bill would increase significantly if bachelor housing quarters were privatized.


| | | | |
|---|---|---|---|
| Analysis prepared by: | Rose Marie Kinnee | (916) 445-6777 | 4/15/03 |
| Revenue prepared by: | Aileen Takaha Lee | (916) 445-0840 | |
| Contact: | Margaret S. Shedd | (916) 322-2376 | |


ls 0451-1rk

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.*