



# STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	03/24/2011	Bill No:	<a href="#">Senate Bill 314</a>
Tax Program:	Property	Author:	Vargas
Sponsor:	De Luz Family Housing	Code Sections:	RTC 107.4
Related Bills:		Effective Date:	01/01/12

## BILL SUMMARY

Related to a requirement that property tax savings from a possessory interest exemption provided to private contractors inure solely to the benefit of the residents of the military housing project, this bill would:

- Allow the tax savings to be held in a reserve account for use in future project construction if the military, in writing or by contract, so requires.
- Allow the assessor to effectively revoke the exemption retroactively via escape assessments if the tax savings are withdrawn from the reserve account.

## ANALYSIS

### CURRENT LAW

**Privatized Military Housing Projects.** Revenue and Taxation Code Section 107.4 provides that a private contractor's interest in rental military housing is not subject to property taxation as a taxable possessory interest, provided certain requirements and conditions are met.

Subdivision (a)(13) of Section 107.4 requires that any reduction in property taxes, or, if unknown, the contractor's reasonable estimate of property tax savings, inure solely to the benefit of the military housing residents through property improvements such as a child care center provided by the private contractor.

The purpose of this provision is to make certain that the tax savings bestowed by California on the project benefit the residents of the military housing project, rather than provide windfall additional profit to the private contractor operating the project.

**Escape Assessments.** Section 532 sets forth the statute of limitations on making escape assessments. An "escape assessment" is a retroactive assessment intended to rectify an omission or error that caused taxable property to be underassessed (or not assessed at all). In most cases, once such an omission or error occurs, the property escapes assessment *each year* thereafter until the underassessment is discovered and corrected. If property escapes assessment, the assessor is required to value the property upon discovery for the appropriate valuation date, enroll the appropriate value on the roll being prepared, process any necessary corrections to the current roll, and process appropriate escape assessments for prior years within the statute of limitations. Generally, the statute of limitations on escape assessments pursuant to Section 532 allows back taxes on the property to be collected for the last four tax years.

### PROPOSED LAW

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This bill would add subparagraph (B) to paragraph (13) of subdivision (a) of Section 107.4 to provide that despite the statute of limitations on making escape assessments, if the military, in writing or by contract, requires the property tax savings to be held in a reserve account for use in future project construction, the county assessor may levy an escape assessment within four years after July 1 of the assessment year in which the property tax savings are withdrawn from the account.

In practical application, the assessor would then have four years to process escape assessments for as many years as needed (i.e., which could be more than 4 years of back taxes) if the tax savings are not used to benefit the military personnel that reside in the housing units.

#### **IN GENERAL**

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

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. The use must be independent, durable and exclusive of rights held by others in the property.

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<sup>1</sup> to constitute more than a mere agency.”

Property Tax Rule 20(c)(8), a regulation, requires that a possessor derive “private benefit” from the use of the property. “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.”

Section 107.4 provides a possessory interest exemption for a private contractor’s interest in rental military family housing, by stating that the contractor’s interest in the property is not “independent” when certain criteria are met.

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<sup>1</sup>Property Tax Rule 20(c)(5) 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.”

### LEGISLATIVE HISTORY

In 2004, Senate Bill 451 (Ch. 853, Ducheny) added Section 107.4 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, renovation, rehabilitation, replacement, management, or maintenance of housing for active duty military personnel and their dependents, if specific criteria are met. An interest that is not independent fails to meet one of the three necessary elements for the interest to be subject to property tax. Thus, a private contractor's interest in military housing meeting the eligibility criteria of Section 107.4 would be exempt from property tax.

In 2006, Senate Bill 1400 (Ch. 251, Kehoe) amended Section 107.4 to define the phrase "military facility under military control" as a "military base that restricts public access to the military base." SB 1400 clarified that privately-developed military housing not located on a military base does not qualify for the military housing possessory interest tax exemption. Shortly after enactment of Section 107.4, concern arose that the statute might not adequately define the term "military facility under military control," and that more expansive interpretations of the military housing possessory interest exemption might be advanced by developers of off-base military housing. The definition refinement was made to avoid an interpretation that Section 107.4 exempts all privatized military housing from the possessory interest tax by creating the bright line test of restricted public access. San Diego County sponsored the legislation because they have a number of privatized military housing projects, some of which are eligible for exemption and others which are not.

In 2009, AB 1344 (Fletcher), held in the Assembly Revenue and Taxation Committee, would have expanded the allowable uses of tax savings on improvements for:

**Project Serving Facilities and Equipment.** The amendments would have expanded upon the types of improvements that could be constructed with the property tax savings and expressly provide that the property tax savings could be used to renovate and refurbish these improvements. Specifically, it would have added "project serving facilities" to include, but not be limited to, day care centers, recreation or community centers, fitness centers, parks or playgrounds, parking, and outdoor lighting. It would have also expressly allowed for the property tax savings to be spent on furnishings, fixtures, and equipment for any of the project serving facilities.

**Tax Savings.** The tax savings could have been used to construct additional housing units or to renovate or upgrade housing units; or on "future" improvements and for "future" residents; or to pay the debt incurred in building the improvements.

**Time Frame to Spend Savings.** The annual property tax savings spent on improvements (or the debt service of the improvements) could be spent over a four year period (rather than annually). However, if the military allowed, the tax savings could have been deposited in secure accounts or invested in interest bearing instruments to be used for future authorized expenditures.

In 2010, AB 1945 (Fletcher) proposed amendments which were identical to this bill. That bill was also held in the Assembly Revenue and Taxation Committee.

## BACKGROUND

Congress established the Military Housing Privatization Initiative (MHPI) in 1996 as a tool to help the military improve the quality of life for its service members by upgrading the condition of their housing. The MHPI was designed and developed to attract private sector financing, expertise and innovation to provide necessary housing faster and more efficiently than traditional military construction processes would allow. The military enters into agreements with private developers selected in a competitive process to own, maintain and operate family housing via a fifty-year lease. The Department of Defense maintains an extensive website on the [MHPI program](#) where more information about the program is available.

## COMMENTS

- 1. Sponsor and Purpose.** This bill is sponsored by De Luz Family Housing, a privatized military housing development in Camp Pendleton, operated by Hunt Companies. According to the sponsor, the purpose of the bill is to allow the assessor to impose an escape assessment if the project uses the tax saving funds improperly. The sponsor states that the existing statute of limitations on escape assessments could prevent an assessor from “holding a developer’s feet to the fire” to insure the tax savings are spent on project improvements.
- 2. Issue.** To date, the De Luz Family Housing project has not qualified for the possessory interest exclusion available under Section 107.4.
- 3. Privatization of Military Housing.** Under the 1996 Defense Authorization Act, the Military Housing Privatization Initiative (MHPI) allows private sector real estate developers, builders and property managers to partner with the Department of Defense to provide military housing. De Luz Housing is a military housing development for Marine Corps Base Camp Pendleton in San Diego County, California. De Luz Housing is a 714-unit development for MCB Camp Pendleton in Oceanside, California. Hunt assumed management responsibility for 512 existing housing units. The construction element of the project included construction of 202 new houses, demolition of 312 existing apartment units, construction of 312 replacement apartment units, and the renovation of 200 existing homes. Hunt Companies, with headquarters in Texas, was also the co-developer, general contractor and property manager for this project. [De Luz Family Housing](#) is managed and operated by a Hunt subsidiary [Hunt Military Communities](#). Whether this particular project qualifies under Section 107.4 is in dispute at the local level.
- 4. Property Tax Implications of Privatization.** Private contractors competitively bid for these projects and are informed that the projects could be subject to property taxes by the various local governments where the properties are located. According to the Department of Defense, the property tax implications of these projects are not guaranteed. The website for potential bidders notes:

[“Are property taxes considered in these deals?”](#) Although DoD will not negotiate with the local jurisdiction on any tax abatements, the developer is free to negotiate to achieve any tax abatements.”
- 5. California enacted Section 107.4 to provide this “tax abatement” in the form of a taxable possessory interest definitional exclusion.** In 2004, Senate Bill 451 (Ch. 853, Ducheny) provided a property tax exemption to the developers and operators of the housing projects. Essentially, the exemption is provided by stating

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that the private contractor's interest in the property does not rise to the level of a taxable possessory interest because the interest in the project is not "independent" from the federal government when certain conditions and requirements are met. One condition is that the property tax savings conferred by the state of California must be passed through to the residents of the military housing project.

6. **Why is the exemption conditional?** The purpose of this provision is to ensure that the property tax exemption extended to the private contractor of the federal military housing project is not merely a windfall savings to the private contractor, but rather that the property tax savings are ultimately passed through to benefit California residents of the military housing project. Other sections of law extending a property tax exemption to an otherwise non-tax exempt entity similarly require that property tax savings inure to the worthy organization in question, via rent reductions. (See Section 202.2 related to property leased to a public school, university or college or leased to a library or museum that is free to the public, and Section 206.2 related to property leased to churches).
7. **Expenditure of Tax Savings.** The County of San Diego, which has many military housing projects and administers this provision of law, has previously expressed concern that the expenditure of the tax savings may not ultimately require the private contractor to provide benefits to the residents over and beyond the contractual obligation already incurred. Whether De Luz Family housing qualifies is in dispute at the local level.
8. **Reserve Accounts.** Although not directly stated, this bill implies that tax savings deposited in a reserve account for "future project construction" is a use that benefits residents. The sponsor states that contracts with the military generally require all revenues not used for debt service, maintenance, etc. to be placed in a secure reserve account until the military approves the additional construction.
9. **Withdrawing Funds vs. Ultimate Use of the Funds.** The language could be interpreted to mean that the mere act of withdrawing the funds could trigger an escape assessment. Presumably, only if the withdrawn funds were not subsequently used (within four years?) for such improvements would it be necessary to issue an escape assessment to revoke the previously granted exemption. On the other hand, it does state the assessor "may" levy the escape assessments – thus giving the assessor the discretion. Clarification might be helpful on this point.
10. **What is Future Project Construction?** This phrase is not defined. Would the use of the tax savings to build more housing units which serves to increase the rental income from the project (as well as provide more housing opportunities for military personnel) qualify? Should "future project construction" provide benefits/improvements to the residents over and beyond the contractual obligation already incurred?
11. **Escape Assessments.** When a property is receiving an exemption for which it does not qualify, an "escape assessment" is occurring every year. Thus, the assessor may revoke the exemption once it is determined that the property does not qualify and issue escape assessments for current and prior tax years. As outlined in Section 532, the "statute of limitations" serves to limit the number of tax years for which *back taxes* may be sought. The statute of limitations on escape assessments is often erroneously interpreted to mean that the assessor only has four years to

determine that the property does not qualify for an exemption, after which the property is permanently exempt from taxation. This is not the case.

**12. Unlimited Escape Assessments for Prior Years Taxes?** It appears that by waiving the statute of limitations in this case, the technical effect of proposed Section 107.4(a)(13)(B) is to allow back taxes to be levied for an unlimited number of prior tax years (i.e., more than the maximum of four years the law currently provides) and to give assessors up to four years after July 1 of the calendar year in which the property tax savings were withdrawn from the reserve account to issue those escape assessments. For example, if the property tax savings were withdrawn anytime during the year 2015, and those funds were ultimately not used to benefit the residents, then the assessor would have until July 1, 2019 to make retroactive assessments for back taxes for as many years as appropriate (i.e., which could be for more than the current limit of four years).

### **COST ESTIMATE**

The BOE would incur insignificant costs (less than \$10,000) to inform and advise county assessors, the public, and staff of the change in law.

### **REVENUE ESTIMATE**

According to San Diego County, this bill affects the possessory interest assessment levied on the De Luz military housing property resulting in a revenue loss of approximately \$520,000 annually.”

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