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December 21, 2001

**RE: *Exemption for Property Leased to Government***

Dear Mr. \_\_\_\_\_,

This is in response to your email request to Mr. \_\_\_\_\_, dated November 14, 2001, in which you request answers to the following questions regarding possible property tax exemptions for privately owned real property leased to a federal agency:

1. If a high rise office building is leased to a federal agency of the U.S. government, is the square footage it occupies (including the prorata portions of the common areas) exempt from property taxation?
2. If property tax exempt, does the county or state have authority to charge or levy any "in lieu" fees?

For the reasons set forth in detail below, the answer to both questions is "no." Privately owned property leased to a federal agency is subject to local property taxation, the same as is property leased to the United States government. Regardless of whether the agency is a federal instrumentality, *leased* property, unlike property *owned* by the federal government, is not immune from state and local taxation. To be immune or exempt from property taxation, the federal agency must meet specific constitutional requirement of property *ownership* with the agreement between the parties reflecting that the government agency has the *full indicia of ownership*.

**Law and Analysis**

All real property and all tangible personal property located in California is taxable unless specifically exempted by the California Constitution or made immune by federal law. Section 1, Article XIII of the California Constitution provides, in part, that

"Unless otherwise provided by this Constitution or the laws of the United States.

(a) All property is taxable and shall be assessed at the same percentage of fair market value. . .” Section 201 of the Revenue and Taxation Code<sup>1</sup> which interprets section 1 of Article XIII states “All property in this State, not exempt under the laws of the United States or of this State, is subject to taxation under this code.”

Thus, local property taxes raise revenue to provide direct services, such as police and fire protection, to the property, its owner(s), and to a federal agency of the U.S. government, as the lessee of the property.

**Property leased to the federal government is not immune from local property tax unless the government acquires the *full indicia of ownership*.**

As an overarching principle governing the laws of taxation, the federal government is immune from taxation, pursuant to the United States Constitution. (*TRW Space & Defense Sector v. County of Los Angeles* (1996) 50 Cal.App.4<sup>th</sup> 1703, 1704(1).) Section 3 of Article XIII exempts both property owned by the state and property owned by a local government (section 3, subdivisions (a) and (b)). Where property is beneficially owned under a lease or any other type of agreement, by either the federal, state or a local government, the property is immune or exempt from property taxation.

The determination of beneficial ownership is a question of fact, and in a leasehold transaction between a private entity and a government agency, depends upon the terms of their agreement. In this regard, the Board staff has advised assessors, vested with the responsibility of making the determination of beneficial ownership in a given transaction, to apply the standard set forth in the leading precedent, *Mayhew Tech Center, Phase II v. Sacramento County* (1992) 4 Cal.App.4<sup>th</sup> 497. In its holding, the Court of Appeal found that land and improvements leased and occupied by the State of California Franchise Tax Board under a lease/purchase agreement were exempt from taxation as property owned by the State.

The central facts were that trustee/developers entered into an agreement with the State of California in 1982 to finance the acquisition of land and the construction of a building for the Franchise Tax Board. The trustee sold certificates of participation for financing purposes, and the state executed a long-term lease, whereby the state’s rental payments were used to pay off the certificate holders. Legal title automatically vested in the state at the end of the lease if all rental payments were made. To satisfy the debt limitation provision of the California Constitution, the agreement provided that the state could unilaterally terminate the lease in the event that in any given year the Legislature and Governor failed to appropriate funds for the rent. If the state defaulted, the trustee could repossess the property. The proceeds of any sale or lease would be applied by the trustee to pay the certificate holders with any surplus to the state, thereby providing the state with a return of equity.

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<sup>1</sup> All section references are to the Revenue and Taxation Code unless otherwise stated.

Sacramento County assessed property taxes for 1983 through 1988 and both the trustee and the state filed for refund. The trial court concluded that the state held beneficial ownership of the property and it was, therefore, exempt from property taxation. The Court of Appeal upheld that decision, rejecting the county's arguments that (1) the property was not exempt because the state held only a leasehold rather than beneficial ownership, or (2) if the agreement conferred beneficial ownership on the state, it constituted an unauthorized installment purchase contract which violated the constitutional debt limitation.

In finding that the arrangement closely resembled a purchase through a loan secured by a deed of trust (i.e., a security transaction), the court determined that the state held "the essential indicia of ownership." The factors supporting this conclusion were (1) the exclusive right of the state to occupy and use the property, (2) the automatic vesting of title in the state at the expiration of the lease if all rental payments were made, and (3) in the event of default, the state would receive any surplus funds following sale of the property and payment of the certificate holders. Thus, any equity in the property belonged to the state. As state-owned property, it was exempt from taxation.<sup>2</sup>

In a subsequent February 14, 1994, Letter to Assessors No. 94/10, entitled, Change-in-Ownership: Lease-Purchase Agreement (*Mayhew Tech Center, Phase II v. County of Sacramento* (1992) 4 Cal.App.4<sup>th</sup> 497), attached, Board staff advised assessors that the following aspects of the lease/purchase agreement were considered important to the court's decision that upon the execution of the agreement, the state acquired beneficial ownership:

"Under the terms of the lease-purchase agreement, the state was required to make specified rental payments over the life of the lease. The state was responsible for all maintenance and repair of the property, and any insurance proceeds were available to the state for those purposes. The state was responsible for utilities and services provided on the property and agreed to pay any taxes and assessments levied on it. The title to the property vested in the state automatically at the end of the lease term if the state had made all required rental payments."

Letter to Assessors No. 94/10, *supra*, concluded as follows:

"The determination of beneficial ownership is a question of fact which depends upon the terms of each agreement. It is the assessor's responsibility to make the initial determination of beneficial ownership in any given case. If the assessor determines that, under the particular agreement, the government lessee holds the essential indicia of ownership, then under the holding of the *Mayhew Tech Center* decision, the property is exempt regardless of whether legal title to that property is held by it or by a private individual."

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<sup>2</sup> The court went on to conclude that the state did not violate the constitutional debt limitation due to the fact that the agreement specifically provided for automatic termination if the Legislature and the Governor did not annually appropriate funds for the rental payments.

The principles of *Mayhew Tech Center, Phase II, supra*, have also been considered applicable to a lease/purchase agreement by other courts, where a local government is a party. In *City of San Diego v. Rider* (1996) 47 Cal. App. 4<sup>th</sup> 1473, the Court of Appeal held that a proposed lease of a city-owned sports stadium to the city's public facilities financing authority, which would make improvements to the stadium and lease the stadium back to the city on a monthly basis, vested ownership in the public entity and complied with the Supreme Court rule that enables a public entity to incur contractual liability without voter approval and not offend the constitutional debt limitation (Constitution, Article XVI, Sec. 18). Citing *Mayhew Tech Center, Phase II v. County of Sacramento, supra*, and other cases, the concurring and dissenting opinion began its analyses "by setting forth those areas where I believe there should be no doubt or confusion. A municipal government may, without incurring a debt proscribed by Article XVI, section 18 of our Constitution, enter into long-term contracts which in the future will require payment of substantial sums of money for services, products or other consideration to be provided in the future."

Turning to your question, the same principles would apply to a lease arrangement between a private lessor and a federal lessee. If it was clear that the terms of the lease agreement provided the federal agency with "the essential indicia of ownership" - as indicated *Mayhew Tech Center*, then the federal agency would be considered the beneficial owner of the office building and the property would be immune from taxation. Thus, the substance of the agreement must meet the criteria discussed in *Mayhew Tech Center, supra*, and in Letter to Assessors No. 94/10, above. If, for example, the substance of the lease agreement contemplated that the federal agency had the exclusive right to occupy and use the property, that title vested in the federal agency at the expiration of the lease when all rental payments were made, and that in the event of default, the federal agency would receive any surplus funds following a sale of the property, the assessor could conclude that the federal agency holds the essential indicia of ownership, per *Mayhew Tech Center*, and the property would be immune or exempt from taxation.

If, on the other hand, the agreement executed between the private property owner and the federal agency here is a true lease, in which the private lessor retains the reversion and the federal agency merely holds the right to possess the property for the extent of the lease term, then the private lessor retains the essential indicia of ownership, and the assessor would not be justified in treating the property as exempt from property taxation under the holding of *Mayhew Tech Center*. Ultimately, it is the assessor who is responsible for the determination of beneficial ownership in an instance such as the one you are considering.

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The views expressed in this letter concerning federal agencies, are, of course, only advisory in nature. They represent the analysis of the legal staff of the Board based upon the present law and facts set forth herein, and are not binding upon any entity or the assessor of any county. Please feel free to contact us if you have any further questions or concerns.

Very truly yours,

*/s/ Kristine Cazadd*

Kristine Cazadd  
Senior Tax Counsel

KEC:tr  
prop/prec/govnprop/01/04kec

Attachment [LTA 94/10]

cc: Honorable John Chiang

Mr. James Speed, MIC:63  
Mr. Timothy Boyer, MIC:83  
Mr. Steve Kamp, MIC:72  
Mr. David Gau, MIC:64  
Chief - PPSD, MIC:64  
Ms. Jennifer Willis, MIC:70