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April 18, 2003

Honorable Stephen L. Vagnini
Monterey County Assessor
P.O. Box 571- Courthouse
Salinas, California 93902

VIA FACSIMILE ORIGINAL TO FOLLOW

RE: : Military Privatization Housing

Dear Mr. Vagnini:

This is in response to your fax, dated January 27, 2003, sent to the Board of Equalization's Assessment Policy and Standards Division, requesting staff's opinion about the property tax treatment of military housing developed under the United States (U. S.) Department of the Army's Residential Communities Initiative (RCI). Specifically, you ask whether the arrangement between the Military Housing, LLC (LLC), and the U. S. Secretary of the Army (federal government) would create a taxable possessory interest in the military residential housing units constructed by the LLC for rent to military personnel on land leased from the U. S. Departments of the Army and Navy. Drafts of the proposed LLC Operating Agreement and proposed Ground Lease were submitted for our review, and we discussed the facts with RCI Director, Mr. K , RCI Deputy Director, Mr. C , and Financial Advisor, Mr. R , from the brokerage firm. However, based on our telephone conversations with Mr. K , the two documents we received accurately reflect the relationship of the parties in this transaction.

As set forth below, based on the documents submitted and subsequent telephone conversations with the individuals named above, we conclude that an agency relationship exists between the federal government and the LLC. As an agent of the federal government, the LLC lacks the independence necessary to have a taxable possessory interest in the military housing it administers. Further, we believe the contractual arrangement is, in effect, a security transaction which results in the LLC obtaining merely a security interest in the property. Specifically, the substance of the underlying transaction guarantees that at all times the federal government has full control, possession, and ownership of the property, and that the equity investor's (C P 's) rights during the term of the lease will be fulfilled by repayment of its cash contribution and payment of fees for its services in financing and managing the property. Accordingly, for property tax purposes, ownership of the property remains in the federal government and, therefore, the property is immune from property taxation.

Background

The Military Housing Privatization Initiative (MHPI) was enacted on February 10, 1996, as part of the National Defense Authorization Act for fiscal year 1996. The MHPI program was created to address two significant problems concerning housing for military service members

and their families: the extremely poor condition of U. S. Department of Defense (DOD) owned housing, and a great shortage of affordable private housing of adequate quality. Under the MHPI, the DOD is authorized to work with the private sector to provide some of the capital and construction expertise to revitalize military family housing by employing a variety of financial tools including direct loans, loan guarantees, equity investments, conveyance or leasing of property or facilities, and rental guarantees.

The DOD has delegated to the various branches of the Military Services (Army, Air Force, and Navy/Marine Corps) the responsibility for identifying and structuring the family housing privatization projects for their individual installations. The Army and Navy have identified and are awaiting final congressional approval to build and renovate military housing in Monterey County for more than 4,000 service personnel and their families to live there. Using their Basic Allowance for Housing ("BAH") the personnel stationed in Monterey County will pay rent over the 50-year term of the agreement.

Under the Army's Residential Communities Initiative (RCI) program, the Army, the Navy, and a contractor have collaborated to finance, design, construct, manage, operate, maintain, and repair the military family housing inventory at the Presidio of Monterey, Ord Military Community, La Mesa Village, and the Naval Postgraduate School in Monterey County, California. In structuring the project, the Army and Navy will lease to the LLC, for a 50-year term, the federal land ("site") containing pre-existing military housing. The "members" of the LLC are the U. S. Secretary of the Army, acting on behalf of the Departments of the Army and Navy, and C P LLC (C P). The LLC is organized solely to acquire, own, design, develop, demolish, expand, construct, renovate, repair, replace, rehabilitate, manage, finance, mortgage, operate, maintain and sell the Project (and such additional property as may be approved by the members), including the leasing of residential units within the Project (and additional property) to members of the military and non-military personnel as permitted in the Ground Lease and all activities necessary or incidental to the ownership and operation of the project as set forth in the LLC Operating Agreement. The federal government will transfer fee title to 2,268 housing units presently existing on the property to the LLC. RCI, under the direction of the Secretary of the Army, will serve as the Asset Manager of the project, overseeing all finances for the duration of the Ground Lease.

Law and Analysis

1. Does Military Housing LLC, have a taxable possessory interest in the housing it constructs and operates?

No. As an agent of the federal government it lacks the independence necessary to have a taxable possessory interest.

Article XIII, section 1 of the California Constitution states that unless otherwise provided by this Constitution or the laws of the United States, all property is taxable. As to property owned by the United States, it is immune from property taxation by a state within whose territorial limits it is located unless the United States consents to such taxation (*Gottstein v. Adams* (1927) 202 Cal. 581; *Rhor Aircraft Corporation v. San Diego County* (1960) 362 U.S. 628, 80 S. Ct. 1050, 4 L.Ed.2d 1002).

Even though federal government-owned real property is not subject to property taxation, a private leasehold or other interest in such property may be taxable as a possessory interest. Under Revenue and Taxation Code section 107, subdivision (a), “possessory interest” is defined as:

Possession of, claim to, or right to the possession of land or improvements that is independent, durable, and exclusive of rights held by others in the property, except when coupled with ownership of the land or improvements in the same person.

The general guiding rule in deciding whether a private leasehold interest constitutes a taxable possessory interest is to weigh the factors of independence, exclusiveness, durability, and private benefit of the possessory rights on a case-by-case basis. (*Pacific Grove Asilomar Operating Corporation v. County of Monterey*, (1971) 43 Cal.App.3d 675, at p. 692). As discussed by the Court of Appeals in *United States of America v. Fresno County* (1975) 50 Cal.App.3d 633, at p. 638, the court observed that some uses or occupancies are not taxable as possessory interests. In that regard, the court explained that:

“[T]o give rise to a taxable possessory interest, the right of possession or occupancy must be more than a naked possession or use; it must carry with it, either by express agreement or tacit understanding of the parties, the degree of exclusiveness necessary to give the occupier or use something more than a right in common with others, or, in the case of employment, something more than the means for performing his employer’s purpose, so that it can be said, realistically, that the occupancy or use substantially subserves an independent, private interest of the user or occupier (citations omitted).”

The question here is whether the LLC’s use or occupancy of the subject property meets the degree of independence necessary to create a taxable possessory interest in the property. In *Pacific Grove Asilomar Operating Corporation v. County of Monterey*, (1971) 43 Cal.App.3d 675 (*Asilomar*), the Court of Appeals discussed the degree of independence necessary to create possessory interest and determined that a non-profit corporation that managed and operated state owned conference grounds was an agent of the State and did not have a taxable possessory interest in that property. The court held that an agent or representative is liable for the property taxes assessed to it only in its representative capacity. Thus, property exempt in the hands of a principal remains exempt in the hands of the agent. In finding that the non-profit corporation was an agent, the court further held that a principal and agent relationship between the government and the operator is established by evidence that a management agreement between the parties sets forth sufficient specific controls by the government, such that the operator has no independent usufructuary use of the property. (*Pacific Grove Asilomar Operating Corporation v. County of Monterey, Supra.*) On the other hand, if the operator has usufructuary use of the property, as evidenced by sufficient operational independence, then the operator can be said to have a taxable possessory interest in the property.

We find that factually the arrangement between the federal government and the LLC is similar to that of the operating agreement in *Asilomar*. *Asilomar* was formed and organized

under the laws of the State, solely for the purpose of managing, on behalf of the State, real property and improvements known as the Asilomar Conference Grounds. Here, the LLC is established and organized solely for the purpose of constructing, managing, and operating the Project for and on behalf of the federal government. The Ground Lease and LLC Operating Agreement between parties include the following specific provisions vesting ownership and control in the federal government:

1. The LLC is organized and established solely to acquire, own, design, develop, demolish, expand, construct, renovate, repair, replace rehabilitate, manage, finance, mortgage, operate, maintain and sell the Project, (government-owned site together with the government-owned improvements and any other buildings, improvements, fixtures and systems located on the site), including the leaseback of newly constructed and some rehabilitated residential units within the Project (and such additional property) to members of the military and "permitted tenants" as authorized in the Ground Lease; and to conduct all management activities necessary or incidental to the ownership and operation of the Project. The LLC shall not engage in any other activity or business with the approval of the members. [Section 2.4, LLC Operating Agreement.]
2. The LLC's members are the federal government and C P . Per RCI Deputy Director Mr. C and the recitals in the LLC Operating Agreement, the federal government issued a Request for Qualification Proposal. After evaluating all submissions within the competitive range, the federal government contracted with a private partner (C P) and created the LLC in order to construct, rehabilitate, and manage the Project in compliance with the privatization requirement pursuant to the 1996 Federal legislation. Both C P and the LLC are authorized to operate the property only within the restricted parameters of that legislation and are subject to the lease-leaseback arrangement described in the Ground Lease and its exhibits.
3. The "consideration" for the Ground Lease is (i) the membership interest in the LLC granted to the federal government in accordance with the LLC Operating Agreement and (ii) the LLC's obligations to operate the property as set forth in the Ground Lease [see Paragraph 2, Ground Lease], including the right of the Managing Member of the LLC to receive certain fees for the construction, management and daily operation, and maintenance of the property.
4. The use and occupancy of the Project is subject to the general supervision and approval of the Installation (Army) Commander, the federal government, and to such rules and regulations as may be prescribed from time to time by the federal government. [Paragraph 5(a), Ground Lease.] Day-to-day operations, including collecting rent, conducting maintenance and repairs, providing services and utilities, and all property management responsibilities are delegated to the Managing Member of the LLC. Exhibit G "Project Management Procedures and Protocols," attached to the Ground Lease states for example that the Lessee (LLC) will operate seven neighborhoods, will

- maintain an On-Site Management Office, including emergency maintenance personnel to meet residents' immediate needs, will oversee all maintenance, repair, pest control, landscaping, clean-up, debris removal, and correction of any defects and deficiencies related to the housing stock.
5. LLC shall neither transfer (sell), nor assign the Ground Lease nor sell or sublet any part of the site (other than rental of dwellings to Permitted Tenants), nor grant any interest, privilege, or license whatsoever in connection with the Ground Lease without prior written approval of federal government. [Paragraph 9(a), Ground Lease.]
 6. In the event of base closure, condemnation, a decrease in the Pay Grade Designation or BAH of any military personnel, the LLC may seek an adjustment to account for its cash flow or construction costs – but, the LLC has no right or interest in the property, except for compensation. [Section 3.13 and 3.14, LLC Operating Agreement.]
 7. LLC, from time to time, with the consent from the federal government, may obtain a mortgage on its interest in the Project. No mortgage shall extend to or affect the fee title in the Project or the right of the federal government to acquire the improvements upon expiration or termination of the Ground Lease. [Paragraph 10(b) and (c).]
 8. The LLC may use the Project for the design, development, demolition, construction, operation, management, rental, rehabilitation, renovation, and maintenance of family housing units and related ancillary facilities, and any other use described in the CDMP or otherwise approved by the federal government. The LLC can not use the Project for other purposes without the consent of the federal government. [Paragraph 21, Ground Lease.]
 9. Unless the federal government retrocedes its jurisdiction or waives its sovereign immunity over the property, the LLC has no rights other than to fulfill its obligations under the Ground Lease. [Sections 3.13, 3.14, LLC Operating Agreement.]
 10. The Installation (Army) Commander will, under U. S. Military regulations, continue to provide security, fire, and police services, and shall have the authority to remove military personnel from units, with respect to (i) the Project, and (ii) military personnel that may be residing or otherwise present on the Project from time to time.
 11. The federal government shall have the right to enter upon the site for any purpose necessary or convenient in connection with federal government purposes and the right to require, review and approve all insurance coverage on the property maintained by the LLC, [Paragraphs 13 and 14, Ground Lease.] and all rental and occupancy requirements.

12. The LLC is required to maintain insurance coverage for the mutual benefit of the federal government and the LLC and the policies will name the federal government as an additional insured. The policy shall be reasonably satisfactory to the federal government in all respects. Failure of the LLC to carry and maintain insurance constitutes default and breach of the Ground Lease. [Paragraph 13, Ground Lease]
13. No immediate profits. C P will receive an equity share in the project of 16 percent (capped and not guaranteed) on the \$7,000,000 to be contributed into the Construction Account during the 6th year of the project. No return will be received until 8 years, 4 months after financial closing and assumption of operation. In addition, C P receives a small fee for performing managing member duties (services), which is 4 percent of the amount remaining (profit) from the rental receipts after allocation to the Project's various accounts. Otherwise, based on the LLC Operating Agreement: (1) No member or any partner, officer, shareholder or employee of any member shall receive any salary or other remuneration for its services rendered pursuant to the Operating Agreement [Section 4.13]. (2) The Managing Member receives a financing fee equal to 25 basis points (0.25) of the aggregate principal amount of any permitted financing in consideration for its role in procuring and structuring the permitted financing upon the LLC's initial borrowing under each such permitted financing [Section 4.12]. (3) Except to the extent the Managing Member shall be entitled to a return on its Initial Capital Contribution as part of any Termination Return payable to the Managing Member, no member shall be entitled to a return or any interest on its Initial Capital Contribution [Section 5.3]. (4) C P is entitled to receive a return of its Capital Contribution (currently estimated at \$7,000,000) upon the end of the 50th year of the Ground Lease [Section 5.4].
14. All property, real and personal including all improvements constructed by the LLC revert to the federal government at the end of the Ground Lease, in the year 2053, or at the end of any extended term agreed upon by the federal government [Paragraph 1, Ground Lease.] Only "bare legal title" to the property is held in the name of the LLC. [Section 2.7, LLC Operating Agreement.]
15. Per Mr. K , RCI Director, RCI controls the distribution of revenues for the duration of the Ground Lease. As member of the LLC, C P prepares an annual budget for the Project and submits to RCI for approval and the ultimate distribution of funds to operate the property. Any amount exceeding the budgeted amount needed to operate the property requires a written request to RCI for approval. Any income of the LLC is exempt from federal income tax.

Under the agreements between the federal government and the LLC, the LLC provides property management, maintenance, and operation services for a military residential rental development. The subject property is the existing military housing and the land on which units

will ultimately be constructed; the purpose of the LLC's use or occupancy of that property is simply to construct, maintain, operate, and manage the housing facilities. In view of the foregoing elements of control, the LLC does not operate independently of the federal government. The Project is on a military facility under the ownership and direct control of the federal government. The use to which the LLC is permitted to make of the property, real and personal, will be entirely for the benefit of the owner, the federal government, and not for the benefit of the LLC. Thus, the LLC's right of use is not a "usufructuary right, that is, 'the right of using and enjoying the profits of a thing belonging to another, without impairing the substance' . . ." (*Douglas Aircraft Company v. Byram* (1943) 57 Cal.App.2d 311.)

Accordingly, based on the foregoing discussion, we conclude that the LLC is an agent for the federal government, which is immune from taxation, and its use or occupancy of the project in this case lacks the degree of independence sufficient to constitute a taxable possessory interest.

LEASE-LEASEBACK SECURITY TRANSACTION ANALYSIS

2. Do the contracts between the parties establish that the substance of the transaction is a financing arrangement rather than the transfer of a present beneficial interest in real property?

Answer: Yes.

Property "owned" by the state or local government is exempt from taxation under article XIII, section 3 of the California Constitution. Privately owned personal property leased to and held by the government is not exempt; however, where title remains with the lessor, i.e., the lessor is the owner. (Assessors' Handbook Section 504, *Assessment of Personal Property and Fixtures* (AH 504), p. 107) Where, as here, the question is who owns the property in a lease-leaseback transaction, the lease agreements and supporting documents are determinative of the parties' intent. In *Mayhew Tech Center, Phase II v. County of Sacramento* (1992) 4 Cal.App.4th 497, the Court of Appeal held that in reviewing the documents and the nature of the transaction, the assessor should determine who holds the "essential indicia of ownership."

The "essential indicia of ownership test" in *Mayhew* is based upon the presence of certain ownership criteria in a transaction, which are also present in this case. First, under the terms of the lease-purchase agreement in *Mayhew*, the State was in possession and responsible for all maintenance and repair of the property and any insurance proceeds upon loss were payable to the State. Secondly, the State was responsible for utilities and services provided on the property and agreed to pay any taxes and assessments levied on it. Thirdly, title vested in the State automatically at the end of the lease term, if the State made all required rental payments. In addition, although the court stated that a title clause standing alone is not always conclusive of ownership for tax purposes, the lease agreement there provided for *automatic vesting of title in the State and that any equity in the property belonged to the State.* (*Mayhew Tech Center, Phase II v. County of Sacramento, Supra*) Thus, even in the event of a default, the State would receive the funds remaining after the sale of the property and payment to lien holders.

Based on the test published in *Mayhew*, the following terms in the Ground Lease and LLC Operating Agreement support the conclusion that, as a member of the LLC, the federal government will remain the present beneficial owner of the subject property throughout both the proposed transaction and upon its termination:

- (1) Title. The Ground Lease (Page 1) state that the LLC is the fee title owner of the improvements and the LLC Operating Agreement (Section 2.7) states that all legal title to LLC property shall be held in the name of the LLC, not C P
- (2) Possession and Control. The LLC alone retains possession and control of the improvements with respect to its operation, maintenance, repairs, modifications and improvements throughout the lease term.
- (3) Operating Profits and Losses. The LLC retains full rights to the operating profits and losses with respect to the improvements during the 50-year term. The LLC will bear all costs of development, construction, and improvements with respect to the Project. However, the obligations of C P and the federal government for such costs are limited to their respective Capital Contributions and Gross Receipts of the Project. [Section 5.2, LLC Operating Agreement.] In addition, C P does not have any personal liability for the costs of development, construction and improvements and shall not under any circumstances be obligated to contribute additional amounts to pay such costs. [Section 5.2, LLC Operating Agreement.]
- (4) Insurance. The LLC alone bears the full risk of loss. [Paragraph 15, Ground Lease.] In the event any item or part of the Project is damaged or destroyed, the LLC must restore or replace the damaged or destroyed property to the extent insurance proceeds are available. The LLC is self-insured with respect to its liability for the property and the insurance proceeds with respect to any loss or damage are paid to the LLC. [Paragraph 13, Ground Lease.]
- (5) Termination/Default. After the expiration or if the federal government terminates the Ground Lease, the LLC must surrender and convey all of the Improvements located on the site to the federal government without compensation. The federal government is deemed to have owned the improvements for the duration of the leasehold term. [Paragraph 16, Ground Lease.]

Thus, under the *Mayhew* test, the Ground Lease and LLC Operating Agreement memorializing this proposed transaction support the conclusion that the federal government is the beneficial owner. Not only does LLC have the full possession and use of the land and improvements to the complete exclusion of all others, but it also suffers all of the benefits and burdens of ownership. In substance, the federal government is borrowing on the equity in its land and improvements, and the lease-leaseback arrangement is nothing more than a security transaction within the meaning of subsection (a) of Property Tax Rule 462.200. Both the Ground Lease and the LLC Operating Agreement provisions effectively guarantee the federal

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government maintains ownership of the property and extinguishes C P 's rights to payment, once the LLC loans are repaid. Accordingly, since the federal government effectively retains the indicia of ownership, the property is immune from property taxation.

In the present case, the purpose of the Ground Lease and the LLC Operating Agreement is to benefit the federal government's military community, not the contractor. The property is government subsidized housing which can only be used for that purpose and cannot be sold or subleased without the federal government's permission. The LLC's authority to manage, operate, maintain and develop the site is subject to the control, policies, rules and regulations of the federal government. Furthermore, the sole purpose for creating the LLC was for the benefit of the federal government.

The opinions expressed herein are advisory only, and represent our views based on the existing law and facts, as we understand them. They do not necessarily represent the views of the elected members of the Board of Equalization and should not be construed or cited as representing the views of the elected board or any of its members.

Sincerely,

/s/ Shirley Johnson

Shirley Johnson
Tax Counsel

SJJ:eb

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