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TAXING POSSESSION OF FEDERAL PROPERTY

Carroll H. Smith*

California's recent attempt to expand its common property tax base may be of interest to tax administrators of other states contemplating similar excursions. The project started many years ago, but culminated in 1959 with an attempt by the counties of the state to tax the possessory interest in federally-owned, tangible personal property in the hands of private contractors.

Since 1859 California case law has recognized a taxable possessory interest in tax-exempt land.[1] A possessory interest in improvements on tax-exempt land was held taxable in 1866.[2] With the enactment of the Field Codes of 1872 the possession or right to possession, as distinguished from ownership, of land and improvements became taxable.[3] Not until 1895 was the taxation of a possessory right in exempt land specifically recognized by the codes.[4] In 1921 the code first provided for taxing improvements on tax-exempt land.[5]

HISTORY: THE PROBLEM OF VALUING POSSESSORY INTERESTS

Except for these statutory provisions and section 1, article XIII of the California constitution, which directs that all property be taxed unless specifically exempt, county assessors were left to their own devices as to methods of valuation of any taxable possessory interest in exempt land and improvements. They could refer to the following statutory definitions of property for tax purposes: real property includes land and improvements; improvements include fixtures; fixtures include trade fixtures; and whatever is not real estate is personal property.[6]

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1 California v. Moore, 12 Cal. 56 (1859).
2 People v. Shearer, 30 Cal. 645 (1866).
3 CAL. POL. CODE § 3617 (Deering 1885).
4 CAL. POL. CODE § 3820, as amended, Cal. Stats. 1895, ch. 218, § 86, p. 331.
5 CAL. POL. CODE § 3820, as amended, Cal. Stats. 1921, ch. 268, § 2268, p. 370.
6 CAL. REV. & TAX. CODE §§ 103, 104, 105, 106; See generally, Trabue Pittmen Corp. v. County of Los Angeles, 29 Cal. 2d 385, 175 P.2d 512 (1946).

Not until 1932 did the supreme court of the state prescribe a formula for assessing possessory interests in exempt land and improvements. In *Blinn Lumber Co. v. Los Angeles County*[7] the court considered three orthodox methods of evaluation: (1) replacement cost, (2) market value, and (3) income analysis. It decided that the income analysis method was best adapted to assess value of the property involved, which was a leasehold interest in tax-exempt land. To ascertain the value of the possessory interest, imputed net income, not actual income, was computed for the remainder of the life of the lease and reduced to present worth.

The method was faulty because it permitted the taxpayer, when computing his net income stream for capitalization, to deduct from gross income the rent charge as an operating expense. Since the *Blinn* case was confined on its facts to possessory interests in exempt land which did not include improvements, the method of valuation was a hazy guide to assessors. It was followed, however, in San Diego and other counties until overruled in 1955.[8]

In 1939 the California tax laws were recodified in the Revenue and Taxation Code, which became effective February 1, 1941. At the same time the Legislature enacted the first possessory interest law.[9] The new law reinstated the provisions of section 3820 of the old Political Code which defined possessory interest as "possession of, claim to, or right to the possession of land or improvements, except when resulting from ownership of the land or improvements" and "taxable improvements on tax exempt land." The new section also provided that "possessory interests shall not be considered as sufficient security for the payment of any taxes." Even today Revenue and Taxation Code section 107 defines a taxable possessory interest in tax-exempt land and improvements only and does not deal with such interests in personal property.

THE FIRST ATTEMPT TO TAX POSSESSION OF EXEMPT PERSONALTY

In February 1943 the California District Court of Appeal for the first time passed on the question of whether there could be a taxable possessory interest in tax-exempt personal property. In *Douglas Aircraft Co. v. Byram*[10] a prime contractor constructing airplanes and spare parts for the federal government possessed work-in-process and inventories, whose title had passed to the United

[7] 216 Cal. 468, 474, 14 P.2d 512, 516 (1932).
[8] De Luz Homes, Inc. v. County of San Diego, 45 Cal. 2d 546, 290 P.2d 544 (1955).
[9] CAL. REV. & TAX. CODE § 107.
[10] 57 Cal. App. 2d 311, 134 P.2d 15 (1943).

States when it made partial payment. The court held that no taxable possessory interest existed in the property. The property had none of the characteristics of property for tax purposes "judged by any standard of which we have knowledge." In addition the contractor was exercising no "usufructuary right" in the property, since he was permitted to make use of the planes and parts only

> for the benefit of their owner, the Federal government, and not for the benefit of the plaintiff. The fact that the plaintiff was to be paid for fabricating a plane out of the government's material does not change its use of the material from a use for the government to a use for the plaintiff. Plaintiff's compensation becomes due because it makes use of the materials and partially completed planes, not for itself, but for the government.[11]

The court further noted that its decision was not based on section 107 of the California Revenue and Taxation Code, which confined taxable possessory interests to real property only, since the section had not taken effect until after the taxes in issue had become a lien. No hearing was sought in the supreme court of the state. The defendant county hoped that the decision, if ignored, would go away.

A New Valuation Develops in the Land Cases

Four years later, in September 1947, the California Supreme Court came to the assistance of the county assessors when it approved a formula for the assessment of possessory interests in tax-exempt land and improvements. In *Kaiser Co. v. Reid*[12] the United States furnished government-owned land, with improvements constructed by the contractor, to the contractor. Title remained in the government under a "Facilities Contract," which allowed the contractor to occupy the property under a revocable permit. He then used the property to perform his contractual obligations to the government.

The assessment formula submitted for the court's approval was substantially the same as the one approved in *Blinn* for evaluation of land. But an entirely new approach was developed for assessing the possessory interest in improvements. After setting out these formulae, the court paused only to comment that they had been "judicially approved in cases presenting analogous considerations," citing the *Blinn* case.[13] The court then stated that

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[11] *Id.* at 317, 134 P.2d 15, 18 (1943).

[12] 30 Cal. 2d 610, 184 P.2d 879 (1947).

[13] The court also cited Hammond Lumber Co. v. County of Los Angeles, 104 Cal. App. 235, 244-45, 285 Pac. 896, 900-01 (1930) and Underwood Typewriter Co. v. City of Hartford, 99 Conn. 329, 122 Atl. 91, 94 (1923).

the issue was not the amount of the assessment, *i.e.*, whether there was an overcharge because of the method of valuation employed, but whether the possessory right had any value. The decision in *Kaiser* was important for the assessors of the state for three reasons: (1) While not overruling, it distinguished the *Douglas* case, which dealt with personal property; (2) it forecast the United States Supreme Court decisions; and (3) it furnished a precise formula for assessing a possessory interest in tax-exempt improvements.

The *Kaiser* formula directs the assessor to take four basic steps to value the possessory interest in an improvement.

1. Ascertain original cost of the improvement, its purchase or acquisition date and its estimated useful life. Depreciate original cost down to tax day (date of appraisal) to determine present worth.

2. From the estimated termination date of the term of possession determine the reversionary value of the property. Reduce this reversionary value to its present worth by application of the present value factor.

3. Subtract the present value of the reversion from the present worth of the improvement. From this figure deduct a reasonable percentage for risk and hazard. The resulting figure is the appraised or market value of the contractor's possessory interest.

4. To ascertain assessed value, apply the uniform percentage ratio of assessed to market value used for all property in the county.

After the 1947 decision in *Kaiser Co. v. Reid* six years passed without significant change. But the counties were never satisfied with the *Douglas* case, which had not been appealed to the supreme court of the state. The counties reasoned that *Alabama v. King & Boozer*[14] supported the view that the right kind of nondiscriminatory property tax on the possessory interest in federally-owned personal property in private hands for profit would be constitutional. After all, the California Supreme Court for thirty-six years (from 1859 to 1895) had recognized a possessory interest tax on exempt land and improvements with no support but the constitutional mandate that all property in the state be taxed unless specifically exempt. This the court did even before the Legislature expressly directed such a tax. No good reason appeared why the court could not do the same with respect to exempt personal property. County assessors could then carve the tangible possessory interest out of

[14] Alabama v. King & Boozer, 314 U.S. 1 (1941).

the fee and assess it, leaving untouched the reversionary interest in the exempt property. This should be possible even though section 14, article XIII was amended in 1933 to give the Legislature the power to classify and exempt personal property for tax purposes.

The New Formula Is Applied to Possession of Personalty

The real difficulty, it was argued, was a practical one. What method of valuation was to be used in assessing this new tax base? No better constitutional approach to valuation could be found than the formula applied to exempt improvements in *Kaiser Co. v. Reid.*[15] Accordingly, in fiscal year 1953-54 Los Angeles and San Diego counties took the initiative and began assessing contractors' possessory interests in federally-owned, tangible personal property and continued to do so until fiscal year 1958-59.

The next development in California law came in 1955 with *De Luz Homes, Inc. v. County of San Diego*[16] and three companion cases from Solano, San Bernardino, and Orange counties. In these cases housing projects had been constructed on United States military reservations under the Wherry Act.[17] Title to the buildings passed to the United States on completion of the projects. The government then gave long-term leases to private contractors, and the counties assessed these leasehold interests. The assessed lessee claimed certain deductions, including amortization of investment and rent, attempting to reduce the assessed value to zero. The court disallowed these deductions and in an exhaustive opinion not only overruled the *Blinn* case but set out a precise guide for assessment of possessory interests in exempt real property. The court stated that while actual income should be used in the income analysis of the leasehold in question, imputed income might be used in appropriate cases.

Legislative Retaliation to the De Luz Decision

Shortly after the *De Luz* decision Congress passed an amendment to the National Housing Act.[18] It provided in substance for an offset or deduction from federal aid advanced to any taxing or public agency assessing a tax against a lessee of the government under a Wherry Act housing project prior to June 15, 1956,

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[15] 30 Cal. 2d 610, 184 P.2d 879 (1947).

[16] 45 Cal. 2d 546, 290 P.2d 544 (1955).

[17] 12 U.S.C. §§ 1748-1748h.

[18] Public Health & Welfare Act, 42 U.S.C. § 1594 (1958), as amended, 70 Stats. 1956 ch. 1028, § 511, p. 1110.

which was still unpaid. Congress was retaliating against the *De Luz* and similar decisions[19] throughout the country. San Diego County believed the federal legislation to be an unconstitutional attempt at retroactive exchange of foreign commodities for local taxes and decided to disregard it until tested in the appellate courts of the state. A test case was filed prior to 1958 in San Diego County, but was settled in compromise by stipulated judgment in 1959.

On the local level opponents of the *De Luz* decision also retaliated. In 1957 they persuaded the California Legislature to amend the Revenue and Taxation Code[20] so as practically to nullify *De Luz*. Revenue and Taxation Code section 107.1 was added in order: (1) to declare possessory interest leaseholds in tax-exempt land to be personal property, so that the Legislature could exempt them from taxation (the Legislature could not constitutionally exempt realty from taxation); (2) to provide for a lower tax on leases created prior to the effective date of *De Luz* by applying to them the *Blinn* method of evaluation, which allowed deductions for rent. The *De Luz* decision was left to operate only on leases executed after its effective date, which was December 25, 1955. The constitutionality of this legislation was doubtful, since only the constitution and not the Legislature can exempt real property from taxation. Possessory interests in land and improvements have always been classified as real property.[21]

THE CONSTITUTIONALITY OF THE LAW IS QUESTIONED

The Attorney General of the state and the County Counsels of Los Angeles and San Diego held this statute unconstitutional and void in opinions to their constituents.[22] They advised that it be disregarded by assessors until brought to test in the appellate courts of the state. The prerequisite steps toward such litigation were taken in San Diego County, and test cases were immediately launched in Los Angeles County.[23]

The issue of taxable possessory interests in exempt personal property was again raised in 1957 in *C. C. Moore & Co. Engineers*

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[19] See Offut Housing Co. v. County of Sarpy, 351 U.S. 253 (1956).

[20] Cal. Stats. 1957, ch. 211, § 1, p. 3747.

[21] San Pedro, Los Angeles, & Salt Lake R.R. v. City of Los Angeles, 180 Cal. 18, 179 Pac. 393 (1919); Bakersfield & Fresno Oil Co. v. Kern County, 144 Cal. 148, 77 Pac. 892 (1904).

[22] OPS. CAL. ATT'Y GEN. 17 (1958).

[23] Forster Shipbuilding Co. v. County of Los Angeles, 54 Cal. 2d 450, 353 P.2d 736, 6 Cal. Rptr. 24 (1960); Texas Co. v. County of Los Angeles, 52 Cal. 2d 55, 338 P.2d 440 (1959).

v. Quinn.[24] Private contractors under contract with the cities of Burbank, Glendale, and Los Angeles had in their possession component parts of boiler plants, which on tax day were not yet fabricated into the finished product. The contractors' possessory interests were assessed. Two of the contracts were silent on the passage of title to the exempt cities, while in the other it was clear that title passed on delivery to the site. The court held that since legal title or beneficial ownership had passed in all cases to the exempt agencies, there was no taxable possessory interest in the property. The California Supreme Court denied a hearing.

Further issues were raised during Los Angeles County's six years of assessing possessory interests in personal property. Two test cases[25] were launched attacking these assessments, and by 1958 these cases were pending before the California Supreme Court. Factually the two cases presented almost every kind of property thus far encountered in this type of litigation: government-owned land, buildings, both moveable and affixed machinery and equipment, tools and tooling, jigs and dies. Some property was furnished to the contractor by the government to aid performance, while other personalty was acquired by the contractor with title passing to the government under terms of the contract. Almost every type of government contract was involved, from cost-plus-a-fixed-fee and fixed price contracts of various kinds with prime contractors and sub- and sub-sub-contractors, to research contracts where the end product bargained for consisted of a written report. Both the *Douglas* and *Moore* cases were vigorously attacked in these appeals, and their disapproval and reversal by the supreme court of the state was sought for the first time by the county. Similar suits were filed in San Diego County, but by tacit consent of the parties were left to await the results in the two Los Angeles County cases.

THE FEDERAL CONSTITUTIONAL DECISIONS

This was the situation in California in March 1958 when the United States Supreme Court handed down four landmark decisions.[26] There was much speculation as to the impact of these

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[24] C. C. Moore & Co. Engineers v. Quinn, 149 Cal. App. 2d 666, 308 P.2d 781 (1957).

[25] General Dynamics Corp. v. County of Los Angeles, 51 Cal. 2d 59, 330 P.2d 794 (1958); Aerojet General Corp. v. County of Los Angeles, 51 Cal. 2d 59, 330 P.2d 794 (1958).

[26] American Motors Corp. v. City of Kenosha, 356 U.S. 21 (1958), *per curiam affirming*, 274 Wis. 315, 80 N.W.2d 363 (1957); City of Detroit v. Murray Corp., 355 U.S. 489 (1958); United States v. Township of Muskegon, 355 U.S. 484 (1958); United States v. City of Detroit, 355 U.S. 466 (1958).

decisions on the California situation, particularly the *General Dynamics* and *Aerojet General* cases pending before the California Supreme Court. It seemed clear to the counties that the federal immunity question was finally resolved in their favor by these Michigan and Wisconsin cases. The Supreme Court had decided that a state has a taxable property right in government-owned, tangible personal property in the possession and use of a private contractor. The Court reached this conclusion even though the state statute may not have specifically recognized such a tax base. If the tax was nondiscriminatory, it did not matter how the right of possession might be evidenced, whether by lease, permit, or contract. Such a tax was assessable to the contractor at full cash value of the property, as though owned in fee.

The counties assumed that the decisions would influence the California Supreme Court's decision on the two Los Angeles cases pending before that court. They believed the state supreme court would find it difficult to reconcile *Douglas* and *Moore* with these latest pronouncements of the United States Supreme Court. The last word on the question of immunity of federally-owned property from taxation by the states seemed to have been spoken.

Some were more cautious, however. California had long since developed the concept that the possessory interest value of land and improvements (and this goes to the tax base) is something less than the fee, except in the case of the long-term lease where there may be no reversionary value to be returned to the exempt lessor. This concept had been born of too hard and prolonged a struggle to be lightly forsaken for the sudden enrichment of personal property tax base now offered by the Supreme Court decisions. Warnings had sounded from the Supreme Court in the *Kern-Limerick, Inc. v. Scurlock*[27] and *United States v. County of Allegheny*[28] cases, which clearly stated that the government's interest in property must be left untouched. By a stroke of the contract pen the private contractor may be made a mere purchasing agent for the government, thus exempting the entire property from any state taxation. It was further pointed out by more pessimistic souls that the lure of new and fabulous riches[29] to enrich the distressed local tax base might blind county assessors to a vital fact: not only the Congress but also the California Legislature could at will declare this personal property entirely exempt from taxation. The California Constitution was amended in 1933 to permit the Legislature to do just this.[30]

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[27] 347 U.S. 110 (1954).
[28] 322 U.S. 174 (1944).
[29] 34 WIS. L. REV. 190, 207, 208, note 95 (1959).
[30] CAL. CONST. art. XIII, § 14.

THE CALIFORNIA BATTLE ENDS

The answer was not long in coming. On October 24, 1958, the California Supreme Court handed down its decisions in *General Dynamics*[31] and *Aerojet General.*[32] To the dismay of the counties the court declined to follow the four United States Supreme Court decisions and held that California must have a specific statute authorizing the tax. No hearing from this ruling was ever sought in the United States Supreme Court. Instead the counties elected to go to the Legislature for aid.

Los Angeles and San Diego Counties collaborated on a bill[33] providing for an optional tax on the property, to be levied at the discretion of each county, and introduced the measure at the 1959 regular session of the California Legislature. The bill passed the Assembly but was killed in the Senate Revenue and Tax Committee through the vigorous opposition of the California Manufacturers Association, the California aircraft companies, and the United States Department of Defense.

Following this blow to the counties, the California Supreme Court handed down decisions[34] on the validity of section 107.1 of the California Revenue and Taxation Code. The cases held that the Legislature could not constitutionally exempt possessory interests arising out of leases in exempt land and improvements from taxation, since they were real property, but that it could confine the *De Luz* decision to prospective operation only. To apply it retroactively to leases executed prior to its effective date of December 25, 1955, would result in too great an economic burden to the lessees affected.

CONCLUSION

California's experience leads to several conclusions. Until the states can present a united front to the federal government, the local tax base cannot be enlarged at the expense of government contractors or lessees without fear of reprisal from federal agencies in the form of withdrawn federal subsidies. Further, until each state can overcome within its own borders the powerful argument

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[31] General Dynamic Corp. v. County of Los Angeles, 51 Cal. 2d 59, 330 P.2d 794 (1958).

[32] Aerojet General Corp. v. County of Los Angeles, 51 Cal. 2d 59, 330 P.2d 794 (1958).

[33] A.B. 487.

[34] Forster Shipbuilding Co. v. County of Los Angeles, 54 Cal. 2d 450, 353 P.2d 736, 6 Cal. Rptr. 24 (1960); Texas Co. v. County of Los Angeles, 52 Cal. 2d 55, 338 P.2d 440 (1959).

that to insist upon this desperately needed local tax is to create an unfriendly climate for business, the chances are remote that the states will ever prevail in their struggle. But the tax base potential is there and waiting, over 22½ billion dollars of it. We know that it is attainable, thanks to the enterprise of Michigan and Wisconsin. But the words of John Marshall in *McCulloch v. Maryland*[35] still cast their shadow: "The power to tax is the power to destroy." The federal government has clearly indicated that it is not prone to let itself be destroyed by excessive taxation of its contractors.

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[35] 17 U.S. (4 Wheat.) 316 (1819).