

To: Chairman Burnet Maybank, TRAC Committee

From: William J. Quirk

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Issue: Can property taxes be collected from a for-profit entity leasing from a public entity?

1. By Constitution (Art. X, § 3) public property is exempt only if it is owned by the State or a municipality and used for “exclusively public purposes.” The lease to the for-profit entity, therefore, must be for an “exclusively public purpose” for the underlying property to remain exempt. If not, the state property becomes taxable and taxes are the landlord’s responsibility.
2. The judicial expansion of what is a public purpose is now so broad that it includes almost everything. The Supreme Court found the Union Camp plant to be used “exclusively for public purposes” in *Quirk v. Campbell*, 302 S.C. 148, 394 S.E.2d 320 (1990), so that should be the end of it.
3. Therefore, the public property in almost all cases will remain exempt. The question is whether the for-profit entity is subject to real estate tax on its leasehold estate.
4. Normally, our property tax system does not tax leasehold estates.
5. My understanding is that the practice today is to treat the for-profit entity as tax-free. (Ports Authority and Navy Yard)
6. Two special provisions govern. In the case of State owned property leased to a non-exempt entity, by section 12-37-950 (test), requires “the leasehold estate shall be valued for property tax purposes as real estate.”
7. Leasing of property owned by counties, cities, or other political subdivisions, “to any other party” since 1995, must include a provision for payment of “in lieu of taxes” in the

amount that would be imposed if the other party owned the property. Section 4-12-20 provides:

Every agreement between a county, municipality, school district, water and sewer authority, or other political subdivision and another party in the form of a lease must contain a provision requiring the other party to make payments to the county, municipality, school district, water and sewer authority, and other political subdivisions in which the project is located in lieu of taxes, in the amounts that would result from taxes levied on the project by a county, municipality, school district, water and sewer authority, and other political subdivisions, if the project were owned by the other party, but with appropriate reductions similar to the tax exemptions, if any, which would be afforded to the other party if it were owner of the project. (emphasis added) [Other fee in lieu of statutes are found at §§ 4-29-60 and 4-29-67(A)(2).]

8. The terms of section 4-12-20 don't seem to raise any questions. I assume since the law requires such a provision it would be read into any agreement if omitted.

9. Section 12-37-950 provides:

When any leasehold estate is conveyed for a definite term by any grantor whose property is exempt from taxation to a grantee whose property is not exempt, the leasehold estate shall be valued for property tax purposes as real estate.

10. The language is clear but the meaning of section 12-37-950, however, is disputed.

11. The terms of section 12-37-950, however, are unambiguous and its history supports the clear language of the statute.

12. *The History*

The statute was originally enacted in 1957 by Act No. 79, 1957 L. 89. The Act is entitled "An Act *Relating to the Taxation and Valuation For Property Tax Purposes of Certain Leasehold Estates Conveyed by Grantors Whose Property is Exempt from Taxation.*" (emphasis supplied) [See Art. III § 17 of S.C. Constitution provides that the subject of every act "shall be expressed in the title."]

The background of 12-37-950 also makes clear that it was intended to both impose a tax on the lessee as well as provide for valuation at the value of the fee. Our statute is similar to statutes enacted by other states, Texas (1950) and Michigan (1953) in response to the consent of the United States to the taxation of the use of its property. Congress in 1947 enacted "An act to authorize leases of real and personal property by the War and Navy Departments and for other purposes," P.L. 364, 80th Cong., 61 Stat. 774. (P.L. 364 is attached.) The Act is codified at 10 U.S.C.A. § 2667.

During World War II the Government “at tremendous cost” constructed wartime plants on United States property. Since these plants might be needed in the future, Congress provided in 1947 that the U.S. should retain title “for an indefinite period to a selected group of plant facilities.” Sen. Rep. No. 626 at U.S. Code and Congressional Service (1947) at 1592. Some of the stand-by defense plants were not adaptable to peacetime purposes, but “as many as possible will be leased to responsible companies which can operate them without making such changes as to prevent their being rapidly put back into operation in the event of emergency.” *Id.*

Congress provided that the property, since it would be used by a for-profit business, should be subject to state and local taxes. Public property, when put to a private use, should pay taxes like others. The tax is imposed on the private party’s use of the property not the underlying property which, as property of the United States, remains exempt. Section 6 of P.L. 384 provides the lessee’s interest shall be subject to state and local tax:

Sec. 6. The lessee’s interest, made or created pursuant to the provisions of this Act, shall be made subject to State or local taxation. Any lease of property authorized under the provisions of this Act shall contain a provision that if and to the extent that such property is made taxable by State and local governments by Act of Congress, in such event the terms of such lease shall be renegotiated.

The term “lessee’s interest,” of course, means the value of the use of the property to the private party, which is the same as the use of comparable taxable property. As the Supreme Court found a few years later: “Other things being the same, it seems obvious enough that use of exempt property is worth as much as the use of comparable taxed property during the same interval.” *United States v. City of Detroit*, 355 U.S. 466, 470 (1958).

Section 6, of course, is pointless if the “lessee’s interest” is construed to mean the value of the leasehold to the lessee. That value—what the leasehold would bring in case of a voluntary sale by the lessee—would normally be zero. A lessee does not normally consider a lease to be an asset since the rental expense offsets the value. The lessor, on the other hand, could value the leasehold by valuing the stream of income, applying some capitalization rate to the annual rent.

The Senate Report explains Section 6 as follows:

Section 6 provides that the interest a lessee holds under this act shall be subject to State and local taxes. In the event of States, not presently having legislation permitting the taxing of such property, enacting such laws subsequent to the negotiation of the lease under this at, this section provides that the lease can be renegotiated. *Id.* at 1593.

It is clear that, absent Section 6, no State would attempt to tax a lessee using United States property. *McCulloch v. Maryland*, 4 Wheat 316. The Third Circuit has found:

In our opinion, the 1947 Act effectively expressed the consent of the United States to the taxation of the lessees’ interest in the property leased here. *Fort Dix Apartment Corp. v. Borough of Wrightstown*, 225 F.2d 473 at 479 (3d Cir. 1955), *cert. den.*, 351 U.S. 362.

The congressional consent, of course, applies only to the lessees' interest and not to any interest which the United States may have retained. *Id.* But, as discussed below, the fact that a state tax is measured by the value of the underlying property used does not make it a tax on the United States.

The Michigan statute similar to 12-37-950 was enacted in 1953 and was litigated and construed by the Supreme Court in *United States v. City of Detroit*, 355 U.S. 466 (1958). The Michigan statute, like 12-37-950, imposes a tax on private lessees and users of tax-exempt property who use such property in a business conducted for profit. The statute, like 12-37-950, applies to all property, exempt or non-exempt, including that of the federal government. The United States argued the Michigan statute was an indirect tax on the property of the United States in violation of the Supremacy Clause. The property of the Federal government remains, of course, exempt even if it is leased to a for-profit entity. *McCulloch v. Maryland*. The Michigan statute provides that, when tax exempt real property is used by a private party in a for-profit business, such private party is subject to taxation in the same amount and to the same extent as though he owned the property, that such taxes are assessed and collected in the same manner as taxes are assessed to the owners of real property.

The Government recognized that Michigan could impose some tax on the lessee but argued that since the tax was measured by the full value of the property used it should be treated as a contrivance to lay a tax on United States property. The Court disagreed, finding the Michigan tax was not levied on any property of the United States. The Court noted that a tax for the beneficial use of property, as distinguished from a tax on the property itself, has long been commonplace in this country. Indeed “[in] measuring such a use tax it seems neither irregular nor extravagant to resort to the value of the property used . . .” 355 U.S. at 470. Moreover, “[i]n our judgment it was not an impermissible subterfuge but a permissible exercise of its taxing power for Michigan to compute its tax by the value of the property used.” *Id.*

The Supreme Court found the legislative intent was to equalize taxes on private business and require that each pay its fair share of local tax responsibility as follows:

Public Act 189 was apparently designed to equalize the annual tax burden carried by private businesses using exempt property with that of similar businesses using nonexempt property. 355 U.S. at 470.

The real estate tax, of course, is imposed a year at a time and the Court found the value of the use of exempt property for a year was comparable to the value of taxable property:

Other things being the same, it seems obvious enough that use of exempt property is worth as much as use of comparable taxed property during the same interval. 355 at 470.

The Court continued:

As suggested before the legislature apparently was trying to equate the tax burden imposed on private enterprise using exempt property with that carried by similar businesses using taxed property. Those using exempt property are required to pay no greater tax than that placed on private owners or passed on by them to their business lessees. In the absence of such equalization the lessees of tax-exempt

property might well be given a distinct economic preference over their neighboring competitors, as well as escaping their fair share of local tax responsibility. *Cf. Henneford v. Silas Mason Co.*, 300 U.S. 577, 583-585. 355 U.S. at 473-74.

The United States lease permitted the corporation to deduct from rent any taxes it was obliged to pay so there was no question the financial burden of the tax would fall on the United States. The Court nonetheless held the Government's constitutional immunity did not shield the private party since the tax was not levied on the Government or its property but on the private lessee who uses the property in a business conducted for profit.

The Court upheld the Michigan tax, finding it had a legitimate purpose and was not a mere subterfuge for taxing the property of the United States. Of course, as noted above, the Michigan statute, like 12-37-950, applies to all exempt owners and does not discriminate against the Federal government. The Court found:

The Michigan statute challenged here imposes a tax on private lessees and users of tax-exempt property who use such property in a business conducted for profit. Any taxes due under the statute are the personal obligation of the private lessee or user. The owner is not liable for their payment nor is the property itself subject to any lien if they remain unpaid. So far as the United States is concerned as the owner of the exempt property used in this case it seems clear that there was no attempt to levy against its property or treasury. 355 U.S. at 469.

The Michigan statute, to avoid a double contribution from the same property, creates an exception for property if the United States was already paying fee in lieu of taxes with respect to it. South Carolina's section 12-37-950 avoids the double contribution problem since it is inapplicable if the governmental entity's property becomes taxable because of the lease, e.g., the property used by Hawthorne Aviation or Aero Aviation in the *Wasson* case where the Court found the property was not used exclusively for public purposes. In that case the Authority is subject to tax and the lessee is not.

The statute taxed the lessee on the full value of the property. 355 U.S. at 476. Justice Whittaker, in dissent, explained the Government's point. He noted: "Before the lease, only one estate existed in the plant . . . By the lease, the Government, in exercise of its right to use, and to let the use of, its property, carved from its fee a subservient leasehold estate and vested the same in the lessee." 355 U.S. at 482. Justice Whittaker believed that the leasehold was private and could be taxed by the State. But he believed the leasehold had to be valued separately "to segregate the value of the leasehold estate from the Government's estate in fee." Since it did not do so, but taxed the full value, Justice Whittaker believed the tax was, in part, on the property of the United States. Justice Whittaker does not indicate how the leasehold could be valued. The majority does not respond directly to Justice Whittaker's point but upheld the tax on the value of the underlying property.

CONCLUSION

The Court, consequently, found the intent of the Michigan statute, similar to 12-37-950, to (1) equate the tax burden imposed on private enterprise using exempt property with similar

businesses using private property; and (2) require that private businesses using exempt property pay “their fair share of local tax responsibility.” South Carolina’s statute is obviously intended to accomplish the same objectives. To accomplish these objectives it is, of course, necessary to tax the value of the underlying property which the Court, in *Detroit*, held permissible.