REPORT OF THE

JOINT SUBCOMMITTEE STUDYING THE

METHOD OF TAXATION OF LEASEHOLD INTERESTS

TO

THE GOVERNOR

AND

THE GENERAL ASSEMBLY OF VIRGINIA

HOUSE DOCUMENT NO. 14

COMMONWEALTH OF VIRGINIA
RICHMOND
1981

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Report of the
Joint Subcommittee Studying the
Method of Taxation of Leasehold Interests
To
The Governor and the General Assembly of Virginia
Richmond, Virginia
December, 1980

To: Honorable John N. Dalton, Governor of Virginia
and
The General Assembly of Virginia

I. EXECUTIVE SUMMARY

House Joint Resolution No. 197 enacted by the 1980 Session of the Virginia General Assembly established a Joint Subcommittee of the House Finance Committee and the Senate Finance Committee to study the method of taxing exempt property when the owner leases the property to a lessee who is engaged in a profit making endeavor.

This area had been studied by the Revenue Resources and Economic Commission. That Commission after two years of study proposed legislation to the 1979 Session of the Virginia General Assembly which provided that this type of property be assessed at 100% of fair market value. The recommendation was due to become effective July 1, 1980.

After the passage of this legislation a number of questions and problems arose. The problems concerned the impact of taxing this property at 100% of fair market value, and the use of the Federal Reserve Discount Rate on a particular date as the interest rate used in the capitalization process.

Because of these concerns the 1980 Session of the Virginia General Assembly delayed the effective date of the new legislation until July 1, 1981 and established this Joint Subcommittee to study this area.

The Joint Subcommittee met on a number of occasions this year to discuss the issues as well as to receive background, information, and alternatives from its staff. In addition, the Joint Subcommittee worked closely with Virginia's assessors as well as representatives of the affected industries.

The present existing leasehold interest legislation was enacted in 1975 and established uniformity among the localities in terms of how this type of property was to be valued and taxed. Before this time, there was no uniformity among the localities in the treatment of this property. The statute enacted in 1975 provided that if the term of the lease was 50 years or longer (or if the property could be acquired at the end of the lease period for a nominal sum) the assesment should be made as if the lessee were the owner. If the term of the lease was less than 50 years, the assessment must be reduced by 2% for each year that the remainder of the lease is less than 50 years, provided that this reduction cannot exceed 90%. That is, a declining value was placed on the property depending on the length of the remaining lease with a minimum assessment of 10% of fair market value. This procedure started with a value that was determined in the same fashion and used the same method as any other taxable property and was then adjusted downward to reflect the economic and appraisal reality that the shorter the life of the lease, the less the value.

This approach was studied by the Revenue Resources and Economic Commission and their two year study recommended a change that would become effective July 1, 1981. This new procedure would determine the value of the leasehold interest by capitalizing the net annual fair market value rent for such leasehold. The capitalization rate would be the Federal Reserve discount rate for the tax day.

The Joint Subcommittee has studied this legislation and recommends the repeal of this legislation which is due to become effective July 1, 1981. The Joint Subcommittee believes this legislation would not accomplish its intent, that is, valuing the property at 100% of fair market value. In addition, the Joint Subcommittee does not believe that this type of property should be valued at

100% of fair market value since the property is worth less to the lessee. Moreover, the Joint Subcommittee believes it inappropriate to specify the use of a particular interest rate on a particular day since the Code of Virginia does not prescribe what interest rate appraisers and assessors should use when valuing other types of income producing property. In addition, the Joint Subcommittee has found that the Federal Reserve discount rate is so volatile that the use of the rate on one day rather than another would yield significantly different tax values and thus be highly inappropriate.

After studying numerous options and considering various alternatives, the Joint Subcommittee makes the following recommendation. The Joint Subcommittee recommends that the present existing method of appraising and assessing leasehold interest property be retained with one change. The Joint Subcommittee recommends that the minimum assessed value be increased from 10% to 15%, or a 50% increase in the minimum assessed value. The increase in this minimum amount is an attempt to ensure that short-term leases which are routinely renegotiated pay on a more reasonable portion of value. For example, the Joint Subcommittee has found that currently Piedmont, United, and Eastern Airlines all operate on an eighteen month lease at Byrd Field. This is not representative of the probable length of the lease since Eastern has operated there since 1930 while the other two have operated there since 1948. The Joint Subcommittee has found that for most leases the lessee generally stays longer than the term of the specific lease. Thus, the Joint Subcommittee believes the value on certain short-term leases is understated. The Joint Subcommittee believes that an increase in the minimum will help to alleviate this inequity.

Finally, the Joint Subcommittee wishes to note that this is one of the most difficult and complex areas in terms of bringing "equity" to all parties involved. The Joint Subcommittee believes that its recommendation is a logical and understandable approach which allows the assessor to assess the property as if it were taxable like any other property and then provide a formula to reduce this value based on the remaining length of lease. The Joint Subcommittee believes this approach is a significant improvement over both the present leasehold interest law and the legislation that would become effective July 1, 1981.

II. INTRODUCTION

This Joint Subcommittee was established pursuant to House Joint Resolution No. 197 enacted by the 1980 Session of the Virginia General Assembly to study the proper and equitable method of taxing leasehold interest. The study relates to the method of taxing tax exempt property which is leased to a lessee who is engaged in a profit making endeavor.

The Joint Subcommittee was composed of five members of the House Finance Committee and three members of the Senate Finance Committee. The Chairman of the House Finance Committee appointed Delegate John S. Buckley, Delegate Frederick H. Creekmore, Delegate William F. Green, Delegate George W. Jones, and Delegate Warren G. Stambaugh. The Chairman of the Senate Finance Committee appointed Senator Herbert H. Bateman, Senator Dudley J. Emick, and Senator William F. Parkerson, Jr. The Joint Subcommittee selected Delegate Frederick H. Creekmore as its chairman.

III. BACKGROUND

The Constitution of Virginia, Article X, § 1, provides that all property is to be taxed unless the Constitution of Virginia gives or permits an exemption. Most of the exempt property is enumerated in § 58-12 et seq. of the Code of Virginia, and basically provides for exemptions for government property, property owned and exclusively occupied or used by churches or for religious worship or for the residences of their ministers, or property used by its owner for religious, charitable, patriotic, historical, benevolent, cultural, or public park and playground purposes, as may be provided by classification or designation by a three-quarters vote of the General Assembly. The exemption is conditional based on the continuation of the property in the above use.

A problem arises, however, when the owner of the tax exempt property leases the property to a lessee who is engaged in a profit making endeavor. The Commonwealth of Virginia has long recognized (Chapter 317, 1954 Acts of Assembly) the inequity of allowing a commercial enterprise to gain the advantage of a tax exemption afforded to no other similar commercial enterprise simply by the arrangement through which it has leased the property from an exempt owner. This inequity is corrected in § 58-758, which states in part that "the term 'taxable real estate' shall include a leasehold interest in every case in which the land or improvements, or both as the case may be, are exempt from assessment for taxation to the owner."

Although the intent of this legislation may be fairly clear, that is, to prevent this type of property from enjoying an unfair tax advantage, the question of how to determine the proper tax on such property has not been satisfactorily concluded and has been the subject of a great deal of discussion over the past few years.

Until 1975, the Code of Virginia did not provide any guidance as to how this type of property should be valued and taxed. As a result, there was a lack of uniform tax treatment throughout the localities of Virginia. Some localities did not tax this property, others used the fee simple approach determining full value and utilizing this value as the base of taxation just as if the lessee owned the real property outright, others taxed only structures upon such exempt property and then only if the structure was in the title ownership of the user, others taxed the possessory interest, while others taxed the capitalized value of the overage of economic rent to contract rent (leasehold interest as defined by the private appraiser).

Partly as a result of this lack of uniformity, the 1975 Session of the Virginia General Assembly enacted legislation (Chapter 374, 1975 Acts of Assembly, later clarified by the 1976 Session of the General Assembly through Chapter 418, 1976 Acts of Assembly) which established how this type of property was to be valued and taxed. The statute provided that if the term of the lease was 50 years or longer (or if the property could be acquired at the end of the lease period for a nominal sum) the assessment should be made as if the lessee were the owner. If the term of the lease was less than 50 years, the assessment must be reduced by 2% for each year that the remainder of the lease is less than 50 years provided that this reduction cannot exceed 90%. In other words, a declining value was placed on the property depending on the length of the remaining lease. For example, a property with 10 years remaining on the lease is valued to the lessee at 20% of the fair market value. Finally, the legislation provided that property leased from the Virginia Port Authority was exempt from the statute.

As a result of a 1978 study by the Revenue Resources and Economic Commission, legislation was introduced and enacted (Chapter 359, 1979 Acts of Assembly) which changed the procedure for valuing this property by requiring the value to be determined by capitalizing the net annual fair market rent for such leasehold by the Federal Reserve discount rate. This legislation changed the valuation of leasehold interests by eliminating the deduction for leases under 50 years.

Capitalizing the annual fair market rent is typically known as the "income approach to value", that is, determining the present value of a stream of income over the lifetime of that particular stream of income (length of the lease in this case). It is unclear why the legislation specified a particular interest rate (the Federal Reserve discount rate) since the statutes do not prescribe what interest rate appraisers and assessors should use when valuing other types of income producing property.

The 1980 Session of the General Assembly delayed the effective date of this legislation by one year, until July 1, 1981, and established this study of the method of the taxation of leasehold interests to recommend appropriate legislation to cure the inequities that may exist.

There are practically as many types of leased tax exempt property as there are types of property and logic would dictate the number of these properties is increasing as the amount of real estate either owned by governmental units or owned by tax exempt organizations increases. Some obvious examples are: (1) airport property leased for airlines, parking, hangars and stores; (2) residential housing owned by institutions of higher education (public and private) leased to faculty members; (3) government property leased to taxable lessees, such as newsstands, restaurants, snack bars, stores, banks, apartments, or credit unions; (4) possession of public property at harbors, factories, golf courses, marinas, fishing piers, recreation areas, parks, stadiums, or other government facilities; (5) property owned by tax exempt organizations leased for profit (e.g., tax exempt hospitals leasing out office space).

The importance of this property in terms of the revenue base of Virginia's localities varies greatly throughout the state. Many localities appear to have none of this type of property. A survey undertaken by the Division of Legislative Services of 13 cities and counties showed a great deal of diversity but also showed a great deal of importance to certain localities. For example, the City of

Richmond has substantial amounts of leased State property and University of Richmond faculty houses. In Henrico, the airport property plus University of Richmond faculty housing comprise property with a fair market value of $4.7 million but assessed for tax purposes at $0.9 million. Fairfax County has property taxed under the leasehold interest provisions with a fair market value exceeding $70 million. Virtually all larger cities and urban counties contain leasehold interest property.

IV. ALTERNATIVES

The Joint Subcommittee explored a number of different alternatives for valuing and taxing leasehold interests. Before these alternatives are discussed it should be noted that there is no unanimity as to the manner by which the value of the "leasehold interest" should be ascertained.

The following represent a few alternatives which the joint subcommittee considered.

1. Taxing the privilege to use.

This alternative basis of taxation would require that the lessee or user of the property be subject to the property tax in the same amount and to the same extent as if he were the owner of the property. In other words, the assessor would value the property and use the same valuation criteria as if he were appraising and assessing any privately held property.

The logic behind this approach is that similarly valued property should be assessed and taxed similarly regardless of the terms of the lease. When a tax exempt owner leases ~~real~~ property to a private for-profit entity the character of the property is deemed to change to private benefit and it becomes taxable. All property (with some exceptions as provided in the Constitution) is valued for tax purposes at its highest and best use regardless of the existing terms of the lease.

Assume two identical income-producing properties in similar locations, one owned by a taxable entity and the other owned by a nonprofit organization which is exempt from taxation but is leased to a for-profit group. If both businesses are in fact operated on a for-profit basis for that tax year, why should they not in fact be subject to the same amount of tax since the users of both properties enjoy the same benefits of the property for that particular year? In terms of the length of lease, it would not matter whether the lease ran for two years or fifty-two years because in the particular year we are considering both seem to be situated equally. Therefore, equity would require that both be taxed equally, that is, in terms of the use that they receive from the real estate for that particular year.

This was the approach taken by the State of Michigan in June, 1953 (Act Number 189 of the Public Acts of 1953). Section 1 of that law reads, in part "When any real property which for any reason is exempt from taxation is leased, loaned or otherwise made available to and used by a private individual, association or corporation in connection with a business conducted for profit ... shall be subject to taxation in the same amount and to the same extent as though the lessee or user were the owner of such property...."

Michigan was the first state to adopt this method of taxing leased tax exempt property. The constitutionality of the act itself was challenged and finally appealed to the Michigan Supreme Court and the United States Supreme Court, where it was held valid. The courts ruled the tax was imposed as a specific tax on the privilege of using the tax exempt property, which tax could be measured by the full value of the property.

In delivering the United States Supreme Court's majority opinion (7 to 2), Justice Hugo Black stated

> "A tax for the beneficial use of property, as distinguished from a tax on a property itself, has long been a commonplace in this country. See Henneford v. Silas Mason Company , 300 U.S. 577. In measuring such a use tax it seems neither irregular nor extravagent to resort to the value of the proerty used; indeed no more so than measuring a sales tax by the value of the property sold. Public Act 189 was apparently designed to equalize the annual tax burden carried by private businesses using exempt proerty with that of similar businesses using nonexempt 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. In our judgement, it was not an impermissible subtrafuge but a permissible exercise of its taxing power for Michigan to compute its tax by the value of the property used."

It appears that this approach has the advantage of being straightforward and allowing the appraiser to value this property as any other property thus making it easier to administer. This particular method of appraising leased tax exempt property was recommended by the consultant studying this area for the Governor's Property Tax Reform Study of 1974. (The consultant was the firm of Roundtree and Associates, Richmond, Virginia.)

One criticism of this alternative is that it may tend to overvalue leased property. According to appraisal principles, the total value of property is viewed as the valuation of a bundle of property rights. The valuation of real property in fee simple supposes ownership of a full bundle of rights. Although there are many rights (rights to sell, lease, mortgage, build upon, leave vacant, subsurface mineral rights, etc.) we can envision the bundle of rights of leased property as two bundles. The first is the use of the property and the second is the "reversion value" of the property. The lessee may have use of the property but he does not have the value of the property reverting back at the end of the lease. Therefore, some argue that to value this property at 100% of fair market value does not accurately reflect value.

2. Taxation according to the value of the possessory interest.

Simply defined, possessory interest is a private interest in publicly owned (or tax exempt) property. This private interest may be created by contract, lease, concession agreement, permit, license or simply by possession or occupation without any actual documentation. The essential point is that a taxable possessory interest exists when private persons have an exclusive right to the use of publicly owned property.

In terms of valuation, the rights that are valued are the lessee's right to the possession and use of the property, together with the right to improve or build on the property, plus any other rights conveyed by the lessor. It is important to keep in mind that under this method of valuation the value is a portion of the bundle of rights that would normally be included in a fee ownership. Therefore, the value derived under this method is normally something less than the value in perpetuity of the whole bundle of rights. Restrictions on the utilization of property (restricting or not having some of these rights) would adversely affect the value of a possessory interest. By the same token, however, many possessory interests convey monopoly rights which would increase the value of a property. One example is concessionaires who have exclusive rights to merchandise their products at a large airport or in the midst of a national park where the concessionaire has in effect a monopoly power which in theory would drive up the value of that particular enterprise.

In terms of the income approach to valuing the possessory interest, the appraiser capitalizes the net economic rental value of the property for the term of the lease. The "rent" determined by the appraiser may not necessarily be the rent as stated in the contract. Many times a lessee will improve property for his own purposes and will leave the improvements for the lessor. Of course, in this case the contract rent would be lower than otherwise would be the case since part of the rent is the value of the improvements which are left to the lessor. Another method of calculating the value of the possessory interest is to calculate the value of the property as if it were not leased and then subtract the present value of the reversion at the end of the lease. The remainder is the value of the possessory interest.

An example may be helpful. Assume a value of $100,000 for land leased for 20 years at its full present rental value of $8,000 per year. The possessory interest of the lessee is defined as the value of the interest which he leases, or $78,545, excluding the reversion in which he has no possessory interest (assume interest rate of 8%).

Present value to lessor of reversion of property in 20 years ($100,000 x .21454)	21,455
Present value to lessor of 20 years' rental to be paid ($8,000 x 9.818)	78,545
	....
TOTAL PROPERTY VALUE	$ 100,000

Taxing and valuing according to the possessory interest is the approach used by the State of California in dealing with the lease of tax exempt property. It is a relatively straightforward approach that values and taxes only the interest that is possessed for the leased period. Under this approach, the most difficult determination that must be made is estimating the probable term of the possession, that is, the lease. Generally, California courts have held that it is within the province of the assessor to determine the term of the possessory interest consistent with the facts and probabilities of each individual case.

The disadvantage to this approach appears to be with the terms of the length of the lease. The assessor may have difficulty obtaining accurate lease information. In addition, there would be an incentive to modify leases for tax purposes. Two similarly situated and valued properties would indeed pay different taxes for the year under this method because the basis of the tax is different.

The statute that is to become effective on July 1, 1981 appears to be a form of possessory interest although the interest rate is set independently of the appraiser's judgment.

3. Modify the present existing law

Although the present method is somewhat arbitrary it does start with a value that is determined assuming the lessee were the owner and then an adjustment is made downward for the fact that the lessee has a shorter period of lease life remaining and the shorter the length of the lease the less the value. This method resembles the method of valuing possessory interest in the sense that a shorter lease results in a lower value. The present 2% reduction appears to be an attempt to approximate this end.

This general approach does have the advantage of simplicity and provides the lessee knowledge of future tax bills. Moreover, the appraisal process remains identical to that of other property. The reduction which the assessor must apply is stated in the Code and results from the considered judgment of the Virginia General Assembly.

The Joint Subcommittee has considered the many advantages of this approach but the Joint Subcommittee believes the present law could be improved by amending the minimum percentage of value for short term leases from the present 10% to 15%. Under the present law, if the lease has a remaining life of 5 years or less, the assessment is 10% of value. Although the leases that were studied consisted of various lengths, the Joint Subcommittee was particularly concerned about short-term leases which are consistently renewed. Presently these leases of less than 5 years are taxed at 10% of value. The present leasehold interest law taxes as though the lease will never be renegotiated. In actuality, it usually is and therefore the present law understates the probable length of the lease. An increase in the minimum percentage of value would be one way of at least partially correcting this inequity. The Joint Subcommittee has studied increasing this minimum to a variety of levels and recommends that it be increased to 15%.

4. Allow localities the option to determine the basis of taxation.

This alternative would leave the method of taxing these lessees up to the locality. Although this alternative would provide that the leasehold interest is taxable each locality would select the method which they believe is the most equitable. The revenues derived from this tax are all local revenues and it could be argued that the locality should determine which method or approach should be utilized.

This alternative was studied by the Joint Subcommittee and although its logic is appealing the Joint Subcommittee had a number of concerns. As previously mentioned, prior to 1975 there was no uniformity among the localities. The Joint Subcommittee was concerned that this option would lead to a lack of uniformity. Uniformity in the valuation of property has been one of the goals of the Virginia General Assembly. Also, the Joint Subcommittee believes this to be a complex area and allowing localities to adopt their own solution could lead to even more problems in the future.

V. RECOMMENDATION

THE JOINT SUBCOMMITTEE RECOMMENDS THAT THE PRESENT, EXISTING APPROACH TO VALUING LEASEHOLD INTERESTS BE RETAINED WITH ONE MODIFICATION, AN INCREASE IN THE MINIMUM PERCENTAGE OF VALUE TO 15%.

The Joint Subcommittee believes the legislation due to become effective July 1, 1981 should be repealed for a number of reasons. First, the legislation would overvalue property and thus be inequitable. Second, the mechanics of establishing the value have serious deficiencies. The legislation specifies not only which interest rate should be used to capitalize fair market rent but also specifies that it must be the interest rate existing on a certain day. The Code does not prescribe what interest rate appraisers or assessors should use when valuing other income producing property, and thus, the Subcommittee believes it is inappropriate to specify an interest rate in this case. The appraisers and assessors of Virginia are required to use their professional judgment in valuing property which entails selecting the appropriate interest rate for capitalizing the income from an income producing property. This is particularly important in light of the many factors that determine the correct interest rate. The requirement that a certain interest rate as of a certain day be used means that a correct interest rate will be used only by chance, and therefore, an incorrect value will be determined in most cases. Finally, the Joint Subcommittee has observed the volatility of the Federal Reserve discount rate. This is another consideration which makes the use of this interest rate highly inappropriate.

The Joint Subcommittee recommends that the present, existing method of valuing leasehold interests be maintained with an increase in the minimum percentage of value to 15%. This recommendation is made for a number of important reasons.

This approach allows the assessor to assess this property just as if it were any other type of property. However, the value would be reduced if the remaining life of the lease was less than 50 years. The 2% reduction for each year less than 50 years is an approximation of the declining value of the property to the lessee, that is, the value of his possessory interest in the property. Obviously, the less time remaining in the lease, the less the value to the lessee. The Joint Subcommittee believes this formula is a much more feasible alternative than requiring Virginia's appraisers to calculate the actual possessory interest (defined as the value of the lessee's right to the possession and use of the property for the term of the lease) which is dependent on correctly determining such factors as the appropriate capitalization rate, fair market rent, probable length of the lease, etc.

Although this approximation will not yield as exact a value it will be simpler to calculate and easier to administer. It will be easier for the taxpayer to understand and it will also allow the lessee as well as the locality to better plan for tax liabilities in future years since the formula is established.

The increase in the minimum percentage from 10% to 15% is primarily aimed at ensuring that short-term lessees pay on a more equitable percentage of value. This inequity arises when short-term leases are routinely renegotiated. In theory, the length of the lease should be the probable length of the lease. However, in some cases it is very difficult to correctly estimate "the probable length of the lease." This increase in the minimum percentage is one way to ensure that these lessees pay on a more equitable portion of value.

The Joint Subcommittee suggests that the attached legislation (see Appendix A) be introduced in the 1981 Session of the General Assembly to implement these recommendations.

Respectfully submitted,

Frederick H. Creekmore, Chairman
John S. Buckley
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A BILL to amend and reenact § 58-758.1 of the Code of Virginia, relating to the taxation of leaseholds of tax exempt real estate.

Be it enacted by the General Assembly of Virginia:

1. That § 58-758.1 of the Code of Virginia is amended and reenacted as follows:

§ 58-758.1. Taxation of certain leasehold interests.–All leasehold interests in real property which is exempt from assessment for taxation from the owner shall be assessed for local taxation to the lessee. If the *remaining term of the lease is 50 years or more, or the* lease permits the lessee to acquire the real property for a nominal sum at the completion of the term, such leasehold interest shall be assessed as if the lessee were the owner. Otherwise, ~~such interest shall be assessed by capitalizing the net annual fair market rent for such leasehold. The discount rate component of the capitalization rate shall be the Federal Reserve discount rate for the tax day~~ *such assessment shall be reduced two percent for each year that the remainder of such term is less than 50 years; provided, however, that no such assessment shall be reduced more than 85 percent. If the lessee has a right to renew without the consent of the lessor, the term of such lease shall be the sum of the original lease term plus all such renewal terms* .

No leasehold interest of tax exempt property of a governmental agency shall be subject to assessment for local property tax purposes where the property is leased to a marine terminal operator or other person whose occupation, use or operation of the tax exempt property is in aid of or promotes the governmental purposes set out in chapter 10 (§ 62.1-128 et seq.) of Title 62.1, of the Code of Virginia, as amended. The provisions of this section shall not apply to any leasehold interests exempted or partially exempted by other provisions of law.