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# Real Property--Taxation of Private Leaseholds in Exempt Government Property

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were not suing on a promise in writing for the payment of money within the meaning of section 516.110.

Section 516.120 states that actions upon contracts must be brought within its five-year limitation period. That is somewhat misleading because many contract actions are governed by the ten-year period of limitation set forth in section 516.110. The court's conclusion that actions to enforce contracts are governed by section 516.110 is sound and reasonable in view of other Missouri decisions. However, the court's treatment of the liquidated damages provision should be examined closely when courts are faced with this issue in the future.

ROBERT B. LEE

## REAL PROPERTY – TAXATION OF PRIVATE LEASEHOLDS IN EXEMPT GOVERNMENT PROPERTY

### *Frontier Airlines, Inc. v. State Tax Commission*<sup>1</sup>

In 1968 Frontier Airlines and other businesses occupied space at Lambert-St. Louis Municipal Airport under rental arrangements with the City of St. Louis, owner of the airport. The airport's location in St. Louis County brought these leasehold or possessory interests under the scrutiny of the county assessor. He valued the private property interests at a total of \$4,300,000 and the taxpayers appealed. The County Board of Equalization, the State Tax Commission, and the Circuit Court of St. Louis County upheld the assessor's valuation. The Missouri Supreme Court reversed, holding that the method of valuation used by the assessor was improper and the action of the State Tax Commission was arbitrary and unreasonable.<sup>2</sup>

The majority of states hold that the property of a municipal corporation located within the boundaries of another governmental unit of the same state is exempt from taxation.<sup>3</sup> In Missouri this exemption is required by the state constitution.<sup>4</sup> When this exempt property is leased to non-exempt lessees, however, most states will allow the leasehold or possessory interest to be taxed.<sup>5</sup> This practice has been upheld on the

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1. 528 S.W.2d 943 (Mo. En Banc 1975).

2. *Id.* at 948. Morgan, J., dissented on the ground that the leaseholds in question were tax exempt under article X, section 6 of the Missouri constitution. *Id.* at 949. See note 4 *infra*. Finch, J., dissented and approved the valuation method approved by the State Tax Commission. *Id.* at 952. Seiler, C. J., joined in the dissenting opinion of Finch, J.

3. *Id.* at 948-49 (Morgan, J., dissenting).

4. Mo. Consr. art. X, § 6 provides in part: "All property, real and personal, of the state, counties and other political subdivisions, and nonprofit cemeteries, shall be exempt from taxation . . . ."

5. Keesling, *Property Taxation of Leases and Other Limited Interests*, 47 CALIF. L. REV. 470, 474 (1959); Annot., 54 A.L.R.3d 402 (1973).

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basis of *Offutt Housing Co. v. County of Sarpy*<sup>6</sup> where the United States Supreme Court held that the states could tax the possessory interests of private investors who leased federal land, constructed housing, and rented it to military personnel.

The Missouri Supreme Court relied on *Offutt* in *State ex rel. Benson v. Personnel Housing, Inc.*,<sup>7</sup> where it upheld taxation of similar military housing in St. Louis County. In that case the court held that buildings erected on leaseholds are real property for taxation purposes. Since the *Benson* decision the court has twice held leaseholds in exempt property taxable, although in both instances it approved determinations by the State Tax Commission that the leaseholds were of no value.<sup>8</sup> Thus, the important issue in *Frontier Airlines* was not whether the leasehold interests were taxable. The problem facing the supreme court was whether the proper method of valuation was used by the assessor.<sup>9</sup>

The assessor determined the value of the leaseholds as being the present (January 1, 1968) value of the land and buildings minus the present value of the city's right of reversion on the land and buildings. To calculate the present value of the right of reversion, the assessor first assumed an occupancy of 15 years. He then determined the cash value of the right to receive in 15 years an amount equal to the 1968 value of the land plus the 1983 depreciated value of the buildings. The resulting possessory interest value was then allocated among the lessees in proportion to the percentage of total space each occupied on the date of assessment.<sup>10</sup> The court objected to this method because it disregarded the actual terms of the leases concerning the area covered by the leases,<sup>11</sup> the remaining life of the leases,<sup>12</sup> and the contract rentals.<sup>13</sup>

The court found no basis for allocating to the lessees the value of the "campus area," which included land adjacent to the buildings which was not leased and was used by the public generally. This objection is supported by reason. While the use made of nearby property may influ-

6. 351 U.S. 253 (1956).

7. 300 S.W.2d 506 (Mo. 1957).

8. *Iron County v. State Tax Commission*, 437 S.W.2d 665 (Mo. En Banc 1968); *St. Louis County v. State Tax Commission*, 406 S.W.2d 644 (Mo. En Banc 1966).

9. Only Judge Morgan dissented on the constitutionality of taxing these leaseholds. He reasoned that the city would for all practical purposes end up paying the taxes, either through decreased rent or by discharging the tax lien to prevent unwanted tenants purchasing the leasehold at a tax sale. 528 S.W.2d at 948-49 (Morgan, J., dissenting).

Similar policy arguments could be made in other situations. For example, in several areas of Missouri resort facilities are operated on state property by private individuals under contract. The lessee-concessionaire needs to earn a net profit in order to continue to operate the facilities. Because the prices charged by the lessee are often government controlled, the state may be faced with the problem of whether to permit a price increase or absorb the tax through decreased rent.

10. 528 S.W.2d at 946.

11. *Id.* at 948.

12. *Id.* at 947.

13. *Id.*

ence the value of a parcel, it would not justify taxing the owner of the parcel on the value of the nearby property. Valuation of leaseholds for tax purposes should be limited to property leased, rented, or used only for the lessee's private benefit.

In rejecting the assessor's use of a 15 year occupancy rather than the actual years remaining on each lease, the court noted that the use of such an estimated term was expressly disapproved in *St. Louis County v. State Tax Commission*.<sup>14</sup> It also judicially noticed that the airlines might choose to discontinue service to St. Louis or that a different airport might be constructed before the end of the 15 year term. The dissent, however, took a more realistic approach on this point. Judge Finch agreed with the State Tax Commission's conclusion that the airlines actually enjoyed quasi-permanent use of the property. This view seems reasonable because of the special nature of airport property, the history of continuing occupancy by the airlines, and their exclusive right to use the facilities until changes in carrier certification.<sup>15</sup>

The court also objected to the use of any valuation method which did not consider the contract rental. It relied on cases apportioning condemnation awards between lessors and lessees<sup>16</sup> in approving the bonus value method of valuing leaseholds for tax purposes.<sup>17</sup> Under the bonus value method the assessor would have subtracted the contract rental from the "economic rental" and determined the present value of the difference over the remaining term of the lease. The "economic rental" is the "actual market value of the use and occupancy."<sup>18</sup> If this had been greater than the rent provided in the lease, there would have been a bonus or savings value. If the economic value had been less than or equal to the contract rental, there would have been no value and the lease would escape taxation.<sup>19</sup>

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14. 406 S.W.2d 644 (Mo. En Banc 1966).

15. 528 S.W.2d at 952 (Finch, J., dissenting).

16. The bonus value method is used in Missouri to value leaseholds in condemnation cases. *Land Clearance for Redevelopment Corp. v. Doernhoefer*, 389 S.W.2d 780 (Mo. 1965).

17. The Missouri Supreme Court had implicitly approved using the bonus value method in tax cases in two prior decisions. In both of those cases the State Tax Commission had found the leaseholds to be of no value and the supreme court agreed. *Iron County v. State Tax Commission*, 437 S.W.2d 665 (Mo. En Banc 1968); *St. Louis County v. State Tax Commission*, 406 S.W.2d 644 (Mo. En Banc 1966).

18. 528 S.W.2d at 947.

19. The bonus value method can be illustrated by the following examples:

(1) Rent \$200	Market value \$200
(2) Rent \$200	Market value \$150
(3) Rent \$200	Market value \$250

In the first illustration the tenant theoretically can rent elsewhere at the same rent. Thus, in condemnation cases he would receive no compensation for the lease value. In the second example the tenant would receive no compensation because he is relieved from an onerous lease. In the third situation the tenant would be compensated in condemnation proceedings because he loses the \$50 bonus value. His share of the condemnation award would be the discounted value of this bonus over the remaining term of the lease.

There are two possible justifications for using the bonus value method to value leaseholds for tax assessment purposes. First, the exempt government unit's property interest can be viewed as both a right of reversion *and* a right to receive contract rent.<sup>20</sup> If this view is accepted, it follows that it would be unfair to tax the non-exempt lessee on the portion of the total value represented by the contract rent because that portion belongs to the lessor. Second, the purpose of the tax exemption is to preserve the benefits of the property for the government owner. This purpose is defeated if the lessee is able to shift the tax to the lessor in future rent negotiations.<sup>21</sup> The bonus value method would avoid any shifting where the contract rental equals or exceeds the "economic rental." This is because the leasehold in either of those situations would be valueless under the bonus value method, and it would therefore escape taxation. This advantage, however, would not exist where a governmental unit leased property for less than the market value in order to subsidize private activity, such as a manufacturing plant or air transportation service. In that situation the governmental unit would be likely to bear the ultimate tax burden no matter which method of valuation is used.<sup>22</sup>

Despite the possible advantages of the bonus value method, several states have rejected it as a method of valuing leaseholds for tax purposes.<sup>23</sup> They distinguish valuation for tax purposes from valuation for eminent domain purposes by pointing out that in the latter cases the lessee is relieved from an obligation to pay future rent and therefore the present value of future rent is properly deducted.<sup>24</sup> These courts described rent as being the price paid for the leasehold and they compare it to an outstanding mortgage on real property, which is not deducted from a fee owner's assessed valuation. They reason that the valuation should be measured by the value of the benefits of ownership of the leasehold and not by the equity of the present possessor of the leasehold.<sup>25</sup> Finally, those

20. Keesling, *supra* note 5, at 483; Comment, *Taxation of Leasehold Interests*, 21 CALIF. L. REV. 596, 600 (1933). This may have been the *Frontier Airlines* court's meaning when it said, "[W]e think the practical result of [the assessor's method] is to value a substantial portion of the real estate rather than the leasehold . . ." 528 S.W.2d at 947. *Contra*, Texas Co. v. County of Los Angeles, 52 Cal.2d 55, 63, 338 P.2d 440, 444 (1959).

21. 528 S.W.2d at 948 (Morgan, J., dissenting).

22. See note 9 *supra*.

23. International Paper Co. v. County of Siskiyou, 515 F.2d 285 (9th Cir. 1974) (applying California law to leases of federal property); De Luz Homes, Inc. v. County of San Diego, 45 Cal. 2d 546, 290 P.2d 544 (1955); *People ex rel. Korzen v. American Airlines, Inc.*, 39 Ill. 2d 11, 233 N.E.2d 568 (1967) (rejecting Missouri authority that approved bonus value method); *Portland General Electric Co. v. State Tax Commission*, 249 Ore. 239, 437 P.2d 827 (1968); *Shaia v. City of Richmond*, 207 Va. 885, 153 S.E.2d 257 (1967); *Pier 67, Inc. v. King County*, 78 Wash. 2d 48, 469 P.2d 902 (1970), *cert. denied*, 401 U.S. 911 (1971).

24. *E.g.*, Texas Co. v. County of Los Angeles, 52 Cal. 2d 55, 62, 338 P.2d 440, 443-44 (1959); *People ex rel. Korzen v. American Airlines, Inc.*, 39 Ill. 2d 11, 16, 233 N.E.2d 568, 571-72 (1967).

25. *E.g.*, Texas Co. v. County of Los Angeles, 52 Cal. 2d 55, 62, 338 P.2d 440, 443 (1959); *Portland General Electric Co. v. State Tax Commission*, 249 Ore. 239, 437 P.2d 827, 833 (1968); *Pier 67, Inc. v. King County*, 78 Wash. 2d

who reject the bonus value method agree that it is unrealistic to say that a possessory interest is of no value when a lessee has contracted to pay rent for its use.<sup>26</sup>

Courts rejecting the bonus value method of valuation for tax purposes have approved a variety of other valuation methods. In *De Luz Homes, Inc. v. County of San Diego*<sup>27</sup> the capitalization of income method<sup>28</sup> was given approval for use in the valuation of income-producing property. The first step under this method is to determine the prospective net income. This is anticipated gross income less the cost of expected necessary maintenance and operation expenses (not including rent). Each future installment of net income is then discounted to reflect a fair return and to account for the hazards of operating the business. The total of the discounted installments over the term of the lease is the valuation.

Another method has received indirect case support.<sup>29</sup> First, the value of the entire property is determined as though it is all subject to taxation. The value is then apportioned between the possessory and reversionary interests by using actuarial tables. Adjustments must be made where the property is depreciable. This method is easy to apply and seems appropriate for property lacking a clear rental market value and not generating ascertainable income. This method is very similar to the one used by the assessor in *Frontier Airlines*, but is limited to the contract as to the area leased and the rental period remaining.

The taxation of privately held possessory interests in publicly owned property is a potential source of revenue for many local government units in Missouri. Such leaseholds can exist at airports, industrial parks, national parks and forests, river port developments, state resort facilities, and toll-road service islands. Because recent cases have clearly established that such interests are taxable, a workable valuation method is needed. The bonus value method is eminently fair in condemnation proceedings but it is less appropriate as a method of valuation for tax purposes. Contract rental should not be considered except as evidence of the market or economic value of the leasehold. It is hoped that the General Assembly will consider the problem and provide guidance for local assessors, the State Tax Commission, and the courts in fairly and accurately valuing this type of property.

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48, 57-58, 469 P.2d 902, 908 (1970), *cert. denied*, 401 U.S. 911 (1971). See also Keesling, *supra* note 5.

26. 528 S.W.2d at 952 (Finch, J., dissenting). Justice Traynor made the same point when he said. "It would be anomalous to hold that a possessory interest has no value merely because the lessee has agreed to pay what it is worth." *Texas Co. v. County of Los Angeles*, 52 Cal. 2d 55, 62, 338 P.2d 440, 444 (1959).

27. 45 Cal. 2d 546, 290 P.2d 544 (1955).

28. *Id.* at 556. See also *Shaia v. City of Richmond*, 207 Va. 885, 895-96, 153 S.E.2d 257, 265 (1967).

29. *People ex rel. Kucharski v. Trans World Airlines, Inc.*, 43 Ill. 2d 174, 251 N.E.2d 225 (1969); Keesling, *supra* note 5, at 482-85.