Official Opinion No. 80-64, Taxation of Property Under Lease-Purchase from a Municipality

October 17, 1980

Ms. Lynn A. Moran
Custer County State's Attorney
Custer, South Dakota 57730

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Taxation of Property Under Lease-Purchase from a Municipality

Dear Ms. Moran:

You have requested an official opinion from this office in regard to the following factual situation:

FACTS:

On September 1, 1971, Lessor, the City of Custer, entered into a written lease and purchase agreement with Lessee, Home Corporation. The agreement provided for a twenty (20) year lease allowing the Lessee the option of purchasing the property at the end of such time for the price of one dollar. The agreement also provided that the Lessee would pay the Lessor $4,000 annually, commencing September 1, 1973 in lieu of personal property taxes. According to the agreement, Lessee was responsible for all taxes levied on the property.

The property consists of a nursing home, paid for through municipal bonds, and the land on which it rests which had been owned in fee by the city. The nursing home is not a charitable entity, nor is Home Corporation.

Based on the above facts you have asked the following question:

QUESTION:

Under SDCL 10-4-23 is the lessee or its assigns subject to property tax on the building and land?

The Constitution of South Dakota, article XI, section 2, provides in part:

To the end that the burden of taxation may be equitable upon all property, and in order that no property which is made subject to taxation shall escape, the Legislature is empowered to divide all property including moneys and credits as well as physical property into classes and to determine what class or classes of property shall be subject to taxation and what property, if any, shall not be subject to taxation. . . .

In fixing the classes of property, among others, the Legislature has established real property as the class. SDCL 10-4-2 reads in part as follows:

Real property, for the purposes of taxation, shall be construed to include the land itself, whether laid out in town lots or otherwise, and all building, structures, mobile homes . . ., and improvements, including systems for the heating, air conditioning, ventilation, sanitation, lighting and plumbing of such structures and buildings, and all rights and privileges thereto belonging or in anywise appertaining, trees or other fixtures of whatsoever kind thereon, and all rights and privileges thereto belonging or anywise appertaining, and all mines, minerals, quarries in and under the same.

At the outset I must distinguish the result of this opinion from the circumstances and law involved in the Appeal of Black Hills Industrial Freeport Inc., 268 N.W.2d 489 (S.D. 1978). There lessees with option to purchase sought the abatement of certain real property taxes. The city had purchased land from the federal government for the purpose of establishing an industrial park and had entered into a lease with option to purchase with a private developer. The court held the city was the equitable owner and not merely a conduit through which the private party should become the owners of the property so that the property was exempt from taxation. The court quoted the provision of the South Dakota Constitution, article XI, section 5, which states:

The property of the United States and of the state, county, and municipal corporations, both real and personal, shall be exempt from taxation, . . .

and which has been held to be self executing with respect to the legal and equitable ownership by a municipality. Egan Consolidated School District v. Minnehaha County, 270 N.W. 527 (S.D. 1936). However, in the Freeport case the Supreme Court only decided the question of whether the property of the municipality itself should be taxed and pointed out:

In past cases involving the question of whether municipal property should be taxed, this court has unequivocably held that the use of the [municipal or otherwise exempt] property has no relevance.

However, the court briefly discussed the leasehold interest question at 268 N.W.2d 492:

Having determined that the city of Edgemont is the equitable owner of the property, under its contract with the United States government, subject only to the leasehold interests and options of appellants, then the next step is merely to apply the provisions of Article XI, Section 5 of the Constitution. . . .

It comes down then to the question, 'Are leasehold interests subject to taxation in South Dakota?'

In an earlier opinion this office, in 1978, held they were. Official Opinion 78-10. The opinion relied to a great extent on a United States Supreme Court decision, United States et al. v. County of Fresno et al., 429 U.S. 452, 50 L.Ed.2d 683, 97 S.Ct. 699 (1977). That case held that a state might, in spite of the federal government's immunity from taxation inherent in the supremacy clause of the United States Constitution, tax federal employees on their possessory interests in housing owned and supplied to them by the federal government as part of their compensation where the legal incidence of the tax falls on the employees, not the federal government, and where the tax does not discriminate against the government or the employees.

Official Opinion 78-10 provides the basis then for my decision on this question and the following is taken therefrom:

The Constitution of South Dakota, Article XI, Sections 1 and 2, extends the power to tax to 'all property.' The language employed indicates that the word 'property' is used in its generic sense including physical things, moneys and credits and privileges, franchises and licenses. National Security Co. v. Starkey, 41 S.D. 356, 170 N.W. 582 (1919). The court there said '[T]he term 'property' as used in our Constitution (see article XI), is broad enough to include everything of value, tangible or intangible, capable of being the subject of individual right or ownership, and under our Constitution all property, except such as is expressly exempted therein as declared to be subject to taxation,' at 360. The Constitution also provides (article XI, section 5) that 'the property of the United States and of the State, county, and municipal corporations, both real and personal shall be exempt from taxation. .

. .' Property is the interest that either the United States, state or the county has in property and not specifically the land. This section does not exempt private noncharitable interest in land. SDCL 10-4-2 defines real property as follows:

Real property, for the purpose of taxation, shall be construed to include the land itself, . . . and all the buildings, structures, . . . and improvements, . . . and all rights and privileges thereto belonging or in anywise appertaining, ...

Generally speaking in actual practice, taxes are levied on land, buildings, equipment, and other things against the fee or title holders. This presents no problem so long as the fee or title owner is not exempt from taxation. The owner simply passes the tax on to the tenant as part of the rent. When the owner-user is exempt from taxation, all interest in the land, buildings and other things are exempt. However, here the owner and tax exempt entity, the federal government, is not the user of the property.

In Fresno, supra, the trial court had sustained the government's claim that among other things the employees had no taxable possessory interest under state law. The California Court of Appeals, Fifth Appellate District, reversed (50 Cal.App.3d 633); the court held that each appellant had a possessory interest in the houses owned by the Forest Service that was subject to taxation under state law and held that the tax on such possessory interest is not a tax on the federal government on government property or on a 'federal function.' They said, 'Rather it is a tax imposed on 'the private citizen, and it is the private citizen's usufructuary interest in the government land and improvements alone that is being taxed. City of Detroit v. Murray Corp. of America, 355 U.S. 489 [2 L.Ed.2d 441, 78 S.Ct. 4581. . .] United States v. Township of Muskegon, 355 U.S. 484, [2 L.Ed.2d 436, 78 S.Ct. 483]. . . .'" That court held and the United States Supreme Court agreed that the tax was not barred by the supremacy clause of the Federal Constitution.

The Supreme Court of South Dakota has consistently held that it is the nature of the use that determines the tax-exempt character of the land and its attachments, not simply the identity of the fee owner. South Dakota State Medical Association v. Jones, 82 S.D. 374, 146 N.W.2d 725 (1966, and cases cited). That interpretation of the charitable exemptions statute, § 10-4-9, is equally applicable to the statute defining real property for the purpose of taxation, § 10-4-2, to include the land itself, the buildings and fixtures on it and all rights and privileges thereto. The basic question is, can the United States Government pass its

exemption along to the individuals who hold a leasehold interest or a possessory right to certain residence quarters?

Exemption from taxation may never be presumed. It is well settled 'since taxation is a rule and an exemption is the exception . . . the presumption is against exemption from taxation and in all cases of doubt as to legislative intention . . . the presumption is in favor of the taxing power . . .' 84 C.J.S. 431-434, Taxation, section 225.

I am not unaware of the difficulties involved in this position. Neither am I unaware of the former opinions of this office holding that lease-hold interests and possessory rights in federal owned property are not subject to taxation. Specifically 1951-52 A.G.R. 385, 1955-54 A.G.R. 98. The latter opinion citing section 5 of Article XI of the Constitution and American Jurisprudence with regard to taxation of lease-hold interests merely states that no provision is made under the laws of this State for assessing lease- hold interests separately except in instances enumerated in SDC 57.0314 (now 10-4-23). That section, however, relates to a certain form of property that is of religious, scientific, benevolent societies or institutions or the State or a railroad company.

I am also aware of the decision of our Supreme Court in the case of Yadco Inc. v. Yankton County, S.D., 237 N.W.2d 665, December 19, 1975. here the owner of the property, while not exempt, was attempting to have the valuation of his property reduced because of a long-term uneconomic lease. The Court, in holding that the full and true value of the property could not take such lease into account, makes the statement, 'In South Dakota, as in New York (People v. Tax Commission of City of New York, 17 A.D.2d 225, 233 N.Y.S.2d 501 (1962)), there is no provision for the taxation of the lessee for the value of the lease to him; only the lessor is assessed and taxed.' This, of course, is distinguishable since that case dealt with property which was not exempt in any way from taxation and the base question only related to the method of determining valuation. In McMannus v. Malloy, 30 S.D. 373, 138 N.W. 963 (1912), the South Dakota Supreme Court held that, although a lessee has no title to the property, he does possess an estate in the premises for the term of the lease. To the extent that such official opinions are in conflict with this opinion they are specifically overruled. On the matter of state excise taxes, the state law is only determinative where federal supremacy is not involved or where Congress has permitted the state to enforce its tax law.

I have reviewed the lease and sub-lease in question and it is my opinion there is definitely a leasehold interest in the lessee and through it to the sub-lessee of these premises and of the project. The sub-lessee is subject to the terms and conditions of the lease and is required to perform all the obligations as if it were the lessee and including the renewal for an extended term of the lease by the lessee for the sub-lessee.

It is my opinion, therefore, in answer to your question, that although SDCL 10-4-23 is not applicable in this instance, there is a leasehold interest which the lessee and sub-lessee have in the property which is subject to taxation upon its value to them. The should be determined by appropriate assessment methods subject, of course, to review by the respective boards of equalization or the courts. If the Legislature did not intend for leasehold interests to be taxed in South Dakota it should change the wording of the definition of real property, particularly after the opinion of this office in 1978 held that such an interest or right in real property was subject to taxation.

Respectfully submitted,

Mark V. Meierhenry
Attorney General