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January 25, 2005

Mr. William C. Katzenstein
County Counsel
Riverside County Office of County Counsel
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Attn.: Carole A. Nunes Fong

Re: *Property Taxation of Property Leased by College Bookstores*

Dear Mr. Katzenstein:

This letter replies to the letter written by Deputy County Counsel Carol A. Nunes Fong dated August 26, 2004, addressed to Assistant Chief Counsel Kristine Cazadd. In her letter, Ms. Nunes Fong requests a legal opinion concerning the taxability of the leasehold interests held by for-profit organizations operating bookstores on community college, private college and state university campuses.

As set forth below, the leasehold interests of these for-profit organizations are exempt from property taxation.

1. Facts

Ms. Nunes Fong did not provide any lease agreements or operating agreements for our review. Rather, she asks us to assume that the leasehold interests held by the bookstores satisfy three of the necessary elements of a possessory interest - possession, durability, and exclusivity, and to confine our analysis to whether the following contractual terms satisfy the fourth element- "independence" so as to justify a finding of a possessory interest:

- (1) The college must approve of the manner of service, product presentation, and price to the consumer;
- (2) The bookstore operating dates and hours must conform to the college calendar;
- (3) The content of the inventory is to be specified by the college;
- (4) Items objectionable to the college are not to be sold or distributed on college property;
- (5) The college has the right to examine, inspect and access the books, records, paper, equipment and facilities with respect to the operation of the bookstore services; and
- (6) Textbooks must be repurchased from students and faculty at prescribed prices and resold as provided by the college.

2. Law and Analysis

A. **Do for-profit organizations that lease property to operate college bookstores on community college, private college, or state university campuses have taxable possessory interests?**

Section 107, subdivision (a) defines a possessory interest as:

Possession of, claim to, or right to the possession of land or improvements that is independent, durable, and exclusive of rights held by others in the property, except when coupled with ownership of the land or improvements in the same person.

Subparagraph (1) of subdivision (a) defines the element of “independence” as:

the ability to exercise authority and exert control over the management or operation of the property or improvements, separate and apart from the policies, statutes, ordinances, rules, and regulations of the public owner of the property or improvements. A possession or use is independent if the possession or operation of the property is sufficiently autonomous to constitute more than a mere agency.

In determining whether a right to use public property meets the element of independence, the court of appeal in *City of San Jose v. Carlson* (1997) 57 Cal.App.4th 1348, 1356, reasoned that such use:

must be determined on a case-by-case basis in light of the entire agreement between the user and the granting public entity. In general, *independence may be measured by the amount of routine control and supervision enjoyed by the user*, with the recognition that the government necessarily retains ultimate control. If the public owner retains sufficient control, the user may be considered to be an agent, and the public entity’s immunity from taxation extends to the user. Furthermore, *‘independent’ uses may be identified by any profit motive of the user as distinguished from those conducted with a governmental purpose.* (Emphasis added.)

In *City of San Jose*, the City challenged a determination that short-term users of a city-owned convention center held taxable possessory interests in the facilities when they obtained use permits on more than one occasion. 57 Cal.App.4th at 1351. The City argued that the conditions of the permits amounted to “substantial and severe” limits on the users’ control over management and operation of the property and, thus, the permittees were mere agents of the City. The conditions specified the number and payment of personnel, access to the premises, the use of caterers and certified utility contractors, compliance with advertised prices and opening times, allowance of sufficient time for intermissions, and selection of the provider and type of concessions, programs and novelties. 57 Cal.App.4th at 1356-1357.

The court of appeal held that the use permit conditions were not so restrictive as to constitute an agency relationship with the City. Rather, the conditions were necessary for health and safety reasons, to ensure proper accounting of ticket sales and to conform to advertised times

and prices. The court also found that, with one exception, any profits from the events belonged to the user, not the City. The court concluded that the use permits allowed the permittees a degree of control sufficient to meet the criterion of independence. 57 Cal.App.4th at 1358.

Under the facts presented here, the lease agreements with the bookstores provide that (1) the college must approve of the manner of service, product presentation, and price to the consumer; (2) the bookstore hours must conform to the college calendar; (3) the content of the inventory is to be specified by the college; (4) items objectionable to the college are not to be sold or distributed on college property; (5) the college has the right to examine, inspect and access the books, records, paper, equipment and facilities with respect to the operation of the bookstore services; and (6) textbooks must be repurchased from students and faculty at prescribed prices and resold as provided by the college. In our view, these conditions are no more restrictive than those in *City of San Jose* and are necessary to establish bookstore policies and practices consistent with the mission of the college or university. In both instances, the public entity lessor has the right to oversee lessee's methods of operation by determining the prices charged by the lessee, the types of merchandise that may be sold and the manner of presentation, and the daily schedule and hours of operation. In addition, it appears that all profits accrue to the bookstores and not to the colleges.

Therefore, we conclude that the bookstore organizations retain sufficient authority and control over the management and operation of the property to satisfy the element of independence within the meaning of section 107, subdivision (a)(1). Assuming that the interests of the bookstore organizations have the requisite elements of possession, durability and exclusivity, all the criteria for the existence of a taxable possessory interest are satisfied.

Having determined that the property interests of the bookstore organizations constitute possessory interests, our next inquiry is whether these interests are exempt from taxation. Section 3(d) of article XIII of the California Constitution exempts "property used exclusively for public schools, community colleges, state colleges and state universities." The term, "used exclusively" does not mean that the property exempted must be used solely for the purposes stated, to the exclusion of any other use, but may include certain types of incidental uses as well. However, "such incidental use must be directly connected with, essential to and in furtherance of the primary use." *Honeywell Information Systems v. County of Sonoma* (1974) 44 Cal.App.3d 23). In *Honeywell Information Systems, Inc., supra.* at 27-28, the court of appeal interpreted the phrase "property used exclusively" within the meaning of article XIII, section 3(d) and concluded that an "incidental use" that does not disqualify the property from the exemption must be "directly connected with, essential to, and in furtherance of the primary use and must be reasonably necessary for the accomplishment of the primary purpose for which the tax-exempt institution was organized."

Likewise, with respect to the private college exemption provided by article XIII, section 3(e), the court of appeal in *English v. County of Alameda*, 70 Cal.App.3d 226, 236-237 held that:

"exclusive use" . . . means that even if the use of certain property is only incidental or reasonably necessary to attain the charitable goal and, therefore, at least in the every day sense of the word, does not foreclose some additional or complementary use on the part of certain authorized private individuals, . . . for

the purpose of property taxation such incidental or reasonably necessary use must be and is considered as an exclusive use which calls for exemption from ad valorem taxation both under the constitution and the statute.

Consistent with those judicial interpretations, the Board and Board staff have opined that property used by for-profit concessionaires for the purpose of providing food service to public schools, LTA No. 80/48, and privately-owned rental housing for students and persons affiliated with the university built on land leased from the Regents of the University of California, are reasonably necessary for public school and state university purposes and are “used exclusively” within the meaning of article XIII, section 3(d). As with those uses, a college bookstore is reasonably necessary to attain the primary purpose of a public or private college’s mission to educate students, conduct research, provide a forum for academic discussion, carry textbooks and supplies, personal computers, and the like. As with those uses, a bookstore's patrons will be mostly students, faculty and staff of the college and the bookstore will be located on campus for their convenience. For these reasons, we conclude that the bookstores are “used exclusively” for public school purposes within the meaning of article XIII, section 3(d), and are “used exclusively” for private college purposes within the meaning of article XIII, section 3(e). Thus, the possessory interests held by those bookstores are exempt from property taxation.

B. Should a for-profit corporation be fully taxed on its possessory interest or, if it is determined that the property is used exclusively for college purposes, does it come within the protection of section 202(a)(3) and section 202(a) even though the organization running the bookstore is for-profit?

The qualification for the exemption pursuant to section 202(a)(3) is based on the *use* of the property. Section 202(a)(3) provides:

- (a) The exemption of the following property is as specified in subdivisions (a), (b), (d), and (h) of Section 3 of Article XIII of the Constitution[:]
- (3) Property used exclusively for public schools, community colleges, state colleges, and state universities, including the University of California.

Thus, if the property is “used exclusively” for one of the enumerated educational institutions, it is exempt from property tax, regardless of the for-profit status of the user.

C. Do certain provisions of the Revenue and Taxation Code and the Internal Revenue Code governing the exemption of property used exclusively for public school, community college, state college, and state university purposes affect our conclusion?

The eligibility for the exemption pursuant to article XIII, section 3(d), is for the *use* of the property *exclusively* for public schools, community colleges, state colleges, and state universities. All bookstores of public colleges and universities are thus eligible for the public schools exemption.

Section 203(a) provides:

(a) The college exemption is as specified in subdivision (e) of Section 3 and Section 5 of Article XIII of the California Constitution.

Your question references sections 202, subdivision (c) and 203, subdivision (d), which limit the property tax exemption for property “owned by an educational institution of collegiate grade or used by a nonprofit corporation operating a student bookstore affiliated with such an educational institution.” Section 202, subdivision (c) provides that:

(c) Without prejudice to the right to assert an exemption otherwise available under subdivision (a), (d), or (e) of Section 3 of Article XIII of the Constitution, a property tax under this division shall be imposed upon that portion of the bookstore property determined to be generating the unrelated business taxable income, as defined in Section 512 of the Internal Revenue Code, to the extent property is:

- (1) Owned by an educational institution of collegiate grade or used by a nonprofit corporation operating a student bookstore affiliated with such an educational institution, and
- (2) Is primarily devoted to bookstore use that produces income that is taxable as unrelated business taxable income.

* * *

Section 203(d) contains similar provisions.

IRC Section 512(a)(1) provides, in relevant part:

. . . the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it . . .

"Unrelated trade or business" is defined at 26 USC Section 513:

The [term] "unrelated trade or business" means . . . any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 . . . except that such term does not include any trade or business . . . which is carried on, in the case of an organization described in section 501(c)(3) or in the case of a college or university described in section 511(a)(2)(B), by the organization primarily for the convenience of its . . . students[.]

As stated above, the specific language in section 3(d) of Article XIII and section 202(a)(3) establishes that the sole requirement for the public schools' exemption is that the property be *used* in the manner specified. As *use* of the property is the criteria, the for- or non-profit ownership status of the property is immaterial. Thus, any property used exclusively for public school purposes is exempt (*Ross v. City of Long Beach* (1944) 24 Cal.2d 758). In *Ross v. City of Long Beach*, the California Supreme Court held that land and a building sited thereon

leased to the Long Beach City High School District for use as a public school was used exclusively for public school purposes and, therefore, was exempt from property taxation.

D. Although section 202.7 applies to organizations operating bookstores at the University of California, does it provide support for the taxation of for-profit organizations running college bookstores in general?

Section 202.7 provides:

Personal property owned or used by student governments of the University of California or by nonprofit corporations operating student book stores of colleges affiliated with the University of California is, for purposes of this section, deemed property belonging to this state and shall be exempt from taxation. (Emphasis added.)

Section 202.7 does not provide support for taxing the possessory interests of for-profit bookstores because it applies only to personal property, and possessory interests do not exist in the types of personal property used by bookstores. Moreover, section 202.7 exempts personal property based on deemed *ownership* by the state, while the public school and private college exemptions are based on the *use* of the property. For these reasons, Section 202.7 does not have any application on for-profit organizations running college bookstores.

The views expressed in this letter are only advisory in nature. They represent the analysis of the legal staff of the Board based on present law and the facts set forth here. They are not binding on any person or public entity.

Sincerely,

/s/ Rafael Icaza

Rafael Icaza
Tax Counsel

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