State of California

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Memorandum

To: Honorable Jerome E. Horton, Chairman
Honorable Michelle Steel, Vice Chair
Honorable Betty T. Yee, First District
Senator George Runner, Second District
Honorable John Chiang, State Controller

Date: March 6, 2014

From: Randy Ferris
Chief Counsel

Subject: **Report on Property Tax Rule 21, *Taxable Possessory Interests - Valuation***
March 25, 2014, Board Meeting – Chief Counsel Matters – Item M

Pursuant to Government Code section 15640 et seq., the Board periodically reviews county assessment practices to determine compliance with Board regulations. Those reviews, known as County Assessment Practice Surveys, have revealed a substantial number of inconsistencies among counties as to the application of the standards set forth in Property Tax Rule[1] 21, subdivision (d) (hereafter Rule 21(d)), regarding the term of possession, as interpreted by Assessors' Handbook section 510, *Taxable Possessory Interests* (AH 510) (December 2002). On May 7, 2013, the Court of Appeal issued its decision in *California State Teachers' Retirement System v. County of Los Angeles* (2013) 216 Cal.App.4th 41 (*CalSTRS*), holding that Government Code section 7510, subdivision (b)(1) is unconstitutional because it bases a lessee's assessment on the lessee's allocable share of the full cash value of the property even though the lessee only had a possessory interest in the property. By basing the lessee's allocable share on the full cash value of the property, the statute unconstitutionally taxed the publicly owned reversionary interest. This case is relevant to Rule 21(d), since the exempt reversionary interest can also be subject to tax if an incorrect term of possession is used. It is thus imperative that the term of possession be calculated correctly.

Due to the documented inconsistent application of Rule 21 and AH 510 and the recent decision in *CalSTRS* reiterating the exempt nature of the public reversionary interest, we recommend the issuance of a Letter to Assessors (LTA) to guide taxpayers, assessors, and assessment appeals boards (AABs) in determining the term of possession by clarifying the Board's intent in promulgating Rule 21(d).[2] Clarification of Rule 21(d) consistent with published guidance will guide all parties in implementing Rule 21(d) consistent with the law.

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[1] All references to Property Tax Rules or Rules are to sections of title 18 of the California Code of Regulations.
[2] Staff intends to issue a separate Letter to Assessors discussing *CalSTRS* in detail.

I. Background

A possessory interest is a privately held property interest in publicly owned real property. Revenue and Taxation Code[3] section 107, subdivision (a) defines "possessory interests" to mean "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." If the possessory interest is separately taxable to the possessor it is a taxable possessory interest (TPI). Most TPIs are created by permits and leases granting possessory rights in government land to private parties.

II. Term of Possession

Since a TPI is by definition a property interest of limited duration, an assessor valuing a TPI must determine a "term of possession" (i.e., the period of time used for valuation purposes for which the TPI exists). (Rule 21, subd. (a)(5).) The term of possession is a significant variable in possessory interest valuation and is particularly important when the assessor uses the "direct income method," which is the most widely used possessory interest valuation method. Under this method, the value of the TPI is estimated by discounting the annual economic rent attributable to the TPI over a specified term of possession. Since the term of possession determines the number of annual income payments that will be discounted, it significantly affects the assessed value.

The term of possession may also determine whether a reduction (i.e., a decline in value) to the assessment is required at each lien date. As with all real property subject to Proposition 13 and Proposition 8, TPI assessments may be reviewed each year for a decline in value. If the fair market value of the TPI on the lien date is below its factored base year value, property taxes must be assessed based on the lower fair market value. (Cal. Const., art. XIII A, § 2; Rev. & Tax. Code, § 51, subd. (a).) Among the factors that may cause a decline in value of a TPI is a reduction in the stated term of possession used to value the interest. As stated in AH 510, page 52:

> . . . if the reasonably anticipated term of possession [used to value the TPI] is based on the stated term of possession, the term of possession will decline each lien date. Other market factors, however, may counteract the effect of a declining term of possession such that the market value of the TPI does not decline.

III. Discussion of Rule 21(d)

After an extensive interested parties process, the Board approved, on March 27, 2002,[4] amendments to the possessory interest rules including the adoption of Rule 21(d), governing the term of possession. Rule 21(d)(1) states:

> The term of possession for valuation purposes shall be the reasonably anticipated term of possession. *The stated term of possession shall be deemed the reasonably*

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[3] All further statutory references are to the Revenue and Taxation Code unless otherwise indicated.

[4] The Board approved amendments to Rule 21 and the deletion of Rules 23, 24, 25 and 26, all relating to the valuation of taxable possessory interests.

> *anticipated term of possession unless it is demonstrated by clear and convincing evidence that the public owner and the private possessor have reached a mutual understanding or agreement, whether or not in writing, such that the reasonably anticipated term of possession is shorter or longer than the stated term of possession.* If so demonstrated, the term of possession shall be the stated term of possession as modified by the terms of the mutual understanding or agreement.

(Emphasis added.)

Thus, under Rule 21(d)(1), the reasonably anticipated term of possession is to be used to value a possessory interest. The stated term of possession is the reasonably anticipated term of possession and must be used to appraise the possessory interest unless it is demonstrated by clear and convincing evidence, whether or not in writing, that a mutual understanding or agreement (i.e., a modification) was reached such that the reasonably anticipated term of possession is not the stated term of possession. The "stated term of possession" is defined as the remaining term of possession (on the valuation date) according to the agreement or permit that created the possessory interest. (Rule 21, subd. (a)(6).)

The Board adopted amendments to Rule 21(d) to ". . . implement the court's holding in *American Airlines, Inc v. County of Los Angeles* 65 Cal.App.3d 325 (1976) [*American Airlines*] with respect to the determination of the appropriate 'term of possession . . . .'"[5] In *American Airlines*, the assessor based his assessment of airline companies' possessory interests on a term of possession that exceeded the years remaining on the airline companies' leases. The Court first confirmed that, consistent with cases concerning leases with the existence of an option, the term of possession for valuation purposes can include any option in the lease exercisable by the private possessor to hold land beyond the stated term in the lease. (*American Airlines*, *supra*, 65 Cal.App.3d at pp. 329-330.) Furthermore, consistent with cases concerning defeasible interests[6] leases, the term of possession for valuation purposes can include the entire stated term even if the public owner has the right to terminate the lease before the lease term expires. (*American Airlines*, *supra*, 65 Cal.App.3d at p. 331.) However, in the Court's view, the assessor's justification to use an extended term of possession amounted to a suggestion that the airlines possessed a "de facto option" to renew the leases even though no evidence that an understanding or expectation as to renewal was presented. The court made clear that a private possessor's mere intent, hope or desire to renew a lease or occupy public land for a term other than the stated term of possession cannot establish a claim or right to any public property on the part of the private possessor and, thus, cannot be the basis for appraising a possessory interest. Specifically, the court stated that:

> . . . it seems that appellants are simply attempting to appeal to some expectation that, airlines being airlines and needing the use of an airport, and airports being airports and having their patronage now, of necessity the two will get together somehow. . . . We know of no authority which would permit taxation based on such a premise.

(*American Airlines*, *supra*, 65 Cal.App.3d at p. 330 [footnotes omitted].)

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[5] 2002 Minutes of the State Board of Equalization, Public Hearings, pp. 122-123.

[6] A "defeasible interest" interest is "an interest that the holder may enjoy until the occurrence of a condition." Black's Law Dict. (9th ed. 2009) p. 885, col. 2.)

However, the court also stated:

> Of course, if the two parties do reach an "understanding" as to renewal, the option cases would seem to govern. And if the "expectation" of the parties is based on statute [citation omitted] or contract or indeed has any real substance at all, something in the nature of a defeasible interest would seem to arise and the termination cases would be relevant.

(*American Airlines*, *supra*, 65 Cal.App.3d at p. 331.)

Therefore, the Court of Appeal held that in the absence of sufficient evidence to establish that the parties had reached an understanding or an expectation of real substance as to renewal, "the airlines have no possessory interests in the leased premises following expiration of the terms of the leases, that is, no possession, claim or right thereto, as required by Revenue and Taxation Code section 107." (*American Airlines*, *supra*, 65 Cal.App.3d at p. 332.) This is the holding that has been promulgated by the Board in Rule 21(d).[7] (Cf. *J.W. Silveira v. County of Alameda* (2006) 139 Cal.App.4th 989, 998 ["*American Airlines* does not stand for the proposition that the taxable term of possession can never exceed the stated term of a lease. There were simply no facts in *American Airlines* on which to find that the leases in that case would be extended beyond their stated terms."].)

American Airlines did not discuss what type of evidence or the standard of evidence that must be met to support a modification of a stated term of possession. However, in a footnote discussing whether the value of a lessee's interest should include the expectation of renewal of his lease in an eminent domain context, the court cited cases contrasting the "expectation of renewal" (the value of which should not be included in a damage award) with a "compensable legal interest" (the value of which should be included in a damage award). (*American Airlines*, *supra*, 65 Cal.App.3d at p. 330, fn. 6.) Although the footnote was in the context of eminent domain, we believe, given the contract-centric language used by the court throughout the case, that whether there is "an understanding or an expectation of real substance as to renewal" of a stated term of possession should be analyzed under contract law principles. Therefore, the inquiry as to whether there is a modification meeting the requirements of Rule 21(d)(1) should be whether a "compensable legal interest" exists to support the modification. A "compensable legal interest" may exist to support a modification to a stated term of possession if a party to the contract has grounds to seek enforcement of the contract as modified, whether by specific performance or through damages.

A compensable legal interest need not be demonstrated by compliance with the statute of frauds. Although compliance with the statute of frauds would conclusively demonstrate a modification to a stated term of possession and thus create a compensable legal interest, the plain language of Rule 21(d)(1) as well as the 2002 interested parties process makes clear that

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[7] See Issue Paper 01-018R (October 9, 2001) p. 5, which states:

> Staff's recommended language is predicated upon the decision in *American Airlines* in the sense that the staff recommendation contains, in effect, a presumption that the stated term of possession is the reasonably anticipated term of possession subject to a strong evidentiary requirement for overcoming this presumption.

the Board did not intend a writing to be necessary to support a mutual modification.[8] A modification may also be established by demonstrating that the parties to the contract could rely on one of a number of contract principles such as, for example, promissory estoppel, quasi-contract, breach of contract, implied contract, or detrimental reliance to create a compensable legal interest. For example, actions by parties to a contract may create an implied contract that supports a modification to a stated term of possession even if the modification was not memorialized in writing.

A proper reading of *Charter Communications Properties, LLC v. County of San Luis Obispo* (2011) 198 Cal.App.4th 1089 (*Charter*) is consistent with this view of Rule 21(d). In *Charter*, a cable TV company had franchise agreements with various public entities, creating TPIs. The remaining stated terms of possession of those agreements varied from 4 to 10 years. The assessor argued that the stated terms had been modified by a mutual understanding or agreement and determined a term of possession as allowed by Rule 21(d). The Court determined that there was sufficient evidence for the AAB to determine that clear and convincing evidence existed for the assessor to value the taxable possessory interest based on a modified term of possession. In order for *Charter* to be read consistently with *American Airlines* and the Board's interpretation of Rule 21(d), *Charter* must be read to stand for the proposition that the *Charter* court implicitly held that substantial evidence existed to support the trial court's conclusion that the county assessment appeals board correctly found clear and convincing evidence of a mutual understanding between the local franchising authorities and the owner of cable television franchises, such that the reasonably anticipated term of possession of the franchises was longer than the stated term of possession (i.e., in effect a de facto option cognizable under contract law principles was created between the contracting parties).

The evidentiary standard established in Rule 21 to determine whether there has been a modification to the stated term of possession is the clear and convincing standard. The clear and convincing evidence standard requires that the evidence be so clear as to leave no substantial doubt (i.e., be sufficiently strong to command the unhesitating assent of every reasonable mind). (*Tannehill v. Finch* (1986) 188 Cal.App.3d 224, 228.) Thus, for example, if a party opposing the asserted modification establishes that substantial doubt exists regarding whether the asserted modification would be enforceable (or compensable) under applicable law, this evidentiary standard is not met. Pursuant to Rule 313, subdivision (e), an AAB may consider any relevant evidence to determine whether the public owner and private possessor reached a "mutual agreement or understanding."[9] When the requisite evidentiary standard is met, such an understanding or agreement, even unwritten, demonstrates the existence of a compensable legal interest.

Charter does not stand for the proposition that a mere expectation of renewal may be the basis for a modified term of possession. Neither does it stand for the proposition that a party may simply assert that a term of possession must have been modified based merely on business practices without the presentation of clear and convincing evidence. Any reading of

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[8] See Issue Paper 01-018R (October 9, 2001), p. 5; see also *J.W. Silveira v. County of Alameda* (2006) 139 Cal.App.4th 989, 998, fn. 5.

[9] In relevant part, Rule 313, subdivision (e) provides: "The hearing need not be conducted according to technical rules relating to evidence and witnesses. Any relevant evidence may be admitted if it is the sort of evidence on which responsible persons are accustomed to rely in the conduct of serious affairs."

Charter that is not consistent with this understanding should be disregarded. We thus view *Charter* as primarily an evidentiary case (with the exception of its interpretation of Rule 21(d)(1) through (d)(3) as explained below), and as such it provides no legal authority for purposes of guiding a county assessor or an AAB in determining whether clear and convincing evidence exists in a particular case to establish that a modification of a stated term has occurred. The facts and circumstances of each case must be analyzed to determine whether clear and convincing evidence has been presented.

Within this framework, an assessor or taxpayer asserting a modification to a stated term of possession should review the circumstances under which a purported modification was made as well as any governing statutory provisions. This is because if a party's agreement to an asserted modification constitutes an ultra vires act that renders the modification *void ab initio* (i.e., an unenforceable act that is invalid from the outset because it is beyond the scope of powers of the parties under applicable local, state and federal laws), absent any other evidence, the modification has not been demonstrated by clear and convincing evidence. For example, a stated term of possession may not be modified by the actions of a local city council that has no authority over the agreement it purports to modify.[10]

Furthermore, unless allowed by the statutory scheme, the reasonably anticipated term of possession may never exceed a limit placed on the occupancy of public land by the Legislature. (See, e.g., Civ. Code, § 718 [tidelands or submerged lands, granted to any city by the State of California, may be leased for a period not to exceed 66 years unless the grant from the state of the use thereof provides specifically the term for which said lands may be leased]); Gov. Code, § 25515.1 [restricting counties from entering into leases of real property for purposes of cultural, residential, commercial, or industrial use or development that exceed 99 years]; Gov. Code, § 37380 [restricting cities from entering into leases that exceed 55 years, or 99 years on certain conditions]; Pub. Util. Code, § 5850, subd. (a) [state-issued video franchise shall only be valid for 10 years after the date of issuance]. For example, if the statutory scheme limits the lease of public land to a specific term of years with no possibility of renewal, there is no legal possibility a modification could be made for a term beyond the statutorily limited term. However, if the statutory scheme allows for automatic renewals, a modification to the stated term of possession could be made that includes a renewal period. Furthermore, if a statutory scheme allows for pro-forma renewals where no substantial possibility of denial exists, the stated term of possession may not be the reasonably anticipated term of possession because the renewing party may effectively extend the stated term of possession at its option. Such a situation may create either a term of "otherwise unspecified duration" (as explained below) or could effectively create a de facto option by statute.

If clear and convincing evidence is presented to support a modification to a stated term of possession, the modification may be to a different, specific stated term, or it may be to an indefinite term (i.e., a "term of otherwise unspecified duration"). In *Charter*, the appellant argued that the assessor must present clear and convincing evidence that the parties modified the originally stated term of possession to a different, specific, definite term of possession.

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[10] Such ultra vires acts must be distinguished from acts that merely make the subject modification voidable, not void. Voidable modifications can create compensable legal interests under certain circumstances. By way of example, a contract modification agreed to by a suspended corporation is voidable, not void. (See, e.g., § 23304.1.)

(*Charter, supra,* 198 Cal.App.4th at pp. 1102-1103.) The appellant also argued that the various factors listed in Rule 21, subdivision (d)(2) may not be considered in valuing an unexpired franchise that started with a stated term. (*Id.* at p. 1103.) The court disagreed, stating that clear and convincing evidence was presented that the parties mutually understood that the franchise had an indefinite term, and that an indefinite term is equivalent to a possessory interest with a term of "otherwise unspecified duration." (*Ibid.*) The court further stated that Rule 21, subdivision (d)(3) requires that such a possessory interest be valued as one with no stated term of possession.[11] (*Id.* at p. 1104.) Finally, the court explained that the factors listed in Rule 21, subdivision (d)(2) are to be used to determine the reasonably anticipated term of possession. (*Ibid.*)

Thus, if clear and convincing evidence is presented to support the modification of a stated term of possession to another definite, stated term of possession, the reasonably anticipated term of possession is the new stated term of possession, and the assessor should decline the term in computing the value of the TPI at each successive lien date. If clear and convincing evidence is presented such that the stated term of possession is modified to a month-to-month lease or to an indefinite term (i.e., a "term of otherwise unspecified duration"), pursuant to Rule 21, subdivision (d)(3), the possessory interest shall be deemed to be a possessory interest with no stated term of possession. When there is no stated term, Rule 21, subdivision (d)(2) provides that ". . . the reasonably anticipated term of possession shall be demonstrated by the intent of the public owner and the private possessor, and by the intent of similarly situated parties, using [the nonexhaustive list of criteria set forth therein]." Therefore, assuming, pursuant to Rule 21(d)(1), the requisite evidentiary standard is met to support a modification to the stated term of possession, and the private holder's possession of the public property is month-to-month, or has been determined to be without fixed term or one of otherwise unspecified duration, the term of possession for valuation purposes may be determined using the factors listed in Rule 21, subdivision (d)(2).

IV. Conclusion

To clarify the Board's intent in amending Rule 21(d) and to provide guidance to assessors, taxpayers, and AABs regarding the term of possession for TPIs, staff recommends the issuance of an LTA consistent with the explanation above.

If you have any questions regarding this matter, please contact Robert Tucker, Assistant Chief Counsel at (916) 322-0437 or Richard Moon, Tax Counsel IV at (949) 440-3486.

Approved: Cynthia Bridges
Cynthia Bridges
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RF:rm

[11] Rule 21, subdivision (d)(3) provides: "For the purposes of this regulation, a [TPI] that runs from month to month, a [TPI] without fixed term, or a [TPI] of otherwise unspecified duration shall be deemed to be a [TPI] with no stated term of possession."

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