State of California

Board of Equalization

Memorandum

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To : Honorable Betty T. Yee, Chairwoman, First District
Honorable Judy Chu, Vice-Chair, Fourth District
Honorable Bill Leonard, Second District
Honorable Michelle Steel, Third District
Honorable John Chiang, Controller

From : Kristine Cazadd, Chief Counsel

Subject : **Petition for Amendment of Property Tax Rule 21**
Taxable Possessory Interests - Valuation
September 12, 2007 Board Meeting – Chief Counsel Matters – Item J1 – Rulemaking

Date : August 22, 2007

On July 13, 2007, the Board received the California Assessors' Association's (CAA) petition, pursuant to Government Code section 11340.6, to amend Property Tax Rule[1] 21, *Taxable Possessory Interests – Valuation*, to: (1) clarify the criteria used in determining a reasonably anticipated term of possession; and (2) modify the burden of proof required to overcome a stated term of possession from clear and convincing to a preponderance of the evidence standard. This matter is scheduled for the Board's consideration at the September 12, 2007 meeting[2] on the Chief Counsel Matters Agenda. On September 12, the Board may: (1) deny the petition; (2) grant the petition in part or in whole and commence the official rulemaking process by ordering publication of the notice pursuant to Government Code section 11346.5; (3) direct staff to commence an interested parties process to consider the requested amendment in part or in whole; or (4) take any other action as it may determine to be warranted by the petition. Staff recommends that the Board institute an interested-parties process to hear testimony and take evidence from assessors and taxpayers regarding application and administration of Rule 21 to determine whether or not there is adequate information concerning the possible need for the requested rule amendments. (Section 11346.3.)

This memorandum sets forth: (1) general background on Rule 21; (2) a discussion of the petition and the requested amendment; and (3) staff's recommendation.

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[1] All "Property Tax Rule" or "Rule" references are to title 18 of the California Code of Regulations.
[2] Petitioner has waived the requirement under Government Code section 11340.7 that the Board take action within 30 days of receiving the petition.

I. General Background of Rule 21

A. *Introduction*

A taxable possessory interest is a privately held property interest in publicly owned real property that meets certain statutory criteria set forth in section 107 of the Revenue and Taxation Code.[3] Most taxable possessory interests are created by permits and leases granting possessory rights in government land to private parties. Since the reversion interest is retained by the exempt government entity, a separate assessment of the taxable possessory interests held by the permit or lease holder must be enrolled. (See *San Pedro, etc. RR Co v. City of Los Angeles* (1919) 180 Cal.18; see also *Tilden v. Orange County* (1949) 89 Cal.App.2d 586.)

In valuing a taxable possessory interest, assessors must determine a "term of possession" since a taxable possessory interest is, by definition, a property interest of limited duration and the publicly owned reversion is exempt. The term of possession is a significant variable in possessory interest valuation and the assessor must review it on each lien or valuation date. The term of possession is particularly important when the assessor uses the "direct income method," which is the most widely used possessory interest valuation approach. Under this approach, the value of the taxable possessory interest is estimated by discounting the annual economic rent attributable to the taxable possessory interest 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 estimated value.

Prior to the 2002 amendment,[4] Rule 21 defined the term of possession as the "reasonably anticipated term of possession," pursuant to enumerated factual criteria. The "reasonably anticipated" standard applied to all types of taxable possessory interests regardless of how the interests were created or the duration of the interests. The reasonably anticipated term of possession could be shorter or longer than the contractual stated term of possession, provided that the assessor could support such term using criteria set forth in the rule.[5]

Certain taxpayers questioned the legality of this rule. Citing *American Airlines, Inc. v. County of Los Angeles* (1976) 65 Cal.App.3d 325, they successfully argued that the assessor should be limited to the use of the stated term of possession (plus any option

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

[4] Prior to 2002, the valuation of taxable possessory interests was governed by Rules 21, 23, 24, 25, and 26. In 2002, after a lengthy interested parties process, these rules were amended and consolidated into Rule 21.

[5] Rule 21, subdivision (a)(6) defines "stated term of possession" as follows: "The 'stated term of possession' for a taxable possessory interest as of a specific date is the remaining period of possession as of that date as specified in the lease, agreement, deed, conveyance, permit, or other authorization or instrument that created, extended, or renewed the taxable possessory interest, including any option or options to renew or extend the specified period of possession if it is reasonable to assume that the option or options will be exercised."

periods) as an outer limit when determining the term of possession for use in valuing taxable possessory interests.[6]

In order to resolve this dispute in a manner consistent with the law under case authority and to provide a uniform and consistent manner of calculating the "term of possession," Rule 21, subdivision (d)(1) was amended to read as follows:

> 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 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.

Thus, the amendment to Rule 21 provided that the term of possession for valuation purposes shall be the stated term of possession unless there is "clear and convincing" evidence that demonstrates that the possessor and the public owner have reached a mutual understanding or agreement, oral or written, such that the reasonably anticipated term of possession is shorter or longer than the stated term of possession.[7]

B. *Burden of Proof*

Under the current rule, the reasonably anticipated term of possession determined by the assessor may be shorter or longer than the stated term of possession only if the county assessor can show by clear and convincing evidence that the parties have mutually agreed to a term other than the stated contract term. If so, the rule states that the term of possession is determined with reference to such mutual understanding or agreement.

The "clear and convincing evidence" standard was added to Rule 21 as one of multiple amendments approved by the Board at a public hearing on March 27, 2002. To meet the clear and convincing evidence standard, the trier of fact must find that there exists a high probability of the veracity of the evidence presented, such that the evidence is so clear as to leave no substantial doubt.[8] In contrast, the "preponderance of the evidence" standard requires a lesser showing of proof. In order to prove a fact by a preponderance of the evidence, the party with the burden of proof must persuade the trier of fact that the

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[6] In *American Airlines, supra* at 327, the court held that the assessor could not value leased passenger terminals on the expectation that the leases would be renewed "when none of the leases contained an option to renew and there was no evidence of any understandings or agreements regarding renewal." (*Wrather Properties v. Los Angeles* (1989) 209 Cal.App.3d 517, 524; see also *Silveria v. Alameda* (2006) 139 Cal.App.4th 989, 999-1000.)

[7] Taxable possessory interests without a stated term of possession are excluded from the clear-and-convincing evidentiary standard. Specifically excluded are taxable possessory interests that run from month-to-month, without a fixed term, or otherwise lack a specified duration period.

[8] *In re Angelia P.* (1981) 28 Cal.3d 908, 918.

existence of a fact is more probable than its nonexistence before finding in favor of that party.[9]

While the general evidentiary standard set forth in Evidence Code section 115 is a preponderance of the evidence, the use of the clear and convincing standard of proof is consistent with other property tax law and California legal standards for demonstrating that a written agreement has been modified. (See 1 Witkin, Cal. Evidence (4th ed. 2000) Burden of Proof and Presumptions, §§ 38 and 39, pp. 187-190; Property Tax Rule 462.200; *Adams v. Young* (1967) 255 Cal.App.2d 145, 155; *Beeler v. American Trust Co.* (1944) 24 Cal.2d 1, 7; see also Civil Code, § 1698.) As noted in Witkin, "In a few situations, for reasons of policy of the substantive law, the ordinary 'preponderance of the evidence' is not considered sufficient to establish the fact in issue, and instead the party must prove it by 'clear and convincing evidence.'" (Witkin, *supra,* at p. 187) Among the specified set of circumstances noted by Witkin in which the higher clear and convincing evidentiary standard should be applied is where one party is trying to prove that the terms of a written document do not reflect the actual substance of the transaction between the parties. (See Witkin, supra, p. 187-188.) Overcoming a stated term of possession is analogous to the situation noted by Witkin in that the assessor has the burden of proving that a written lease term does not, in fact, accurately reflect the agreement or understanding of the parties as to term of possession.

Finally, the application of the clear and convincing standard as provided in Rule 21 is consistent with *American Airlines, Inc. v. County of Los Angeles, supra,* with respect to the determination of the appropriate "term of possession" for assessment valuation purposes.

II. Discussion of Petition

The petitioner requests that the Board make the following amendments to Rule 21:

1. Amend Rule 21, subdivision (a) to include the following definitions of terms used in Rule 21, subdivision (d):

   "Mutual understanding" means any noncontractual information, conditions, regulations, statutes or ordinances that have a substantive affect on a possessory interest's term of possession. Mutual understanding requires that both parties to a possessory interest have knowledge of the information, conditions, regulations, statutes or ordinances affecting term but it does not necessarily require an explicit communication, discussion, or agreement between the parties to a possessory interest.

   "Agreement" means an explicit meeting of the minds of the parties to a possessory interest as in a contract. This agreement may be either written or unwritten.

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[9] *Id.,* at 919.

"Fixed term of possession" means a stated term with clearly defined beginning and ending dates including any options.

"Without fixed term of possession" means a possessory interest that does not have a clearly defined ending date, or has a contractual provision that allows for automatic renewals for an indefinite period of time.

"Unspecified term of possession" means a term of possession that does not have a clearly defined duration, or does not have any term of possession stated at all.

2. Change the standard of "clear and convincing evidence" in Rule 21, subdivision (d)(1) to "preponderance of evidence."

3. Modify Rule 21 to define "clear and convincing evidence" or "preponderance of evidence" (if amended) and include examples and criteria that demonstrate how the standard is applied.

Previously, in 2003, the CAA filed a petition to amend Rule 21 to change the burden of proof from clear and convincing to preponderance of the evidence. That prior petition was heard by the Board at its December 4, 2003 meeting and denied. While similar, the instant petition alleges problems encountered in the application of the clear-and-convincing burden of proof standard; the lack of regulatory definitions to help define the relevant terms; and the lack of examples or practical criteria demonstrating how the clear-and-convincing evidence burden of proof standard should be applied in real-world situations.

In its current petition, however, the petitioner does not cite any new statutes or published appellate court decisions or differing sets of factual circumstances demonstrating a need for the proposed rule changes. Instead, petitioner points to problems in administering and applying the clear-and-convincing evidentiary standard set forth in Rule 21.

Staff agrees that determining the proper term of possession for a taxable possessory interest is a challenging valuation issue. Staff also agrees that neither assessors nor tax practitioners generally have expert knowledge as to the respective requirements of differing evidentiary standards with respect to the valuation of taxable possessory interests.

Nevertheless, before staff can address the requested amendments, more information is required from the petitioner, including specific examples of the problems typically encountered in applying Rule 21 and (subject to confidentiality rules) an enumeration of the specific situations where application of Rule 21 has resulted in underassessments or administrative problems that cannot properly be resolved or avoided under the current rule language. Along with this information, staff also will need an opportunity to review taxpayers' responses to the evidence and arguments submitted by the petitioner in order to assess the merits of the rule petition, including any potential increase in recordkeeping or compliance requirements. (Government Code section 11346.3.)

III. Staff's Recommendation

For the above reasons, staff recommends that the Board institute an interested-parties process to hear testimony and take evidence from assessors and taxpayers regarding the application and administration of Rule 21's clear-and-convincing evidentiary standard to determine whether or not there is adequate information concerning a possible need for the requested rulemaking changes.

If you need more information or have any questions, please contact Acting Assistant Chief Counsel Robert Lambert at (916) 324-6593.

Approved: _____
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