State of California

Board of Equalization
Legal Department-MIC: 83
Office of the Chief Counsel
(916) 445-4380
Fax: (916) 323-3387

Memorandum

To : Honorable Judy Chu, Ph.D., Chair
Honorable Betty T. Yee, Vice-Chairwoman
Honorable Bill Leonard
Honorable Michelle Steel
Honorable John Chiang

Date: March 26, 2008

From : Kristine Cazadd
Chief Counsel Kristine Cazadd

Subject: **Draft Letter to Assessors**
Assessment of Cable Television Taxable Possessory Interests
April __, 2008 Board Meeting – Chief Counsel Matters – Item L

In light of recent federal and state regulatory developments affecting cable television and video service providers, at the March 19, 2008 Board Meeting, the Board directed staff to prepare a draft Letter to Assessors (LTA) addressing the property tax assessment of cable television and video service taxable possessory interests for discussion and/or approval at the April __, 2008 Board Meeting. A draft of the proposed LTA is attached.

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

Approved: ______________________
Ramon J. Hirsig
Executive Director

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Attachment

cc: (w/attachment)

Mr. Ramon Hirsig	MIC:73
Mr. David Gau	MIC:63
Mr. Robert Lambert	MIC:82
Mr. Dean Kinnee	MIC:64
Mr. Todd Gilman	MIC:70

STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
PROPERTY AND SPECIAL TAXES DEPARTMENT
450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0064
916 445-4982 • FAX 916 323-8765
www.boe.ca.gov

March 26, 2008

No. 2008/0XX

TO COUNTY ASSESSORS AND INTERESTED PARTIES:

NOTICE OF BOARD ACTION

ASSESSMENT OF CABLE TELEVISION AND VIDEO SERVICE TAXABLE POSSESSORY INTERESTS

On April ___, 2008, the State Board of Equalization approved the following guidelines pertaining to the assessment of cable television taxable possessory interests.

SUMMARY OF BOARD GUIDELINES FOR ASSESSING CABLE TELEVISION AND VIDEO SERVICE TAXABLE POSSESSORY INTERESTS

In the interest of promoting uniform assessment practices and equal treatment of cable television and video service providers, the Board advises that county assessors apply the preferred income method using annual rent based solely upon the franchise fee, or portion thereof described under Revenue and Taxation Code section 107.7, subdivision (b)(2), as the annual rent to be capitalized in determining the fair market value of cable television or video service taxable possessory interests.

EFFECT OF DIGITAL INFRASTRUCTURE AND VIDEO COMPETITION ACT OF 2006 (DIVCA) UPON PROPERTY TAX ASSESSMENT OF CABLE TELEVISION TAXABLE POSSESSORY INTERESTS

DIVCA

The Digital Infrastructure and Video Competition Act of 2006[1] (DIVCA) was enacted to promote competition in the video service market and encourage the deployment of broadband Internet and other advanced technologies by establishing a state-issued franchise authorization

[1] Stats. 2006, ch. 700. In 2007, the Legislature passed and the Governor signed Assembly Bill 1715 (Stats. 2007, ch. 123), which made "technical, nonsubstantive, clarifying, and conforming changes" (*Id.* at § 2), including changes to the numbering of subdivision (a) of section 5830 of the Public Utilities Code. References in this LTA to DIVCA provisions are to the amended version effective January 1, 2008.

process that allows both cable operators and other video service providers (most prominently, telephone companies) to use their networks to provide video, voice, and broadband services to all residents of the state,[2] and encourage investment in broadband Internet service and other advanced technologies.[3] Under DIVCA, all persons or corporations that wish to provide cable or video services after January 1, 2008, must, in exchange for a franchise fee,[4] obtain a state franchise if they do not already have one.[5] Accordingly, over time, local government franchises held by cable television operators will be replaced by state franchises issued by the California Public Utilities Commission (CPUC).

Cable television franchises

Cable television franchises include the right to build a communication network using public rights-of-way,[6] which constitutes taxable possessory interests in government-owned property.[7] Local cable television operators who have existing local franchises are required to obtain a state franchise when an existing franchise expires, and have the option of obtaining a state franchise prior to the expiration date of an existing franchise under certain circumstances. Obtaining a state franchise, however, simultaneously terminates any existing taxable possessory interest and creates a new one. The creation of such a new taxable possessory interest in locally assessed property[8] is a change in ownership and results in the fair market value assessment of the newly created property interest.[9]

Expected increase in cable television taxable possessory interest change-in-ownership reassessments

Under DIVCA, the first date that a state franchise for an incumbent cable television operator[10] can be effective is January 2, 2008.[11] Board staff has been advised that many cable television operators will be obtaining state franchises prior to the stated expiration date of existing franchises,[12] thereby accelerating the reassessment of their taxable possessory interests. Thus, commencing in 2008, the Board anticipates that there will be a material statewide increase in change-in-ownership reassessments of cable television taxable possessory interests.

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[2] Pub. Util. Code, § 5810, subd. (a)(1)(C).
[3] Pub. Util. Code, § 5810, subd. (a)(2)(E).
[4] Pub. Util. Code, § 5841, subd. (i)(2); see Pub. Util. Code § 5840, subd. (q).
[5] Pub. Util. Code, § 5840, subd. (c).
[6] Gov. Code, § 53066, subd. (d); Pub. Util. Code, § 5840, subd. (i)(2).
[7] Rev. & Tax. Code, § 107. A telephone company's use of public rights-of-way also is a taxable possessory interest.
[8] Under existing law that was unchanged by DIVCA, taxable possessory interests owned by cable television operators are assessed at the county level, and benefit from the protections of Proposition 13, while taxable possessory interests held by telephone companies that are state assessees are annually assessed by the Board at fair market value. As a practical matter, all state assessees operating cable or video services eventually will hold state franchises.
[9] Rev. & Tax. Code, § 61, subd. (b) and Property Tax Rule 462.080.
[10] An incumbent cable operator is one that serves subscribers under an existing cable television franchise on January 1, 2007. (Pub. Util. Code, § 5820, subd. (i).)
[11] Pub. Util. Code, § 5930, subd. (b).
[12] A listing of state franchises may be viewed at the California Public Utilities Commission website.

DETERMINATION OF FAIR MARKET VALUE OF CABLE TELEVISION TAXABLE POSSESSORY INTERESTS UPON CHANGE IN OWNERSHIP REASSESSMENT

California Constitution

The California Constitution requires that locally assessed real property be assessed at the adjusted base year value, or the fair market value if lower.[13]

Property Tax Rule 21

Under the income approach to value, the future net income expected to be derived from the property held or used by the entity is discounted to a present value to arrive at an estimated value subject to *ad valorem* property taxation. "The income to be capitalized must be attributable to the rights in real property in the subject taxable possessory interest." (Rule 21, subd. (e)(3)(C).) Accordingly, Rule 21, subdivision (e)(3)(C), provides that the income to be capitalized may be based on either:

- The estimated economic rent for the subject taxable possessory interest;[14] or
- The estimated net operating income received by a typical, prudent operator of the taxable possessory interest subject to the taxable possessory interest.

Thus, fair market value may be estimated by capitalizing either the annual economic rents paid by the holder of the taxable possessory interest or the "net operating income" received from operation of the property. Subdivision (e)(3)(C) of Rule 21 explains that "[r]ental income is preferable to operating income (i.e., income from operating a business) because operating income may be influenced by managerial skills and may derive, in part, from nontaxable property."

Revenue and Taxation Code section 107.7

Revenue and Taxation Code section 107.7 specifically addresses the valuation of taxable possessory interests in publicly owned rights-of-way used for the delivery of cable television and video services by local and state franchisees. This statute specifically states that, in valuing cable television and video service taxable possessory interests, the "preferred method" of valuation is to utilize an income approach that capitalizes that portion of the franchise fee attributable to annual rent at the appropriate capitalization rate.[15]

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[13] Cal. Const., art. XIII A, § 2.

[14] Rule 21, subdivision (e)(3)(C) provides that contract rent may serve as economic rent under the income approach to value under appropriate circumstances.

[15] We note in this regard that Revenue and Taxation Code section 107.7, subdivision (d) provides that, "Intangible assets or rights of a cable system or the provider of video services are not subject to ad valorem property taxation. These intangible assets or rights, include, but are not limited to: franchises or licenses to construct, operate, and maintain a cable system or video service system for a specified franchise term (excepting therefrom that portion of the franchise or license which grants the possessory interest), subscribers, marketing, and programming contracts, nonreal property lease agreements, management and operating systems, a work force in place, going concern value, deferred, startup, or prematurity costs, covenants not to compete, and goodwill. However, a cable possessory interest or video service possessory interest may be assessed and valued by assuming the presence of intangible assets or

While DIVCA retained the existing assessment jurisdictions of the counties and the Board, the Legislature furthered its goal of equal treatment between state and locally assessed cable and video service providers by specifying that the requirements of section 107.7 of the Revenue and Taxation Code apply to taxable possessory interests held by all cable and video service providers operating under a state-issued franchise.

Assessor's valuations under the preferred method

Under the income approach, in describing the annual rent to be capitalized, subdivision (b)(2) of section 107.7 offers the option of using either:

> (1) That portion of the franchise fee received that is determined to be payment for the taxable possessory interest for the actual remaining term or the reasonably anticipated term of the franchise; or
>
> (2) The appropriate economic rent, if different.[16]

Nevertheless, the subdivision goes on to provide that, if the county assessor does not use a portion of the franchise fee as the capitalized annual rent, then the resulting assessment does not benefit from the presumption of correctness ordinarily accorded the assessor under subdivision (a) of Rule 321. Furthermore, under subdivision (c) of section 107.7, use of the comparable sales method also results in the loss of the presumption of correctness when it is used to value cable television or video service taxable possessory interests which are sold in combination with other property including, but not limited to, intangible assets or rights.

Thus, section 107.7 provides that the preferred method of valuing cable television and video service taxable possessory interests for real property tax assessment purposes is the application of an income approach to value that capitalizes that portion of the franchise fee attributable to annual rent at the appropriate capitalization rate.

Assessor's valuations using a non-preferred method

Under Property Tax Rule 321, subdivision (a):

> Subject to exceptions set by law, it is presumed that the assessor has properly performed his or her duties. The effect of this presumption is to impose upon the applicant the burden of proving that the value on the assessment roll is not correct, or, where applicable, the property in question has not been otherwise correctly assessed. The law requires that the applicant present independent evidence relevant to the full value of the property or other issue presented by the application.

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rights necessary to put the cable possessory interest or video service possessory interest to beneficial or productive use in an operating cable system or video service system."

[16] "Economic rent" is defined in subdivision (a)(8) of Rule 21, but is most easily understood as "market rent," which may or may not be the same as the "contract rent" actually paid by the assessee.

The loss of the assessor's presumption of correctness means that, in the context of an assessment appeal, neither party (assessor nor taxpayer) has a presumption of correctness. The assessment appeals board must then weigh the evidence to decide whether the assessor's determination is incorrect, based on the preponderance of evidence presented.[17] Subdivision (b) of Rule 321 provides that the presumption of correctness is not evidence.

Thus, under section 107.7, an assessor's use of any valuation method other than the preferred method will require the assessor to present independent evidence that the taxable possessory interest was properly valued. However, reliable evidence of economic rent or other indicators of fair market value in these cases frequently is non-comparable or unavailable. Furthermore, use of non-preferred indicators of value may result in a lack of uniformity of assessments between the various counties, and between the counties and the state.[18]

Determination of cable television franchise fees

As discussed above, the application of the preferred method under section 107.7 mandates that the assessor treat that portion of the franchise fee received that is determined to be payment for the taxable possessory interest for the actual remaining term or the reasonably anticipated term of the franchise as the appropriate annual rent to be capitalized. Under federal and state law, the maximum amount of a cable television franchise fee is limited. Federal law provides that the amount of the franchise fee payable by any cable operator for any 12-month period may not exceed 5 percent of the cable operator's "*gross revenues* derived in such period from the operation of the cable system *to provide cable services*"[19] (emphasis added). Gross revenues on which the franchise fee is measured are not defined in the federal statute. The Federal Communications Commission (FCC), however, under its general rulemaking authority, has defined the types of revenues that are included in and excluded from the gross revenues upon which the 5 percent maximum franchise fee is measured.[20] While the issue is not definitively settled, it reasonably may be concluded from federal regulatory agency rulings that the base upon which a cable television franchise fee is measured cannot legally include revenues from broadband Internet service.

DIVCA, on its part, requires the holder of a state franchise to pay as rent to each local governmental entity where it provides cable or video service a franchise fee based on gross revenues. Under DIVCA, the maximum state franchise fee is 5 percent of gross revenues as defined in subdivision (d) of section 5860 of the Public Utilities Code. In section 5860, DIVCA defines, in relevant part, the gross revenues on which the 5 percent franchise fee is measured as:

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[17] Assessment Appeals Manual, page 87.

[18] We note that the Board attempts to accurately and correctly apply section 107.7's preferred valuation approach in valuing, for assessment purposes, cable television or video service taxable possessory interests held by state assessees.

[19] 47 U.S.C.A. § 542(b).

[20] FCC, Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities, 17 FCC Rcd 4798 (2002), ¶¶ 39, 40, 43, 60, & 105; FCC, Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as amended by the Cable Television Consumer Protection and Competition Act of 1992, *Report and Order* (72 Fed. Reg. 13189 (March 21, 2007) ¶ 98; FCC, Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as amended by the Cable Television Consumer Protection Act of 1992, *Second Report and Order* (72 Fed. Reg. 65670 (Nov. 23, 2007) ¶ 11.

> All revenue actually received by the holder of the state franchise…that is derived from the operation of the holder's network to *provide cable or video services* within the jurisdiction of the local entity…. (Emphasis added.)

DIVCA further specifies that gross revenues do not include revenues derived from non-cable services, as defined under federal law or FCC rules, regulations, standards or orders.[21] Thus, we conclude that franchise fees imposed under DIVCA cannot properly be based upon any non-cable service revenues and, additionally, that broadband Internet revenues should for this purpose be considered non-cable service revenues.

CURRENT LOCAL ASSESSMENT PRACTICES FOR VALUATION OF CABLE TELEVISION TAXABLE POSSESSORY INTERESTS

For assessments of cable television taxable possessory interests made prior to the obtaining of a state franchise by a local cable operator, some county assessors have used valuation methodologies other than the section 107.7 preferred method discussed above, despite the loss of the presumption of correctness. Board staff has been unofficially advised that some county assessors have capitalized "economic rent" greater than the franchise fee, and that, in some instances, county assessors have sought to consider broadband Internet service revenues in their income approach calculations. Other county assessors reportedly are considering applying such non-preferred valuation methodologies upon the issuance of new state cable television or video service franchises in 2008 and subsequent years.

As a result, assessments based on non-preferred valuation methodologies have been the subject of several assessment appeals and at least one lawsuit. Judicial resolution of the validity of such assessments may require years to resolve. Consequently, both county assessors and cable television industry representatives have requested the Board's guidance on the valuation of cable television taxable possessory interests in light of DIVCA and, in addition, on the legality and propriety of taking broadband Internet service revenues into consideration in valuing cable television taxable possessory interests using the income approach to value.

BOARD'S RESPONSIBILITY FOR ENSURING UNIFORMITY OF STATEWIDE PROPERTY TAX ASSESSMENTS

Board's uniformity responsibilities

Under the California Constitution, the Board is responsible for ensuring the uniformity of property tax assessments throughout the state.[22] In order to accomplish this objective, the Board is required to provide specific directions to the county assessors. Section 15606, subdivision (c) of the Government Code requires the Board to "prepare and issue instructions to assessors designed to promote uniformity throughout the state and its local taxing jurisdictions in the assessment of property for the purposes of taxation." Section 15608 of the Government Code requires the Board to "instruct, advise, and direct assessors as to their duties under the laws."

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[21] Pub. Util. Code, § 5860, subd. (e)(3).

[22] Cal. Const., art. XIII, § 18; Rev. & Tax. Code § 169.

In 1988, the Legislature enacted section 107.7 in part to "provide uniformity and certainty in the assessment of cable television possessory interests."[23] As to the assessment of taxable possessory interests, the Legislature has recognized that assessing taxable possessory interests presents particular challenges to uniformity of assessments. Thus, the Legislature has enacted several statutes to address assessment issues related to particular types of taxable possessory interests.[24] The Board also is directed to "[p]rescribe rules and regulations to govern local boards of equalization when equalizing and assessors when assessing with respect to the assessment and equalization of possessory interests."[25]

Board Letters To Assessors

The Board's Letters To Assessors (LTAs) provide ongoing advisory guidance for county assessors and other interested parties on Board staff's interpretation of rules, laws, and court decisions on property tax assessment. While LTAs are not legally binding, the intent of the Board is to promote uniform assessment practices through the issuance of LTAs.

BOARD'S RECOMMENDATIONS TO COUNTY ASSESSORS FOR ASSESSMENT OF CABLE TELEVISION TAXABLE POSSESSORY INTERESTS

Thus, in the interest of promoting uniform assessment practices and equal treatment of cable and video service providers, the Board advises that county assessors apply section 107.7's preferred method, capitalizing the franchise fee attributable to annual rent at the appropriate capitalization rate, in determining the fair market value of cable television and video service taxable possessory interests.

This advice is based upon the following considerations:

- It is the Board's constitutional responsibility to encourage and promote fair and uniform property tax assessment practices throughout the state.
- In enacting DIVCA, the Legislature expressed its intention of promoting investment and competition in the cable industry by ensuring the equal regulatory and tax treatment of cable and video service providers.
- In enacting Revenue and Taxation Code section 107.7, the Legislature expressed its preference that county assessors use the income approach to value using annual rent based upon cable television or video service franchise fees or portion thereof.
- Federal and state law dictate that the fees paid for cable television or video service state and local franchises be limited to 5 percent of cable television or video

[23] Stats. 1988, ch. 1630. § 3.
[24] See Rev. & Tax. Code, §§ 107.1-107.9.
[25] Gov. Code, § 15606, subd. (g).

service gross revenues and that broadband Internet service revenues be excluded from such calculation.

For an assessor to utilize a non-preferred approach – such as an income approach that capitalizes economic rent other than the cable television or video service franchise fee attributable to annual rent – is to, first, deviate from the valuation approach recommended and preferred by the Legislature and, second, establish and promote a lack of uniformity in valuation practices both among the counties and between the state and the counties. Application of such a non-preferred income valuation approach in the cable television or video service context will be particularly difficult in that not only will the contract rents for the real property being valued be limited to 5 percent of gross cable video revenues, but the contract rents for virtually all comparable real property throughout the state will be similarly limited under federal and state law.

In conclusion, we advise that county assessors value cable television and video service taxable possessory interests on a consistent basis throughout the state by applying section 107.7's preferred valuation approach.

If you have any questions regarding this exclusion, please contact

Sincerely,

Xxxxxx X. Xxxxx
Title
Department

XXX:xx