

M e m o r a n d u m

To: Honorable Carole Migden, Chairwoman
Honorable Claude Parrish, Vice Chairman
Honorable Bill Leonard
Honorable John Chiang
Honorable Steve Westly, Controller

Date: November 25, 2003

From: Jean Ogrod
Acting Chief Counsel, Legal Department



Subject: **Petitions for Amendment of Property Tax Rules**
Rule 21, Taxable Possessory Interests—Valuation
Rule 138, Exemption for Aircraft Being Repaired, Overhauled, Modified or Serviced
Rule 305.3, Application for Equalization Under Revenue and Taxation Code Section 469
Rule 461, Real Property Value Changes

Chief Counsel Matters – Thursday, December 4, 2003**Background**

On September 29, 2003, Chairwoman Carole Migden received the four attached petitions per Government Code section 11340.6 from Joan Thayer, President, California Assessors' Association (CAA), proposing that the Board commence the rulemaking process to amend the following Property Tax Rules:

- Rule 21, *Taxable Possessory Interests—Valuation*
- Rule 138, *Exemption for Aircraft Being Repaired, Overhauled, Modified*
- Rule 305.3, *Application for Equalization Under Section 469*
- Rule 461, *Real Property/ Fixtures Value Changes*

Under Government Code section 11340.7, the Board has 30 days from receipt to deny the petitions in whole or in part, indicating the reasons why, or to initiate the rulemaking process. The CAA has agreed to waive the 30-day time limit. Accordingly, these petitions are scheduled for consideration by the Board at its meeting on Thursday, December 4, 2003, on the Chief Counsel Matters Agenda.

On December 4, the Board may (1) deny all of the petitions in their entirety or in part; (2) initiate the rulemaking process by ordering publication of the notice in Government Code section 11346.5 to adopt the requested amendments in whole or in part; or (3) initiate rulemaking by requesting the Property Tax Committee to begin the interested parties process to consider the requested amendments in whole or in part.

Summary of Staff Recommendation

Rule 21 Taxable Possessory Interests – Valuation. Staff recommends that the Board deny the petition to amend subsection (d)(1) of Rule 21. The rule's current language on the evidentiary standard for determining the term of possession for valuing a taxable possessory interest is consistent with statutory provisions.

Rule 138 Exemption for Aircraft Being Repaired, Overhauled, Modified: Staff recommends that the Board deny the petition to amend subsection (b) of Rule 138. The rule's current language requires aircraft out of revenue service and stored in California to be in California for repair, overhaul, modification or service in order to qualify for exemption. This is consistent with section 220 of the Revenue and Taxation Code, and is within the Board's regulatory authority to provide uniform guidance on qualification for the exemption for such aircraft.

Rule 305.3, Application for Equalization Under Section 469. Staff recommends that the Board deny the portion of the petition requesting amendment of subsection (b)(2) of Rule 305.3. The rule's current language is consistent with the requirements of section 469 regarding "property subject to an escape assessment." Staff further recommends that the Board consider granting the portion of the petition requesting amendment of subsection (b)(3) of Rule 305.3, and direct staff to work with interested parties to develop language to ensure that the assessor retains discretion to determine property subject to escape assessment while simultaneously protecting taxpayers' rights of appeal.

Rule 461 Real Property/ Fixtures Value Changes. Staff recommends that the Board deny the petition to amend subsection (e) of Rule 461. In staff's opinion the requested amendment is inconsistent with constitutional and legislative intent and statutory provisions. Additionally, pending litigation may impact the specific provision at issue.

Discussion of the Petitions

Petition 1: Property Tax Rule 21

The petition requests that the Board amend subsection (d)(1) of Rule 21, Taxable Possessory Interests – Valuation. This subsection specifies the "*clear and convincing evidence*" standard of proof for rebutting the presumption that the term of possession for a taxable possessory interest is the "stated term" of the lease contract. The subsection also states that if the presumption is rebutted, the term of possession is the stated term *as modified by the terms of the mutual understanding or agreement* reached by the parties. The petition requests that the "*clear and convincing evidence*" standard be changed to "*a preponderance of the evidence*" standard of proof. The petition also requests that that if the presumption is rebutted, the term of possession is not the stated term *as modified*, but rather, *the reasonably anticipated term* of possession.

Evidentiary Standard for the Term of Possession and Reasonably Anticipated Term

A taxable possessory interest is a property interest of limited duration, and thus, its value derives in part from a determination of the "term of possession agreed upon or anticipated with the

public owner." Subsection (d)(1) of Rule 21 currently provides that for valuation purposes, the reasonably anticipated term of possession is deemed to be the "stated term" of possession under the agreement, unless it is demonstrated by *clear and convincing evidence* that the public owner and the private possessor have reached a mutual understanding or agreement such that the reasonably anticipated term of possession is shorter or longer than the stated term.

The term for which a possessory interest is granted varies with the use of the properties, locations, and the policies of the public owner. Terms range from month-to-month tenancies to terms of 30 years or more. Under the current rule, the reasonably anticipated term 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 current rule states that the "new term" is stated term *as modified by the terms of the mutual understanding or agreement* of the parties

During the interested parties process and public hearing regarding the current rule, 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. During the rulemaking process, staff worked with the CAA and other interested parties to reach agreement on all of the proposed amendments. The CAA remained opposed to the *clear and convincing evidence standard*. The CAA argued that the standard places an unreasonable burden of proof on the assessor even though custom and practice demonstrate that the reasonably anticipated term is different from the stated contract term.

The CAA advocates a *preponderance of the evidence standard* which requires a lesser showing of proof than the clear and convincing standard. 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 existence of a fact is more probable than its nonexistence before finding in favor of that party.¹ 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.² The CAA states that the clear and convincing standard of proof is not the standard generally incorporated into other property tax rules, rather the preponderance of the evidence is the accepted standard. The CAA contends that

...The fiscal impact of this rule, as amended in early 2002, is significant for many counties and, ultimately, the state. The CAA estimates that the implementation of the current Rule 21 will result in over a \$1,500,000,000 loss of assessed value that should and would have been enrolled under the previous rules and established court decisions. The estimated immediate impact in Los Angeles County alone on assessed value is a decrease of \$625,000,000 and an approximate additional ongoing loss of \$125,000,000 in assessed value per year.

¹ *In re Angelia P.* (1981) 28 Cal.3d 908, 918.

² *In re Angelia*, at 919.

...Current law now has the effect of making it more difficult if not impossible for county assessors to carry out their constitutional and statutory assessment duties with regard to certain possessory interests. Rule 21 contradicts California statutes, court precedents, and the state board's own rules by introducing the "*clear and convincing evidence*" standard, forcing assessors to annually decline the term of virtually every possessory interest with a stated term of possession regardless of whether or not it is reasonable, equitable, or consistent with the market reality.

Staff's position is that the *clear and convincing evidence* standard of proof to rebut the presumption of the stated term of possession is consistent with Civil Code requirements for modifying a written agreement. Civil Code section 1698 provides that a written contract may only be modified by another written contract or by an oral agreement to the extent that the oral agreement is actually executed by the parties. Section 1698 requires *clear and convincing evidence* to modify the terms of a written lease agreement.

Evidence Code Section 115 generally provides that the standard of proof for raising a reasonable doubt about the existence or nonexistence of a fact is a preponderance of the evidence. However, the Board has prescribed the evidentiary standard in a rule to be greater than preponderance when written agreements or deeds are involved. Specifically, in Rule 462.200 (a) the Board incorporated by reference the standard of proof in Evidence Code Section 662 which contains the "clear and convincing" standard for rebutting the presumption that a deed or title instrument is presumed correct. The Board established the *clear and convincing standard* in Rule 21 based upon the legal premise that a greater standard was needed to rebut the presumption that a written contract correctly state the partner's intent regarding the stated term.

Based on the above, staff recommends that the Board deny the petition for amendment of Rule 21.

Petition 2: Property Tax Rule 138

The petition requests that the Board amend subsection (b) of Rule 138, *Exemption for Aircraft Being Repaired, Overhauled, Modified or Serviced*. The rule specifies the aircraft that are eligible for the exemption from property taxation under section 220 of the Revenue and Taxation Code. The petition requests that the exclusionary language in the rule be amended as follows:

Aircraft in California primarily for the purpose of storage may require incidental maintenance or servicing related to storage. Such aircraft do not qualify for the exemption.

Rule 138 was adopted following the September 11, 2001 terrorist attacks to provide that certificated aircraft owned by air carriers, temporarily out of revenue service and stored and maintained in California, are eligible for the exemption as provided by section 220. The rule was adopted by the Board on an emergency basis on November 28, 2001 and became effective on December 14, 2001. It was re-adopted as an emergency rule on March 27, 2002, effective April 3, 2002; and was permanently adopted on March 27, 2002, effective May 20, 2002.

Certificated aircraft used by air carriers are subject to taxation when in revenue service in California. However, in 1955, the Legislature adopted section 220 to provide a property tax exemption for aircraft in California on the lien date “solely for the purpose of being repaired, overhauled, modified, or serviced.” The stated objective for the enactment of this exemption was to promote California job creation in the aircraft service and repair industry. That industry is in competition with similar industries in other states that do not have a comparable tax on aircraft.

In the aftermath of the September 11 terrorist attacks, the airline industry experienced a significant reduction in patronage. As a result, air carriers cancelled between 25 and 30 percent of their scheduled flights, reducing their need for aircraft in revenue service by a similar percentage. While out of revenue service, the aircraft must continue to be serviced, modified, and repaired in accordance with regulations of the Federal Aviation Administration (FAA) in order to maintain airworthiness. Section 220 authorizes exemption in such circumstances and does not include any restriction on period of time during which the maintenance and repair occurs.

During the rulemaking process, the CAA opposed the rule as contrary to the specific provisions of section 220 on the basis that it broadly extended the statutory exemption to aircraft regularly operated in the state in intrastate or interstate commerce, taken out of service on the lien date. The CAA petition to amend the rule states:

...Clearly, Rule 138 exempts personal property not referenced in Section 220. Whether one believes that stored aircraft should be taxed is not relevant to this situation. *Current law does not exempt stored aircraft.* Rule 138, therefore, is legislative in its application.

The California Assessors’ Association believes the language and intent of Section 220 is clear and no clarifying Property Tax Rule should be necessary...

In staff’s view, Rule 138 does not expand the statutory exemption of section 220 to include mere “storage.” The rule requires that the aircraft be taken out of revenue service and be under contract for repair, overhaul, maintenance, or service, where such servicing is in accordance with FAA requirements. The mere servicing of an aircraft on the lien date, to maintain the aircraft for continued operation in revenue service, will not qualify that aircraft for exemption; the mere storage of aircraft taken out of revenue service without any servicing, maintenance or repair will not qualify the aircraft for exemption under the requirements of subdivision (b).

Based on the above, staff recommends that the Board deny the petition for amendment of Rule 138.

Petition 3: Property Tax Rule 305.3

The petition requests that the Board amend subsections (b)(2) and (b)(3) of Rule 305.3, *Application for Equalization Under Revenue and Taxation Code Section 469*. Subsection (b)(2)

defines the phrase “property subject to an escape assessment” and subsection (b)(3) defines the phrase “result of an audit” as used in Revenue and Taxation Code section 469. The CAA proposes the following language:

(b)(2)...If no such finding is made by the assessor, the taxpayer may file an application and present evidence to the board of the existence and disclosure of property of material value subject to escape assessment.

and

(b)(3) “Result of an audit” means the final conclusions reached by the assessor during the audit process as described in Rule 191 and shall include a description of any property subject to escape assessment as noted in the audit work papers ~~or as identified in writing by the taxpayer.~~

Rule 305.3 was adopted at a Public Hearing on November 28, 2001 and became effective May 17, 2002. The rule interprets the provisions of section 469 by clarifying the conditions under which an assessee may appeal and the property assessments that may be appealed as the result of an audit conducted by an assessor. If an assessor discovers property subject to escape assessment as the result of an audit, the assessee has a right to appeal the assessed value of all the property, except property previously equalized, at the location of the profession, trade, or business that is the subject of the audit, regardless of whether the county assessor actually enrolls an escape assessment.³ *All property* as that phrase is used in section 469, means land, improvements, and personal property.

During the rulemaking process, the CAA expressed concern regarding proposed definitions of the phrases “property subject to an escape assessment” and “result of an audit.” The CAA stated that the language ultimately adopted by the Board, contradicted the legislative intent of section 469 and other provisions of the Revenue and Taxation Code, giving business taxpayers advantages that individual taxpayers do not enjoy, and establishing an equalization process that was inefficient and unworkable.

In the petition, the CAA reiterates its position that it is the duty of the assessor to determine the property subject to escape assessment as the result of an audit, not the taxpayer or the assessment appeals board. In support of the request to amend subsection (b)(2) to add “of material value” to the definition of “property subject to escape assessment,” the CAA states:

...This sentence could create the misimpression that the taxpayer can control the Assessor’s audit findings by presenting evidence to the Assessment appeals board (AAB) that a minor item of minimal value had not been assessed or was underassessed, and, therefore, should have been the subject of an audit escape assessment. For example, a taxpayer owning personal property assessed at \$50

³ *Heavenly Valley v. El Dorado County Board of Equalization* 92000) 84 Cal.App.4th 1323 (opn.mod. 86 Cal.App.4th 25d).

million could contend before the AAB that the Assessor failed to levy an audit escape assessment on an item of property worth on \$250...

In staff's opinion, the CAA's proposal to amend subsection (b)(2) to require an escape assessment of "material value," is inconsistent with section 469. That section places no minimum threshold on the value of property subject to escape assessment. In staff's view, a statutory amendment would be required in order to accommodate this CAA request.

Regarding the proposal to amend subsection (b)(3) to delete "or as identified in writing by the taxpayer" from the definition of "results of an audit," the CAA states:

...The last portion of that sentence...could be misinterpreted to mean that the taxpayer can control the final conclusions of the Assessor's audit by merely stating in writing the taxpayer's contentions as to what property has escaped assessment. This potential interpretation is contrary to the law as stated in two published California appellate opinions⁴...those opinions make it clear that the assessor, and not the taxpayer, determines the results of an audit conducted pursuant to revenue and Taxation Code Section 469...

Staff agrees with the CAA's position on subsection (b)(3) in that there is no legal authority for a taxpayer to identify an escape assessment as a result of an audit. Under section 469 and other sections, the assessor is responsible for conducting an audit and determining the results of the audit. Staff recommends that the Board initiate the rulemaking process to amend subsection (b)(3) as proposed by the CAA, and direct staff to work with interested parties to develop language intended to ensure that the assessor retains the discretion to determine property subject to escape assessment while simultaneously protecting taxpayers' rights of appeal. Proposed amendments to Rule 305.3 should be presented to the Board's Property Tax Committee for approval.

Petition 4: Property Tax Rule 461

The petition requests that the Board amend subsection (e) of Rule 461, *Real Property Value Changes*, which states that "fixtures constitute" a separate appraisal unit for property tax valuation purposes. The CAA requests that subsection (e) be modified to provide that fixtures "may" be a separate appraisal unit. Specifically, the CAA requests that the word "may" be added as follows:

...For purposes of this subsection, fixtures and other machinery and equipment classified as improvements may constitute a separate appraisal unit.

⁴ *Heavenly Valley v. El Dorado County Board of Equalization* (2000) 84 Cal.App.4th 1323; *Apple Computer, Inc. v. County of Santa Clara Assessment Appeals Board* 105 Cal.App.4th 1355.

The language in subsection (e) pertaining to fixtures was amended into the rule on January 25, 1979, effective March 1, 1979. The CAA expressed concern regarding the Board's interpretation of subsection (e) of Rule 461 during the interested parties' proceedings on Assessors' Handbook Section 502, *Advanced Appraisal*, and Assessors' Handbook Section 504, *Assessment of Personal Property and Fixtures*.

At issue is whether fixtures must always be considered an appraisal unit separate from land and improvements for purposes of measuring a decline in value. When fixtures are treated as a separate appraisal unit, a decline in value will not be offset by an increase in the value of associated land or improvements. In contrast, when fixtures are not recognized as a separate appraisal unit for decline in value purposes, but rather, are considered part of a larger appraisal unit comprising, land and improvements other than fixtures, value increases of associated land and improvements in that larger appraisal unit offset any decline in the value of fixtures, and thereby preclude the independent recognition of a decline in value of the fixtures. CAA states that fixtures may be considered a separate appraisal unit only if they meet the definition set forth in Revenue and Taxation Code section 51(d) which provides that "'real property' means that appraisal unit that persons in the marketplace commonly buy and sell as a unit, or that is normally valued separately."

Current subsection (e) of Rule 461, which provides that fixtures constitute a separate appraisal unit, was based on the following recommendation in the Task Force Report on Property Tax Administration of the Assembly Revenue and Taxation Committee, 1979:

In determining the extent of a potential decline in value, the assessor must look to the net change in value of the appraisal unit which is commonly bought and sold in the market place, or which is normally valued separately... this means that land and improvements are ordinarily treated as a unit, and that a taxpayer cannot claim a new decline in full cash value terms of an improvement due to depreciation [i.e., decline in value], without also including any appreciation in the value of the land. If the building depreciation is offset by the increase in land value, then no reduction in assessment occurs. *Fixtures*, however, are normally appraised separately, thus owners may claim a decline based on depreciation of the fixture without regard to the value of the surrounding land or improvements.⁵

Staff's position has consistently been that the language in subsection (e) correctly reflects the constitutional and legislative intent to allow fixtures to be depreciated separately from land and improvements. The CAA takes exception, stating that subsection (e) was intended to reflect the "market reality," that fixtures are normally, *but not always*, considered to be a separate appraisal unit:

⁵ *Implementation of Proposition 13*, Volume 1, "Property Tax Assessment," Assembly Revenue and Taxation Committee, October 29, 1979, page 16.

The purpose of Rule 461(e) is to aid in the implementation of Proposition 8, and prevent declines in value of machinery and equipment [M&E] classified as fixtures (real property) from being offset by increases in the value of land and improvements. The goal is to ensure that when applying the provisions of Proposition 13 and 8th M&E classified as fixtures, those fixtures determined to be separate appraisal units in the marketplace would be annually adjusted independent from any other real property they were associated with. Rule 461(e) expresses the general rule of the market reality that the vast majority of M&E classified as fixtures constitute separate appraisal units. In addition, the rule clarifies and provides guidance that in the annual processing of property statements such fixtures will continue to be treated as separate appraisal units to determine their assessed value, and any declines in value will be recognized. However, it has also been implicitly understood, and expressed by Section 51(d), that fixtures, which are not, a separate appraisal unit will continue to be treated as part of the real property appraisal unit dictated by the marketplace.

...It is the position of the California Assessors' Association (CAA) that when the base year value of M&E classified as fixtures is determined by an allocation from a total property appraisal unit, whereby such fixtures are subject to supplemental assessment pursuant to Section 75.5, such fixtures are to be valued as part of the same appraisal unit for purposes of determining future declines in value.

Staff recommends that the Board deny the petition for amendment of Rule 461. In staff's opinion the requested amendment is inconsistent with constitutional and legislative intent. Additionally, there is pending litigation, *BP West Coast Products LLC v. County of Los Angeles and City of Carson*, LA County Super. Ct., Case No. BC 269200, that is expected to impact the interpretation of subsection (e) of Rule 461 regarding the proper treatment of fixtures as a separate appraisal unit for decline in value purposes. The case is scheduled for hearing on December 8, 2003.

If you have question on these matters, please contact Assistant Chief Counsel Kristine Cazadd at (916) 323-7713.

Attachments

LA:eb

Prop/Nonprec/Kec/03/13kec.doc
Prop/Rules/Rule 21/03/Petition.doc
Prop/Rules/Rule 138/03/Petition.doc
Prop/Rules/305.3/03/Petition.doc
Prop/Rules/461/03/Petition.doc

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