Issue Paper Number **01-018**

☐ Board Meeting
☐ Business Taxes Committee
☐ Customer Services and Administrative Efficiency Committee
☐ Legislative Committee
☒ Property Tax Committee
☐ Other

BOARD OF EQUALIZATION
KEY AGENCY ISSUE

Property Tax Rule 21, Taxable Possessory Interests - Valuation

I. Issue

Should the Board authorize publication of proposed new Property Tax Rule 21, *Taxable Possessory Interests – Valuation*, and what should the rule include with respect to the definition of "term of possession"?

II. Staff Recommendation

Staff recommends that the language for Property Tax Rule 21 in Attachment 1 be authorized for publication.

Additionally, staff recommends that the Board authorize the repeal of existing Property Tax Rules 21, 23, 24, 25 and 26, as their subject matter is incorporated into proposed Rule 21.

III. Other Alternative(s) Considered

The Board could authorize publication of proposed Property Tax Rule 21, with the alternative definition and language proposed by the California Taxpayers' Association (Attachment 2.)

IV. Background

General

The existing set of regulations governing taxable possessory interests comprise Property Tax Rules 20 through 28. Board staff, with the participation of interested parties, has been involved in a project to review, revise, and combine existing Rules 21, 22, 23, 24, 25, and 26 into a proposed new rule (tentatively designated Property Tax Rule 21) that addresses taxable possessory interest valuation in a unified fashion.

During this revision process, staff worked with the California Assessors' Association (CAA), California Taxpayers' Association (Cal-Tax), and other interested parties to arrive at rule language. Staff and interested parties were unable to reach an agreement concerning the proper definition of "term of possession," an important variable in taxable possessory interest valuation. This issue paper presents and discusses the competing language and viewpoints concerning term of possession; more specifically, it compares staff's language to alternative language offered by the Cal-Tax. The California Assessors' Association is in agreement with staff's recommended language.

[A copy of proposed Property Tax Rule 21 that includes all agreed-upon changes among interested parties, and staff's language in subsection (d) concerning term of possession is provided in Attachment 1. Attachment 2 shows staff's recommended language for term of possession compared to Cal-Tax's alternative language. Differences from staff's language are shown in strikethrough-underline format.]

Term of Possession

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. Most taxable possessory interests are created by permits and leases granting possessory rights in government land to private parties. In order to value a taxable possessory interest for property tax purposes, the assessor generally must determine an estimated term of possession. This is particularly true when the assessor uses the "direct income method," probably the most widely used possessory interest valuation approach. In 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. Thus, in using the direct income method to value taxable possessory interests, the term of possession determines the number of annual income payments that will be discounted, significantly impacting the assessed value.

The existing Board rule on the valuation of taxable possessory interests permits assessors to examine the intent of the parties and the factual circumstances in order to determine whether or not the "reasonably anticipated term of possession" of a taxable possessory interest exceeds the remaining "stated term" set forth in the lease or permit that created it. If the reasonably anticipated term is either longer or shorter than the remaining stated term, the assessor is permitted to use the reasonably anticipated term for valuation purposes. In recent years, an issue has arisen with regard to the legality of this practice, with some taxpayers asserting that assessors should be limited to the remaining stated term, plus any option periods, in determining the estimated term of possession of taxable possessory interests for valuation purposes.

V. Staff Recommendation

Adopt staff's recommended language for Property Tax Rule 21, which includes language stating that the anticipated term of possession shall be the stated term of possession unless there is evidence demonstrating that the anticipated term will be shorter or longer than the stated term of possession.

A. Description of the Staff Recommendation

Staff's language defines the term of possession for valuation purposes as "the reasonably anticipated term of possession," a standard expressed in terms of stated criteria (the criteria appear as subparagraphs (A) through (E) in staff's proposed rule language, as shown in Attachment B). The reasonably anticipated standard applies to all taxable possessory interests regardless of the type of real property or form of tenancy (e.g., month-to-month, long-term, or some other type of relationship). The assessor may review the term of possession on each lien, or valuation, date.

The stated term of possession (defined more precisely in the rule, but, for example, the remaining period of possession under a lease as of the valuation date) is the term of possession for valuation purposes unless the stated term conflicts with the reasonably anticipated term (as indicated by the criteria under the reasonably anticipated standard). In effect, staff's language creates an informal presumption that the term of possession for valuation purposes is the stated term of possession, but the assessor may establish a term of possession that is shorter or longer than the stated term using the criteria under the reasonably anticipated standard. Also, in light of *American Airlines Inc.* v. *County of Los Angeles* (1976) 65 Cal.App.3d 325, staff added the following language: "Evidence demonstrating that the reasonably anticipated term of possession is shorter or longer than the stated term of possession must go beyond the unsubstantiated expectations of the parties or others." This sentence emphasizes that a departure from the stated term of possession must be well supported under the criteria for the reasonably anticipated standard.

B. Pros of the Staff Recommendation

- Staff's proposed language is consistent with the constitutional requirement that real property be assessed at fair market value. In adhering to the reasonably anticipated term of possession standard, the staff recognizes that market participants may consider factors other than the remaining lease term in estimating the term of possession of a taxable possessory interest, such as those factors enumerated in subsection (2), (A) through (E), of the staff's proposed language.

  For example, market participants may analyze the stated renewal policy of a government landowner and conclude that the expected remaining period of possession of a taxable possessory interest is longer than the remaining lease term. This being the case, those market participants may decide that the economic value of the taxable possessory interest is greater than if only the remaining lease term were taken into consideration. In such case, the correct application of staff's proposed language regarding the determination of the reasonably anticipated term of possession would provide an accurate estimate of the fair market value of the taxable possessory interest. A requirement that only the remaining lease term be considered, however, would lead to an assessment below fair market value, resulting in violation of the requirements of the article XIII, section 1 of the California Constitution.

- Staff's recommended language on term of possession adheres closely to the language in existing rule 23 with limited substantive modifications to reflect intervening case law. Rule 23 has been in place for over 30 years. Thus, adoption of staff's recommended language would continue a long-standing and consistently applied Board interpretation of property tax law concerning this important variable in the valuation of taxable possessory interests.

- The use of the reasonably anticipated term of possession standard is sufficiently ingrained in California law that: (1) it has been expressly statutorily mandated as an integral part of the preferred method of valuing cable television possessory interests as set forth in section 107.7 of the Revenue and Taxation Code (Rev. & Tax. Code, §107.7(b)(2)); and (2) the change in ownership of taxable possessory interests is statutorily tied to renewals or extensions "during the reasonably anticipated term of possession used by the assessor to value that interest." (Rev. & Tax. Code, §61(b)(2).)

- Staff's language is consistent with court decisions regarding reasonably anticipated term of possession. In *Wrather Port Properties, Ltd. v. County of Los Angeles* (1989) 209 Cal.App.3d 517, 522-525, the court approvingly cited Rule 23's requirement that the reasonably anticipated term be tied to the "intent of the parties" and "evidence of any understandings or agreements regarding renewal."

  In *American Airlines, Inc. v. County of Los Angeles* (1976) 65 Cal.App.3d 325, 328-333), the court held that, in order to apply the reasonably anticipated term standard set forth in rule 23, the assessor would have to show either an "understanding" as to renewal or an "expectation" that is based upon a statute, contract, or evidence of "real substance." As indicated above, subsection (d)(2), of the staff's proposed language on term of possession contains an enumeration of the types of evidence of such an understanding or expectation that may be relevant to market participants in determining the intent of the owner, possessor, or similarly situated parties. In recognition of the *American Airlines* decision, the staff's proposed language on term of possession states the following: "Evidence demonstrating that the reasonably anticipated term of possession is shorter or longer than the stated term of possession must go beyond the unsubstantiated expectations of the parties or others."

  Additionally, the concept of the reasonably anticipated term of possession was implicitly approved in *Dressler v. County of Alpine* (1976) 64 Cal.App.3d 557, 564-565, where the court upheld a lien date assessment of a grazing rights taxable possessory interest on federal land predicated upon a demonstrated history of many years of annual re-issuances of grazing permits. The court found that this history demonstrated either a custom or a renewal policy of the U. S. Forest Service sufficient upon which to base an assessment.

- Staff's proposed language provides a basis for arriving at a reasonable term of valuing taxable possessory interests where there is no stated term of possession or the stated term is indefinite, such as with tenancies at will, periodic tenancies, tenancies at sufferance, and trespassers or *de facto* actual occupiers of government-owned land. In these cases, there is no option but to use a reasonably anticipated term of possession.

C. Cons of the Staff Recommendation

- Some interested parties argue that the reasonably anticipated standard for determining term of possession, upon which staff's recommendation is based, is legally invalid. Cal-Tax believes that the term of possession should be the stated term of possession (i.e., the remaining term of possession, on the valuation date, under the "enforceable agreement" evidencing the taxable possessory interest).

- Some interested parties contend that the California Court of Appeal, in *American Airlines, Inc. et al. v. County of Los Angeles*, 65 C.A.3d 325 (1976), declared that rule 23 was invalid to the extent it attempted to establish a reasonably anticipated term longer than the stated term. They contend that the court held that such a reasonably anticipated term did not meet the statutory definition of "property" or "possessory interest."

- Allowing the assessor discretion in establishing the term of possession for a possessory interest may result in a lack of uniformity among counties in determining the term of possession for valuation purposes.

D. Statutory or Regulatory Change

Action by the Board on attached Property Tax Rule 21 will result in the amendment of Title 18 of the California Code of Regulations, Subchapter 1.

E. Administrative Impact

None.

F. Fiscal Impact

1. Cost Impact

No additional cost.

2. Revenue Impact

None.

G. Taxpayer/Customer Impact

None.

H. Critical Time Frames

None.

VI. Alternative 1 (Cal-Tax Proposal)

Adopt proposed Property Tax Rule 21, which includes language stating that the reasonably anticipated term of possession shall be the stated term of possession if there is an enforceable agreement containing a stated term. (Cal-Tax's language regarding term of possession is shown in Attachment 2.)

A. Description of the Alternative (Cal-Tax Proposal)

Cal-Tax's language defines the term of possession for valuation purposes as "the reasonably anticipated term of possession," which is entirely based upon the express term stated in the agreement or contract. This standard applies to all taxable possessory interests regardless of the type of real property or form of tenancy (e.g., month-to-month, long-term, or some other type of relationship). Cal-Tax contends that the term of possession should be the stated term of possession (i.e., the remaining term of possession on the valuation date under the "enforceable agreement" evidencing the taxable possessory interest).

Although the language of "reasonably anticipated term" is retained, the alternative effectively abandons the reasonably anticipated standard, at least in large part. If a taxable possessory interest is evidenced by an "enforceable agreement" that contains a stated term of possession, the term of possession for valuation purposes is conclusively presumed to be the stated term of possession (i.e., the remaining term of the agreement on the valuation date), clearly negating the reasonably anticipated standard.

If there is no stated term of possession, the term of possession is determined in accord with the existing criteria for reasonably anticipated term of possession. This would also hold for a defeasible interest, or in Cal-Tax's language "an interest terminable by the [public owner] lessor either at will or upon the happening of some contingency," although this is not part of Cal-Tax's proposed rule language.

Cal-Tax proposes, on the stated grounds of administrative expediency, an arbitrary term of possession for valuation purposes of one year for month-to-month tenancies, although this is not part of its proposed rule language. Cal-Tax contends that possessory interests on month-to-month tenancies should be valued using a one year term of possession based on the following argument: Month-to-month tenancies typically are possessory interests with a one month term. Technically, when a month-to-month tenancy is renewed for a year, the assessor should issue twelve supplemental assessments. This creates an administrative nightmare. Accordingly, for administrative convenience, month-to-month tenancies should be assessed using a one-year term. Furthermore, because of the Statute of Frauds, where there is no writing it is impossible to have a term beyond one year and it is not a possessory interest because such a term is not "possession of, claim to, or right to possession of "real property (Revenue and Taxation Code Section 107).

B. Pros of the Alternative

Cal-Tax provided the following arguments in support of its alternative:

- Using a term longer than the stated term violates either the United States Constitution (U.S. Const. Art. VI, cl. 2, Supremacy clause), if the United States is the landlord, or the California Constitution (Ca Const. Art XIII, Sec. 3, Subdivisions (a) or (b) if a state or local government is the landlord.

Cal-Tax contends that rule 23 is unconstitutional based on the following argument (presented verbatim): Real property is commonly viewed as a bundle of sticks. If a government landlord creates a possessory interest by creating a term of ten years, it has transferred some of the sticks, say ten, and retained some of the sticks, say ninety in this example. If an assessor uses a reasonably anticipated term of 20 years, he is taxing some of the sticks that are still in the hands of the government. This he cannot do under the United States and California Constitutions.

- The California Court of Appeal in *American Airlines, Inc. et al. v. County of Los Angeles*, 65 C.A.3d 325 (1976), declared that Rule 23 was invalid to the extent it attempted to establish a reasonable anticipated term longer than the stated term. The court held that such a reasonably anticipated term did not meet the statutory definition of "property" or "possessory interest."

Cal-Tax contends that Rule 23 exceeds statutory authority and thus is void (American Airlines).In *American Airlines* the Court noted the following:

(a) That the Assessment Appeals Board received ". . . rather lengthy testimony concerning LAX, its history and future, changes already underway and to be expected, the change in the operations of the airlines and the airline industry." Id. At 328.

(b) That the trial court judge was not obligated to consider the factual record before it in order to resolve the legal issue and, therefore, made no findings of fact. Id.

(c) That ". . . the validity of the rule rather than its construction . . . must be resolved." Id.

(d) That the definition of "'Property' includes all matters and things, real, personal, and mixed, *capable of private ownership*. (Rev. & Tax. Code, §103.)" Id. at 328. [Emphasis added.]

(e) [That] "Possessory interest" means the following: "(a)*Possession of, claim to, or right to the possession* of land or improvements, except when coupled with ownership of the land or improvements in the same person. . . . (Rev. & Tax. Code, §107.)" [Emphasis added.]

The Court posed the question as ". . . what do the airlines have following termination of their leases that the assessor purported to assess?" The Court restated the question as ". . . not how to assess an interest undeniably held by the airlines, but whether they can be taxed on something they do not have, namely possessory interests extending beyond the terms of their leases." Id. At 331.

The Court then concluded as follows:

"As indicated by the foregoing discussion, we have determined that in this case 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. Nor does it appear, however one describes the airlines' relation to the leased property at the end of their leases, as hope or expectation of future use, that it is *'capable of private ownership'* as property must be. (Rev. & Tax. Code, §103.) Accordingly, insofar as rule 23 permits the challenged method of assessment here, we declare the same to be invalid." Id. at 332. [Emphasis added.]

Cal Tax contends that the Assessment community has largely ignored this decision since 1976. It is time that the Board follow the clear mandate of this case. Footnote 8 makes it clear that the possessor must have a claim or a right to the leased property beyond the end of the stated term in order for that period to be included in the term. "The point is, however, that whether hope or intention, the airlines have no claim or right to the leased property after 1991." Id. At 332.

C. Cons of the Alternative

- There is no authority that supports the contention that the application of a reasonably anticipated term of possession standard is violative of either the Supremacy Clause of the United States Constitution or subdivisions (a) or (b) of section 3 of article XIII of the California Constitution.

- The decision in *American Airlines* did not declare rule 23 invalid. To the contrary, the court noted its approval of the application of the reasonably anticipated term standard set forth in rule 23, not only to option and contingent termination cases but also to those cases where the assessor could show either an "understanding" as to renewal or an "expectation" that is based upon a statute, contract, or evidence of "real substance." (See *American Airlines, Inc. v. County of Los Angeles, supra* at 331-332.)

- The proposed alternative language is violative of the constitutional requirement that real property be assessed at fair market value per section 1 of article XIII of the California Constitution. The proposed alternative language mandates that only the remaining lease or permit term may be used to estimate the value of a taxable possessory interest for property tax purposes. In many cases, however, market participants look to the policies and history of the government lessor as to lease or permit renewals and conclude that the period of possession will be significantly longer than the remaining lease or permit term. This results in a market value for the taxable possessory interest that is greater than if only the remaining lease or permit term were taken into consideration. Typical among these cases are taxable possessory interests for grazing rights and boat slips. In such cases, the application of a reasonably anticipated term of possession standard is necessary if an accurate estimate of the fair market value of the taxable possessory interest is to be obtained.

  In summary, the adoption of the proposed alternative language – which arbitrarily limits assessors to consideration of the remaining lease or permit term when establishing a term of possession – would lead to assessments that are below fair market value, in violation of the requirements of the California Constitution. (Cal. Const. art. XIII, § 1.)

- The proposed alternative language is based upon incorrect assumptions regarding the market approach to valuation. While it is true that, in assessing taxable possessory interests, it is the real property that is being assessed, it is the real property as viewed by the market (i.e., market participants) and in light of the market's expectations. For example, a building lot might be currently zoned for agriculture, but market participants may anticipate a rezoning in the immediate future that would permit a more intense (and hence more valuable) commercial use. Consequently, the market would place a value on the lot that is greater than otherwise would be justified by the existing agricultural uses. By definition, however, the fair market value of the lot is the value that the market places upon it, regardless of what market expectations might lie behind that value.

  Similarly, it is not uncommon for the market to place high values on possessory interests based upon short term or month-to-month leases, particularly in such cases as boat slips, which are often in short supply. These cases typically involve public owners who have adopted a policy or maintained a long-standing practice of allowing existing lessees to periodically renew or otherwise extend their leases indefinitely. Given the short-term, defeasible nature of the leases and the seemingly high prices being paid for them, it is reasonable to assume that the market must be anticipating that possession and use will continue beyond the stated lease term. Nevertheless, the fair market value of real property must remain the value that the market places upon it. As stated earlier, the proposed alternative language violates the fair market value standard set forth in the California Constitution by artificially restricting the market considerations that the assessor may take into account in determining the fair market value of taxable possessory interests.

- In departing from the use of the reasonably anticipated term of possession standard for assessments, the proposed alternative language breaks with a standard that has been used for more than 30 years in this state. In addition, the proposed language is inconsistent with both (1) section 107.7 of the Revenue and Taxation Code, which mandates the use of the reasonably anticipated term of possession standard in the preferred method for valuing cable TV possessory interests; and (b) section 61(b)(2) of the Revenue and Taxation Code that ties the change of ownership of possessory interests to renewals or extensions during the reasonably anticipated term of possession.

- In some cases, adoption of the proposed language could be disadvantageous to lessees – and result in assessments in excess of fair market value – if the reasonably anticipated term is less than the stated term.

- The adoption of the proposed alternative language would create an additional workload for assessors. The language would require the annual revaluation of a significant number of taxable possessory interests that, under the reasonably anticipated term of possession standard, need not be valued on a yearly basis.

- The Cal-Tax discussion concerning the legal nature of month-to-month tenancies is incorrect. Month-to-month tenancies are *not* leases with one-month terms. (Miller & Starr, California Real Estate 2d, vol. 6, § 18.23, p. 52; Witkin Summary of California Law 9th, vol. 4, §513,514.) Month-to-month tenancies do not have fixed terms and, under the law, are a form of tenancy at will. (*Ibid.*). Like other periodic tenancies, month-to-month tenancies have terms that do "not terminate by the mere lapse of time"; thus, their terms are *indefinite* and *unspecified*. (Miller & Starr California Real Estate 2d, *supra* at §18:23, p. 52; see also *Miller & Desatnik Management Co. v. Bullock* (1990) 221 Cal.App.3d, Supp. 13, 17-18.).

  The Cal-Tax discussion presumes – without presenting evidence or authority – that all month-to-month tenancies are oral. In the staff's opinion, the vast majority of month-to-month tenancies are, in fact, set forth in executed written agreements. The discussion also states that without a writing, there can be no taxable possessory interest. This is contrary to rule 20, which includes "actual" possession within the definition of a possessory interest, and to section 107 of the Revenue and Taxation Code, which includes "possession" along with the "right to possession" in the definition of a possessory interest. The Cal-Tax discussion additionally proposes a maximum 12-month term of possession for taxable possessory interests based upon month-to-month tenancies; there is no legal authority for this proposal.

  Finally, the issues surrounding term of possession and month-to-month tenancies or tenancies without stated terms are addressed by Cal-Tax only in its discussion materials, not in any proposed rule language itself. If Alternative 1 is adopted, these areas would require subsequent Board clarification, probably through some form of administrative guidance.

D. Statutory or Regulatory Change

Action by the Board on attached Property Tax Rule 21 will result in the amendment of Title 18 of the California Code of Regulations, Subchapter 1.

E. Administrative Impact

The Property Taxes Department's assessment practices survey program periodically reviews the operations of assessor's offices for conformity with property tax law. The procedures of the survey teams and the contents of the survey reports would require updating to reflect a change in regulation.

F. Fiscal Impact

1. Cost Impact

No additional cost.

2. Revenue Impact

See attached "Revenue Estimate."

G. Taxpayer/Customer Impact

In most cases, this alternative would reduce the property tax levy for a taxable possessory interest.

H. Critical Time Frames

Not applicable.

Prepared by: Property Taxes Department; Policy, Planning and Standards Division; and Legal Division, Property Taxes Section

Current as of: May 21, 2001

Rule 21. TAXABLE POSSESSORY INTERESTS—VALUATION

Reference: Sections 107 and 107.1, Revenue and Taxation Code

(a) Definitions. For the purposes of this regulation:

(1) “Real property” is defined in rule 20(c)(1).

(2) “Possession” is defined in rule 20(c)(2).

(3) A “right” to the possession of real property includes a “claim to a right” to the possession of real property within the meaning of rule 20(c)(3).

(4) “Possessor” is defined in rule 20(c)(4).

(5) The “term of possession” of a taxable possessory interest means the term of possession for valuation purposes.

(6) 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.

(7) "Contract rent" means any compensation or payments, in cash or its equivalent, that are required to be paid or provided by a possessor under an authorization or instrument that creates a taxable possessory interest for the rights in real property provided by the taxable possessory interest.

(8) "Economic rent" means the estimated amount that would be paid by the possessor, on the valuation date in cash or its equivalent, for the rights in real property provided by the taxable possessory interest if (i) the rights to possession were offered in an open and competitive market and (ii) the public owner’s interest in the property were not exempt or immune from taxation. Economic rent does not include payments by the possessor to the public owner that are not paid as consideration for rights in real property, such as payments for the rental of personal property, for the provision of security services, and for advertising and promotional services.

(9) "Creation” means the creation of a taxable possessory interest. Creation includes (i) an initial grant or other conveyance of a taxable possessory interest; (ii) a subsequent grant or other conveyance of additional land or improvements to a preexisting taxable possessory interest; or (iii) a subsequent grant or other conveyance of additional valuable property rights or uses to a preexisting taxable possessory interest.

(10) "Extension or renewal" means the lengthening of the period of possession of a taxable possessory interest, such as by the exercise of an option to extend or to renew a lease or permit.

(b) Rights to be Valued. Except as provided in subsection (f) or specifically provided otherwise by law, the rights to be valued in a taxable possessory interest are all rights in real property held by the possessor.

(1) The fair market value of a taxable possessory interest is not diminished by any obligation of the possessor to pay rent or to retire debt secured by the taxable possessory interest. In other words, the fair market value of a taxable possessory interest is the fair market value of the fee simple absolute interest reduced only by the value of the property rights, if any, granted by the public owner to other persons and by the value of the property rights retained by the public owner (excluding the public owner's right to receive rent).

(2) Examples of rights in real property that may be granted or retained by the public owner include the following: (i) the right to take possession of the property upon the termination of the taxable possessory interest due to the occurrence of an event such as the expiration of the contract term, a breach of agreement, or the happening of a condition that terminates the possessor's right to possession; (ii) the right to put the property to a higher and better use or otherwise restrict the possessor's use of the property; (iii) the right to terminate possession upon notice; (iv) the right to approve a sublessee or assignee; (v) the right to approve a loan secured by the taxable possessory interest; and (vi) the right to allow other possessors to use the property.

(c) Standard of Value. Assessors shall value a taxable possessory interest consistent with the requirements of subsections (a), (d), (e), and (f) of section 110 of the Revenue and Taxation Code. A taxable possessory interest subject to article XIII A of the California Constitution shall also be valued consistent with the requirements of section 110.1 of the Revenue and Taxation Code.

(d) Term of Possession for Valuation Purposes

(1) The term of possession for valuation purposes shall be the stated term of possession unless there is evidence demonstrating that the reasonably anticipated term of possession will be shorter or longer than the stated term of possession. Evidence demonstrating that the reasonably anticipated term of possession is shorter or longer than the stated term of possession must go beyond the unsubstantiated expectations of the parties or others.

(2) In determining the reasonably anticipated term of possession, the assessor shall be guided by the intent of the public owner and the possessor, as well as by the intent of similarly situated parties, as evidenced by the following criteria:

(A) The sale price of the subject taxable possessory interest and sales prices of comparable taxable possessory interests.

(B) The rules, policies, and customs of the public owner and of similarly situated public owners.

(C) The history of the subject taxable possessory interest's use and the histories of the uses of comparable taxable possessory interests.

(D) The history of the relationship of the parties to the subject taxable possessory interest and the histories of the relationships of similarly situated parties.

(E) The actions of the parties to the subject taxable possessory interest, including any amounts invested in improvements by the public owner or the possessor.

(3) If there is no stated term of possession, the term of possession for valuation purposes shall be the reasonably anticipated term of possession as determined in accordance with subsection (d)(2).

(e) Valuation of Post-De Luz Taxable Possessory Interests. Except as specifically provided otherwise by law, and excluding a taxable possessory interest involving the production of gas, petroleum, or other hydrocarbons, the value of a taxable possessory interest created, extended, or renewed after December 24, 1955 (i.e., a "Post-De Luz" taxable possessory interest) may be estimated using one or more of the following methods, as appropriate for the taxable possessory interest being valued.

(1) Comparative Sales Approach to Value. In the comparative sales approach, a taxable possessory interest is valued using the sale price of the subject taxable possessory interest or sales prices of comparable taxable possessory interests, provided such interests shall have sold under the conditions of fair market value described in subsection (a) of section 110. A taxable possessory interest may be valued by the direct comparison method or the indirect comparison method.

(A) Direct Comparison Method

1. In the direct comparison method, the appraiser shall add the following to the sale price of the subject taxable possessory interest, or to the sale price of a comparable taxable possessory interest, to derive an indicator of the fair market value of the subject taxable possessory interest: (i) the present value on the sale date of any unpaid future contract rent for the term of possession; (ii) the fair market value on the sale date of any debt assumed by the buyer of the taxable possessory interest; and (iii) the present value on the sale date of any future costs that the buyer is contractually obligated to pay for the right of possession (e.g., the cost of site restoration at the end of the term of possession) less the present value on the sale date of any future benefits in addition to the right of possession or use that the buyer is contractually entitled to receive (e.g., the salvage value of, or reimbursement value for, improvements existing at the end of the term of possession). The unpaid future contract rent in (i) above shall be reduced by any expense necessary to

maintain the income from the taxable possessory interest, including any element of "gross outgo" as defined in subsection (c) of rule 8.

2. When valuing a taxable possessory interest by comparison with the sales of other taxable possessory interests, the other taxable possessory interests shall be located sufficiently near the subject taxable possessory interest and shall be sufficiently alike in respect to character, size, situation, usability, zoning or other enforceable government restrictions on use (unless rebutted pursuant to subdivision (c) of section 402.1 of the Revenue and Taxation Code), and restrictions on possession or use contained in the legal authorization or instrument that created extended or renewed the taxable possessory interest to make it clear that the comparable taxable possessory interests and the subject taxable possessory interest are comparable in value and that the cash equivalent price realized for the comparable taxable possessory interests may fairly be considered as shedding light on the value of the subject taxable possessory interest. The comparable sales also shall be sufficiently near in time to the valuation date of the subject taxable possessory interest. "Near in time to the valuation date'' does not include any sale more than 90 days after the valuation ~~lien~~ date.

(B) Indirect Comparison Method. In the indirect comparison method, a taxable possessory interest is valued by (i) estimating the fair market value on the valuation date of the possessor's rights in real property in the taxable possessory interest as if owned in perpetuity (i.e., the value of the fee simple absolute interest in such rights) using sales of fee simple absolute interests in properties that are comparable to the subject property as prescribed in section 402.5 of the Revenue and Taxation Code and whose highest and best use corresponds to, or is comparable with, the permitted use of the subject taxable possessory interest; and (ii) reducing this value by both the present value of those property rights for the period subsequent to the term of possession (i.e., the value of the fee simple absolute interest in such rights at the end of the term of possession) and the present value of all other rights of fee simple absolute ownership, if any, that are not provided to the possessor.

(2) Cost Approach to Value. In the cost approach, a taxable possessory interest is valued by (i) adding the estimated replacement cost new less depreciation of improvements that meet the requirements of the possessor's permitted use to the estimated value of the taxable possessory interest in land; and (ii) reducing this amount by the estimated present value of the improvements that shall revert to or be retained by the public owner at the end of the term of possession.

(A) The replacement cost new less depreciation of the improvements may be estimated as prescribed in subsections (d) and (e) of rule 6. The estimated value of the taxable possessory interest in land may be estimated using the comparative sales approach (direct or indirect method) or the income approach (direct or indirect method), as prescribed in subsections (e)(1) and (e)(3).

(B) If a possessor's property use is limited to specified time periods (e.g., certain hours of the day or certain days of the week) or is shared with other possessors, the value determined by the cost approach shall be reasonably allocated to each possessor in a manner that reflects each possessor's proportionate value of the right to possession.

(3) Income Approach to Value. In the income approach, a taxable possessory interest is valued by discounting the future net income that the interest in real property is capable of producing. A taxable possessory interest may be valued using the direct income method or the indirect income method.

(A) Direct Income Method. In the direct income method, a taxable possessory interest is valued by capitalizing the future net income that the taxable possessory interest is capable of producing under typical, prudent management for the term of possession.

(B) Indirect Income Method. In the indirect income method, a taxable possessory interest is valued by (i) estimating the fair market value of the possessor's rights on the valuation date as if owned in perpetuity (i.e., the value of the fee simple absolute interest in such rights) using the income approach to value as prescribed in rule 8; and (ii) reducing this value by the present value of the those rights for the period subsequent to the term of possession (i.e., the present value of the value of the fee simple interest in such rights at the end of the term of possession).

(C) Income to be Capitalized. The income to be capitalized in the valuation of a taxable possessory interest is the "net return" (as defined in subsection (c) of rule 8) attributable to the taxable possessory interest. The income to be capitalized may be based on either (i) the estimated economic rent for the subject taxable possessory interest or (ii) if the estimated economic rent is unreliable or unavailable, the estimated net operating income of a typical, prudent operator of the property subject to the taxable possessory interest. Rental 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. The income to be capitalized must be attributable to the rights in real property in the subject taxable possessory interest and must reflect the restrictions on use inherent in the subject taxable possessory interest.

1. Economic rent

a. The economic rent of the subject taxable possessory interest may be estimated by reference to (i) the contract rent for the subject taxable possessory interest; (ii) contract rents for comparable taxable possessory interests; (iii) contract rents for comparable fee simple absolute interests in real property; or (iv) contract rents for other comparable interests in real property. All such contract rents shall have been negotiated in an open and competitive market involving real property reasonably comparable to the subject taxable possessory interest in terms of physical attributes, location, legally enforceable restrictions on the property's use, term of possession, and risk of cancellation of the taxable possessory interest by public owner. In addition, the contract rents shall have been negotiated sufficiently near in time to the valuation date as to shed light on the economic rent of the subject taxable possessory interest.

b. When using the contract rent of a taxable possessory interest as an indicator of the economic rent, the assessor shall add to the contract rent (i) an estimate of the amount, if any, by which the contract rent has been reduced because improvements have been constructed at the possessor's expense that will revert to the public owner at the end of the term of possession; and (ii) an estimate of the amount, if any, by which the contract rent has been reduced because the possessor will bear the cost of restoring the real property to its original condition on reversion to the public owner, including the cost of removing improvements (less any estimated salvage value of, or reimbursement value for, the improvements), or the cost of any similar obligation.

c. To arrive at the income to be capitalized, any expense necessary to maintain the income from the subject taxable possessory interest, including any element of "gross outgo" as defined in subsection (c) of rule 8, whether paid by the public owner or the possessor, must be deducted from the estimated economic rent if the expense will be paid out of the estimated economic rent.

2. Net Operating Income

a. Net operating income is gross operating income less allowed expenses. Gross operating income, allowed expenses, and net operating income are defined herein consistent with "gross return," "gross outgo," and "net return," respectively, in subsection (c) of rule 8.

b. When valuing a taxable possessory interest using operating income, allowed expenses include the following: cost of goods sold (if applicable), typical operating expenses, typical management expense, an allowance for a return on working capital, and an allowance for a return on the value of any nontaxable property that contributes to the gross operating income. Typical operating expenses may include expenses for the rental of personal property, for the provision of security services, and for advertising and promotional services, provided such expenses are necessary for the production of the gross income. Typical operating expenses and typical management expense include expenses that an owner/operator typically would bear to maintain the property and to continue the production of income from the property but are borne by the public owner in the case of the subject taxable possessory interest.

c. Allowed expenses do not include the following: amortization, depreciation, depletion charges, debt retirement, interest on funds invested in the taxable possessory interest, the contract rent for the taxable possessory interest, property taxes on the taxable possessory interest, income taxes, or state franchise taxes measured by income.

(D) Capitalization Rate. Subsection (g) of rule 8 provides that a capitalization rate may be developed by either comparing the anticipated net incomes of recently sold comparable properties with their sales prices, or by deriving a weighted average of the capitalization rates (rates of return) for debt and equity capital appropriate to California money markets. In accordance with rule 8, the capitalization rate used in the valuation of a taxable possessory interest may be developed by (i) comparing the anticipated net incomes from comparable taxable possessory interests with their sales prices stated in cash or its equivalent and adjusted as described in subsection (e)(1)(A); (ii) comparing the anticipated net incomes of comparable fee simple absolute interests in real property with their sales prices stated in cash or its equivalent, provided the comparable fee properties are not expected to produce significantly higher net incomes subsequent to the subject taxable possessory interest's term of possession than during it; or (iii) by deriving a weighted average of the capitalization rates for debt and equity capital appropriate for the subject taxable possessory interest, weighting the separate rates of debt and equity by the relative amounts of debt and equity capital expected to be used by a typical purchaser of the subject taxable possessory interest. Consistent with subsection (f) of rule 8, the capitalization rate shall contain a component for property taxes where applicable

(f) Valuation of Pre-De Luz Taxable Possessory Interests. Except as specifically provided otherwise by law, and excluding a taxable possessory interest involving the production of gas, petroleum, or other hydrocarbons, the value of a taxable possessory interest created prior to December 24, 1955, and not since renewed or extended (i.e., a "Pre-De Luz" taxable possessory interest) is the excess of the fair market value on the valuation date of the taxable possessory interest over the present value of unpaid future contract rent for the unexpired term of possession (i.e., for the term of possession). This value may be estimated using one or more of the following methods, as appropriate for the taxable possessory interest being valued.

(1) Comparative Sales Approach to Value. A Pre-De Luz taxable possessory interest may be valued by the comparative sales approach using the direct comparison method or the indirect comparison method, as described in subsection (e)(1), but with the following modifications:

(A) Direct Comparison Method. In the direct comparison method, the present value of the unpaid future contract rent is not added to the sale price of the taxable possessory interest.

(B) Indirect Comparison Method. In the indirect comparison method, the value of the possessor's rights as if owned in fee is reduced by the present value of the unpaid future contract rent of the taxable possessory interest, as well as by the value of those property rights for the period subsequent to the term of possession.

(2) Cost Approach to Value. A Pre-De Luz taxable possessory interest may be valued by the cost approach as described in subsection (e)(2), but the present value of any unpaid future contract rent of the taxable possessory interest in land for the term of possession is also deducted.

ATTACHMENT 2 - ISSUE PAPER 01-018
LANGUAGE DIFFERENCES REGARDING TERM OF POSSESSION

Staff Recommendation (as shown in Attachment 1)	Alternative (Cal Tax) (proposed to replace text in Attachment 1)
(d) Term of Possession for Valuation Purposes (1) The term of possession for valuation purposes shall be the stated term of possession unless there is evidence demonstrating that the reasonably anticipated term of possession will be shorter or longer than the stated term of possession. Evidence demonstrating that the reasonably anticipated term of possession is shorter or longer than the stated term of possession must go beyond the unsubstantiated expectations of the parties or others. (2) In determining the reasonably anticipated term of possession, the assessor shall be guided by the intent of the public owner and the possessor, as well as by the intent of similarly situated parties, as evidenced by the following criteria: (A) The sale price of the subject taxable possessory interest and sales prices of comparable taxable possessory interests. (B) The rules, policies, and customs of the public owner and of similarly situated public owners. (C) The history of the subject taxable possessory interest's use and the histories of the uses of comparable taxable possessory interests. (D) The history of the relationship of the parties to the subject taxable possessory interest and the histories of the relationships of similarly situated parties. (E) The actions of the parties to the subject taxable possessory interest, including any amounts invested in improvements by the public owner or the possessor. (3) If there is no stated term of possession, the term of possession for valuation purposes shall be the reasonably anticipated term of possession as determined in accordance with subsection (d)(2).	**(d) Term of Possession for Valuation Purposes** (1) The reasonably anticipated term shall be the term of possession for valuation purposes. The reasonably anticipated term shall be determined pursuant to subsection (d)(2) if there is a stated term and pursuant to subsection (d)(3) if there is no stated term. ~~(1) The term of possession for valuation purposes shall be the stated term of possession unless there is evidence demonstrating that the reasonably anticipated term of possession will be shorter or longer than the stated term of possession. Evidence demonstrating that the reasonably anticipated term of possession is shorter or longer than the stated term of possession must go beyond mere possibility or the unsubstantiated expectations of the parties or others.~~ (2) If there is an enforceable agreement that contains a stated term of possession, then the reasonably anticipated term shall be the term so stated. (3) ~~(2)~~ If there is no stated term of possession, the reasonably anticipated term shall be determined by reference to ~~In determining the reasonably anticipated term of possession, the assessor shall be guided by~~ the intent of the public owner and the possessor, as well as by the intent of similarly situated parties, as evidenced by the following criteria: (A) The sale price of the subject taxable possessory interest and sales prices of comparable taxable possessory interests. (B) The rules, policies, and customs of the public owner and of similarly situated public owners. (C) The history of the subject taxable possessory interest's use and the histories of the uses of comparable taxable possessory interests.

ATTACHMENT 2 - ISSUE PAPER 01-018
LANGUAGE DIFFERENCES REGARDING TERM OF POSSESSION

Staff Recommendation (as shown in Attachment 1)	**Alternative (Cal Tax) (proposed to replace text in Attachment 1)**
	(D) The history of the relationship of the parties to the subject taxable possessory interest and the histories of the relationships of similarly situated parties. (E) The actions of the parties to the subject taxable possessory interest, including any amounts invested in improvements by the public owner or the possessor. ~~(3) If there is no stated term of possession, the term of possession for valuation purposes shall be the reasonably anticipated term of possession as determined in accordance with subsection (d)(2).~~

(3) Income Approach to Value. A Pre-De Luz taxable possessory interest may be valued by the income approach using the direct income method or the indirect income method, as described in subsection (e)(3), but with the following modifications:

(A) Direct Income Method. In the direct income method, the net income to be capitalized is reduced by the unpaid future contract rent for the term of possession, as well as by allowed expenses.

(B) Indirect Income Method. In the indirect income method, the present value of the unpaid future contract rent for the term of possession is deducted from the value of the fee interest, as well as the deduction of the present value of the property rights for the period subsequent to the term of possession.

BOARD OF EQUALIZATION

REVENUE ESTIMATE

ISSUE #01-018

Taxable Possessory Interests and Term of Possession

Staff Recommendation

Under the staff's recommendation, the Board would adopt language for Property Tax Rule 21 which includes language stating that the term of possession for valuation purposes shall be the stated term of possession unless there is evidence demonstrating that the reasonably anticipated term will be shorter or longer than the stated term of possession.

Alternative

Under the alternative proposed by the California Taxpayers' Association (Cal-Tax), the Board would adopt language for Property Tax Rule 21 which includes language stating that the term of possession for valuation purposes shall be the stated term of possession if there is an enforceable agreement containing a stated term. In effect, the term of possession is restricted to the remaining term of possession on the valuation date under the "enforceable agreement" for the taxable possessory interest.

Background, Methodology, and Assumptions

The periods of time for which possessory interests are granted vary with the use of the properties, locations, and the policies of the public fee owner. Examples of taxable possessory interests include boat slips at public marinas, tie-downs and hangars at public airports, grazing land permits, employee housing on tax-exempt land, harbor leases, airline and concessionaire facilities at municipal airports, mineral rights in public lands, cable television interests in public streets, and permitted use of U.S. Forest Service property such as ski resorts, stores, and cabins. Terms range from month-to-month tenancies that are renewed each month to contract terms of 30 years or more.

A significant factor in any of the valuation methods used in valuing taxable possessory interests is the term of possession. Under current practice and under the staff recommendation, the term of possession for valuation purposes is the reasonably anticipated term of possession, i.e., the expected remaining period of possession. Under the alternative, the term of possession used in valuing a possessory interest is presumed to be the remaining lease term on the valuation date; however, month-to-month tenancies would be valued assuming a one-year term. For example, a possessory interest for 10 years with 4 years remaining would be valued only for the 4 years that are remaining; and would be valued for a 3-year term of possession in the following year. Under any of the valuation approaches, the value of a taxable possessory interest will be, in many cases, substantially lower under the Cal-Tax proposal than under the recommended definition of "term of possession".

There is no revenue effect under the recommendation since it would continue current practice.

It is difficult to gauge the revenue effect of the Cal-Tax proposal without a comprehensive examination of each taxable possessory interest. Pinpointing the potential effect would require detailed information on the distribution of the form of tenancy, the expiration dates of the leases, the expected remaining terms, the valuation methods used, and the current assessed values for all interests. Much of this information can be found in the appraisal records; however, some required details may not be readily available. Also, it is difficult to predict how future agreements might be affected by this proposal. It is possible that, under the alternative definition, the lives of agreements written in the future would be much shorter than existing ones.

Based on data gathered for the Special Topics Survey, Assessment of Taxable Possessory Interests, published last year, the assessed value of taxable possessory interests totaled more than $22.5 billion in 1999. The year-to-year increase statewide between 1999 and 2000 in assessed values on the county-assessed rolls as reported by the county auditors is 8.3 percent. Assuming that the assessed value of taxable possessory interests grew at the same rate, the estimated total assessed value of possessory interests for 2000 is then:

$22.5 billion x 108.3% or $24.4 billion

It is likely that the values of month-to-month tenancies would be lowered significantly under the Cal-Tax proposal. Although most possessory interests fall into this group, their average assessed value is relatively small. Based on information from Alameda, Los Angeles, San Diego, and San Mateo counties, staff estimates month-to-month tenancies comprise 15 percent of the total value of all possessory interests. The expected remaining term of possession used in these counties and in Riverside and Orange counties for this group ranges from two to ten years. Under the Cal-Tax proposal, they would be valued assuming a one-year term.

2000 assessed value for month-to-month tenancies: $24.4 billion x 15% or $3.66 billion

The value of a month-to-month interest currently valued under the direct income method using a three-year constant term of possession and a discount rate of ten percent would decrease by 63 percent. For a five-year constant term of possession, the value of the interest would be reduced by 76 percent. Assuming that about half of the month-to-month tenancies are currently valued using a three-year term and the other half are valued using a five-year term, the reduction in assessed value for this group can be estimated as follows:

½ x 2000 assessed value for month-to-month tenancies: ½ x $3.66 billion = $1.83 billion

Current term	Reduction
3 year reasonably anticipated term	$1.83 billion x 63% = $1.15 billion
5 year reasonably anticipated term	$1.83 billion x 76% = $1.39 billion
Total	$2.54 billion

The value of month-to-month interests under the alternative definition would drop from $3.66 billion to $1.12 billion ($3.66 billion - $2.54 billion).

The effect on interests with long-term tenancies can be estimated in a similar fashion. Assuming that these would be valued using the direct income method, the most widely used possessory interest valuation method, and that about half of this group are currently valued using a term of 20 years or less and the other half are valued using a term of 21 to 40 years, the reduction in assessed value for long-term tenancies can be estimated as follows:

2000 Assessed value for all other lease terms: $24.4 billion - $3.66 billion = $20.74 billion

½ x 2000 Assessed value for all other lease terms: ½ x $20.74 billion = $10.37 billion

Maximum term	Estimated Percent Reduction	Reduction
1 to 20 years	26%	$10.37 billion x 26% = $2.70 billion
21 to 40 years	19%	$10.37 billion x 19% = $1.97 billion
Total		$4.67 billion

The value of all other lease term interests under the alternative definition would drop from $20.74 billion to $16.07 billion ($20.74 billion - $4.67 billion), and the total assessed value of all taxable possessory interests would drop by $7.21 billion from $24.4 billion to $17.19 billion.

Revenue Summary

There is no revenue effect under the recommendation since it would continue current practice.

The decrease in annual revenues at the basic one percent property tax rate under the Cal-Tax proposal can be computed as follows:

Type	Reduction in assessed value	Revenue at 1%
Month-to-month	$2.54 billion	x 1% = $25.4 million
All other lease terms	$4.67 billion	x 1% = $46.7 million
	$7.21 billion	$72.1 million

Qualifying Remarks

State-assessed taxable possessory interests are not included in this analysis since they account for only about one percent of all taxable possessory interests and it is likely that any potential impact on them would be relatively minor.

It is possible that, under the Cal-Tax proposal, many of the possessory interests, especially the month-to-month interests, would qualify for the low-value property exemption in a particular county. Section 155.20 of the Revenue and Taxation Code permits counties to exempt property where the tax proceeds are less than the costs of administration, up to a full value of less than $5,000, or $50,000 in the case of a possessory interest for a temporary and transitory use. Forty-two counties have adopted ordinances exempting low value properties; of these, 31 counties exempt low value properties by assigning them a taxable value of zero.

Preparation

This revenue estimate was prepared by Aileen Takaha Lee, Research and Statistics Section, Agency Planning and Research Division. The estimate was reviewed by Ms. Laurie Frost, Chief, Agency Planning and Research Division, and Mr. Richard Johnson, Deputy Director, Property Tax Department. For additional information, please contact Ms. Lee at 445-0840.

Current as of June 8, 2001.