STATE OF CALIFORNIA

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450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 322-0050

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December 2, 1993

Honorable Robert C. Petersen
Santa Cruz County Assessor
Courthouse, 701 Ocean Street
Santa Cruz, CA 95060

Dear Mr. Petersen:

This is in response to your letter to Richard Ochsner of November 19, 1993 in which you request our advice concerning the valuation of certain commercial real property recently acquired through inheritance.

The property is subject to a multi-year lease agreement with rents below prevailing market rents. Your staff used economic rents to value the property as of the date of the change in ownership.

After reading Dennis v. County of Santa Clara (1989) 215 Cal.App.3d 1019 and noting numerous references to the phrase "arm's length transaction," you ask:

1. Is the assessor required to use the Dennis case methodology when valuing a non-arm's length transaction?

Answer: Yes. As you know, Revenue and Taxation Code section 110(b) provides, in part, that the purchase price of real property shall "be rebuttably presumed to be the 'full cash value' or 'fair market value' if the terms of the transaction were negotiated at arm's length between a knowledgeable transferor and transferee neither of which could take advantage of the exigencies of the other."

In Dennis, the Court of Appeal interpreted section 110(b) to mean that "an arm's length, open market sale for a price that is not influenced by an exigency of either buyer or seller permits the assessor to presume fair market value from the purchase price, but the presumption may nevertheless be rebutted by evidence that the fair market value of the property is

otherwise." The court held that the assessor properly looked beyond the purchase price which reflected below market leases and properly valued the property using the comparable sales and income approaches. The court in Dennis also held that the fair market value assessment properly reflected the interest of the plaintiff (lessor) in the property as well as the "bonus value" of the below market leases to the plaintiff's lessees. See also the court's discussion at page 1029 of Clayton v. County of Los Angeles (1972) 26 Cal.App.3d 390 in which an assessment based on economic rent rather than contract rent was upheld because it properly reflected the interest not only of the owner of the property but also of the entity renting the department store facility at well below market. Thus, although there is no arm's length transaction here because the property was transferred by inheritance, the principles of the Dennis case nevertheless require an assessment based on economic rather than contract rent.

In valuing such property by the income approach to value, Board Rule 8(d) is to the same effect, and specifically provides:

> In valuing property encumbered by a lease, the net income to be capitalized is the amount the property would yield were it not so encumbered, whether this amount exceeds or falls short of the contract rent and whether the lessor or the lessee has agreed to pay the property tax.

2. If the answer is yes, would it be appropriate to use a Proposition 8 reduction to recognize the income limiting aspect of the below market rent provisions of the lease agreement?

Answer: No. In making a Proposition 8 reduction, section 51(b) requires a determination of "full cash value, as defined in Section 110, as of the lien date, taking into account reductions in value due to damage, destruction, depreciation, obsolescence, removal of property, or other factors causing a decline in value." A lease at below market rentals is not a factor causing a decline in value. As indicated above, a valuation of property based on contract rent which is below economic rent reflects only the value of the lessor's interest and does not include the bonus value of the leasehold interest. An assessment at fair market value must reflect the value of all the interests in the property, i.e., both the interests of the lessor and the lessee. It would, therefore, be improper to appraise the property by recognizing "the income limiting aspect of the below market rent provisions of the lease agreement."

Our intention is to provide timely, courteous and helpful responses to inquiries such as yours. Suggestions that help us to accomplish this goal are appreciated.

Very truly yours,

Eric F. Eisenlauer

Eric F. Eisenlauer
Staff Counsel III

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cc: Mr. John Hagerty -- MIC:63
Mr. Verne Walton -- MIC:64