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July 31, 2000

RE: ***Interpretation of Property Tax Rule 25(b)***

Dear Mr. :

This is in reply to your March 14, 2000 request to Assistant Chief Counsel Lawrence A. Augusta regarding the interpretation of Property Tax Rule 25(b).

As discussed further below, it is our opinion that (1) a lessor's gross rental income generally should be reduced by both a reasonable vacancy and loss factor and typical management and other operating expenses of the lessor to arrive at the income to be capitalized; (2) net rental income may be considered the same as gross rental income where a lessee is responsible for all expenses, as in a "triple net" or "net" lease situation; however, in general, gross income must always be reduced by various types of expenses to arrive at net income and the income to be capitalized; and (3) if an amount for property taxes is included in the income being capitalized, then a property tax component should be added to the capitalization rate, but if property taxes will not be paid out of the income being capitalized, it is not necessary to add a property tax component to the capitalization rate. Each of the questions presented in your letter is reviewed individually below.

Factual Background

As detailed in your letter and in follow-up telephone conversations with you, the valuation of a lessee's possessory interest, a concessionaire, has been based upon the gross rents received by the lessor/public owner without adjustment for operating expenses prior to capitalization, such as operating expenses (i.e., electrical, sewer, etc.) incurred by the lessor. Property taxes, however, have been passed through and paid by the lessee. The county has contended that gross income is equivalent to net income. The valuation of this possessory interest is currently the subject of an assessment appeal in County.

Law and Analysis

QUESTION 1—It is our understanding that the gross income can be reduced by deducting (1) the Lessor's expenses necessary to maintain the income stream and (2) a reasonable vacancy and collection loss factor. As used in Property Tax Rule 25, what is the definition of "net income" and are there any circumstances where the net income might be considered the same as gross income?

Before answering the question above, a couple of valuation principles should be noted. First, the direct income approach is not a preferred valuation method over the indirect income approach. The particular income method should be applied as circumstances permit. Property Tax Rule 25(b) provides in part that

> The direct income method is preferred over the indirect income method when the remaining economic life of wasting assets does not exceed the estimated term of possession or when a constant income stream is projected. The indirect income method is preferred when the remaining economic life of wasting assets exceeds the estimated term of possession.

Second, when applying the income approach, the use of contract rent (e.g., rent to the lessor) should only be used for valuation purposes if the contract rent provides good evidence of economic rent. Property Tax Rule 8(e) provides in part that

> Recently derived income and recently negotiated rents . . . (plus any taxes paid on the property by the lessee) of the subject property and comparable properties should be used in estimating the future income if, in the opinion of the appraiser, they are reasonably indicative of the income the property will produce in its highest and best use under prudent management. . . .

With the above as an introduction, Property Tax Rule 25(b) provides in part that

> The net income to be capitalized is either the imputed economic rent, which may be estimated by reference to rentals recently negotiated in a competitive market or, if such evidence is inadequate, by reference to the anticipated gross income of a typical operator of the property subject to the possessory interest, less cost of goods sold and typical management and other operating expenses. When the second of these methods of estimating economic rent is employed, the "other operating expenses" to be deducted do not include amortization, depreciation, depletion charges, debt retirement, interest on funds invested in the possessory interest, the contract rent for the possessory interest, property taxes on the possessory interest, income taxes, or state franchise taxes measured by income.

In the present situation, the "net income to be capitalized" is based upon the contract rent. In other words, the income being capitalized is rental income as opposed to operating income (i.e., "business income").[1] More precisely, the contract rent is being used as an indicator of the economic rent. Based upon the language of Property Tax Rule 25(b) above, an adjustment should then be made to this income--that is, the contract rent being used to impute the economic rent--for associated typical management and other operating expenses. Property Tax Rule 8(c) reiterates this by stating

> The amount to be capitalized is the net return . . . Net return, in this context, is the difference between the gross return and gross outgo. Gross return means any money or money's worth which the property will yield over and above vacancy and collection losses . . . Gross outgo means any outlay of money or money's worth, including current expenses and capital expenditures (or annual allowances therefor) required to develop and maintain the estimated income. Gross outgo does not include amortization, depreciation, or depletion charges, debt retirement, interest on funds invested in the property, or rents and royalties payable by the assessee for use of the property. Property taxes, corporation net income taxes, and corporation franchise taxes measured by net income are also excluded from gross outgo.

Consistent with the above definition of the income to be capitalized, the lessor's gross rental income should be reduced by both a reasonable vacancy and loss factor and typical management and other operating expenses of the lessor. In this situation, in which some operating expenses have been incurred by the lessor/public owner, such as electrical expenses, the income to be capitalized should reflect a reasonable reduction for such expenses.

Regarding the second half of the first question, "are there any circumstances where the net income might be considered the same as gross income", the answer to this part of the question is: possibly. With rental income, depending upon the type of lease agreement, a lessee may be responsible for all expenses, such as with a "triple net" or "net" lease. In this case, the lessor's rental income may not have to be reduced for any operating expenses, as such expenses are being incurred by the lessee. In general, however, gross income must always be reduced by various types of expenses to arrive at the net income; that is, the income to be capitalized.

<u>QUESTION 2(a)</u>—Is the county appraiser's application of a "Property tax adjustment" formula, citing Property Tax Rule 25(b)(2), correct?

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[1] Property Tax Rule 8(e) provides that ". . . Income derived from rental of properties is preferred to income derived from their operation since income derived from operation is the more likely to be influenced by managerial skills and may arise in part from nontaxable property or other sources. . . ."

In general, when estimating the income to be capitalized, ad valorem taxes should not be deducted as an expense because to do so would assume that the value of the subject property is already known (i.e., since property taxes are a function of a property's value, the property's value must be known in order to estimate the taxes). Rather, in accordance with Property Tax Rule 8(f), a component for property taxes is added to the capitalization rate. However, this issue must be further analyzed in terms of the lease type (i.e., a gross lease or a net lease).

When capitalizing rental income under a gross lease, in which the lessor pays for all expenses, including property taxes, out of the rental income, it is unnecessary to add an amount to the stated rent for property taxes as the rent already contains, implicitly, an amount for property taxes. A component for property taxes should be added to the capitalization rate when capitalizing such income, as an amount for property taxes is implicitly included in this income. In other words, if an amount for property taxes is included in the income being capitalized, then a property tax component should be added to the capitalization rate. (Property Tax Rule 25(b).)

Under a net lease, the lessee pays the property taxes separately, *in addition to the stated rent,* so an amount for property taxes should not be added to the stated rent. Here, the addition of a component for property taxes to the capitalization rate is not required as property taxes will not be paid out of the rental income that is being capitalized. In other words, if an amount for property taxes is not included in the income being capitalized, then a property tax component should <u>not</u> be added to the capitalization rate.

Thus, there must be a consistent application of the property tax component to the rent income capitalized. As Property Tax Rule 8(f) provides, the capitalization rate should include a property tax component "where applicable". To reiterate, if an amount for property taxes is included in the income being capitalized, then a property tax component should be added to the capitalization rate. If, on the other hand, an amount for property taxes is not included in the income being capitalized, then a property tax component should not be added to the capitalization rate.

<u>QUESTION 2(b)</u>—Is there a section of the Property Tax Code that outlines the proper use of the "Property tax adjustment"?

There is no Revenue and Taxation Code section that addresses or defines the term "property tax adjustment." This term is only addressed in Property Tax Rules 8 and 25 and is discussed, in passing, in Assessors' Handbooks 501 and 502.

The views expressed in this letter are only advisory in nature. They represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity. You may wish to contact the County Assessor's Office to ascertain whether it is in agreement with the analysis and conclusions set forth herein.

Very truly yours,

/s/ Anthony Epolite

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Tax Counsel

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