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May 10, 2002

TO INTERESTED PARTIES:

ASSESSORS' HANDBOOK SECTION 510,
ASSESSMENT OF POSSESSORY INTERESTS

In LTA 2001/068, dated November 1, 2001, the Board announced a project to revise Assessors' Handbook Section 510, *Assessment of Possessory Interests* (AH 510). Staff has completed a draft of the revision, a copy of which is enclosed for your review.

Interested parties may submit proposed changes to the AH 510 draft in the form of alternative text (i.e., specific language that adds to, deletes from, or modifies the text in the draft). Please identify the page and line number of all proposed changes. Proposed changes will be accepted until July 12, 2002. Staff will review the suggested changes submitted and incorporate into the draft those changes that are deemed appropriate.

After reviewing comments received from interested parties, the project will proceed as follows:

- Staff will meet with interested parties on October 8, 2002, to discuss proposed changes to the draft. The meeting is scheduled to begin at 9:30 a.m. in Room 122, Board of Equalization, 450 N Street, Sacramento. The purpose of the meeting is to arrive at final language for the handbook. Staff will distribute an agenda matrix prior to the meeting.

- Staff will submit an issue paper and other required documents for the December 18, 2002 Property Tax Committee meeting at which the Committee will hear discussion regarding the revised handbook section.

If you have questions or comments regarding the enclosed draft, please contact Mr. Paul Lane at (916) 324-5828, paul.lane@boe.ca.gov. This letter and all future letters regarding this project will be posted on the Board's Web site and can be accessed by way of the following links: 1) Property Taxes, 2) Property Tax Committee Work Plans, and 3) Property Tax Committee Work Plans 2002.

Sincerely,

/s/ David J. Gau

David J. Gau
Deputy Director
Property Taxes Department

DJG:pl
Enclosure

DRAFT

ASSESSORS' HANDBOOK
SECTION 510

ASSESSMENT OF TAXABLE POSSESSORY INTERESTS

MAY 2002

CALIFORNIA STATE BOARD OF EQUALIZATION

Preface

The original version of this manual was issued as Assessors' Handbook Section 517, *Appraisal of Possessory Interests*, in February 1955, shortly before the landmark decision in *De Luz Homes, Inc.* v. *County of San Diego*. The manual was revised in 1968, 1971, and 1974. The 1971 revision was significant, incorporating the provisions of the first set of property tax rules to address taxable possessory interests, which were also adopted by the Board that year. The 1974 revision added a chapter about the appraisal of ski resorts, including a sample appraisal of this form of taxable possessory interest. In 1997 the manual was reformatted, renumbered, and retitled *Assessment of Possessory Interests*, without change in content.

In this revision, the manual has been substantially reorganized and rewritten (and retitled as *Assessment of Taxable Possessory Interests*). Notable differences between this and the previous manual include the following: 1) greater discussion of the standards, or criteria, for establishing that a taxable possessory interest exists; 2) coverage of the application of Article XIII A of the California Constitution (added by 1978's "Proposition 13") to taxable possessory interests (law that came into being after the previous version of the manual); and 3) inclusion of a "special topics" chapter that discusses statutory provisions that apply to specific types of taxable possessory interests and other special issues. The chapter and sample appraisal concerning ski resorts has been deleted.

Based on data supplied by assessors and Board data, the total assessed value of taxable possessory interests in California was about $25 billion for the 2000 assessment year, which represented about 1.1 percent of the assessed value of all property subject to taxation ($2.3 trillion). While this may seem insignificant, the relative importance of taxable possessory interest assessments to the local assessment roll varies from county to county; in a few smaller counties in particular, taxable possessory interest assessments represent a significantly higher percentage of the local assessment roll than the statewide average and hence also a greater part of the assessment workload.

The valuation of taxable possessory interests is a specialized type of valuation that, in large part, is applicable only to valuation for property tax purposes, and this manual is primarily directed toward property tax appraisers and others working in assessors offices. But we also hope the manual will be useful to others with questions concerning this form of assessment.

Section 15606, subdivision (c), of the Government Code directs the State Board of Equalization to prescribe rules and regulations governing local boards of equalization in the performance of their duties, and subdivision (f) provides that the Board shall issue instructions, such as those set forth in this handbook. While regulations adopted by the State Board of Equalization are binding as law, Board-adopted handbooks are advisory only. Nevertheless, courts have held that they may be properly considered as evidence in the adjudicatory process.[1]

As part of the process of producing this manual, Board staff worked with members of the California Assessors' Association, industry representatives, and other interested parties to solicit input for this handbook section. The Board approved this section to the handbook on _________.

David J. Gau
Deputy Director
Property Taxes Department
Date

[1] *Coca-Cola Co.* v. *State Board of Equalization* (1945) 25 Cal.2d 918; *Prudential Ins. Co.* v. *City and County of San Francisco* (1987) 191 Cal.App.3d 1142; *Hunt-Wesson Foods, Inc.* v. *County of Alameda* (1974) 41 Cal.App.3d 163.

CONTENTS

CHAPTER 1: INTRODUCTION 1

CHAPTER 2: DEFINING A TAXABLE POSSESSORY INTEREST 3

Legal Background 3
Current Statutory and Regulatory Provisions 5
Special Cases Regarding What Constitutes a Taxable Possessory Interest 11
  Personal Property *11*
  Fixtures *12*
  Natural Resource Property *12*
  Federal Enclaves *13*
  Indian Lands *13*
Examples of Taxable Possessory Interests 14

CHAPTER 3: VALUATION OF TAXABLE POSSESSORY INTERESTS 16

General Concepts 16
  Standard of Value *16*
  Review of Property Interests *17*
  Pre- and Post-De Luz Taxable Possessory Interests *19*
  Term of Possession *21*
Taxable Possessory Interest Valuation Methods 24
  Valuation of Post-De Luz Taxable Possessory Interests *25*
  Valuation of Pre-De Luz Taxable Possessory Interests *45*
  Applicability of Valuation Methods *47*

CHAPTER 4: TAXABLE POSSESSORY INTERESTS AND ARTICLE XIII A OF THE CALIFORNIA CONSTITUTION 49

Base Year Value 49
Taxable Value on Each Lien Date 49
Change in Ownership 50
  Review of Legal Provisions *50*
  Subleases and Change in Ownership *54*
  Change in Ownership and Leased Property Acquired by a Public Entity *55*
  Month-to-Month Tenancies and Change in Ownership *56*
New Construction 56
Supplemental Assessment 57
Low-Value Exemption 59
Disaster Relief 60

CHAPTER 5: SPECIAL ASPECTS OF TAXABLE POSSESSORY INTEREST ASSESSMENT 61

Discovery of Taxable Possessory Interests 61
Assessment Enrollment 62
Taxable Possessory Interests and Property Taxable Under Section 11 of Article XIII of the California Constitution 63
Taxable Possessory Interests and Investment Property of Public Employees Retirement Systems 68
  Local Public Employees Retirement System: Real Property Inside System's Boundaries *68*

Local Public Employees Retirement System: Real Property Outside System's Boundaries *69*
State Public Employees Retirement Systems *70*
PROPERTY OF THE CALIFORNIA DEPARTMENT OF TRANSPORTATION 73
PROPERTY LEASED FROM REDEVELOPMENT AGENCIES 73
SECTION 107.7: VALUATION OF CABLE TELEVISION INTERESTS 74
SECTION 107.8: LEASE-LEASEBACK TRANSACTIONS INVOLVING A PUBLIC OWNER OF REAL PROPERTY 75
SECTION 107.9: OTHER TAXABLE POSSESSORY INTERESTS IN PUBLICLY OWNED AIRPORTS 76
SECTION 201.5: TAXABLE POSSESSORY INTERESTS IN PROPERTY ACQUIRED BY OR FOR THE CALIFORNIA POLLUTION CONTROL FINANCING AGENCY 77
APPENDIX: LEGAL PROVISIONS 78
STATUTES 78
REGULATIONS 79
COURT CASES 80
GLOSSARY 88

CHAPTER 1: INTRODUCTION

Rights in real property are often compared to a bundle of sticks, with each stick representing a different right or interest. The entire bundle of sticks represents the complete set of rights, which is called the fee simple interest.

The bundle of rights can be divided in almost innumerable ways. In a possessory interest, the ownership of the possessory rights in real property is separated from the ownership of the fee interest. Generally, a possessory interest consists of a right to the possession of real property for a period less than perpetuity by one party, the holder of the possessory interest, while another party, the fee simple owner, retains the right to regain possession of the real property at a future date.

The most common example of a possessory interest is the interest created by a lease. The tenant's (or lessee's) right to possession of the property is called the leasehold interest. The landlord's (or lessor's) right to receive rents during the term of the lease and to regain possession of the property when the lease terminates is called the leased fee interest. In the case of privately owned real property, both the tenant's and the landlord's interests are taxable, and typically both interests are valued and assessed in the aggregate to the landlord, or fee owner. It is not necessary, or administratively feasible, for the assessor to separately assess the value of the leasehold (i.e., possessory) interest and the value of the leased fee (i.e., nonpossessory) interest; instead, the assessor typically makes a single assessment of the entire taxable interest in the real property.

The subject of this manual (as the separately published sections of the *Assessors' Handbook* are often referred to) is the assessment of taxable possessory interests. A "taxable possessory interest" is a possessory interest that is separately taxable to the possessor. For introductory purposes, a taxable possessory interest can be defined as the taxable interest held by a private possessor in publicly owned real property. The public owner may be the United States of America and its administrative instrumentalities; the state of California; or one of California's local jurisdictions, which include counties, cities, and special districts. With a taxable possessory interest, since the underlying fee simple interest held by the public owner is almost always tax exempt, it is necessary to separately value the possessory interest held by the private possessor.[2]

The legal basis for the taxation of taxable possessory interests is found in the general mandate of the California Constitution, article XIII, section 1, that all property is taxable unless otherwise provided by the California Constitution or federal law. "Property," as defined is sections 103 and 104 of the Revenue and Taxation Code, includes "all matters and things, real, personal and mixed, capable of private ownership," and "real estate," or "real property," includes "the possession of, claim to, ownership of, or right to possession of land and improvements." There is also statutory,

[2] The vast majority of taxable possessory interests involve tax exempt publicly owned real property. It is possible, however, to have a taxable possessory interest in taxable publicly owned real property. This occurs when the publicly owned real property is taxable under section 11 of article XIII of the California Constitution. The assessment of taxable possessory interests in taxable publicly owned property is discussed in Chapter 5. Also, with one minor exception discussed later, taxable possessory interests may only exist in real property, and taxable possessory interests are classified as real property for assessment purposes. This is discussed in Chapter 2.

regulatory, and judicial authority for the assessment, under specified conditions, of the private, beneficial right to the possession of publicly owned real property.[3]

Thus, although publicly owned real property is generally either immune from taxation—in the case of federal property—or exempt from taxation—in the case of state and local government property—under certain conditions, the private, beneficial right to the possession of publicly owned real property is subject to separate assessment as a taxable possessory interest.

In brief, the remaining contents of this manual are as follows:

- In Chapter 2, we discuss one of the two fundamental questions of taxable possessory interest assessment: how to determine whether the relation between the private possessor and the publicly owned real property constitutes a taxable possessory interest. The answer to this question is determined by legal criteria. It is also a threshold question, because if there is no taxable possessory interest, there is obviously nothing to assess.
- In Chapter 3, we discuss the second fundamental question: how to value a taxable possessory interest. The valuation approaches used with taxable possessory interests are similar to those used to value other real property, but they must be modified because only a partial interest is being valued, not the full fee simple interest generally valued in property tax assessments.
- A taxable possessory interest assessment is subject to the provisions of article XIII A of the California Constitution (added by 1978's "Proposition 13") and its implementing legislation and regulations. We discuss the application of article XIII A to taxable possessory interest assessments in Chapter 4.
- Finally, in Chapter 5, we address several "special topics" associated with the assessment of taxable possessory interests. Among other topics, this chapter discusses assessment discovery, reviews several specific statutory provisions that apply to certain types of taxable possessory interests, and analyzes the assessment of taxable possessory interests in taxable publicly owned real property (i.e., real property that is taxable under section 11 of article XIII of the California Constitution).

[3] Unless otherwise indicated, all references to "section" refer to sections of the California Revenue and Taxation Code and all references to "rule" or "property tax rule" refer to a section of Title 18, California Code of Regulations.

CHAPTER 2: DEFINING A TAXABLE POSSESSORY INTEREST

This chapter attempts to provide the appraiser with a general understanding of what constitutes a taxable possessory interest, that is, how a taxable possessory interest is defined in California law. First, we present a brief review of the legal development of the topic. Second, we analyze the current statutory and regulatory provisions that define taxable possessory interests: namely, Revenue and Taxation Code section 107 and Property Tax Rule 20. Third, we discuss a few special cases concerning what constitutes a taxable possessory interest. Finally, we present examples of property relations that do and do not constitute taxable possessory interests.

LEGAL BACKGROUND

There have been many appellate cases concerning what constitutes a taxable possessory interest. A comprehensive review of these cases is beyond the scope of this manual. The purpose here is much more limited: to provide some brief legal background to facilitate the discussion of current statutory and regulatory provisions in the next section.[4]

There is longstanding judicial support for the taxable nature of the private possession of publicly owned property. In 1859, in *State* v. *Moore*, the California Supreme Court held that a private mining claim on federal land constituted taxable property, even though the land itself (i.e., the underlying fee simple interest) was immune from taxation under the terms of the agreement that admitted California to the Union. In *Moore*, the court began the process of defining a taxable possessory interest:

> The term 'property in lands' is not confined to title in fee, but is sufficiently comprehensive to include any usufructuary interest, whether it be a leasehold or a mere right of possession. Several persons may have, in the same land, a property which is subject to taxation, and it is not perceived that the fact, that the property of the Government is exempt from taxation, affects the right to tax the interest which private individuals have acquired in the same property. Exemption from taxation is a privilege of the Government, not an incident of the property.[5]

Shortly thereafter, in *People* v. *Shearer*, the California Supreme Court again recognized a private taxable interest in federal land. A private possessor, Shearer, had adversely possessed federal lands for agricultural purposes, also constructing improvements. The court ruled that the private possessor's mere occupancy, or possession, constituted a taxable interest, as did the improvements to the land constructed by the possessor:

> The possession itself of the public lands whether by naked trespassers, or those who claim in addition a right of pre-emption, as to everybody except the United States, have always in California, and in most, if not all the new States, been

[4] The Appendix contains a list of cases relevant to taxable possessory interests.
[5] *State* v. *Moore* (1859) 12 Cal. 56.

> regarded as valuable property interests…. Such possession of the public lands, and the improvements put upon them, are, therefore, recognized and protected as a valuable species of property in the possessor.
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> * * * * * * * * *
>
> It is not the land itself, nor the title to the land, nor is it the identical estate held by the United States. It is not the pre-emption right, but it is the possession and valuable use of the land subsisting in the citizen. Why should it not contribute its proper share, according to the value of the interest, what it may be, of the taxes necessary to sustain the Government which recognizes and protects it.[6]

There were also early statutory enactments involving taxable possessory interests. In the Field Codes of 1872 (an early codification of California law), the possession or right to possession, as distinguished from the ownership, of land and improvements became taxable. In 1895, the taxable nature of a possessory right in tax-exempt land first received statutory recognition. In 1921, a statute first specifically provided for the assessment of taxable improvements on tax-exempt land.

In 1919, in *San Pedro, Los Angeles & Salt Lake Railroad Co.* v. *City of Los Angeles*, the California Supreme Court applied the same rationale for taxing possessory interests in federal lands to state lands.[7] The case involved a leasehold interest in state tidelands. The court characterized the leasehold as a property interest fully taxable pursuant to the constitutional mandate that all nonexempt property was subject to tax, concluding that the reversion holder's (i.e., the public owner's) tax-exempt status should not allow the leasehold interest to escape taxation and that the lessee should be separately assessed and taxed on the value of the leasehold interest.

In 1939, existing California tax law was recodified into the Revenue and Taxation Code, which became effective February 1, 1941. At that time the Legislature also enacted the first possessory interest law. This new statute reinstated the provisions of section 3820 of the old Political Code that had defined a possessory interest as (1) "possession of, claim to, or right to the possession of land or improvements, except when resulting from ownership of the land or improvements" and (2) "taxable improvements on tax exempt land" into the initial version of Revenue and Taxation Code section 107. Then, as now, section 107 defines a taxable possessory interest as an interest in tax-exempt land and improvements only; the statutory definition of a possessory interest excludes interests in personal property.

Kaiser v. *Reid* is the most significant "modern era" case that addresses what constitutes a taxable possessory interest.[8] The 1947 case involved Kaiser Co.'s exclusive possession of federally owned shipyards during World War II. In its holding, the California Supreme Court provided a set of criteria, or standards, for determining when a private possessory right constitutes a taxable possessory interest. These criteria still provide the legal framework for defining taxable

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[6] *People* v. *Shearer* (1866) 30 Cal. 645, 655-657.
[7] *San Pedro, Los Angeles & Salt Lake Railroad. Co.* v. *City of Los Angeles* (1919) 180 Cal. 18.
[8] *Kaiser Co., Inc.* v. *Reid* (1947) 30 Cal.2d 610.

possessory interests. In *Kaiser*, the court established three criteria to determine when a possessory interest exists:

1. The possessor must possess a right to possess public land for an ascertainable period.
2. The possessor must hold the interest exclusive "against all the world, including the rightful owner."
3. The possessor must receive a private benefit.

The law subsequently has evolved such that four primary criteria—each of which derives, directly or indirectly, from *Kaiser*—must be met for a possessor's interest in publicly owned real property to constitute a taxable possessory interest:

1. Independence
2. Durability (*Kaiser*'s "ascertainable")
3. Exclusivity
4. Private benefit

These criteria have been codified into both statute and regulation and will be discussed at greater length in the next section.

Another important aspect of *Kaiser*, related to its criterion of durability, was its holding that neither the government's ability to terminate a contract at will nor its prohibition on a transfer of the contractor's interest reduced the interest to a "nontaxable license." The court reasoned that, until the date of termination, the contractor had "exclusive possession of the premises against all the world, including the owner." The court found that the government's restrictions were matters that affected valuation, not whether or not a taxable possessory interest existed.

CURRENT STATUTORY AND REGULATORY PROVISIONS

In 1971, the Board incorporated the *Kaiser*-based criteria into its first group of administrative regulations governing the assessment of taxable possessory interests. In 1996, the criteria were incorporated into statute through amendments to existing section 107. Parts of then-existing Property Tax Rule 21 (the regulation that had addressed what constitutes a taxable possessory interest) were inconsistent with amended section 107, and a new regulation was promulgated in 1997, Property Tax Rule 20, which defines a taxable possessory interest in a manner consistent with the amended section 107.[9]

[9] Portions of Property Tax Rule 21 remained in effect but were subsequently encompassed in new Property Tax Rule 21, adopted in 2002, which addresses the valuation of taxable possessory interests.

Thus, section 107 and Property Tax Rule 20 are the primary statutory and regulatory sources that address what constitutes a taxable possessory interest. The rule follows the statute closely but clarifies it by defining several important terms that appear, but are not defined, in the statute. The following discussion focuses on the provisions of the rule.[10]

Rule 20 begins by defining a "possessory interest" as an interest in real property that results from the possession, a right to the possession, or a claim to a right to the possession of land and improvements that is independent, durable, exclusive of the rights held by others in the property and that provides a private benefit to the possessor.

The first part of the definition ("the possession, a right to possession, or a claim to a right to the possession") derives from the early case law discussed above that broadly construes the type of property relation that could give rise to a taxable possessory interest (this is also the language that appeared in the first version of section 107 in 1941).[11] The second part of the definition ("independence, durability, exclusivity, and private benefit") derives from *Kaiser* and subsequent case law drawing on it.

The rule then states that a possessory interest includes "taxable improvements on tax-exempt land." This refers to privately owned improvements constructed or owned by the possessor (i.e., not the public owner) on the land subject to the taxable possessory interest. This provision makes it clear that a possessory interest includes all improvements constructed pursuant to a possessory interest in land, whether the improvements are constructed at the possessor's or the public owner's expense and regardless of whether the possessor or the public owner holds legal ownership of them. As mentioned earlier, this provision dates to a 1921 statute, which in turn dates back to early case law, such as *People* v. *Shearer*.

Finally, the rule defines a *taxable* possessory interest as simply "a possessory interest in publicly owned real property." Thus, the overall structure of the definition is to first define possessory interests in a manner specific to property taxation and then to define a taxable possessory interest as simply a possessory interest in publicly owned real property.[12]

The remainder of Rule 20 provides definitions for several of the key terms that appear in the general definition described above. The rule defines "possession" and the four criteria cited in the rule: "independence," "durability," "exclusivity," and "private benefit."

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[10] The Appendix lists the statutes and regulations pertinent to taxable possessory interests.

[11] Whether or not a taxable possessory interest exists does not depend on the type of document, if any, that evidences the possession, right to possession, or claim to a right of possession. The fact that no written document exists does not mean that a taxable possessory interest does not exist. Further, if a document does exist, it need not be denominated as a lease (i.e., it could be called an agreement, a permit, a contract, etc.).

[12] In the realm of property assessment, when someone refers to a "possessory interest," the person almost always means a taxable possessory interest as that term is defined in Rule 20 and not "possessory interest" in its general legal sense. In this manual, unless the context clearly indicates otherwise, "possessory interest" means "taxable possessory interest" as that term is defined in Rule 20.

Possession. Rule 20 defines "possession" as meaning actual physical occupation. Thus, possession means something qualitatively different than a possessor's receipt of a mere economic benefit from the use of publicly owned real property that the possessor does not occupy or have the right to occupy. Similarly, the rule defines "a right to the possession" or "a claim to a right to the possession" as meaning a right to or a claim to a right to actual physical occupation.

Independence. Under Rule 20, a possession, a right to possession, or a claim to a right to possession is independent if it is "sufficiently autonomous to constitute more than a mere agency." In other words, if the possessor acts an agent of the public owner, the public owner's immunity or exemption from taxation extends to the possessor's activities, and there is no taxable possessory interest. Although not one of the original *Kaiser* criteria, the independence criterion is derived from them.

To constitute more than a mere agency, in the language of the rule, "the possessor must have the right and ability to exercise significant authority and control over the management or operation of the real property, separate and apart from the policies, statutes, ordinances, rules, and regulations of the public owner of the real property." In general, independence may be measured by the amount of routine control and supervision enjoyed by the possessor, recognizing that the government necessarily retains ultimate control. [13]

> Example: The control of an airport runway or taxiway by the Federal Aviation Administration (FAA) or another government agency or its agent is so complete that it precludes the airlines from exercising sufficient authority and control over the management or operation of the runways or taxiway and does not constitute sufficient "independence" to support a possessory interest.

Durability. The durability criterion derives directly from the *Kaiser* requirement that a taxable possessory interest have a "determinable," or "ascertainable," period of possession or anticipated possession. As defined in Rule 20:

> "Durable" means for a determinable period with a reasonable certainty that the possession of the real property by the possessor, or the possessor's right or claim with respect to the possession of the real property, will continue for that period.

There is no minimum time period, or duration, required to establish durability; the interest must only last for a "determinable" period to satisfy the standard. A month-to-month tenancy can

[13] An agent is one who represents another in dealings with third persons, and the existence of an agency relationship is a question of fact. (California Civil Code section 2295; Witkin *Summary of California Law. 9th*, "Agency and Employment," Section 3.) "[W]hether an agency relationship has been created or exists is determined by the relation of the parties as they in fact exist by agreement or acts and the primary right of control is particularly persuasive." (*Pagan* v. *Spencer* (1951) 104 Cal.App.2d 588, 592- 593.) Factors to be considered to determine if an independent contractor is acting as an agent include the following: (i) whether the principal and agent are engaged in distinct occupations; (ii) the skill required to perform the agent's work; (iii) whether the principal supplies the workplace; (iv) whether the work is part of the principal's regular business; and (v) whether the parties intended to create an agency relationship. (*Ibid*.)

satisfy the durability requirement.[14] In addition, several cases have held that even though a right in publicly owned real property may be revocable or terminable at the option of the government under a lease or contract provision, such a provision is not relevant to whether the right constitutes a taxable possessory interest; rather, it is relevant only to the issue of valuation.[15]

Exclusivity. "Exclusivity" is defined in subsection (c)(7) of Rule 20:

> "Exclusive of rights held by others in the real property" means the enjoyment of an exclusive use of real property, or a right or claim to the enjoyment of an exclusive use together with the ability to exclude from possession by means of legal process others who may interfere with that enjoyment.

In the context of what constitutes a possessory interest, "exclusivity" is not limited to possession by a single individual or entity against all the world. As interpreted by case law, and subsequently codified, a possession of real property that is concurrent with that of another party or parties may still be exclusive. In addition, in order to meet the exclusivity standard, a possessory interest need not provide an exclusive right to provide products or services, only a sufficiently exclusive right to possess real property.

Rule 20 cites the following types of uses of real property, as well as rights and claims to such types of uses, as satisfying the criterion of exclusivity:

1. Sole possession, occupancy, or use of real property.

2. Possession, occupancy, or use of real property as a co-tenant or a co-owner as to leaseholds, easements, profits a prendre, or any other legal or equitable interests in real property of less than fee simple or life estate, where the uses of the co-tenants or co-owners constitute a single use jointly enjoyed.

3. The concurrent use of real property (but not as a co-tenant or co-owner as in 2. above) by a person who has a primary or prevailing right to use the real property and/or to have its designees use the real property.

   Example: A public marina leases boat slips with a lease provision that allows the marina to rent a leased boat slip to a short-term user if the primary lessee is away; subject to the primary lessee's right to exclude the short-term user on the primary lessee's return. Under these facts, the primary lessee has a primary and prevailing right to use the leased boat slip.

   Example: For purposes of this subdivision, concurrent use of real property demonstrating a primary or prevailing right also includes alternating uses of the same

[14] In regard to month-to-month tenancy, see *McCaslin* v. *DeCamp* (1967) 248 Cal. App. 2d 13.

[15] Beginning, in fact, with *Kaiser Co., Inc.* v. *Reid* (1947) 30 Cal.2d 610. See also *Lucas* v. *County of Monterey* (1977) 65 Cal.App.3d 947,956; *Board of Supervisors* (1971) v. *Archer* 18 Cal.App.3d 717; and *United States of America* v. *County of Fresno* (1975) 50 Cal.App.3d 633.

real property by more than one party, such as the case when certain premises are used by a professional basketball team on certain days of each week while a professional hockey team uses the same premises on certain other days.

4. Concurrent uses of real property (but not as co-tenants or co-owners as in 2. above) making qualitatively different uses of the real property.

   Examples of "qualitatively different" uses: (1) those by persons making different kinds of uses of the same real property, such as the case when one person is developing mineral resources on real property while others are concurrently enjoying recreational uses on the same real property; and (2) those where different persons have the right to concurrently enter onto and take different things from the same real property.

5. Concurrent uses of real property (but not as co-tenants or co-owners as in 2. above) engaged in qualitatively similar uses that diminish the quantity or quality of the real property.

   Examples of uses that diminish the quantity or quality of the real property: (1) grazing cattle; (2) mining; (3) the extraction of oil or gas; and (4) the extraction of geothermal energy.

6. Concurrent uses of real property (but not as co-tenants or co-owners as in 2. above) that do not diminish the quantity or quality of the real property, provided that the number of concurrent use grants is restricted. "Concurrent use grants" include grants, permits, deeds, agreements, and other documents that provide rights to the concurrent use of real property. The number of concurrent use grants is "restricted" when the number is limited by law or by the policies or management decisions of the public owner of the real property or other public agency.

   Example: Commercial rafting outfitters have a county use permit to commercially operate on a river. While any private recreational user may raft on the river without limitation or regulation, only approximately 80 commercial rafting outfitters are presently allowed to operate under permit on the river. The commercial rafting outfitters' use of the river is exclusive for purposes of this regulation since the number of commercial use permits issued by the county to commercial rafting outfitters is restricted, regardless of whether or not the commercial rafting outfitters' use of the river diminishes its quantity or quality.

   Example: X operates a shuttle van service, picking up passengers at their homes and other locations and transporting them to the airport. When the shuttle van reaches the airport, it utilizes the public street which surrounds the airport to drop passengers off at the various terminals at the airport. The street around the airport is available to all licensed drivers, for commercial and noncommercial uses. Neither the traffic laws, nor the policies or management decisions of the public owner of the airport facility restrict the number of users of the public street. In addition, under the assumed facts of this hypothetical, X's use of the public street surrounding the airport does not diminish the quantity or quality of the real property.

Given that (i) the shuttle vans using the public street are making qualitatively similar uses of that real property; (ii) there are no facts indicating that the quality or quantity of the real property is being diminished; and (iii) the number of users of the real property is not restricted, X's right to use the public street surrounding the airport is not exclusive, and X does not have a possessory interest in the public street surrounding the airport.

Private Benefit. The private benefit criterion was one of the original requirements in *Kaiser*, and in recent history, it perhaps has been the dominant factor in judicial analyses of what constitutes a taxable possessory interest. Private benefit is defined in subsection (c)(8) of Rule 20:

> "Private benefit" means that the possessor has the opportunity to make a profit, or to use or be provided an amenity, or to pursue a private purpose in conjunction with its use of the possessory interest. The use should be of some private or economic benefit to the possessor that is not shared by the general public. The fact that a possession of real property is not for a business or commercial purpose or that the possessor is a non-profit corporation does not preclude the possessor from being found to have received a "private benefit" from that possession.

The requirement of private benefit is met if there is an opportunity for the holder of the possessory interest to make a profit; significantly, however, as the above definition indicates, the absence of an opportunity to make a profit does not necessarily mean that the requirement of a private benefit is not met. The scope of "private benefit" is broad. If the possession or use confers some amenity, or allows the pursuit of some private purpose, economic or otherwise, that is not available to the public at large, courts have generally deemed the requirement for private benefit satisfied.[16]

In summary, consistent with the criteria discussed above and the meaning of Rule 20, the private possession of publicly owned real property is taxable only if the possessor (1) physically occupies or holds either the right to physically occupy or the claim to the right to physically occupy the subject real property; and (2) such occupation, right to occupation, or claim to the right of such occupation is independent, durable, exclusive, and confers a private benefit upon the possessor.

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[16] See *Wells Natl. Service Corp.* v. *County of Santa Clara* (1976) 54 Cal.App.3d 579,585; *Rand Corp.* v. *County of Los Angeles* (1966) 241 Cal.App.2d 585; and *City of San Jose* v. *Carlson* (1997) 57 Cal.App.4th 1348,1359-60, for discussion of private benefit.

SPECIAL CASES REGARDING WHAT CONSTITUTES A TAXABLE POSSESSORY INTEREST

PERSONAL PROPERTY

Beginning with the first possessory interest statute in 1895 down to present section 107, the statutory definition of a possessory interest has always been limited to interests in land and improvements, that is, to interests in real property. Several counties, however, did not interpret this as precluding possessory interests in personal property, and such interests were assessed.

In 1943, in *Douglas Aircraft Co.* v. *Byram*, a California appellate court ruled for the first time on the question of whether or not there could be a taxable possessory interest in tax-exempt personal property.[17] A contractor for the federal government possessed work-in-process and inventories that had been assessed as possessory interests. The court held that no possessory interest existed in the property, stating that the property had none of the characteristics of property for tax purposes "judged by any standard of which we have knowledge" and that the contractor was exercising no "usufructuary right."

The court noted, however, that its decision was not based on section 107 [of the California Revenue and Taxation Code], which confined taxable possessory interests to real property only, since the section had not taken effect until after the taxes in issue had become a lien, and several counties continued to assess possessory interests in personal property.

In 1957, the issue was again litigated in *G. G. Moore & Co. Engineers* v. *Quinn*.[18] Private contractors working for several municipalities possessed component parts of boiler plants that were not yet fabricated into the finished product. Possessory interest assessments were levied against the property. The court held that since legal title or beneficial ownership had passed in all cases to the exempt public agencies, there was no taxable possessory interest in the property.

Finally, in 1958, the California Supreme Court handed down a decision in *General Dynamics Corp.* v. *Los Angeles County* that proved to be definitive.[19] The court held that the state must have a specific statute authorizing the assessment of possessory interests in personal property in order for such assessments to be valid, stating that "[t]he legislature has not defined personal property as including a right to its possession as it has real property." Subsequent legislative efforts to obtain a statute that authorizes the taxation of possessory interests in personal property have been unsuccessful.

The one exception, alluded to above in Chapter 1, is found in section 201.5. Under that section, taxable possessory interests in property acquired by or for the California Pollution Control Financing Authority, whether in real or personal property, are subject to taxation. The California Pollution Control Financing Authority provides financing for pollution control facilities to assist

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[17] *Douglas Aircraft Co.* v. *Byram* (1943) 57 Cal.App.2d 311.
[18] *G. G. Moore & Co. Engineers* v. *Quinn* (1957) 149 Cal.App.2d 666.
[19] *General Dynamics Corp.* v. *Los Angeles County* (1958) 51 Cal.2d 59.

private entities in meeting state environmental standards. This is the only case in which a taxable possessory interest may exist in personal property.

FIXTURES

"Fixture" is defined in Rule 122.5:

> A fixture is an item of tangible property, the nature of which was originally personalty, but which is classified as realty for property tax purposes because it is physically or constructively annexed to realty with the intent that it remain annexed indefinitely.

Thus, a fixture is an item of personal property that, if certain criteria are met, becomes real property. As real property, and assuming the criteria for a taxable possessory interest are met, a taxable possessory interest may exist in a fixture. [20]

NATURAL RESOURCE PROPERTY

Specific legal provisions prescribe assessment methods for certain types of "natural resource" property—oil and gas, mining, and geothermal—that may constitute taxable possessory interests but are assessed under such provisions. Specifically:

- Subdivision (b) of section 107 excludes leasehold estates "for the production of gas, petroleum and other hydrocarbon substances … and other rights relating to these substances which constitute incorporeal hereditaments or profits a prendre" from classification as taxable possessory interests for assessment purposes.
- Rule 468 prescribes a specific method for the assessment of oil and gas producing property.
- Sections 107.2 and 107.3 prescribe a specific assessment method for "certain oil and gas interests" that is analogous to the pre-De Luz assessment method (discussed below) for certain possessory interests prescribed in section 107.1. Rule 27 clarifies and interprets the provisions of sections 107.2 and 107.3.
- Rule 469 prescribes a specific method for the assessment of mining property—that is, for "the rights to explore, develop and produce minerals, other than oil, gas and geothermal resources, and the real property associated with these rights."
- Finally, Rule 473 prescribes a specific method for the valuation of geothermal property.

The assessment of these types of properties is not addressed in this manual. When assessing these types of properties, the appraiser should refer to the statutory and regulatory provisions that apply and to applicable sections of the *Assessors' Handbook*.[21]

[20] Sections 104 and 105 also work together to define fixtures as real property. Under section 104, real property is defined to include land and improvements. Section 105 then defines improvements to include "all buildings, structures, fixtures, and fences erected on or affixed to the land." The subject of fixtures is addressed in AH 504, "Assessment of Personal Property and Fixtures."

FEDERAL ENCLAVES

A "federal enclave" is land to which the United States of America claims exclusive jurisdiction, including jurisdiction over all forms of taxation. Under the United States Constitution, article 1, section 8, clause 19, Congress is empowered as follows:

> To exercise exclusive Legislation in all Cases whatsoever…over all Places purchased by the Consent of the Legislature of the State in which the Same shall be, for the Erection of Forts, Magazines, Arsenals, dock-Yards and other needful Buildings.…

This constitutional provision has been held to invalidate state and local taxes imposed on property in federal enclaves.

Whether or not federal lands are located in a federal enclave, thus proscribing state or local property taxation, may depend upon the date on which the federal government acquired the lands. Prior to 1939, cessions of property from California to the federal government for military purposes did not reserve the power of taxation to the state. In 1939, the state statutorily reserved (in the predecessor of current subdivision (e) of section 126 of the Government Code) the power of taxation as to all later transfers. Thus, in general, a taxable possessory interest may exist in property ceded by the state to the federal government after 1939, but a taxable possessory interest cannot exist, in the absence of express congressional authorization, in property ceded from the state to the federal government prior to 1939.[22]

INDIAN LANDS

In general, real property located on an Indian reservation or real property otherwise held in trust by the U.S. Government for Indians or Indian tribes is nontaxable. If the possessor is a non-Indian, however, a taxable possessory interest in Indian lands will exist if the criteria for establishing a taxable possessory interest are satisfied.[23]

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[21] The valuation of oil and gas property and mining property is addressed in AH 566, "Assessment of Petroleum Properties" and AH 560, "Assessment of Mining Properties."

[22] Information concerning when state lands were ceded to the federal government can be obtained from the State Lands Commission.

[23] See *Agua Caliente Band of Mission Indians* v. *County of Riverside* (9th Cir. 1971) 442 F. 2d 1184 and *Fort Mojave Tribe* v. *County of San Bernardino* (9th Cir. 1976) 543 F. 2d 1253; *Palm Springs Spa. Inc.* v. *Riverside County* (1971) 18 Cal.App.3d 372.

EXAMPLES OF TAXABLE POSSESSORY INTERESTS

The following is a listing of types of private interests in publicly owned real property that have been found, under certain factual circumstances, to constitute taxable possessory interests. The listing is not all inclusive.

TYPE OF PRIVATE POSSESSION	CITATION
Airport office and counter space	*County of Los Angeles* v. *County of Los Angeles AAB No. 1* (1993) 13 Cal.App.4th 102
Amusement machine concession	*Freeman* v. *Fresno County* (1981) 126 Cal.App.3d 459
Berthing and use of related facilities at public harbors and marinas	*Euro-Pacific* v. *Alameda County* (1992) 11 Cal.App.4th 891; *Lucas* v. *County of Monterey* (1977) 65 Cal.App.3d 947; *Sea-Land Service, Inc.* v. *Alameda County* (1974) 36 Cal.App.3d 837; *Seatrain Terminals of California, Inc.* v. *Alameda County* (1978) 83 Cal.App.3rd 69
Commercial rafting operation	*Scott-Free River Expeditions, Inc.* v. *El Dorado County* (1988) 203 Cal.App.3d 896
Convention facilities used on a short-term, recurrent (two or more times) basis	*City of San Jose* v. *Carlson* (1997) 57 Cal.App.4th 1348
Employee-occupied residence on national forest lands	*United States* v. *Fresno County* (1975) 50 Cal.App.3d 633
Federal shipyard for the construction of ships	*Kaiser Co., Inc.* v. *Reid* (1947) 30 Cal.2d 610
Food and drink concession at stadium	*Stadium Concessions, Inc.* v. *City of Los Angeles* (1976) 60 Cal.App.3d 215; *Service America Corporation* v. *San Diego County* (1993) 15 Cal.App.4th 1232
Ground leases provided to faculty for residential purposes on land owned by a state university	*Connolly* v. *Orange County* (1992) 1 Cal.4th 1105
Grazing of livestock on national forest lands	*Board of Supervisors* v. *Archer* (1971) 18 Cal.App.3d 717; *Dressler* v. *Alpine County* (1976) 64 Cal.App.3d 557; *El Tejon Cattle Co.* v. *San Diego County* (1966) 64 Cal.2d 428
Lease held by a non-Indian in real property held in trust by the federal government for the benefit of reservation Indians	*Fort Mojave Tribe* v. *San Bernardino County* (1976) 543 F.2d 1253, cert. den. 430 U.S. 983

TYPE OF PRIVATE POSSESSION	CITATION
Leased land that is improved, then leased back to a city in a lease-leaseback transaction	*City of Desert Hot Springs* v. *Riverside County* (1979) 91 Cal.App.3d 441
Rental of television sets to patients in a county hospital	*Wells National Services Corporation* v. *Santa Clara County* (1976) 54 Cal.App.3d 579
Rights in real property associated with a cable television franchise	*Cox Cable San Diego, Inc.* v. *San Diego County* (1986) 185 Cal.App.3d 368; *Stanislaus County* v. *Assessment Appeals Board* (1989) 213 Cal.App.3d 1445
Single-family residence owned by an irrigation district and occupied by a district employee	*McCaslin* v. *DeCamp* (1967) 248 Cal.App.2d 13
Snack bar at a golf course clubhouse	*Mattson* v. *Contra Costa County* (1968) 258 Cal.App.2d 205.
Stationary vessel permanently affixed and used as a restaurant	*Specialty Restaurants Corporation* v. *Los Angeles County* (1980) 111 Cal.App.3d 607

The following is a listing of types of private interests in publicly owned real property that have been found, under certain factual circumstances, not to constitute taxable possessory interests. The listing is not all inclusive.

TYPE OF PRIVATE POSSESSION	CITATION
Dwelling units provided to military personnel	*United States* v. *Humboldt County* (1980) 628 F.2d 549
Employee-occupied living quarters at the exempt property of colleges and hospitals that is reasonably necessary to the exempt purposes	*English* v. *County of Alameda* (1977) 70 Cal.App.3rd 226
Management and operation of conference facilities	*Pacific Grove-Asilomar Operating Corp.* v. *Monterey County* (1974) 43 Cal.App.3d 675
Nonexclusive right to use airport real property in common with the general public	*County of Los Angeles* v. *County of Los Angeles AAB No. 1* (1993) 13 Cal.App.4th 102
Student-occupied residences on university-owned real property	*Mann* v. *County of Alameda* (1978) 85 Cal.App.3rd 505

CHAPTER 3: VALUATION OF TAXABLE POSSESSORY INTERESTS

This chapter discusses the valuation of taxable possessory interests. The chapter begins with a discussion of a few general concepts related to the valuation of taxable possessory interests in general and then discusses each of the specific taxable possessory interest valuation approaches. The valuation of taxable possessory interests is primarily addressed in rule, not statute, with Rule 21 as the primary rule that addresses valuation.[24]

There are also several statutory provisions that apply to specific types of taxable possessory interests such that, if the assessor follows the prescribed valuation method, the assessment retains the presumption of correctness; conversely, if the prescribed method is not followed, the assessment's assumption of correctness is lost. These statutes are discussed in Chapter 5.

GENERAL CONCEPTS

STANDARD OF VALUE

General. Under section 1 of article XIII of the California Constitution (and considered in conjunction with the provisions of article XIII A ["Proposition 13"]), all property is taxed according to its "full value," meaning its fair market value, unless an alternative standard of value is constitutionally prescribed. There is no special standard prescribed for most types of taxable possessory interests; therefore, the standard of value for the assessment of taxable possessory interests generally is fair market value, the same standard that generally applies to all other taxable property.[25]

The applicability of the market value standard to taxable possessory interests also was made clear by the California Supreme Court in *De Luz Homes, Inc.* v. *County of San Diego*:

> The standard of "full cash value" applies equally to a leasehold [i.e., taxable possessory] interest. Accordingly, the assessor must estimate the price a leasehold would bring on an open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other. He must therefore capitalize, not the anticipated net earnings of the present lessee, but those of a prospective assignee.

The precise definition of fair market value for assessment purposes is found in section 110:

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[24] Rule 21 was significantly revised in the year 2002. Existing Rules 21, 23, 24, 25, and 26, each of which had addressed separate aspects of taxable possessory interest valuation, were combined into new Property Tax Rule 21, which addresses taxable possessory interest valuation in a single rule.

[25] The taxable possessory interests addressed in section 107.1—that is, "pre-*De Luz*" taxable possessory interests—are an exception. Under section 107.1, the full cash value of a pre-*De Luz* taxable possessory interest is the "excess value" of the lease on the open market. Pre-*De Luz* taxable possessory interests are discussed shortly.

> "[F]air market value" means the amount of cash or its equivalent that property would bring if exposed for sale in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other, and both the buyer and the seller have knowledge of all of the uses and purposes to which the property is adapted and for which it is capable of being used, and of the enforceable restrictions upon those uses and purposes.

Market value and highest and best use. A property's fair market value is premised on highest and best use. In brief, the highest and best use is the use that produces the greatest long-term economic return to the property's owner. Among alternative uses that are physically practicable, legally permitted, and economically feasible (i.e., that produce a positive net return), the highest and best use is the use that produces the highest net return.

Under both the statutory definition of fair market value and in the determination of highest and best use, the appraiser must consider the "enforceable restrictions" on a property's use. In property tax valuation, this is generally interpreted to mean enforceable government restrictions. In the case of a taxable possessory interest, however, enforceable restrictions include the specific restrictions placed by the public owner on the possessor's possession and use. These restrictions must be considered in addition to other land use restrictions generally applicable to the property. For instance, the restrictions placed on a property's use contained in a lease provision must be considered in determining the highest and best use of the taxable possessory interest created by the lease. Occasionally, the conditions of a taxable possessory interest preclude the highest and best, but in most cases the permitted use under the taxable possessory interest and the highest and best use of the property coincide.

Purchase price presumption not applicable. Subdivision (b) of section 110 establishes a rebuttable presumption that full cash value, or fair market value, is the purchase price if the sale was negotiated at arms length between a knowledgeable transferor and transferee neither of which is able to take advantage of the exigencies of the other. The statute, however, specifically states that the purchase price presumption does not apply to sales of taxable possessory interests.

In the case of taxable possessory interests, the purchase price does not include the entire interest that is being valued, and, for this reason, the purchase price presumption cannot be applied. As we discuss in detail below, the sale price of a taxable possessory interest represents only the equity value of the taxable possessory interest. Thus, the purchase price must be adjusted (for any unpaid rent for the reasonably anticipated term of possession) in order to arrive at the value of the entire taxable possessory interest.

REVIEW OF PROPERTY INTERESTS

As briefly discussed in the Chapter 1, when a possessory interest is created, the bundle of rights that constitute the fee simple interest is divided into a possessory interest (or interests) and a nonpossessory interest (or interests). For example, in the creation of a lease, the fee simple interest is divided into the leasehold interest (i.e., the possessory interest) and the leased fee interest (i.e., the nonpossessory interest). By paying rent, the holder of the leasehold interest, the lessee, obtains the right to possess the property under the terms and conditions specified in the lease. In exchange for giving up the right to possess the property during the term of the lease, the holder of the leased fee interest, the lessor, obtains the right to receive rent during the term of the lease and the right to the reversion, that is, the right to regain possession of the property at lease termination.

The "value of the leased fee interest" is the sum of the present value of the contract rents over the remaining term of possession under the lease and the present value of the reversionary interest at lease termination, that is, the present value of the right to possess and control the property when the lease terminates. The value of the leased fee interest generally is not relevant to possessory interest valuation.

The term "value of the leasehold interest" (or "leasehold value") can be interpreted in two ways. On the one hand, it may refer to the value of the leasehold interest to a prospective lessee; that is, the present value of the market (i.e., economic) rent for the remaining term of the leasehold interest. Stated slightly differently, it is the amount a prospective lessee would pay for the subject leasehold interest if he or she prepaid the future rents at the market rental rate.

On the other hand, the "value of the leasehold interest" may refer to what is called the "equity value," "bonus value," or "leasehold advantage" in the leasehold interest. This value is based on the present value of the difference between the current market rent and the contract rent, which could be a positive or negative amount. If the contract rent for the remaining term of the lease is below the expected future market rent, the equity value is positive; if the contract rent is above the market rent, the equity value is negative. To avoid confusion, it is perhaps helpful to use the term "full value of the leasehold interest" to refer to the first meaning of "value of the leasehold interest" and the term "equity value of the leasehold interest" to refer to the second meaning.

Using these terms, the value that is sought when assessing a taxable possessory interest, what we have termed the "full value of the leasehold interest," is equal to any of the following:

1. The present value of the future market (economic) rents over the remaining term of the lease at the market rental rate

2. The present value of the future contract rents over the remaining term of the lease plus what we have called the positive or negative "equity value of the leasehold interest"

3. The value of the fee simple interest minus the present value of the reversionary interest (i.e., the estimated present value of the land and improvements at the termination of the lease).

These relationships form the conceptual basis for the various taxable possessory interest valuation approaches.

Although a taxable possessory interest created by a lease—that is, a leasehold interest—is a common form of taxable possessory interest, a taxable possessory interest can be created in many ways that do not require the execution of a lease, or, for that matter, any written agreement. The concepts and terms used above in the context of a lease can be generalized to refer to other types of property relations that also constitute taxable possessory interests.

PRE- AND POST-DE LUZ TAXABLE POSSESSORY INTERESTS

***Blinn* Method.** In 1932, in *Blinn Lumber Co.* v. *Los Angeles County*, a case that concerned the valuation of a leasehold interest in publicly owned tidelands, the California Supreme Court provided the first guidance to assessors regarding the valuation of taxable possessory interests.[26] The *Blinn* court considered the three generally accepted valuation approaches and decided that the income approach was the most appropriate approach given the facts before it. To estimate the value of the subject taxable possessory interest, the court discounted (i.e., calculated the present value of) the lessee's imputed net income (i.e., not the actual income) over the remaining term of the leasehold. However, in developing the imputed net income, the court allowed the deduction of the rent paid by the possessor.

By allowing the deduction for rent paid, the *Blinn* method of valuation restricted the value of the taxable possessory interest to (at most) the lessee's equity value, or bonus value, in the leasehold interest. In other words, it restricted the value of the taxable possessory interest to (at most) the present value of the difference between the market (economic) rent and the contract rent. In general, assessors adhered to the *Blinn* method until 1955.

***De Luz* Method.** The next significant development in the valuation of taxable possessory interests occurred in 1955 in *De Luz Homes, Inc.* v. *County of San Diego*.[27] *De Luz* involved a military housing project constructed on a United States military reservation in San Diego County (there were also companion cases from Solano, San Bernardino, and Orange Counties). Ownership of the improvements passed to the United States on completion of construction; the federal government then contracted with a private party for the long-term operation and management of the project. San Diego County (as did the other counties in the companion cases) assessed the leasehold interest as a taxable possessory interest.

In *De Luz*, the California Supreme Court reversed itself, disapproving the method of valuation it had previously set forth in *Blinn*. As noted, *Blinn* had allowed the lessee to deduct his rental payments and some other costs when calculating the net income to be capitalized. In *De Luz* (and the companion cases), the lessee had claimed deductions that also included the amortization of the investment in improvements in addition to the land rent. The effect was to reduce the net income to be capitalized, and hence the estimated value of the taxable possessory interest, to practically zero.

The *De Luz* court held that in valuing a taxable possessory interest by the capitalization of income method, it was improper to deduct the lessee's charges for rent, amortization of investment, or

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[26] *Blinn Lumber Company* v. *County of Los Angeles* (1932) 216 Cal. 148. Until this case, assessors did not have much guidance in regard to the valuation of taxable possessory interests.
[27] *De Luz Homes, Inc.* v. *San Diego County* (1955) 45 Cal.2d 546.

payment of principal or interest on mortgage debt from the estimated gross return in developing the net income to be capitalized. Essentially, the court held that such deductions were part of the "purchase price," or "full cash value," of the property and should not be allowed because the result was a deviation from the full cash value (or fair market value) standard. Rather, said the *De Luz* court, the assessor should capitalize the market (economic) rent applicable to the property rights held by the lessee, that is, the net income that would be expected by a prospective purchaser of the subject property (in this case, the leasehold interest). As stated by the court:

> The standard of "full cash value" applies equally to a leasehold interest. Accordingly, the assessor must estimate the price a leasehold would bring on an open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other. He must therefore capitalize, not the anticipated net earnings of the present lessee, but those of a prospective assignee. To a prospective assignee, anticipated net earnings equal expected gross income less necessary expenditures for maintenance, operation, and taxes. No deduction is made for the cost of the lease to the present lessee, i.e., his charges for rent and amortization of improvements, for to a prospective assignee the value of a leasehold is measured solely by anticipated gross income less expected necessary expenditures.[28]

Thus, the *De Luz* method captures the full value of the leasehold interest. For example, it is the amount a prospective lessee might pay for the subject leasehold interest if he or she prepaid the future rents at the market (economic) rental rate, with deductions from the rent for only "necessary expenditures" and recognition of the time value of money on a risk-adjusted basis.

Section 107.1. The *De Luz* decision became final on December 25, 1955. Obviously, prior to that date many taxpayers had entered into leases under the assumption that their possessory interest assessments would be assessed under the *Blinn* method. In 1957, the Legislature attempted to return these parties to their pre-*De Luz* position by enacting section 107.1. As originally enacted, section 107.1 contained two main provisions: (1) the first provision declared taxable possessory interests to be personal property, opening the possibility that the Legislature might exempt them from taxation entirely (the Legislature has had the power to classify and exempt personal property since 1933); and (2) the second provision recognized the *De Luz* method as the correct method for valuing taxable possessory interests. For leases entered into prior to *De Luz* (i.e., prior to December 25, 1955), however, section 107.1 defined the full cash value for assessment purposes as the present value of the amount by which the market (economic) rent exceeded the contract rent, if any, over the unexpired term of the lease. Thus, section 107.1 restored the valuations of pre-*De Luz* taxable possessory interests to substantially what they would have been under the *Blinn* method.

The constitutionality of section 107.1 was questioned on two grounds. First, taxable possessory interests are real property and exempting real property required constitutional authorization;

[28] *De Luz Homes, Inc.* v. *San Diego County, supra,* 45 Cal.2d 546, 566.

legislative authorization alone was insufficient. Second, in *De Luz*, the California Supreme Court had held that the *Blinn* method was an illegal departure from the requirement that all property be assessed at its full cash value; therefore, allowing the *Blinn* method to apply to certain taxable possessory interests also seemed to violate the California Constitution. In 1960, these constitutional questions were addressed in *Forster Shipbuilding Co.* v. *County of Los Angeles.*[29] The *Forster* decision struck down the portion of section 107.1 that had defined a possessory interest as personal property, but upheld the prospective-only application of the *De Luz* method of valuation for possessory interests under the reasoning that it was a reasonable exercise of the Legislature's power to mitigate hardships caused by the overruling of established law.

Thus, for taxable possessory interests created before the *De Luz* decision became final and not since extended or renewed, the *Blinn* method of valuation applies; these taxable possessory interests typically are called "pre-*De Luz* taxable possessory interests." For taxable possessory interests created, extended, or renewed after the *De Luz* decision became final, the *De Luz* method of valuation applies; these taxable possessory interests typically are called "post-*De Luz* taxable possessory interests." The vast majority of taxable possessory interests are post-*De Luz*. However, pre-*De Luz* taxable possessory interests still exist, some with significant values.

TERM OF POSSESSION

In General. Perhaps the cardinal feature of a taxable possessory interest is that it is an interest of finite duration. At some future date, the interest of the private possessor will terminate, and possession of the property will revert to the public owner. The "term of possession" is the measure of a taxable possessory interest's future duration.

It is impossible to value a taxable possessory interest without assuming or postulating a term of possession—this variable appears in each of the taxable possessory interest valuation methods. The term of possession also significantly affects the valuation. A one-year term of possession means that the taxable possessory interest will be valued at only a small fraction of the value of the fee simple interest; a 25-year term of possession means that the value of the taxable possessory interest will approach the value of the fee simple interest.

Reasonably anticipated term of possession. Rule 21 defines the term of possession through a standard called the "reasonably anticipated term of possession." 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). As stated in subsection (d)(2) of the rule, the reasonably anticipated term of possession is "demonstrated by intent of the public owner and the private possessor, and similarly situated parties," through criteria such as the following:

1. The sales prices of the subject and comparable taxable possessory interests

2. The rules, policies and customs of the public owner and other similarly situated public owners

[29] *Forster Shipbuilding Co.* v. *County of Los Angeles* (1960) 54 Cal.2d 450.

3. The customs and practices of the private possessor and similarly situated private possessors

4. The history of the public owner and the private possessor and similarly situated public owners and private possessors

5. The actions of the public owner and the private possessor, such as investments in improvements by the public owner or the private possessor

Rule 21 defines the "stated term of possession" of a taxable possessory interest as the remaining period of possession on the valuation date as specified in the lease or other legal instrument that created, renewed, or extended the taxable possessory interest (including any option periods).[30] Under Rule 21, the stated term of possession is presumptively the reasonably anticipated term of possession unless there is "clear and convincing" evidence that demonstrates that the possessor and the public owner have reached a mutual understanding or agreement, oral or written, such that the reasonably anticipated term of possession is shorter or longer than the stated term of possession. Also under the rule, however, certain taxable possessory interests are deemed to not have a stated term of possession, such as those created by month-to-month leases or agreements. The presumption regarding stated term of possession is not applicable to these taxable possessory interests.

Section 115 of the California Evidence Code defines burden of proof as "the obligation of a party to establish by evidence a requisite degree of belief concerning a fact in the mind of the trier of fact or the court." The party with the burden of proof is required to establish the existence or nonexistence of a fact by producing evidence that satisfies a required standard. It is the assessor's burden to prove that the reasonably anticipated term of possession differs from the stated term of possession. In general, this means that the assessor must present evidence that the private possessor and the public owner have reached an understanding in regard to future possession of the property that differs from the stated term of possession (i.e., remaining term under the existing agreement).

Unless otherwise provided by law, the required civil burden of proof in California is proof by a preponderance of the evidence.[31] A preponderance of the evidence is usually defined "in terms of probability of truth" and as evidence which, when weighed against evidence offered in opposition to it, "has more convincing force and the greater probability of truth."[32]

In order to overcome the presumption that the stated term of possession is the reasonably anticipated term of possession, however, the required burden of proof is clear and convincing evidence. The clear and convincing standard is a higher standard than preponderance of the evidence and has been held to require evidence "so clear as to leave no substantial doubt."[33] In

[30] In *County of Riverside* v. *Palm-Ramon Development Co.* (1965), 63 Cal. 2d 534, the California Supreme Court upheld the assessor's right to include option periods in the term of possession. An option period should be included in the term, however, only if it is reasonable to assume that the option will be exercised.
[31] Evidence Code section 115.
[32] 1 Witkin, *Evidence* (3d ed. 1986) § 157, p.135.
[33] *In re Jost* (1953) 117 Cal.App.2d 379.

other words, a preponderance calls for probability while "clear and convincing proof demands a high probability."[34]

If the assessor successfully demonstrates that the public owner and the possessor have reached a mutual understanding or agreement such that the reasonably anticipated term of possession differs from the stated term of possession, the term of possession for valuation purposes is the stated term of possession as modified by the terms of the mutual understanding or agreement. Such a mutual understanding or agreement may be proved by evidence relating to the conduct of one or both parties. The reasonably anticipated term of possession so demonstrated may be longer or shorter than the stated term of possession.

As noted above, for taxable possessory interests without a stated term of possession, the presumption that the stated term of possession is the reasonably anticipated term of possession is not applicable. Examples of such taxable possessory interests include taxable possessory interests than run from month to month, taxable possessory interests without a fixed term, and taxable possessory interests of otherwise unspecified duration.[35] For a taxable possessory interest that is without a stated term of possession, the assessor should determine a term of possession on each valuation date using the criteria for the reasonably anticipated term of possession listed above together with other relevant criteria.

Recurring taxable possessory interests. A taxable possessory interest may recur from year to year without the possession, right to possession, or claim to a right to the possession inherent in the interest being continuous in time. That is, the possession, right to possession, or claim to a right to possession may apply to a recurring annual time period that is less than the entire year.[36]

If the contract term of an annually recurring taxable possessory interest begins each year after January 1 but ends before January 1 of the succeeding year, then it could be argued that the taxable possessory interest does not exist on the January 1 lien date of any given year and that, as a consequence, the annually recurring taxable possessory interests are subject only to annual supplemental assessments. In other words, each year a new taxable possessory interest would be created with a reasonably anticipated term of possession of less than one year, causing annual changes in ownership with resulting annual supplemental assessments.

Under *Dressler v. County of Alpine*, however, a history of annually recurring taxable possessory interests with contract terms of less than one year ending on or before December 31 of each year may nevertheless, under appropriate facts, establish the existence of an actual or constructive

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[34] 1 Witkin, *Evidence* (3d ed. 1986) § 160, p.137.

[35] Other examples are tenancies at will, tenancies at sufferance, periodic tenancies, and tenancies with an indefinite term.

[36] For certain taxable possessory interests, however, there is no expectation of annual recurring periods of occupancy; such interests can be called "one-time-only" taxable possessory interests. Even though a "one-time-only" taxable possessory interest may have a reasonably anticipated term of possession of less than one year, assessors typically value such interests using a term of possession of one year, presumably for administrative convenience. This treatment generally results in a somewhat lower assessment than if the interest's shorter reasonably anticipated term of possession had been used.

possession, right to possession, or claim to a right to possession that extends to each January 1 lien date.[37] Pursuant to this authority, under appropriate facts, assessors may make annual lien date assessments of such recurring taxable possessory interests provided that their reasonably anticipated terms of possession are at least one year in length.[38]

"Terminating" taxable possessory interests. A special case exists when the evidence establishes that at a certain future date the public owner of the real property will no longer make the real property available for private possession. This situation is sometimes called a "terminating taxable possessory interest." If the evidence establishes the existence of a terminating taxable possessory interest, the term of possession on each valuation date should be the anticipated remaining period that the real property will be available for private possession.

TAXABLE POSSESSORY INTEREST VALUATION METHODS

The valuation approaches for taxable possessory interests are similar to the conventional approaches to value—the comparative sales approach, the income approach, and the cost approach—that are generally accepted and used in the valuation of the fee simple interest. However, the conventional approaches must be modified to accommodate the finite duration of a taxable possessory interest and the corresponding fact that the portion of the fee simple interest retained by the public owner, the reversionary interest, is nontaxable.[39]

A taxable possessory interest may be valued using "direct methods" or "indirect methods." With the direct methods, the appraiser directly estimates the present value of the rights held by the possessor over the reasonably anticipated term of possession. With the indirect methods, the appraiser estimates the value of the rights in the taxable possessory interest as if it were owned in perpetuity (i.e., as if it were owned in fee simple) and subtracts the estimated present value of the nontaxable reversionary rights retained by the public owner, leaving a remainder equal to the value of the taxable possessory interest. The indirect methods thus require estimates of two values: the as-if-owned-in-fee value and the present value of the nontaxable, publicly owned reversion.[40]

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[37] *Dressler* v. *County of Alpine* (1976) 64 Cal.App.3d 557.

[38] See also Rule 22, "Continuity of Possessory Interests."

[39] The valuation of taxable possessory interests requires familiarity with the concepts and techniques used in the valuation of property in fee simple. See, for example, AH 501, "Basic Appraisal," and AH 502, "Advanced Appraisal," or a standard appraisal text.

[40] When using the indirect methods, the nontaxable reversionary value is typically based on the value of all the rights in the publicly owned real property. This does not present a problem if all the rights of economic significance in the property are also contained in the subject taxable possessory interest. However, if there are economically significant rights not contained in the subject taxable possessory interest (for example, if there are multiple, concurrent taxable possessory interests), the estimated present value of the reversion should reflect only the rights contained in the subject taxable possessory interest. Thus, when we say, "subtract the present value of the reversion," we mean, more precisely, "subtract the portion of the value of the reversion that corresponds to the value of the rights held by the possessor."

There are direct and indirect methods for both the comparative sales and income approaches. The cost approach is a hybrid in the sense that the improvements are valued on the basis of depreciated replacement cost, while the land or site is valued using any of the methods, direct or indirect, applicable to the comparative sales or income approaches.

The valuation methods are very similar for post-*De Luz* and pre-*De Luz* taxable possessory interests. As we shall see, only a relatively minor adjustment is required to convert a post-*De Luz* valuation to a pre-*De Luz* valuation. Most taxable possessory interests are post-*De Luz* taxable possessory interests. Most appraisers, in fact, will never see a pre-*De Luz* taxable possessory interest; there simply are not that many of them that remain.

VALUATION OF POST-*DE LUZ* TAXABLE POSSESSORY INTERESTS

The post-*De Luz* methods include the following:

1. Comparative Sales Approach (Post-*De Luz*)

   Comparative Sales Approach-Direct Method

   Comparative Sales Approach-Indirect Method

2. Income Approach (Post-*De Luz*)

   Income Approach-Direct Method

   Income Approach-Indirect

3. Cost Approach (Post-*De Luz*)

Comparative Sales Approach (Post-*De Luz*)

Comparative Sales Approach-Direct Method

In the comparative sales approach-direct method, the appraiser uses the sale price of the subject taxable possessory interest and/or the sale price of one or more comparable taxable possessory interests to derive a value indicator. The method involves the following steps:

1. If necessary, adjust the sale price of the subject or comparable for cash equivalence to arrive at a cash equivalent sale price.

2. Add the present value on the sale date of the unpaid contract rent for the reasonably anticipated term of possession (in some cases, this will be based on the stated term of possession; in others, it will be based on the criteria in Rule 21). The contract rent should be reduced by any expenditure necessary to maintain the income from the taxable possessory interest during the possessor's reasonably anticipated term of possession, including any element of "gross outgo" as defined in subsection (c) of Rule 8.

3. Add the cash equivalent present value on the sale date of any debt obligations assumed by the buyer as part of the transaction (or, as to which, the buyer takes the property "subject to").

4. Add the present value on the sale date of any future contractually required cash expenditures that the buyer will incur that are associated with the possession of the subject property (e.g., site restoration expenditures at the termination of the taxable possessory interest).

5. Subtract the present value on the sale date of any future contractually entitled cash receipts that the buyer will receive associated with the possession of the property (the salvage value of, or the reimbursement value for, any possessor-constructed improvements at the termination of the taxable possessory interest).

6. In the case of a comparable taxable possessory interest, the comparable taxable possessory interest should meet the general standards for comparability contained in section 402.5, and the sales prices of the comparable taxable possessory interests should also be adjusted, if necessary, as prescribed in subsections (c) and (d) of Rule 4. That is, the appraiser should make adjustments to the equity sale price of the comparable taxable possessory interest, if necessary, for changes in market conditions ("price level"), relevant physical or economic differences, and differences in permitted uses. An adjustment for cash equivalence, if necessary, should be made initially, as noted above.

Unless all future contract rents have been prepaid, the equity sale price of a taxable possessory interest is an incomplete indicator of its fair market value. If the future contract rents are not prepaid (the typical case), the sale price is only an indicator of the equity value of the leasehold. To arrive at the consideration paid for the taxable possessory interest (i.e., the "full value of the leasehold interest"), the appraiser must add the present value of the unpaid future contract rents for the reasonably anticipated term of possession to the cash equivalent equity sale price.

The equity sale price may vary depending on any contractually obligated future costs that are assumed by the buyer. The present value of any significant obligated costs (e.g., site restoration at the end of the term of possession) should be added to the cash equivalent equity sale price of the taxable possessory interest since these costs, like rent, are part of the consideration the lessee pays for the right to possession. Conversely, the equity sale price may vary depending on any future contractual benefits received by the buyer that are in addition to the right to possession. The present value of any significant benefits (e.g., the right to salvage the improvements or be reimbursed for the cost of improvements) should be subtracted from the cash equivalent equity sale price, since, presumably, a portion of the purchase price was for these benefits and not for the right to possession.

The following example illustrates the valuation of a taxable possessory interest using the comparative sales approach-direct method:

EXAMPLE 3.1

USING THE COMPARATIVE SALES APPROACH-DIRECT METHOD TO VALUE TAXABLE POSSESSORY INTEREST

Subject taxable possessory interest: the right to possess a cabin in a national forest.

PERTINENT INFORMATION:

- Purchase price: $76,000 (cash)
- Reasonably anticipated term of possession: 20 years
- Annual contract land rent: $1,200
- Assume that the sale of the subject cabin occurred 2 years ago; market values of comparable cabins have increased about 10% per year since the sale date of the subject cabin; thus, use $15,000 as market conditions adjustment.
- Capitalization (discount) rate used to discount future contract rent, exclusive of property taxes: 12% (It is not necessary to add a property tax component to the discount rate because the possessor will pay the possessory interest taxes.)

The sale price of the subject property itself is used to derive the value indicator: thus, no adjustment for comparability is required. Accordingly, the only required adjustments are for market conditions and the present value of unpaid future contract rent. If this sale were used as a comparable in the valuation of another subject property, the adjustment for market conditions might be different, and an additional adjustments for property attributes (i.e., the comparable vis-a-vis the subject property) also might be necessary.

Equity Sale Price of Subject	$76,000	
Market Conditions Adjustment	15,000	
Add Present Value of the Contract Rent		
($1,200/yr. for 20 yrs. @ 12%)		
PV$1PP (annual)/20 yrs./12% = 9.13		
$1,200 x 9.13	10,956	
Adjusted Sale Price	$101,956	
Indicated Value of Subject	$101,956	Say, $101,500

* Although there were no such adjustments in this example, the present value of any obligated costs of the buyer, such as site restoration at the end of possession, should be added to the equity sale price. Such costs, like the future contract rent, are part of the lessee's full cost of possession. Also, the present value of any contractually entitled benefits received by the buyer (in addition to the right to possession) should be subtracted from the equity sale price. The part of the purchase price paid for such benefits is not part of the consideration paid for the right to possession.

Comparative Sales Approach-Indirect Comparison Method

In the comparative sales approach-indirect comparison method, the appraiser derives a value indicator using the estimated value of the subject taxable possessory interest as if it were owned in fee and the estimated value of the nontaxable, publicly owned reversion. This method involves the following steps:

1. The appraiser estimates the value of the subject taxable possessory interest using comparable sales of the fee-owned properties. That is, the assessor first estimates the value of the taxable possessory interest as if it were privately owned in fee simple using the "conventional" comparative sales approach. As with the comparative sales approach-direct method, the comparable sales properties should meet the standards for comparability contained in section 402.5, and the comparable sales prices should be adjusted, if necessary, in accord with Rule 4. The highest and best use of the comparable fee-owned properties must correspond to the permitted use of the subject taxable possessory interest.

2. The appraiser then subtracts the estimated present value of the nontaxable reversionary interest from the as-if-in-fee value.[41]

Reversionary rights to be valued. In estimating the as-if-in-fee value, only the rights to possession held by the possessor are valued; correspondingly, in estimating the present value of the reversion only the value of those same rights should be estimated and subtracted from the as-if-in-fee value. The reversionary rights (i.e., the rights that revert to the public owner at the termination of the subject taxable possessory interest) are sometimes less than the full unrestricted rights to possess the property (e.g., if there are concurrent taxable possessory interests). In a strict legal sense, "reversion" typically refers to the full unrestricted rights in a property; we use "reversion," however, to refer only to the rights contained in the subject taxable possessory interest. By doing so, we avoid the problem of having to value rights not held by the possessor when estimating the as-if-in-fee value.

Present value of the reversion. An estimate of the present value of the reversionary interest is required in both the comparative sales approach-indirect method and the income approach-indirect method (discussed below). Unavoidably, this value estimate may sometimes be imprecise. Here are three reasonable approaches:

1. If the reasonably anticipated term of possession on the valuation date is relatively lengthy (e.g., greater than 15 years), assume that the estimated as-if-in-fee value of the subject taxable possessory interest will increase at something approaching the long-term inflation rate (e.g., 3-4 percent per year) and use this amount as the estimated value of the

[41] To estimate the present value of the reversion, the appraiser must discount the estimated value of the reversion to its present value. This requires the development of a capitalization, or discount, rate. The development of a discount rate is discussed below (under the income approach). In general, that discussion also applies to the development of the capitalization rate used in the indirect approaches. That discussion also addresses the treatment of property taxes in relation to the capitalization rate.

reversion. Then, discount this value at an "appropriate" discount rate to arrive at the estimated present value of the reversion.

2. If the reasonably anticipated term of possession is intermediate in length (i.e., 6 to 15 years), and a growth rate different from the long-term rate is expected, use this rate to estimate the value of the reversion. Discount this value to its present value as in No. 1.

3. If the reasonably anticipated term of possession is relatively short (5 years or less), do as in No. 2 or simply use the estimated as-if-in-fee value as the present value of the reversion.

In the indirect methods (i.e., comparative sales and income), assuming the subject taxable possessory interest is improved, the as-if-in-fee value generally is estimated using an appraisal unit that includes land and improvements. The same appraisal unit, that is, a unit that comprises land and improvements normally should be used when estimating the present value of the reversion. Even though the appraisal unit may comprise land and improvements, however, the appraiser may conclude that the improvements will contribute no value on reversion.

The following example illustrates the valuation of a taxable possessory interest using the comparative sales approach-indirect method:

EXAMPLE 3.2

USING THE COMPARATIVE SALES APPROACH-INDIRECT METHOD TO VALUE TAXABLE POSSESSORY INTEREST

Subject taxable possessory interest: the right to possess a ten-unit motel in state park.

PERTINENT INFORMATION:

- Estimated value as if owned in fee simple: $400,000.
- The appraiser estimates this value using sales data from otherwise comparable fee-owed properties. For example, the appraiser might develop a unit of comparison from the comparable sales based on sale price per unit or might develop a gross rent multiplier.
- Reasonably anticipated term of possession: 15 years. (The remaining lease term on the valuation date.)
- Estimated value of the reversion: $720,000.
- Estimated value 15 years hence, given the 15-year reasonably anticipated term of possession. The appraiser estimates that the value of the subject property [land and improvements] will increase at a rate of 4 percent per year, compounded, over the term of possession. ($400,000 x 1.8000 [FV$1/15yrs/4%] = $720,000).
- Capitalization, or discount, rate, used to discount the reversionary value, exclusive of property taxes: 12%.*

Property value as if owned in fee simple	$400,000	
Less: present value of reversion: = $720,000 x PV$1/15yrs/12% = $720,000 x 0.1827 =	(131,544)	
	$268,456	say, $268,000

* It is not necessary to add a property tax component to the discount rate because the possessor will pay the possessory interest taxes. The development of a capitalization rate and the treatment of property taxes in relation to the capitalization rate is discussed below (with the income approach).

Income Approach (Post-*De Luz*)

Income Approach—General

Income to be Capitalized

When using the income approach to value a taxable possessory interest, the income to be capitalized is the "net return" (as that term is defined in subsection (c) of Rule 8) that is attributable to the taxable possessory interest. The income to be capitalized may be based on either (1) the estimated market (economic) rent attributable to the taxable possessory interest or (2) the estimated net operating income attributable to the taxable possessory interest. Rental income is preferred because operating income may be influenced by managerial skill or derived, in part, from nontaxable property.

Rental Income. If rental income is used, the appraiser may estimate the market (economic) rent as of the valuation date using any of the following as indicators, or evidence, of the market rent, as appropriate:

1. The contract rent for the subject taxable possessory interest
2. Contract rents for comparable taxable possessory interests
3. Contract rents for leasehold interests in comparable real property held in fee
4. Contract rents for other comparable interests in real property

Preferably, the contract rents should have been negotiated in a 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 the public owner. Also, the contract rents should 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.

The structure of a lease can vary in terms of how operating expenses are paid. In a gross lease, all operating expenses, including property taxes, are included in the stated, or contract, rent, and the landlord pays these expenses from the stated, or contract, rent. In a net lease, all operating expenses, including property taxes, are excluded from the stated, or contract rent, and these expenses are paid by the tenant in addition to the stated, or contract, rent. Some lease structures are hybrids of these pure forms, with the landlord paying some types of expenses and the tenant paying others.

When using contract rents from comparable properties as an indicator of the market (economic) rent for the subject taxable possessory interest, a contract rent with the same lease structure as the subject taxable possessory interest with regard to the payment of operating expenses is preferred. In doing so, the appraiser avoids the necessity of adjusting the contract rent such that it reflects a lease structure, with regard to the payment of operating expenses, that is comparable to that of the subject taxable possessory interest.

When using the contract rent of a taxable possessory interest as an indicator of the market rent, the assessor should add the following to the contract rent:

1. 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

2. 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

The purpose of both of the above adjustments is to arrive at a rent that reflects the full consideration paid for the right to possess the property. If, in addition to the contract rent, the possessor pays for improvements that will have a significant value at the termination of the taxable possessory interest, the full consideration paid for the possession of the property includes this value, and the contract rent should be adjusted accordingly. Similarly, the full consideration paid for the possession of the property may include significant site restoration costs at the end of the term of possession, less any off-setting salvage value or reimbursements.[42]

Operating Income. If operating income is used, the income to be capitalized is the net operating income. Net operating income is gross operating income less allowed expenses. Gross operating income, allowed expenses, and net operating income are defined consistent with "gross return," "gross outgo," and "net return," respectively, in subsection (c) of Rule 8.

Allowed expenses may include the following, as applicable: cost of goods sold, typical operating expenses, typical management expense, an allowance for a return on working capital, and an allowance for a return on and a return of the value of any nontaxable property that contributes to the gross operating income. 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.

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 from the subject taxable possessory interest. Typical operating and management expenses include expenses that an owner/operator typically would bear to maintain the property and to continue the production of income from the property but which, in the case of the subject taxable possessory interest, are borne by the public owner.

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[42] Typically, the adjustment to the contract rent is calculated using an appropriate compound interest factor to convert the amount of the adjustment to its annual or monthly equivalent.

Developing the Capitalization Rate

Under subsection (g) of Rule 8, a capitalization rate may be developed either (1) from income and sales data from comparable properties (the "market-derived rate") or (2) by deriving a band of investment (or "weighted average cost of capital") using market rates of return for debt and equity capital, respectively (the "band of investment rate"). Consistent with Rule 8, a capitalization rate for valuing a taxable possessory interest may be developed similarly, using any of the following methods:

1. By 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)

2. By 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

3. 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

Also, consistent with subsection (f) of Rule 8, the capitalization rate should include a component for property taxes, where applicable, and as discussed below.

In other words, the appraiser can develop a capitalization rate by using sales and income data from comparable taxable possessory interests or otherwise comparable fee-owned property or by deriving a weighted average of the appropriate rates of return on debt and equity, with the respective weights determined by the typical loan-to-value, or equity-debt, ratio in the market. In essence, "appropriate" means the typical investor's required rates of return on debt and equity on a risk-adjusted basis. That is, the relevant question is the following: what rate of return would a typical buyer of the subject taxable possessory interest require on his or her equity investment in the subject taxable possessory interest and what rate of return would a typical lender require in order to lend?

There are two generic methods of capitalization in real property appraisal: "direct capitalization" and "yield, or annuity, capitalization" (which also encompasses discounted cash flow analysis). In direct capitalization, the value indicator is obtained by dividing a single year's expected net income by a type of capitalization rate that is typically called an "overall rate." An overall capitalization rate is simply the reciprocal of a net income multiplier (i.e., the quotient of the comparable sales price divided by the comparable property's expected annual net income). In yield capitalization, the value indicator is obtained by discounting the subject property's expected net incomes for multiple years over an expected holding period (the reasonably anticipated term of possession in taxable possessory interest valuation); the discounted income also includes any expected reversionary income at the end of the holding period (or reasonably anticipated term of possession). The capitalization rate used in yield capitalization is called a yield rate (or, "interest rate" or "rate of return"). A yield rate is always used in conjunction with a discounting process, that is, in conjunction with annuity factors or the equivalent (e.g., discounted cash flow analysis). Given adequate data, both overall rates and yield rates can be developed using the two techniques prescribed in Rule 8—that is, the market-derived method and the band of investment method, although the application of the techniques is slightly different for the two kinds of capitalization rates.[43]

Whenever multiple incomes are discounted to arrive at a value indicator, the proper method of capitalization is yield capitalization, and the proper capitalization rate is a yield rate, not an overall rate. The valuation of a taxable possessory interest always involves, in one form or another, depending on the particular approach, a discounting of multiple net incomes. Thus, taxable possessory interest valuation always involves yield, or annuity, capitalization and the use of a yield rate.

In order to derive a yield rate from sales data (i.e., "the market-derived" way), the appraiser requires the buyer's expected annual net incomes (including the expected income that results from the reversionary value) over the buyer's expected holding period. This data is very difficult to obtain for sales of fee simple interests and almost impossible to obtain for sales of taxable possessory interests.

This often leaves the band of investment technique as the only practical means by which the appraiser can arrive at a discount rate. In the band of investment, the estimate of the debt return component is relatively straightforward; the appraiser may have access to lender data involving comparable taxable possessory interests, and he or she will almost certainly have access to market loan rates for comparable fee-owed property. It also is not difficult to estimate a typical loan-to-value ratio. The difficult part in the band of investment technique is the estimate of the equity rate of return, about which only limited data is available from fee-owed comparables and practically no data is available from taxable possessory interests. Nonetheless, there are several possible approaches to estimating the equity rate of return:

1. One approach to the estimation of the equity rate of return involves the use of financial market data in conjunction with asset pricing models, such as the capital asset pricing model, but this approach is controversial when the estimates of equity return are used to value real property.[44]

2. Another approach involves investor surveys. Certain real estate research organizations periodically survey institutional investors with in regard to their expected rates of return for the types of properties in which they invest (which, generally, reflect fee ownership). For example, a rate of return survey involving institutional investors in hotel properties might provide rate-of-return information applicable to the valuation of a taxable

[43] See AH 502, Chapter 4.
[44] Ibid.

possessory interest involving a hotel. This approach, however, may be open to criticism based on problems of comparability.

3. In yet another approach, an equity rate of return can be estimated by applying a simple equity-over-debt premium. The expected equity rate of return will always be higher than the related debt rate because the equity return is residual to the equity return and is more volatile (i.e., riskier) due to financial leverage. The difficulty here, of course, is estimating exactly what the equity-over-debt premium should be; nevertheless, a "small" equity-over-debt premium arguably is supportable on theory alone (i.e., the higher required rate of return on equity vis-a-vis the debt rate, given the equity position's greater risk).

4. Finally, the appraiser could consider the following relationship:

$$r_o = k_o - g \text{ or}$$
$$k_o = r_o + g,$$

where r_o is the overall capitalization rate, k_o is the yield rate (sometimes designated y_o), and g is the estimated long-term growth rate in the net income attributable to the taxable possessory interest.

This equation relates the overall capitalization rate, r_o, to the yield rate, k_o, given the assumption that in the long-run (technically, in perpetuity), the net income (i.e., the net income attributable to the total property, both debt and equity) grows at a constant rate, g. For example, assume one derives an overall rate from a comparable sale property of 10 percent. If one assumes that, in the long run, the net income from the comparable property (and hence from the subject taxable possessory interest) will grow at 3 percent per year, then the indicated yield rate, k_o, is 13 percent (10 percent + 3 percent).[45]

Property Tax Component and Capitalization Rate

In General. If property taxes will be paid out of the income to be capitalized, a property tax component (typically, the one-percent general property tax rate) should be added to the capitalization rate. Conversely, if property taxes will not be paid out of the income to be capitalized, a property tax component should not be added to the capitalization rate.

When rental income is used, and the income to be capitalized is based on a gross rent (i.e., all operating expenses, including property taxes, are included in the gross rent and are paid by the landlord from the gross rent), property taxes will be paid out of the income to be capitalized (i.e., the gross rent, less allowed expenses), and the capitalization rate should contain a component for property taxes. When rental income is capitalized, and the income to be capitalized is based on a net rent (i.e., all operating expenses, including property taxes, are excluded from the net rent and are paid by the tenant in addition to [or "outside of"] the net rent), property taxes will not be paid out of income to be capitalized (i.e., the net rent) and the capitalization rate should not contain a component for property taxes.

[45] The relationship is based on the formula for a growing perpetuity. The derivation of the formula for a growing perpetuity is covered in most introductory finance and many appraisal texts.

With most taxable possessory interests, the possessory interest tax is paid by the possessor in addition to rent; this is a standard contractual provision. Assuming that the rental income to be capitalized for the subject taxable possessory interest has been estimated on this basis—that is, using comparable rents that reflect, or have been adjusted to reflect, a lease structure in which the possessor pays the property taxes in addition to rent—the capitalization rate should not contain a property tax component. If the appraiser, however, must estimate the income to be capitalized for the subject taxable possessory interest on a gross basis—that is, using comparable rental data that reflects a lease structure in which the landlord pays the property taxes out of the rent—then the capitalization rate must contain a property tax component.

When operating income is used, property taxes will always be paid out of the income to be capitalized, and the capitalization rate should always contain a component for property taxes.[46]

When discounting reversion. When using the indirect methods of valuing a taxable possessory interest, the value of the reversion is discounted to a present value, which is then subtracted from the as-if-in-fee value. Should a property tax component be added to the rate that is used to discount the reversion? The answer is no. Again, a property tax component should be added only if the property taxes will be paid out of the income to be capitalized as an operating expense, that is, in terms of Rule 8 as an element of "gross outgo." This is not the case when discounting the value of the reversion.

[46] The rationale for adding a property tax component to the capitalization rate, rather than deducting an amount for property taxes from the income to be capitalized, is that the latter presumes that the appraiser knows beforehand the value he or she is attempting to estimate. That is, since property is assessed ad valorem, it would be necessary for the appraiser to know the value of the subject property in order to estimate the property taxes. This puts the cart before the horse.

Income Approach-Direct Method

In the income approach-direct method, the appraiser estimates the value of the subject taxable possessory interest by discounting the expected future net operating income attributable to the subject taxable possessory interest for the reasonably anticipated term of possession using a discount rate that reflects the risk associated with the receipt of the expected future net operating income. The direct income method is probably the most widely used method in the valuation of taxable possessory interests because of the quantity and quality of data available relating to market (economic) rents.

As discussed in the previous section, the income to be capitalized may derive from either rents or operations (i.e., rental income or operating income) and should be estimated in accordance with subsection (c) of Rule 8. Also as discussed above, the capitalization (discount) rate should be developed in accordance with subsection (g) of Rule 8.

The following example illustrates the valuation of a taxable possessory interest using the income approach-direct method:

EXAMPLE 3.3

USING THE INCOME APPROACH-DIRECT METHOD TO VALUE TAXABLE POSSESSORY INTEREST

Subject taxable possessory interest: grazing rights on federal lands.

PERTINENT INFORMATION:

- U.S. Forest Service grazing permit for 200 animal unit months (AUMs) per year. (An AUM represents the grazing of one animal for one month.)
- Reasonably anticipated term of possession: 10 years
- Contract rent: $2.00 per AUM
- Market (economic) rent: $10.00 per AUM. Derived from leases of comparable privately owned lands
- Capitalization (discount) rate, exclusive of property taxes: 12%
  Added component for property taxes (general rate): 1%

In this approach, the appraiser capitalizes (discounts) the estimated market (economic) rent over the reasonably anticipated term of possession.

Although often the contract rent is a valid indicator of the market (economic) rent, the appraiser should not uncritically accept it as the market (economic) rent.

In this example, it was necessary to add a property tax component to the discount rate because the market rent for the subject taxable possessory interest is derived from rental data in which the landlord pays the property taxes.

Estimated annual market rent: (200 AUM @ $10/AUM)	$2,000
	x
Present value factor: (PV$1PP (annual)/10 yrs/12% = 5.65)	5.65
Indicated Value	$11,300

Income Approach-Indirect Method

The income approach-indirect method is very similar in concept to the comparative sales approach-indirect method. The only difference is that with the income approach-indirect method, the appraiser estimates the as-if-in-fee value of the taxable possessory interest using the "conventional" income approach rather than the "conventional" comparative sales approach. Thus, the income approach-indirect method involves the following two steps:

1. The appraiser estimates the value of the subject taxable possessory interest as if it were owned in fee simple, using a "conventional" income approach to estimate the as-if-in-fee value of the subject taxable possessory interest. Direct capitalization, yield capitalization, or both may be used to estimate the as-if-in-fee value.

2. The appraiser subtracts the estimated present value of the nontaxable reversionary interest retained by the public owner from the as-if-fee value estimated in No. 1 above. The estimated present value of the reversion can be estimated using the methods described in the discussion of the comparative sales approach-indirect method. As also stated earlier, the estimated present value of the reversion should be based on the same rights as those contained in the subject taxable possessory interest.

The following example illustrates the valuation of a taxable possessory interest using the income approach-indirect method:

EXAMPLE 3.4

USING THE INCOME APPROACH-INDIRECT METHOD TO VALUE TAXABLE POSSESSORY INTEREST

Subject taxable possessory interest: the right to possess a mini-storage warehouse, newly constructed by possessor, located within a CalTrans right-of-way.

PERTINENT INFORMATION:

- Estimated value of taxable possessory interest as if owned in fee simple: $1,125,000.
- Typically, the appraiser would estimate this value using direct capitalization, that is, by capitalizing the subject property's expected net operating income for the upcoming year using an overall capitalization rate derived from comparable sales.
- The appraisal unit comprises land and improvements; this is always the case in the indirect methods (assuming of course, that the property is improved).
- Reasonably anticipated term of possession: 30 years.
- Based on the stated term of possession (i.e., remaining term of the lease on the valuation date, including options).
- Estimated value of the reversion: $ 2,730,668.
- Estimated real property value 30 years hence, given the 30-year reasonably anticipated term of possession. The appraiser estimates that the value of the subject property [land and improvements] will appreciate at a compound rate of 3 percent per year for the reasonably anticipated term of possession. ($1,125,000 x 2.42726 [FV$1/30 yrs/3%] = $2,730,668.)
- Capitalization, or discount, rate used to discount the reversionary value, exclusive of property taxes: 12%.
- Developed using any of the methods described above. It is not necessary to add a property tax component to the discount rate when discounting the reversionary value.

As noted, the income approach-indirect method is identical in concept to the comparative sales approach-indirect method, except that the appraiser estimates the as-if-in-fee simple value using the income approach rather than the comparative sales approach.

As-if-in-fee value of subject taxable possessory interest:	$1,125,000	
Less: present value of reversion:		
= $2,730,668 x PV$1/30 yrs/12%		
= $2,730,668 x 0.033378 =	(91,444)	
Value indicator:	$1,033,556	say, $1,033,500

Cost Approach (Post-*De Luz*)

When applied to the valuation of a taxable possessory interest, the cost approach includes the following steps:

1. The appraiser estimates the value of the improvements. In most cases, this is done on the basis of depreciated replacement cost. That is, the appraiser estimates the replacement cost new of the improvements and then subtracts an amount for depreciation. Typically, the amount of depreciation is estimated using a standard depreciation schedule.

2. The appraiser estimates the value of the taxable possessory interest in land. This value may be estimated using any of the previously discussed methods—that is, the comparative sales approach (direct or indirect method) or the income approach (direct or indirect method). More than one of these approaches may be used with the results reconciled into a final value indicator for the taxable possessory interest in land.

3. Next, the appraiser adds the estimated value of the improvements to the estimated value of the taxable possessory interest in land. Thus, as in the "conventional" cost approach, land and improvements are valued separately and then summed.

4. Finally, the appraiser subtracts the estimated present value of the nontaxable reversionary improvements, if any, from the amount in No. 3 above. As in No. 1 above, the estimated reversionary value of the improvements typically is estimated as the replacement cost new less depreciation of the improvements at the end of the reasonably anticipated term of possession. Again, as of the valuation date, such improvements will be nontaxable because their ownership will have reverted back to the public owner.[47]

In the cost approach, the value of the possessory interest in land, obtained by the direct or indirect method, is added to the replacement cost new less depreciation of the improvements, and this sum is then reduced by the estimated present value, if any, of the improvement value at the end of the reasonably anticipated term of possession. The cost approach is often used when improvements are constructed by the possessor on an underlying taxable possessory interest in land.

The appraiser also can estimate the value of the taxable possessory interest in land by reference to the sale price of the subject taxable possessory interest in land or to the sales prices of comparable taxable possessory interests in land. As discussed earlier, however, this sale price represents an equity sale price to which the present value of the future contract rents must be added and to which other adjustments also may be required. This is an application of the direct method.

The appraiser also can choose to estimate the value of the taxable possessory interest in land using sales of fee simple interests in otherwise comparable land and then reducing this estimated value by the estimated present value of the nontaxable reversionary interest in the land. This is an application of the indirect method.

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[47] This method for estimating the value of taxable improvements on tax-exempt land was first stated in the previously discussed *Kaiser* v. *Reid, supra,* 30 Cal.2d 610.

The value of the taxable possessory interest in improvements may be based on an estimate of the replacement cost new less depreciation of the improvements. If the estimated remaining economic life of the improvements exceeds the reasonably anticipated term of possession, the estimated present value of the nontaxable reversionary interest in the improvements must be subtracted.

The following example illustrates the valuation of a taxable possessory interest using the cost approach:

EXAMPLE 3.5

USING THE COST APPROACH TO VALUE TAXABLE POSSESSORY INTEREST

Subject taxable possessory interest: the right to possess a maintenance building constructed by the possessor at a publicly owned airport.

PERTINENT INFORMATION:

- The possessor groundleases 1.50 acres of land (65,340 square feet) from the airport authority and constructs a 45,000 square foot aircraft maintenance building. The market ground rent is $0.10 per square foot per month, or $78,408 per year. The market rent is constant over the reasonably anticipated term of possession.
- The reasonably anticipated term of possession is 30 years, based on the stated term of possession (the remaining term of the ground lease on the valuation date). There are no factors that indicate that the reasonably anticipated term of possession is other than 30 years.
- The capitalization (discount) rate is 12%. The capitalization rate could be developed by any of the described methods. In the example, it is not necessary to add a property tax component to the discount rate because the possessor will pay the possessory interest taxes in addition to the ground rent.

A. Computation of possessory interest value in land:

The appraiser estimates the value of the taxable possessory interest in land using the income approach-direct method, that is, by discounting the estimated market rent over the reasonably anticipated term of possession ($78,408 x 8.055 [PV$1PP, 30 yrs/12%] = $631,576, rounded to $631,500). The appraiser could estimate the value of the taxable possessory interest in land using this method or any of three other methods—the comparative sales approach-direct method, the comparative sales approach-indirect method, or the income approach-indirect method—with the selected method(s) determined by the quantity and quality of the data.

The estimated market value of the taxable possessory interest in land is $631,500.

EXAMPLE 3.5 (CONTD.)

B. Computation of possessory interest value in improvements:

Typically, the appraiser will estimate the value of the improvement using the possessor's reported costs, an independent cost estimate based on cost service data, or both. The objective is an estimate of the replacement cost new less depreciation of the improvements that includes all components of full economic cost. Next, the appraiser must decide whether to attribute a reversionary value to the improvements. In the example, we assumed that the improvements will be valueless at the end of the reasonably anticipated term of possession; thus, it is not necessary to adjust the improvement value for a reversionary value.

On subsequent valuation dates, the appraiser also would estimate the value of the improvements based on replacement cost new less depreciation, probably by adopting a standard depreciation schedule, for example, straight-line depreciation.

The estimated market value of the taxable possessory interest in improvements is $1,000,000.

Estimated market value of the taxable possessory interest in land	$631,576	say	$631,500
Estimated market value of the taxable possessory interest in improvements			$1,000,000
Estimated market value of the entire subject taxable possessory interest			$1,631,500

Summary: Post-*De Luz* Taxable Possessory Interest Valuation Methods

Comparative Sales Approach-Direct Method

	Equity sale price (subject or comparable)
Adjust for (+ or -)	Cash equivalence
Adjust for (+ or -)	Market conditions
Adjust for (+ or -)	Comparability
Add	Present value of contract rents for reasonably anticipated term of possession.
Add	Present value of possessor's contractually obligated future costs, if any.
Subtract	Present value of possessor's contractually entitled benefits, if any.
Equals	Indicated value of subject taxable possessory interest

Comparative Sales Approach-Indirect Method

Estimate	Value of the subject taxable possessory interest as if owned in fee (i.e., owned in perpetuity) using the "conventional" comparative sales approach.
Estimate	Reversionary value of the subject taxable possessory interest
Calculate	Present value of the reversion.
Subtract	Present value of the reversion from the estimated fee value.
Equals	Indicated value of subject taxable possessory interest.

Income Approach-Direct Method

Estimate	Expected market (economic) rent of the rights of possession under the subject taxable possessory interest over the reasonably anticipated term of possession.
Calculate	Present value of the future expected market rents.
Equals	Indicated value of subject taxable possessory interest.

Income Approach-Indirect Method

Estimate	Value of the subject taxable possessory interest as if fee owned (i.e., owned in perpetuity) using the "conventional" income approach.
Estimate	Reversionary value of the subject taxable possessory interest.
Calculate	Present value of the reversion.
Subtract	Present value of the reversion from the estimated fee value.
Equals	Indicated value of subject taxable possessory interest.

Cost Approach

Estimate	Value of the improvements on the valuation date (estimated replacement cost new less depreciation).
Estimate	Value of the taxable interest possessory in land, using the comparative sales approach (direct or indirect method) or the income approach (direct or indirect method).
Sum	Estimated value of the improvements and estimated value of the taxable possessory interest in land .
Subtract	Present value of the estimated future reversionary value of the improvements, if any.
Equals	Indicated value of subject taxable possessory interest.

VALUATION OF PRE-*DE LUZ* TAXABLE POSSESSORY INTERESTS

As discussed above, pre-*De Luz* taxable possessory interests are interests that were created prior to the effective date (i.e., December 25, 1955) of *De Luz Homes, Inc.* v. *County of San Diego* and that have not since been extended or renewed. Under section 107.1, the full cash value of such interests is limited to the possessor's equity value in the leasehold interest. A taxable possessory interest valued under a pre-*De Luz* method will always have a lower value than if it were valued under a post-*De Luz* method.

The clearest way to present the valuation methods for pre-*De Luz* taxable possessory interests is to simply describe how each pre-*De Luz* method differs from the corresponding post-*De Luz* method described earlier. As with post-*De Luz* taxable possessory interests, the are five methods of valuation for pre-*De Luz* taxable possessory interests:

1. Comparative Sales Approach (Pre-*De Luz*)
   - Comparative Sales Approach-Direct Method
   - Comparative Sales Approach-Indirect Method
2. Income Approach (Pre-*De Luz*)
   - Income Approach-Direct Method
   - Income Approach-Indirect Method
3. Cost Approach (Pre-*De Luz*)

Each pre-*De Luz* valuation method requires a single adjustment only to the corresponding post-*De Luz* method to arrive at the pre-*De Luz* value indicator.

Comparative Sales Approach (Pre-*De Luz*)

Comparative Sales Approach-Direct Method

The subject taxable possessory interest is valued as in the corresponding post-*De Luz* method described earlier, but the present value of the unpaid future contract rent for the reasonably anticipated term of possession is not added to the sale price of the taxable possessory interest.

Comparative Sales Approach-Indirect Method

The subject taxable possessory interest is valued as in the corresponding post-*De Luz* method described earlier, but the value of the private possessor's rights as if owned in fee (i.e., as if owned in perpetuity) is reduced by the present value of the unpaid future contract rent for the reasonably anticipated term of possession in addition to being reduced by the present value of the reversionary rights of the public owner.

Income Approach (Pre-*De Luz*)

Income Approach-Direct Method

The subject taxable possessory interest is valued as in the corresponding post-*De Luz* method described earlier, but the net income to be capitalized is reduced by the unpaid future contract rent for the reasonably anticipated term of possession in addition to the reductions for allowed expenses.

Income Approach-Indirect Method

The subject taxable possessory interest is valued as in the corresponding post-*De Luz* method described earlier, but the value of the possessor's rights as if owned in fee (i.e., as if owned in perpetuity) is reduced by the present value of the unpaid future contract rent for the reasonably anticipated term of possession in addition to being reduced by the present value of the reversionary rights of the public owner.

Cost Approach (Pre-*De Luz*)

The subject taxable possessory interest is valued as in the corresponding post-*De Luz* method described earlier, but the indicated value is reduced by the present value of the unpaid contract rent for the taxable possessory interest in land for the reasonably anticipated term of possession.

Summary—Pre-*De Luz* Valuation Methods

PRE-*DE LUZ* VALUATION METHOD	**DIFFERENCE FROM POST-*DE LUZ* METHOD**
Comparative Sales Approach-Direct Method	Do not add the present value of unpaid future contract rent to the sale price of the taxable possessory interest.
Comparative Sales-Indirect Method	Subtract the present value of unpaid future contract rent from as-if-in- fee value of the taxable possessory interest.
Income-Direct Method	Reduce the net income to be capitalized by the unpaid contract rent of the taxable possessory interest.
Income-Indirect Method	Subtract the present value of the unpaid future contract rent from as-if-in-fee value of the taxable possessory interest.
Cost Approach	Reduce the indicated value by the present value of the unpaid contract rent for the taxable possessory interest in land.

APPLICABILITY OF VALUATION METHODS

Read together, Rules 4, 6, and 8 provide an order of preference for the applicability of the valuation approaches. When reliable comparative sales data are available, the preferred valuation approach is the comparative sales approach. When market sales data are not available, but an income for the subject property can be reliably estimated, the income approach is next preferred. Finally, when neither reliable sales nor income data are available, the cost approach is preferred. The same order of preference applies to the valuation approaches for taxable possessory interests.

In practice, as most appraisers realize, the application of the valuation approaches is strongly influenced by the quantity and quality of the available data. Set forth below are some comments regarding the applicability of the taxable possessory interest valuation approaches:

1. For most types of taxable possessory interest, sales data are very scarce. This limits the application of the comparative sales approach-direct method, which relies on sales data. Nevertheless, this approach is sometimes applied to those types of interests for which sales data may be available (e.g., resort cabins and boat slips).

2. Because quality rental data is often readily available, the income approach-direct method is probably the most widely used valuation method for taxable possessory interests. This is particularly true for taxable possessory interests in land only, but it is also true for taxable possessory interests that include improvements (in which case, of course, the income to be

capitalized would include the income attributable to the entire appraisal unit, that is, both land and improvements).

3. The comparative sales approach-indirect method requires an estimate of the reversionary value of the appraisal unit (i.e., either land only or land and improvements if the subject taxable possessory interest is improved). An estimate of this value may be speculative because it requires the appraiser to estimate the value of the subject property as of a future date. This shortcoming, however, is mitigated if the reasonably anticipated term of possession is either relatively long or relatively short. If the reversion is far into the future, the estimate of the reversionary value is less significant because it will be deeply discounted and will have a relatively insignificant impact on the value indicator. If the reversion is near into the future, an estimate of its value is significantly less speculative.

4. As with the comparative sales approach-indirect method, the limitation of the income approach-indirect method involves the difficulty of supporting a reversionary value tied to a future date. But again this drawback is reduced if the reversion occurs either relatively far or relatively near into the future.

5. The cost approach is almost always used when the improvements are constructed by the possessor, although it also may be applicable in other circumstances. As with the conventional cost approach used in the valuation of a fee simple interest, the difficult aspect of the approach with taxable possessory interests also involves an estimate of the amount of depreciation. With a taxable possessory interest, applying the cost approach also requires a determination of the reversionary value, if any, of the improvements and a technique for estimating this value. The value of the associated taxable possessory interest in land, as discussed, can be estimated using any of the other four valuation methods for taxable possessory interests, subject to the attendant limitations.

CHAPTER 4: TAXABLE POSSESSORY INTERESTS AND ARTICLE XIII A OF THE CALIFORNIA CONSTITUTION

This chapter discusses taxable possessory interest assessment in the context of article XIII A of the California Constitution (i.e., "Proposition 13," the tax limitation initiative approved in June 1978). In general, the provisions of article XIII A and related statutes and regulations apply to the assessment of taxable possessory interests. In brief, this means the following:

- A taxable possessory interest receives a base year value according to section 110.1.
- Annually thereafter, the taxable value of the possessory interest is the lesser of its factored base year value or its fair market value, as prescribed in section 51.
- A taxable possessory interest is subject to the change in ownership and new construction provisions of sections 60 and following and sections 70 and following, respectively.
- A taxable possessory interest, with one excepted case, is subject to supplemental assessment under sections 75.10 and following.

In addition to the above, at the end of the chapter we discuss some general assessment issues related to taxable possessory interests that do not derive from article XIII A.

BASE YEAR VALUE

As with other real property and as provided in section 110.1, a taxable possessory in existence on March 1, 1975, received a base year based on its fair market value as of that date, with that value indexed by the inflation factor to the 1978 lien date. A taxable possessory interest created after March 1, 1975, receives a base year value equal to its fair market value on the date of its change in ownership.[48] The base year value for taxable improvements on tax-exempt land completed after March 1, 1975, is based on the fair market value of the newly constructed improvements on their date of completion.

TAXABLE VALUE ON EACH LIEN DATE

As with other real property, and as provided in section 51, the taxable value of a taxable possessory interest on each lien date is the lesser of (1) its base year value compounded annually since its base year by the annual inflation factor or (2) its fair market value ("full cash value") on the lien date taking into account factors that may have caused a decline in value of the taxable possessory interest. Taxable possessory interests may also qualify for valuation under the disaster, misfortune, or calamity provisions of subdivisions (b) and (c) of section 51.

[48] The change in ownership date of a taxable possessory interest may be based on the interest's date of creation, renewal, extension, or assignment, depending on the circumstances; change in ownership is discussed in more detail below.

Among the factors that may cause a decline in value of a taxable possessory interest is a reduction in the reasonably anticipated term of possession used to value the interest. As discussed in Chapter 3, if the reasonably anticipated term of possession is based on the stated term of possession, as is presumed under subsection (d) of Rule 21, the reasonably anticipated term of possession will decline each year because the stated term of possession on the lien date is defined as the remaining term of possession on the valuation date under the legal instrument that evidences the taxable possessory interest.

Thus, to estimate the fair market value of such a taxable possessory interest using the income approach-direct method, the appraiser should use an income and capitalization rate that reflects market conditions on the lien date and discount the income over the stated term of possession (i.e., the remaining term under the lease or agreement) as of the lien date. This value does not constitute a new base year value; rather, it is an estimate of the fair market value (full cash value) on the lien date, which the appraiser must compare to the factored base year for enrollment purposes.

CHANGE IN OWNERSHIP

Under Article XIII A of the California Constitution and related legal provisions, real property is reappraised on a change in ownership. The general definition of change in ownership appears in section 60:

> A "change in ownership" means a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest."

Thus, under the above definition, in order to constitute a change in ownership, a transfer must meet three tests: (1) it must convey a present interest in the real property; (2) it must convey beneficial use of the real property; and (3) it must convey an interest in the real property that is substantially equal in value to the fee simple interest. Change in ownership provisions specifically applicable to taxable possessory interests are discussed below.

REVIEW OF LEGAL PROVISIONS

The legal provisions that relate to a change in ownership of a taxable possessory interest are contained in sections 61 and 62 and Rule 462.080. Under subdivision (d) section 61, the following events constitute a change in ownership of a taxable possessory interest:

- The creation, renewal, extension, or assignment of a taxable possessory interest for any term, with the following exception: The renewal or extension of a taxable possessory interest during the reasonably anticipated term of possession used by the assessor to establish the existing base year value of the interest does not constitute a change in ownership until the end of that reasonably anticipated term of possession. (Section 61, subdivision (b)(2); Rule 462.080, subsection (b)(2).) Creation, renewal or extension, and assignment are defined as follows:

> "Creation" of a taxable possessory interest 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 an existing taxable possessory interest; or (iii) a subsequent grant or other conveyance of additional valuable property rights to uses to a preexisting taxable possessory interest. (Rule 21, subsection (a)(9).)
>
> "Renewal" or "extension" of a taxable possessory interest means the lengthening of the period of possession of a taxable possessory interest, such as by the exercise of an option to renew or to extend a lease or permit. But "renewal" and "extension" do not include the granting of an option to renew or extend an existing agreement pursuant to which the term of possession of the existing agreement would, upon exercise of the option, be lengthened, whether the option is granted in the original agreement or subsequently. (Rule 21, subsection (a)(10); Rule 462, subsection (a).)
>
> "Assignment" of a taxable possessory interest means the transfer of all rights held by a transferor in a taxable possessory interest. (Section 61, subdivision (b)(3).)

- The sublease of a taxable possessory interest for a term (including renewal options) that exceeds half the length of the remaining term of the master taxable possessory interest (including renewable options). (Section 61, subdivision (d)(1).)
- The termination of a sublease of a taxable possessory interest with an original term (including renewal options) that exceeds half the length of the remaining term of the master taxable possessory interest (including renewal options). (Section 61, subdivision (d)(1).)
- The transfer of a sublessee's interest with a remaining term (including renewal options) that exceeds half of the remaining term of the master taxable possessory interest (including renewal options). (Section 61, subdivision (d)(1).)
- The transfer of a taxable possessory interest subject to a sublease with a remaining term (including renewal options) that does not exceed half the remaining term of the master taxable possessory interest (including renewal options). (Section 61, subdivision (d)(2).)

Under section 62 and Rule 462.080, the following activities do not constitute a change in ownership of a taxable possessory interest:

- The creation of an interest by reservation in the instrument that deeds the interest to a tax exempt government entity, regardless of whether the interest created is an estate for years or an estate for life. (Rule 462.080, subsection (b)(1).)
- The sublease of a taxable possessory interest for a term (including renewal options) that does not exceed half the length of the remaining term of the master taxable possessory interest (including renewal options). (Rule 462.080, subsection (b)(3).)

- The termination of a sublease of a taxable possessory interest having an original term (including renewal options) that did not exceed half the length of the remaining term of the master taxable possessory interest (including renewal options) when the sublease was entered into. (Rule 462.080, subsection (b)(4).)
- The transfer of a sublessee's interest in a taxable possessory interest, with a remaining term (including renewal options) that does not exceed half of the remaining term of the master taxable possessory interest. (Rule 462.080, subsection (b)(5).)
- The transfer of a taxable possessory interest subject to a sublease with a remaining term (including renewal options) that exceeds half the length of the remaining term of the master taxable possessory interest (including renewal options). (Rule 462.080, subsection (b)(6); section 62, subdivision (o).)

Summary: Taxable Possessory Interests and Change in Ownership Provisions

CONSTITUTES A CHANGE IN OWNERSHIP	EXCLUDED FROM A CHANGE IN OWNERSHIP
The creation, renewal, extension, or assignment of a taxable possessory interest for any term, with the following exception:. A renewal or extension does not constitute a change in ownership until the end of the reasonably anticipated term of possession used by the assessor to establish the existing base year value of the interest. [Section 61, subdivision (b)(1).]	
	The creation of an interest by reservation in an instrument that deeds the interest to a tax exempt government entity, regardless of whether the interest created is an estate for years or an estate for life.[Rule 462.080, subsection (b)(1).]
The sublease of a taxable possessory interest for a contract term (including any renewal options) that exceeds half the length of the remaining contract term (including any renewal options) of the master taxable possessory interest. [Section 61, subdivision (d)(1).]	The sublease of a taxable possessory interest for a term (including renewal options) that does not exceed half the length of the remaining contract term of the master taxable possessory interest (including renewal options). [Rule 462.080, subsection (b)(3).]
The termination of a sublease of a taxable possessory interest with an original contract term (including any renewal options) that exceeds half the length of the remaining contract term (including any renewal options) of the master taxable possessory interest. [Section 61, subdivision (d)(1).]	The termination of a sublease of a taxable possessory interest with an original term (including renewal options) that did not exceed half the length of the remaining contract term of the master taxable possessory interest (including renewal options) when the sublease was entered into. [Rule 462.080, subsection (b)(4).]
The transfer of a sublessee's interest in a taxable possessory interest with a remaining contract term (including any renewal options) that exceeds half the remaining contract term of the master taxable possessory interest. [Section 61, subdivision (d)(1).]	The transfer of a sublessee's interest in a taxable possessory interest, with a remaining term (including any renewal options) that does not exceed half of the remaining contract term of the master taxable possessory interest. [Rule 462.080, subsection (b)(5).]
The transfer of a taxable possessory interest subject to a sublease with a remaining contract term (including any renewal options) that does not exceed half the contract term of the master taxable possessory interest. [Rule 61, subdivision (d)(2).]	The transfer of a taxable possessory interest subject to a sublease with a remaining contract term (including any renewal options) that exceeds half the length of the remaining contract term of the master taxable possessory interest (including any renewal options). [Rule 462.080, subsection (b)(6); section 62, subdivision (o)]

SUBLEASES AND CHANGE IN OWNERSHIP

Most of the above provisions pertain to the change-in-ownership implications of a sublease of a taxable possessory interest. The sublease provisions regarding taxable possessory interests are analogous to those contained elsewhere in statute that pertain to change in ownership vis-à-vis leasehold interests in privately owned real property. The guiding principle behind them is that a change in ownership occurs, for property tax purposes, when the primary economic interest in a property transfers. In the case of privately owned property held in fee simple, this is deemed to occur with the creation of a leasehold interest of 35 years or more. In the case of a taxable possessory interest, this is deemed to occur with the creation of subleasehold interest in the taxable possessory interest that is greater than half the remaining term of the taxable possessory interest itself.

Thus, for example, as to privately owned real property held in fee, a change in ownership occurs when a lease of 35 years or more is created, but a change in ownership does not occur when there is a transfer of an underlying fee interest that is subject to a leasehold interest of 35 years or more. In the first case, the primary economic interest in the property transfers; in the second, it does not. Similarly, a change in ownership occurs when a sublease of a taxable possessory interest is created that has a contract term that is greater than half the remaining term of the taxable possessory interest, but a change in ownership does not occur when there is a transfer of the taxable possessory interest subject to a subleasehold interest with a contract term greater than half the remaining term of the taxable possessory interest.

When a change in ownership of a taxable possessory interest occurs because of a sublease transaction, and the sublease involves a portion rather than all of the taxable possessory interest, only the subleased portion of the taxable possessory interest changes ownership, not the entire taxable possessory interest; that is, only a portion of the existing taxable possessory interest should receive a new base year value. In this case, establishing the new assessed value of the subject taxable possessory interest involves removing the portion of its base year value that corresponds to the newly subleased portion and adding the value of the newly subleased portion that results from the change in ownership.

When estimating the value of a subleased portion, the valuation variables, whatever the approach used, should reflect market conditions on the valuation date (i.e., the date of the change in ownership). The correct term of possession is the reasonably anticipated term of possession of the "parent" taxable possessory interest (i.e., the master taxable possessory interest or masterleasehold interest) because it is this property interest (or a portion thereof) that changed ownership and, consequently, is being revalued.

EXAMPLE 4.1

SUBLEASE OF TAXABLE POSSESSORY INTEREST AND CHANGE IN OWNERSHIP

Assume a private developer leases a 50-acre tract of land from a public entity for 60 years. The assessor values the taxable possessory interest based on the stated term of possession—that is, the remaining term under the lease—which initially is 60 years.

Five years later, the developer subleases 10 acres of the tract to a private corporation for 30 years. The sublease constitutes a change in ownership of the 10-acre portion because the sublease is for a period greater than half the remaining term of the taxable possessory interest (i.e., 30 years > ½ of 55 years). The reasonably anticipated term of possession used in the valuation of the subleased portion should be 55 years, based on the master taxable possessory interest, not 30 years based on the remaining term of the sublease.

Which party should be assessed is largely in the assessor's discretion. Section 405 provides that the assessor shall assess all taxable property in the county, except state-assessed property, "to the persons owning, claiming, possessing, or controlling it on the lien date." The section does not limit the assessor to either the holder of the taxable possessory interest (i.e., the masterlessee) or the holder of the subleasehold interest (i.e., the sublessee). Instead, the statute authorizes an assessment to either party or both.[49]

CHANGE IN OWNERSHIP AND LEASED PROPERTY ACQUIRED BY A PUBLIC ENTITY

Two questions arise when a public entity acquires privately owned real property subject to a lease, that is, when the public entity acquires a leased fee interest:[50]

1. Do any leasehold interests that exist on the acquisition date become taxable possessory interests on that date?

2. If so, is there a change in ownership of such interests on the acquisition date?

The answer to the first question is that, assuming they satisfy the legal criteria for constituting a taxable possessory interest, the leasehold interests become separately assessable taxable possessory interests on the date of acquisition by the public entity. The answer to the second question, however, is that the acquisition does not constitute a change in ownership of the leasehold interests for the purposes of section 61(b). The tenant's leasehold interests have not changed ownership. Such interests should be valued as if they had been taxable possessory

[49] Although it does not specifically address the sublease of a taxable possessory interest, see also section 2188.4.

[50] A common example of this occurs when a public employees retirement system acquires investment real estate subject to existing leases.

interests when the leases commenced. In other words, they should receive a base year value, in retrospect, as of the date the leases commenced. If the interests are subsequently renewed, extended, or assigned, of course, a change in ownership under section 61(b) occurs, and they should be reassessed and new base year values established.[51]

MONTH-TO-MONTH TENANCIES AND CHANGE IN OWNERSHIP

When a tenant "carries over" under a month-to-month tenancy, this is a change in ownership.

Civil Code section 1946 states:

> A hiring of real property, for a term not specified by the parties, is deemed to be renewed as stated in Section 1945, at the end of the term implied by law unless one of the parties gives written notice to the other of his intention to terminate the same.…

And under Civil Code section 1945:

> If a lessee of real property remains in possession thereof after the expiration of the hiring, and the lessor accepts rent from him, the parties are presumed to have renewed the hiring on the same terms and for the same time, not exceeding one month when the rent is payable monthly, nor in any case one year.

Thus, pursuant to the above, a taxable possessory interest consisting of a month-to-month tenancy is renewed each month that a notice to terminate is not given, and a "renewal" constitutes a change in ownership under subdivision (b) of section 61. But, as discussed, under subdivision (b)(2) of section 61, the change in ownership would not be recognized until the end of the reasonably anticipated term of possession used by the assessor to establish the existing base year value of the interest.

NEW CONSTRUCTION

The statutory and regulatory provisions governing the assessment of "newly constructed" real property, or "new construction," are contained in section 70 et seq. and Property Tax Rules 463 and 463.500, respectively. Briefly described, these provisions explain the application of the base-year-value concept to newly constructed real property, define what constitutes new construction, cite specific statutory exclusions from new construction, and define the "date of completion" of new construction. As with all other newly constructed real property assessed under article XIII A, the assessment of new construction associated with a taxable possessory interest is governed by these provisions. By "new construction associated with a taxable possessory interest," we mean new construction that is directly related to the exercise of the rights held under the subject taxable possessory interest.

[51] LTA 83/03 should be disregarded to the extent that it conflicts with this advice.

In Chapter 2 we pointed out that all improvements associated with a taxable possessory interest, whether constructed or owned by the private possessor or the public owner, are part of the taxable possessory interest. Because they are part of the taxable possessory interest, all improvements should be valued as a taxable possessory interest—that is, net of the estimated present value of their reversionary value, if any.

New construction often is valued using the cost approach. In the case of new construction associated with a taxable possessory interest, if the appraiser uses the cost approach to derive a value indicator, the appraiser should adjust the cost indicator to account for the reversionary value, if any. This adjustment may be significant or nil, depending on the specific circumstances.

SUPPLEMENTAL ASSESSMENT

The legal provisions governing supplemental assessment are found in section 75 et seq. In general, a taxable possessory interest is subject to supplemental assessment in the same manner as other real property subject to article XIII A of the California Constitution—that is, a taxable possessory interest is subject to supplemental assessment on change in ownership or new construction. A few issues regarding supplemental assessment, however, that are particular to taxable possessory interests are discussed below.

Section 75.5 exclusion. Under section 75.5, a newly created taxable possessory interest that is established by a month-to-month agreement and has a full cash value of $50,000 or less is excluded from supplemental assessment.

Termination and creation of interest in same tax year. This issue concerns what to do when one taxable possessory interest is terminated during an assessment year (i.e., after the January 1 lien date) and a second (but distinct) taxable possessory interest is created involving the same land and improvements during the same assessment year. Concerning this situation, some have raised the following questions:

1. Should there be a negative supplemental assessment (a "supplemental refund") for the taxable possessory interest that terminated?

2. Is the proper supplemental assessment amount for the newly created taxable possessory interest the fair market value of the newly created interest with no offset for an existing value on the regular assessment roll, or is it the fair market value of the newly created interest reduced by the existing roll value of the taxable possessory interest that terminated?

The proper treatment of this situation was described in Letter to Assessors No. 86/12, and that guidance remains in effect. There should not be a negative supplemental assessment for the taxable possessory interest that terminated, and the supplemental assessment amount for the newly created possessory interest should be based on its fair market value (i.e., its full cash value, or new base year value) without offset for a prior value on the regular assessment roll.

The reasoning behind this treatment is as follows. It is not the government's land and improvements that are being assessed; rather, it is the taxpayer's right to possess the land and improvements that is being assessed. Thus, each respective taxpayer's taxable possessory interest, each right to possess, is subject to separate assessment.[52]

To assess two successive (but distinct) taxable possessory interests involving the same real property does not constitute double taxation for the reason that double taxation only occurs when "two taxes of the same character are imposed on the same property by the same taxing authority within the same jurisdiction during the same time period."[53] In the case of two different (albeit successive) taxable possessory interests, the "same property" is not being taxed; thus, there is no double taxation.

If, however, an existing taxable possessory interest is assigned or otherwise transferred to another, it would violate the prohibition on double taxation to levy assessments on both the existing interest and the assigned interest. This treatment would impose two property taxes on the same taxable possessory interest for the same taxing period.

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[52] See *United States* v. *Fresno County* (1975) 50 Cal.App.3d 633; 640; Revenue and Taxation Code section 104, subdivision (a).

[53] See *Russ Building Partnership* v. *City and County of San Francisco* (1988) 199 Cal.App.3rd 1496, 1509.

EXAMPLE 4.2

TERMINATION AND CREATION OF SEPARATE TAXABLE POSSESSORY INTEREST IN THE SAME ASSESSMENT YEAR INVOLVING THE SAME LAND AND IMPROVEMENTS

Assume that Taxpayer A holds a taxable possessory interest in a parking lot on January 1, 2001. The possessory interest is assessed at $100,000 for that lien date. On July 31, 2001, the lease expires, and Taxpayer A's taxable possessory interest is terminated. On September 1, 2001, Taxpayer B acquires a possessory interest in the same parking lot. This taxable possessory interest is assessed at $120,000, reflecting its fair market value on September 1.

The correct treatment is as follows: Taxpayer A does not receive a negative supplemental assessment; he is assessed based on $100,000 for the entire 2001-2002 fiscal year. Taxpayer B receives a supplemental assessment for the remainder of the 2001-2002 fiscal year based on a new base year value of $120,000. The amount of the supplemental assessment is $120,000; there is no offset for a current roll value in the levy of the supplemental assessment because two distinct interests—A's and B's—are being assessed.

If the example is modified slightly, however, a different conclusion results. If Taxpayer A had assigned or otherwise transferred the taxable possessory interest to Taxpayer B, the amount of Taxpayer B's supplemental assessment would have been $20,000 ($120,000 - $100,000); that is, the existing roll value of $10,000 would have been subtracted from the new base year value of $12,000. This treatment is based on the reasoning that the same interest is being taxed but to a new owner, Taxpayer B.

LOW-VALUE EXEMPTION

Under the provisions of section 155.20, a county board of supervisors may exempt from taxation all real property with a base year value so low that the total taxes, special assessments, and applicable subventions on the property are less than the cost of assessing and collecting them. In no instance, however, may a county exempt property with a base year value less than or equal to a statutory base year value limit; for most types of property, this limit is $5,000.

However, the statutory base year value limit is raised to $50,000 in the case of a taxable possessory interest for temporary or transitory use located in a publicly owned fairground, fairground facility, convention facility, or cultural facility. A "publicly owned convention or cultural facility" is defined in subdivision (b)(1) of section 155.20 as a publicly owned convention center, civic auditorium, theater, assembly hall, museum, or other civic building that is used primarily for staging conventions, trade and consumer shows, or civic and community events; live theater, dance, or musical productions; or artistic, historic, technological, or educational exhibits.

DISASTER RELIEF

Section 170 contains provisions related to the reassessment of property damaged by misfortune or calamity. The statute describes the conditions under which property is eligible for such reassessment, the method by which the damaged property should be reassessed, and the assessment roll procedures that should be used to effect the reassessment.

In general, under section 170, taxable possessory interests should be treated in the same manner as all other property. There is, however, one exception. Subdivision (a)(3) of section 170 applies specifically to taxable possessory interests. This subdivision provides that, with respect to a taxable possessory interest in land owned by the state or federal government, a misfortune or calamity that causes the possessor's right to possession to be suspended or restricted is eligible for reassessment. This subdivision cites a drought condition that affects state or federal lands in private possession as one example of such misfortune or calamity.

CHAPTER 5: SPECIAL ASPECTS OF TAXABLE POSSESSORY INTEREST ASSESSMENT

DISCOVERY OF TAXABLE POSSESSORY INTERESTS

Taxable possessory interests are often difficult for the assessor to discover. The document evidencing an interest (such as a lease or permit) may or may not be recorded. In addition, because taxable possessory interests involve publicly owned lands, interests may often go undiscovered by appraisers in the field.

There are several statutory provisions designed to help assessors discover the existence of taxable possessory interests (although none of them apply to federally owned real property). Of the statutory provisions, section 480.6 is the most notable and comprehensive.[54] This statute requires every state or local governmental entity that is the fee owner of real property in which a taxable possessory interest has been created to either (1) file the required preliminary change in ownership report or change in ownership statement with respect to a renewal of a taxable possessory interest; or (2) file an annual real property usage report that includes the following information:

- The name and address of the fee owner of the real property (i.e., the name of the public entity).
- The name and address of each holder of a taxable possessory interest in the real property.
- The type of transaction through which the holder of the taxable possessory interest acquired the interest (e.g., creation, renewal, sublease, or assignment).
- The description of the subject real property.
- The date of each transaction in which a holder of a taxable possessory interest in the real property acquired the interest.
- The terms of each transaction, to include the following: (i) the consideration given for the taxable possessory interest, whether in money or otherwise; (ii) the terms of the taxable possessory interest, including any options for renewal or extension; (iii) for any subleases, the original term and remaining term of the sublease, and the consideration paid for the master lease; and (iv) for any assignments, the original term and remaining term of the assignment and the consideration paid for the underlying lease.

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[54] In addition to Revenue and Taxation Code section 480.6, Health and Safety Code section 33673.1 requires a redevelopment agency to provide notice to the assessor (within 30 days) when the agency leases real property in a redevelopment project to any legal entity for redevelopment. The notice must provide the date on which the private possessor/lessee acquired the beneficial use of the property and must be accompanied by a memorandum of lease and a map of the leased property. Also, under Streets and Highways Code section 104.10, the California Department of Transportation (CalTrans) must notify each county of the rental amount and location of each parcel of rental property administered by CalTrans for which rents are deposited in the State Highway Account of the State Transportation Fund.

The most reliable method of discovery for taxable possessory interests is for the assessor to contact those public entities—federal, state, and local—that own real property in which taxable possessory interests may have been created. Within each level of government, the assessor must also identify the specific agency or bureau that administers publicly owned lands.[55]

Although citing the requirements of section 480.6 may be helpful, relying on statutory reporting requirements alone usually is insufficient, and, in the case of taxable possessory interests in federally owned property, the reporting requirements are not applicable. Thus, rather than simply waiting for government entities to report the existence of taxable possessory interests, the assessor usually must take a more active approach. For example, the assessor might try the following:

1. First, the assessor could identify all possible government entities whose property might be subject to a taxable possessory interest within the county.
2. Second, for each such entity, the assessor could prepare a spreadsheet or table that describes all known taxable possessory interests related to the entity and the assessor's existing data relating to the interest (e.g., contract rent, remaining term, etc.).
3. Finally, each year the assessor could make a written request that asks each governmental entity to update the information on the assessor's spreadsheet regarding the taxable possessory interests to which the governmental entity is a party.

Essentially, this approach follows section 480.6, but the assessor takes the initiative. It also simplifies the task of the reporting government entity because the entity only has to report by exception, that is, the entity only has to indicate any changes to the prior year's report.

ASSESSMENT ENROLLMENT

Although, under California law, taxable possessory interests pertain only to interests in real property, property taxes on these interests generally are collected as if they were levied on unsecured personal property, with the assessor entering the assessed value of the taxable possessory interest on the unsecured roll. The tax levied against a taxable possessory interest becomes a lien against the taxable possessory interest; and under Sections 2901, 2903, and 2951, taxes on property on the unsecured roll are due immediately on assessment and may be collected by the assessor by seizure and sale of the property.

Under section 107, however, at the discretion of the county board of supervisors, any taxable possessory interest may be considered sufficient security for the payment of property taxes levied on the interest and may be enrolled on the secured roll. In addition, under section 2190, the

[55] A list of federal, state, and local agencies that may lease public lands for private possession can be found in a report published by the State Lands Commission titled "Public Land Ownership in California." Mailing address: Public Land Ownership Report, State Lands Commission, 1020 12th Street, Second Floor, Sacramento, California 95814. Web site: <www.slc.ca.gov>.

assessment of any taxable possessory interest to which a homeowners' exemption has been applied must be entered on the secured roll.

TAXABLE POSSESSORY INTERESTS AND PROPERTY TAXABLE UNDER SECTION 11 OF ARTICLE XIII OF THE CALIFORNIA CONSTITUTION

In general. Real property owned by a local government (such as a county, city, or special district) and located outside its boundaries is subject to taxation under the provisions of section 11 of article XIII of the California Constitution. In general, land owned by a local government and located outside its boundaries is taxable if the land was taxable when acquired, and improvements owned by a local government and located outside its boundaries are taxable if the improvements were taxable when acquired or were constructed to replace improvements that were taxable when acquired.

Taxable possessory interests in taxable government-owned real property are subject to taxation under the same general authority of section 1 of article XIII that applies to taxable possessory interests in nontaxable publicly owned property. The taxability of such interests also is affirmed in subdivision (f) of section 11, which provides that "[a]ny taxable interest of any character, other than a lease for agricultural purposes and an interest of a local government, in any land owned by a local government that is subject to taxation pursuant to section 11(a) of this Article shall be taxed in the same manner as other taxable interests."[56]

Given that both extraterritorial government-owned real property and any related taxable possessory interests are potentially subject to taxation under section 11, subdivision (f) of section 11 was added to ensure that, for a given unit of real property, the total of the assessment of the taxable government owned interest and of any taxable possessory interest assessments would not exceed the value of the entire fee simple interest in the unit of real property (i.e., full cash value of the unit of real property).[57]

Recently adopted Rule 29 prescribes a method for determining the limit to the aggregate assessment of taxable possessory interests in a unit of taxable government-owned real property under subdivision (f) of section 11. The fundamental principle of Rule 29 is to allow taxable possessory interest assessment up to the amount of exemption from fair market value provided under the value formulas of section 11, but to exclude from taxable possessory interest assessment any potential additional exemption from fair market value resulting from the base-year-value concept of article XIII A.

Rule 29 operates through two primary concepts: (1) the "section 11 value of taxable government-owned real property"; and (2) the "section 11 taxable possessory interest limitation amount,"

[56] Note that this constitutional provision specifically excludes agricultural leases in taxable government-owned real property from taxation.
[57] See also *Scott-Free River Expeditions, Inc.* v. *El Dorado County* (1988) 203 Cal.App.3d 896.

which is the limit placed on the aggregate taxable possessory interest assessment under subdivision (f) of section 11.

Section 11 value of taxable government owned real property. The section 11 value of taxable government-owned real property is defined as the sum of the following three values determined as of the lien date:

1. The value of taxable government-owned land, as determined in accordance with subdivisions (b) and (c) of section 11
2. The value of any taxable replacement improvements, as determined in accordance with subdivision (d) of section 11
3. The fair market value of any other taxable improvements

Frequently, the above values, which are based on the value formulas contained in subdivisions (b) through (e) of section 11, are not the same as the assessed values (i.e., the values actually enrolled) because they do not consider the base year value concept of article XIII A of the California Constitution. Section 11 was adopted prior to Article XIII A; consequently, the value formulas of section 11 do not address the concept of base year value.[58] In determining the "section 11 value of taxable government owned real property," factored base year value is not considered. In other words, the "section 11 value of taxable government owned real property" is determined solely in accordance with the provisions of article XIII, section 11, as if article XIII A did not exist. [59]

Section 11 taxable possessory interest limitation amount. The "section 11 taxable possessory interest limitation amount" is the difference between the fair market value of the taxable government-owned real property on the lien date and the section 11 value of the taxable government-owned real property on the lien date. The concept of the fair market value of the taxable government-owned property on the lien date is largely self-explanatory. It may not be clear, however, why the amount subtracted from the fair market value of the taxable government-owned real property should not simply be the assessed value of the taxable government-owned real property rather than the section 11 value of taxable government-owned real property defined in Rule 29 and described above.

One way to view section 11 and article XIII A is that both provide a partial "exemption" from the standard of fair market value. That is, the extent to which subdivisions (b) through (d) of section 11 allow an assessed value below fair market value can be considered a partial exemption;

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[58] In *City and County of San Francisco* v. *County of San Mateo* (1995) 10 Cal.4th 554, the court held that the factored base year value concept of article XIII A applies in the assessment of government owned real property that is taxable under article XIII, section 11.

[59] Section 11 does not provide a special assessment formula for "other taxable improvements" (as that term is defined in Rule 29); improvements in this category are fully taxable to the government owner. Thus, the only potential partial exemption from full cash value that could be provided to these improvements is through article XIII A of the California Constitution (i.e., the base year value concept).

likewise, the extent to which article XIII A allows an assessed value below fair market value also can be considered a partial exemption. To calculate the limitation amount applicable to the assessment of taxable possessory interests in section 11 real property by reference to the assessed values is to potentially include the partial exemption provided by article XIII A in the assessments of these taxable possessory interests. Instead, by calculating the taxable possessory interest limitation amount in a manner that excludes consideration of article XIII A's base year value concept, Rule 29 prevents the allowable assessment of taxable possessory interests in section 11 real property from encompassing the partial exemption under article XIII A that has been provided to the government owner.

Rule 29 only addresses the limit to taxable possessory interest assessment in taxable government-owned real property. Conceivably, however, the unit of real property could also include taxable possessory interests in nontaxable government-owned real property, such as extraterritorial local-government-owned land that was not taxable when acquired. There is no taxable possessory interest limitation amount with regard to nontaxable government-owned property; taxable possessory interests in nontaxable government owned real property may be assessed up to the fair market value of such real property.

If limitation amount exceeded. In addition to defining the taxable possessory interest limitation amount, Rule 29 prescribes a method for reducing the aggregate assessed value of taxable possessory interests in an appraisal unit of taxable government-owned property when the aggregate assessed value of such interests exceeds the taxable possessory interest limitation amount. The most likely occurrence of this is in the event of a decline in value. In essence, Rule 29 provides that the assessed value of each taxable possessory interest shall be reduced pro rata, based on its proportion of the total assessed value of all taxable possessory interests in the appraisal unit, such that the total assessed value of all taxable possessory interests no longer exceeds the taxable possessory interest limitation amount on the lien date.

Supplemental assessments. Because section 11 was adopted prior to article XIII A, the limitation on the assessment of taxable possessory interests in section 11 real property prescribed in section 11 was drafted as if all assessments took place on the lien date only. As a consequence, there is no straightforward or practical method of applying the limitation amount to the supplemental assessment of a newly created taxable possessory interest. That is, the taxable possessory interest limitation amount has only lien date application.

EXAMPLE 5.1

DETERMINATION OF TAXABLE POSSESSORY INTEREST LIMITATION AMOUNT

Subject property: Investment real estate owned by a county employees retirement system and located outside the system's boundaries. The property is subject to assessment under article XIII, section 11, and to taxable possessory interest assessment.

Assuming the relevant lien date values below, determine the taxable possessory interest limitation amount, that is, the property's maximum allowed aggregate taxable possessory interest assessment, as prescribed in Rule 29.

Land:		
Fair market value	$10,000,000	
Factored base year value	3,000,000	
Article XIII, section 11	4,000,000	
Assessed (enrolled) value		$3,000,000
Taxable replacement improvements:		
Fair market value	$6,000,000	
Factored base year value	5,000,000	
Article XIII, section 11	4,000,000	
Assessed (enrolled) value		$4,000,000
Other taxable improvements:		
Fair market value	$3,000,000	
Factored base year value	2,000,000	
Article XIII, section 11	3,000,000	
Assessed (enrolled) value		$2,000,000
Nontaxable improvements:		
Fair market value	$1,000,000	
Factored base year value	-0- (n/a)	
Article XIII, section 11	-0- (n/a)	
Assessed (enrolled) value		-0- (n/a)
Totals (entire unit):		
Fair market value	$20,000,000	
Factored base year value	10,000,000	
Article XIII, section 11	11,000,000	
Assessed (enrolled) value		$9,000,000

EXAMPLE 5.1 (CONTD.)

Solution:

Total real property fair market value		$20,000,000
Less:		
Land—section 11	($4,000,000)	
Taxable replacement improvements—section 11	(4,000,000)	
Other taxable improvements—fair market value	(3,000,000)	
Nontaxable improvements	0	(11,000,000)
Taxable possessory interest limitation amount		$9,000,000

Thus, taxable possessory interests may be assessed up to an aggregate amount of $9,000,000. This is the taxable possessory interest limitation amount.

Note that the limitation amount is not simply equal to the fair market value of the unit minus the assessment made pursuant to article XIII, section 11, and article XIII A. In the example, the limitation amount is $9,000,000, but the fair market value of the unit minus the assessed value of the unit is $11,000,000 ($20,000,000 - $9,000,000).

If a property's aggregate taxable possessory interest assessment exceeds the limitation amount, it must be reduced to the limitation amount. If more than one taxable possessory interest exist, the limitation amount should be allocated among the subject property's existing taxable possessory interests based on their respective fair market values.

For example, assume that the subject property above has two taxable possessory interests, with fair market values on the lien date of $6,000,000 and $4,000,000, respectively. The allocation of the taxable possessory interest limitation amount of $9,000,000 would be as follows:

First taxable possessory interest allocated amount:

$6,000,000/$10,000,000 x $9,000,000 = $5,400,000.

Second taxable possessory interest allocated amount:

$4,000,000/$10,000,000 x $9,000,000 = $3,600,000.

TAXABLE POSSESSORY INTERESTS AND INVESTMENT PROPERTY OF PUBLIC EMPLOYEES RETIREMENT SYSTEMS

Most of California's public employees retirement systems hold investment real property, that is, income-producing real property held in a system's investment portfolio for the benefit of the system's beneficiaries. The assessment of this type of real property is governed by the provisions of Government Code section 7510, a specific statute that addresses the issue; California Constitution, article XIII, section 11, which allows for the taxation of real property that is owned by a local government but is located outside its boundaries; and section 107, which together with related regulations, governs the assessment of taxable possessory interests. To correctly assess this type of property, the appraiser must reconcile these several legal provisions.

There are both state and local public employees retirement systems in California. The two major state retirement systems are the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS). There are many local systems operated by the state's counties, cities, and special districts; county systems are by far the most significant in terms of asset value.[60]

The problem of assessing public employees retirement system property can be analyzed in terms of three questions:

1. If a local retirement system (i.e., a system of a county, city, or special district) owns investment real property inside its boundaries, how should the property be assessed?

2. If a local retirement system owns investment real property outside its boundaries, how should the property be assessed?

3. How should the investment real property of a state retirement system, (e.g., CalPERS or CalSTRS) be assessed?[61]

LOCAL PUBLIC EMPLOYEES RETIREMENT SYSTEM: REAL PROPERTY INSIDE SYSTEM'S BOUNDARIES

Subdivision (a) of section 7510 of the Government Code, which applies only to investment real property owned by local public employees retirement systems, contains the concept of an in-lieu fee (i.e., a fee in lieu of property taxes):

[60] Public employees retirement systems are considered legal instrumentalities of the government entities that create them, and a system's boundaries for assessment purposes correspond to that of its parent governmental entity. Thus, a county system has the boundaries of the parent county; a city system the boundaries of the parent city; and a special district system, the boundaries of the parent district. The boundaries of the state public employees retirement systems are the boundaries of the state of California.

[61] In general, investment real property located in California that is owned by a public employees retirement system from another state is taxable as if it were privately owned.

> … [A] public retirement system, which has invested assets in real property and improvements thereon for business or residential purposes for the production of income, shall pay annually to the city or county, in whose jurisdiction the real property is located and has been removed from the secured roll, a fee for general governmental services equal to the difference between the amount that would have accrued as real property secured taxes and the amount of possessory interest unsecured taxes paid for that property.

Absent the above provisions, if a local public employees retirement system acquired investment real property inside its boundaries, its interest would become nontaxable under article XIII, section 3, and the assessment would be "removed from the roll." Subdivision (a) of Section 7510, however, provides for a fee in lieu of property taxes in this case. This in-lieu fee operates to prevent certain investment real property of public employees retirement systems from leaving the assessment roll as exempt.

The in-lieu fee is the difference between (i) the property taxes that would have been collected had the property been assessed under article XIII A ("the amount that would have accrued as real property secured taxes") and (ii) the aggregate amount of property taxes resulting from taxable possessory interest assessments in the property. Thus, the assessor must determine the following when assessing the investment real property of a local public employees retirement system located within the system's boundaries:

1. The assessed value of the property in accordance with article XIII A and related statutes, as if the property were owned by a private entity
2. The aggregate assessed value of all taxable possessory interests in the property
3. The value on which the in-lieu fee is based by subtracting No. 2 from No 1

Subdivision (a)(2) of section 7510 restricts the application of the in-lieu fee , providing that the in-lieu fee does not apply "to any retirement system which is established by a local governmental entity if that entity is presently authorized by statute or ordinance to invest retirement assets in real property." In other words, if a local public retirement system was authorized to invest in real property prior to the effective date of section 7510 (January 1, 1983), any investment real property owned by the system is not subject to the in-lieu fee. This restriction, however, applies to the in-lieu fee only; it is not applicable to the assessment of taxable possessory interests in the real property.

LOCAL PUBLIC EMPLOYEES RETIREMENT SYSTEM: REAL PROPERTY OUTSIDE SYSTEM'S BOUNDARIES

The in-lieu fee of subdivision (a) of section 7510 only applies to investment real property whose value "has been removed from the secured roll." The investment real property of a local public employees retirement system is not removed from the roll; rather, it is taxable under the provisions of article XIII, section 11. Therefore, the in-lieu fee does not apply to investment real property of a local public employees retirement system that is located outside its boundaries.

The assessment of the investment real property of a local public employees retirement system that is outside the system's boundaries involves (1) an assessment under article XIII, section 11; and (2) separate assessments for any taxable possessory interests in such property, subject to the limitation set forth in subdivision (f) of section 11. As we discussed in the above section concerning the assessment of taxable possessory interests in section 11 real property, the taxable possessory interest limitation amount operates to establish an aggregate limit to the assessment of taxable possessory interests in section 11 real property.

Thus, the proper assessment of the investment real property of a local public employees retirement system that is located outside the system's boundaries requires that the appraiser determine the following:

1. The assessed values of the publicly owned land and improvements determined according to article XIII, section 11
2. The values of any taxable possessory interests in the section 11 property, determined in accordance with the applicable statutes and rules governing the assessment of taxable possessory interests, and subject to the taxable possessory interest limitation amount defined in Rule 29

The unit of real property's entire assessment is the sum of the values in Nos. 1 and 2.

STATE PUBLIC EMPLOYEES RETIREMENT SYSTEMS

As previously stated, subdivision (a) of Government Code section 7510 applies to the assessment of the investment property of local public employees retirement systems only. The assessment of the investment real property of state public employees retirement systems (e.g., the investment real property of CalPERS or CalSTRS) is governed by subdivision (b) of section 7510.

Neither the in-lieu fee nor, by definition, an assessment under article XIII, section 11, applies to investment real property owned by state public employees retirement systems. Nevertheless, under subdivision (b) of section 7510, a taxable possessory interest in the investment real property of a state public employees retirement system (e.g., CalPERS or CalSTRS) is subject to assessment. Subdivision (b)(1) of section 7510 prescribes a specific method for determining the assessed value of each taxable possessory interest in such property:

> [T]he full cash value, as defined in Sections 110 and 110.1 of the Revenue and Taxation Code, of the possessory interest upon which property taxes will be based shall equal the greater of (A) the full cash value of the possessory interest, or (B), if the lessee has leased less than all of the property, the lessee's allocable share of the full cash value of the property that would have been enrolled if the property had been subject to property tax upon acquisition by the state public retirement system.

In other words, the assessed value of each taxable possessory interest is the greater of (1) the full cash value of the subject taxable possessory interest or (2) a value based on the possessor's allocable share of the full cash value of the real property, meaning the value that would have been enrolled under article XIII A and related statutes for the entire fee simple interest (i.e., not a partial or possessory interest value). Subdivision (b)(1) further provides that each possessor's "allocable share" shall be a simple allocation based on the square feet leased by the possessor divided by the total leasable square feet of the real property.

Even if a taxable possessory interest in the investment real property of a state public employees retirement system is assessed in an amount equal to its allocable share of the value of the fee simple interest, the lessee (or possessor) as the assessee and the "person affected," must receive notification of the amount of the assessment under section 619 and must be given the opportunity to apply for a reduction in the assessment under the procedures set forth in section 1601 and following and Property Tax Rule 301 and following.

Finally, subdivision (b) of section 7510 also provides that indirect investment in real property by a state public retirement agency—that is, investment in a legal entity that invests in real property as opposed to direct ownership—does not constitute investment in real property for the purposes of section 7510. Legal entities include, but are not limited to, partnerships, joint ventures, corporations, trust, or associations.[62]

[62] An issue related to the subject matter of this section concerns the creation of, and the change in ownership of, taxable possessory interests when leased investment property is acquired by a public employees retirement system. This is discussed in Chapter 4 under "Change in Ownership."

Summary: Assessment of Investment Real Property of Public Employees Retirement Systems

Property Category	Assessment Method	Comments
Investment real property owned by a local public retirement system where the property is within the system's boundaries	• In-lieu fee to local government for difference between the property taxes that would have been levied under the California Constitution, article XIII A, and the property taxes resulting from the aggregate taxable possessory interest assessment. • Taxable possessory interests assessed as all other taxable possessory interests.	• Value based on article XIII A is just as if property had been purchased or was owned by a nongovernmental entity. • Thus, amount of in-lieu fee varies with aggregate taxable possessory interest assessment. • Only situation in which in-lieu fee applies.
Investment real property owned by a local public retirement system where the property is outside the system's boundaries	• Local public retirement system's interest assessed in accordance with California Constitution, article XIII, section 11, and article XIII A. • Taxable possessory interests assessed as all other taxable possessory interests but also subject to the provisions of subdivision (f) of section 11 and the taxable possessory interest limitation amount of Rule 29.	• Sum of article XIII, section 11, assessment and aggregate taxable possessory interest assessment subject to taxable possessory interest limitation amount of Rule 29. • In-lieu fee does not apply.
Investment real property owned by a state public retirement system (e.g., CalPERS or CalSTRS)	• Taxable possessory interest assessment is the greater of (1) taxable possessory interest value or (2) possessor's allocable share of full cash value that would have been enrolled had property been subject to taxation when acquired by the state public retirement system (i.e., what the property's taxable value would have been under the provisions of article XIII A). • Each private possessor's allocable share based on each possessor's leasable area divided by property's total leasable area.	• Assessment for taxable possessory interests only. Section 11 does not apply. • In-lieu fee does not apply.

PROPERTY OF THE CALIFORNIA DEPARTMENT OF TRANSPORTATION

The California Department of Transportation (CalTrans) holds title to real property needed for future state highway purposes and real property once thought needed for that purpose but now awaiting sale or exchange. If such property is leased to a private possessor, a taxable possessory interest is created. Under section 104.13 of the California Streets and Highway Code, CalTrans must provide an annual list of this property to the assessor in each county in which such property is located; and in turn, the assessor must provide the possessory interest tax bill for each property directly to CalTrans, which is responsible for the payment of the tax.

Section 104.13 also provides that, instead of the information required in Revenue and Taxation Code section 107.6 (i.e., the required notice from the public owner to the private possessor that the property interest created may create a taxable possessory interest and that the possessor is responsible for any taxes levied on the interest), the CalTrans lease must contain a provision stating that CalTrans will pay all possessory interest taxes and that the rent charged by CalTrans reflects the cost of this provision.[63]

In addition to the specific real property referenced in section 104.13, CalTrans owns other real property in which a taxable possessory interest may exist. Taxable possessory interests in this real property are subject to the provisions of Revenue and Taxation Code section 107.6 and to the provisions of Revenue and Taxation Code section 480.6 (i.e., the requirement that a public entity file an annual real property usage report with the local assessor that describes the taxable possessory interests created by the public entity).

PROPERTY LEASED FROM REDEVELOPMENT AGENCIES

Under the California Community Development Law (Health and Safety Code sections 33000 and following), the legislative body of a city, county, or city and county may create a public entity known as a "redevelopment agency." Redevelopment agencies carry out a variety of real estate-related activities aimed at promoting the development and redevelopment of blighted areas, expanding the supply of low- and moderate-income housing, creating economic growth, and generally improving the quality of the urban environment.

Section 33673 of the Health and Safety Code prescribes how real property owned by a redevelopment agency and leased for private use should be assessed:

> Whenever property in any redevelopment project has been redeveloped and thereafter is leased by the redevelopment agency to any person or persons or whenever the agency leases real property in any redevelopment project to any person or persons for redevelopment, the property shall be assessed and taxed *in*

[63] This is a departure from the typical circumstance in which the possessory interest tax is paid by the lessee in addition to rent. For property subject to Streets and Highway Code section 104.13, the income to be capitalized (i.e., the rental income) includes an amount for property taxes; therefore, a property tax component should be added to the discount rate.

> the same manner as privately owned property, and the lease or contract shall provide that the lessee shall pay taxes upon the assessed value of the entire property and not merely the assessed value of his or its leasehold interest.

A taxable possessory interest is created when property that is owned by a redevelopment agency is leased for private use. The meaning of the above statute is that such an interest should be assessed as if owned in fee simple, that is, the assessed value should include the value of the reversionary interest retained by the redevelopment agency. In determining this value, as with other property, the assessor must consider any enforceable restrictions to which the property is subject, which in the case of a taxable possessory interest also include the terms contained in the lease or other form of legal instrument associated with the taxable possessory interest.[64]

If a taxable possessory interest involves a portion of the total leasable area, the assessed value of the taxable possessory interest should reflect a pro-rata allocation of the property's total fee simple value. Typically, the value allocation would be based on leasable area. In other words, the statute does not subject a possessor-lessee to assessment based on the fee simple value of the entire real property if the possessor-lessee occupies only a portion of the real property.

In general, under applicable constitutional and statutory provisions, assessors are required to assess real property, which includes taxable possessory interests, at the lesser of current fair market value or factored base year value. Some may argue that section 33673 results in assessments of taxable possessory interests in redevelopment agency property at assessed values above the fair market values of such interests (due to the inclusion in the assessed value of the value of the nontaxable reversionary interest of the public owner). Under California Constitution, article III, section 3.5, however, neither the Board nor an assessor, acting administratively, may refuse to enforce a statue on the grounds that it is unconstitutional or violates another statute. In the view of Board staff, the language of section 33673 is clear, and until an appellate court holds that the language is unconstitutional or the legislature amends Health and Safety Code section 33673, the statute must be implemented as it is written.

SECTION 107.7: VALUATION OF CABLE TELEVISION INTERESTS

Section 107.7 codified case law holding that a cable television company's rights of way in publicly owned real property (for placement of wires, conduits, and related equipment) contained in a cable television franchise or license constitutes a taxable possessory interest.[65] Section 107.7 also contains special provisions relating to the assessment of "cable television possessory interests." These special provisions are briefly summarized below:

1. A cable television possessory interest must be valued in a manner consistent with section 401. This provision means that a cable television possessory interest must be assessed at

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[64] See also LTA No. 77/73, May 16, 1977.

[65] See *Cox Cable San Diego, Inc.* v. *San Diego County* (1986) 185 Cal.App.3d 368; *Stanislaus County* v. *Assessment Appeals Board* (1989) 213 Cal.App.3d 1445.

its full value—that is, not at a fraction, or ratio, of its full value—and is simply a reiteration of a general assessment requirement.

2. The preferred method for determining the assessed value of a cable television taxable possessory interest is the income approach—that is, by "capitalizing the annual rent, using an appropriate capitalization rate." For the purpose of section 107.7, "annual rent" is defined as the portion of the annual franchise fee determined to be payment for the cable television taxable possessory interest. If the assessor does not use a portion of the franchise fee as an estimate of the economic rent for the taxable possessory interest, the taxable possessory interest assessment loses the usual presumption of correctness.

3. If the assessor uses the comparative sales approach, and the comparable sales data reflects the sale of a cable television possessory interest in combination with other property that includes, but is not limited to, intangible assets or rights, the assessment also loses it presumption of correctness.

4. Intangible assets or rights of a cable television system are exempt from property taxation; however, a cable television possessory interest may be assessed by assuming the presence of intangible assets or rights necessary to put the cable television possessory interest to beneficial or productive use in the operation of a cable television system. The statute provides a not-all-inclusive list of intangible assets or rights that may be associated with the operation of a cable television system. In essence, this provision reiterates subdivisions (d) and (e) of section 110.

5. Finally, as a reporting requirement associated with a change in ownership of a cable television possessory interest, section 107.7 states that the appropriate legal entity must provide, if requested by the assessor and if applicable, the following: (1) a confirmation of the sales price, (2) an allocation of the sales price among the counties, and (3) the gross revenue and franchise fee expenses of the cable television system by county.

SECTION 107.8: LEASE-LEASEBACK TRANSACTIONS INVOLVING A PUBLIC OWNER OF REAL PROPERTY

A lease-leaseback of publicly owned real property occurs when a the public owner leases real property to a private possessor and then subleases it back from the private possessor (i.e., the private possessor is the sublessor, and the public owner the sublessee). Under conditions specified in section 107.8, the lease-leaseback of publicly owned real property does not constitute a taxable possessory interest because the criterion of "independence" is not met; that is, the lessee's (i.e., the private possessor's) interest does not constitute a taxable possessory interest.

Pursuant to section 107.8, a lease-leaseback transaction of publicly owned real property does not create a taxable possessory interest if all of the following conditions are satisfied:

1. Upon execution of its lease, the lessee (i.e., the private possessor) is simultaneously obligated to sublease the property to the public owner of the property for all or substantially all of the lease period ("all or substantially all" meaning at least 85 percent of the lease period).
2. The lessee may not exercise authority and exert control over the management or operation of the property separate and apart from the policies, statutes, ordinances, rules and regulations of the public owner.
3. The lessee agrees in writing in the sublease that the public owner has the right to repurchase all of the lessee's rights in the lease.
4. The lessee cannot receive rent or other amounts from the public owner under the sublease (including any amounts due with respect to any repurchase) the present value of which, at the time the lease is entered into, exceeds the present value of the rent or other amounts payable by the lessee under the lease.

SECTION 107.9: OTHER TAXABLE POSSESSORY INTERESTS IN PUBLICLY OWNED AIRPORTS

Section 107.9 establishes the existence of a taxable possessory interest in publicly owned airports held by operators of certificated aircraft (i.e., commercial airlines) that is in addition to any other taxable possessory interests in terminal, hangar, cargo, or other site-specific facilities ("excluded possessory interests") held by such operators. With the exception of site-specific assessments, which are separately assessed, the assessment for all other taxable real property rights in publicly owned airports held by commercial airlines is subsumed into this additional, "general purpose," or "unitary," taxable possessory interest assessment. [66]

Section 107.9 prescribes a detailed method of valuation that, if followed by assessors, confers a presumption of correctness to the assessment. If, on the other hand, the prescribed method is not followed, the assessment's usual presumption of correctness is lost.

In brief, the prescribed method requires that the full cash value of the defined taxable possessory interest for 1998 and subsequent tax years be determined using a direct income capitalization approach that capitalizes the net economic rent. The values for the variables in the income approach (i.e., net economic rent, expense ratio, capitalization rate, and term of possession) are defined in the statute, with their initial values established using on data from 1996 assessments, or, if the county's 1996 assessment did not include "landing rights," from airport data derived from the 1995-96 tax year. Subsequent annual adjustments to the assessments are based on changes in

[66] Section 107.9 is based on a settlement agreement in 1998 between 18 counties and 13 airlines who were engaged in a dispute relating both to the valuation of commercial aircraft (business personal property) and to the taxability and valuation of airline real property interests in publicly-owned airports, including the taxable possessory interests formerly known as "landing rights." For additional background, see LTA No. 86/75.

the "standardized" 1996 values. For more detailed information about the valuation method, see the statute.

Consistent with article XIII A of the California Constitution and related statutes, the annual value determined in accordance with the section 107.9's prescribed method should not be enrolled if it exceeds the factored base year value; that is, the lower of the statute's formulaic value or the factored base year value should be enrolled.

SECTION 201.5: TAXABLE POSSESSORY INTERESTS IN PROPERTY ACQUIRED BY OR FOR THE CALIFORNIA POLLUTION CONTROL FINANCING AGENCY

Section 201.5 states that a possessory interest in property acquired by or for the California Pollution Control Financing Authority is subject to taxation. In this regard, as we noted in Chapter 2, section 201.5 also provides that such taxable possessory interests may exist in real or personal property. This is the only instance in which a taxable possessory interest may exist in personal property.

Subdivision (b) of section 201.5 also states that if the amount of property tax that results from the taxable possessory interest assessment is less than the amount that would have resulted had the "participating party" owned the pollution control facility (i.e., the amount that would have been collected had the fee simple or entire ownership interest in the property been assessed at full cash value), then the agreement between the parties must provide that the amount of the difference will be paid by the participating party to the tax collector at the same time that the property tax is paid.

APPENDIX: LEGAL PROVISIONS

STATUTES

The primary statutes relating to taxable possessory interests:

APPLICABLE CODE AND SECTION	TITLE
Revenue and Taxation Code	
60	Meaning of "change in ownership"
61	"Change in ownership" includes
62	"Change in ownership" exclusions
75.5	"Property"
107	Possessory interests
107.1	Valuation of certain possessory interests
107.2	Valuation of certain oil and gas interests (Not addressed in this manual)
107.3	Valuation of certain oil and gas interests—extended (Not addressed in this manual)
107.6	Notification of taxability of possessory interest
107.7	Valuation of cable television interests
107.8	Lease-leaseback agreements
107.9	Valuation of interests in publicly owned airports
155.20	Preparation of 1979–80 assessment roll
480.5	Real property usage reports
480.6	Change in ownership statement; possessory interest
7510	Investment of assets in real property; payment of fee for general governmental services
Health and Safety Code	
33673	Taxation of leased property
33673.1	Notice of property leases
Streets and Highways Code	
104.13	Department as agent for payment of possessory interest taxes due from lessees

REGULATIONS

The primary regulations relating to taxable possessory interests:

RULE	TITLE
20	Taxable Possessory Interests
21	Taxable Possessory Interests—Valuation
22	Continuity of Possessory Interests
27	Valuation of Possessory Interests for the Production of Hydrocarbons (Not addressed in this manual)
28	Examples of Taxable Possessory Interests
29	Taxable Possessory Interest Limitation Amount

COURT CASES

Significant cases relating to taxable possessory interests:

Agua Caliente Band of Mission Indians v. *Riverside County* (1971) 442 F.2d 1184, cert. denied 405 U.S. 933. A federal court refused to enjoin the imposition of a tax on the possessory interest held by lessees of Indian land holding that the tax was on the lessee's interest in the land and not on the Indians' land. The mere fact that the tax increased the financial burden on the Indians in the form of reduced rents did not vitiate the tax.

American Airlines, Inc. v. *County of Los Angeles* (1976) 65 Cal.App.3d 325. The court invalidated an assessment based on a valuation method that used a reasonably anticipated term of possession in excess of the remaining lease term plus option periods.

Bakersfield & Fresno Oil Co. v. *Kern County* (1904) 144 Cal. 148. The possessory right to a mining claim subject to a lease is taxable as a possessory interest.

Blinn Lumber Company v. *County of Los Angeles* (1932) 216 Cal. 148. The court allowed a deduction for rent paid by lessee when estimating the income to be capitalized for a taxable possessory interest. In this regard, subsequently reversed in *De Luz Homes, Inc.* v. *San Diego County*.

Board of Supervisors v. *Archer* (1971) 18 Cal.App.3d 717. The court upheld assessment of taxable possessory interests in federal lands based on grazing permits and leases.

City and County of San Francisco v. *County of San Mateo* (1995) 10 Cal.4th 554. Base year value concept of Californian Constitution, article XIII A, applies to real property assessed under California Constitution, article XIII, section 11.

City of Desert Hot Springs v. *Riverside County* (1979) 91 Cal.App.3d 441. A possessory interest acquired by a contractor under a lease from a city was retained upon the leaseback of the property to the city. Possession by the city under the sublease was not in opposition to but pursuant to and subordinate to the contractor's right.

City of San Jose v. *Carlson* (1997) 57 Cal.App.4th 1348. Short-term users of a city's facilities obtained taxable possessory interests in the facilities when they obtained use permits on more than one occasion. Two-time uses of the facilities meet the criteria of durability, independence, and exclusivity necessary to constitute possessory interests. And the agreement between the city and the users accorded sufficient control to the users to meet the criterion of independent possession.

Connolly v. *Orange County* (1992) 1 Cal.4th 1105. Possessory interests taxable under this section include privately held possessory interests in property owned by the federal, state, or municipal government, since the use is private rather than public. However, the governmental entity does not lose its tax exemption by leasing its land. The reversion is not taxed, for it is only the value of the use for the unexpired term of the lease that is assessed. This rule applies to property owned by public schools and colleges.

Cox Cable San Diego, Inc. v. *San Diego County* (1986) 185 Cal.App.3d 368. The interests of a cable television distribution company in franchise agreements granting the company the right to use and occupy public rights of way for the purpose of distributing its service are property subject to property taxation since the company's use of the public rights of way constitutes a taxable possessory interest. A possessory interest may be the interest of either an easement holder or a mere permittee or licensee.

County of Los Angeles v. *County of Los Angeles AAB No. 1* (1993) 13 Cal.App.4th 102. A nonexclusive right to use public property that is merely in common with, and coequal to, the general public's does not constitute a taxable possessory interest.

De Luz Homes, Inc. v. *San Diego County* (1955) 45 Cal.2d 546. Taxable possessory interests must be valued at full cash value, like all other real property, without deductions for leasehold costs.

Douglas Aircraft Co. v. *Byram* (1943) 57 Cal.App.2d 311. Absent specific statutory authorization, a taxable possessory interest cannot exist in personal property.

Dressler v. *Alpine County* (1976) 64 Cal.App.3d 557. The recurrent character of federal grazing permits issued subsequent to the tax lien date supports the existence of a taxable possessory interest.

El Tejon Cattle Co. v. *San Diego County* (1966) 64 Cal.2d 428. In assessing the possessory interest of a lessee of tax-exempt land leased for grazing purposes, it is proper to capitalize the rent for the total number of years of the lease and renewal options. Natural grasses on the land, which do not require annual or seasonal planting, are not exempt from taxation as growing crops.

English v. *County of Alameda* (1977) 70 Cal.App.3rd 226. An occupation of a hospital- or university-owned residence by a physician or professor is exempt under the welfare or college exemption if incidental to, or reasonably necessary for, the accomplishment of the exempt purpose.

Euro-Pacific v. *Alameda County* (1992) 11 Cal.App.4th 891. Vessel owner's contractual right to use publicly owned maritime facilities may be a possessory interest in real property that is subject to taxation, even though the right is concurrent with the rights of others and subject to restrictions on right of use. Exclusive use is not destroyed by concurrent use when the extent of each party's use is limited by the other party's right to use the property at the same time. And possible interference with use affects value, but not the existence of a possessory right. Possible interference with use affects value, but not existence of a possessory right.

Forster Shipbldg. Co. v. *Los Angeles County* (1960) 54 Cal.2d 450. Leasehold interests in tax-exempt land are not personal property within the meaning of Section 14 of Article XIII of the

State Constitution and that portion of the above section which declares such leasehold interests to be personal property is invalid; however, the remaining provisions of the above section are valid.

Fort Mojave Tribe v. *San Bernardino County* (1976) 543 F.2d 1253, cert. den. 430 U.S. 983. The imposition of a taxable possessory interest on non-Indian lessees of reservation land is not violative of the Indian Reorganization Act. Upheld the assessment of a taxable possessory interest in land held in federal trust for reservation Indians but leased to a non-Indian.

Freeman v. *Fresno County* (1981) 126 Cal.App.3d 459. The owner of amusement machines placed for private profit in public facilities, including an airport terminal, meets the requirement of exclusiveness, and is therefore subject to a taxable possessory interest. Despite the small size and variable location of the space occupied by each machine, the owner had a special right of access for profit not shared in common by all who entered such facilities, and such space was not by its size or movement made unvaluable to the owner.

General Dynamics Corp. v. *Los Angeles County* (1958) 51 Cal.2d 59. The legislature has not defined personal property as including a right to its possession as it has real property.

Georgia-Pacific Corporation v. *Mendocino County*; *International Paper Company* v. *Siskiyou County* (1972) 340 F.Supp. 1061; 357 F.Supp. 380; 515 F.2d 285. The interest of timber operators created by a contract with the U.S. Forest Service whereby the timber operators obtain a present right in the standing timber and the right to go upon the federal land to harvest the timber constitutes a taxable possessory interest. There is no rule under California law that a vendee under a land sale has no taxable interest until the sale is completed.

G. G. Moore & Co. Engineers v. *Quinn* (1957) 149 Cal.App.2d 666. There is no taxable property interest in unassembled boiler parts held by contractors because legal title or beneficial ownership was held by the exempt public agencies.

Hammond Lumber Co. v. *City of Los Angeles* (1936) 12 Cal.App.2d 277. A leasehold estate carries a right to the possession of land, and therefore constitutes real property for purposes of taxation. Although ordinarily a leasehold is taxed to the owner of the reversionary interest, the value of the lessee's estate being treated as a constituent part of the valuation of the freehold, where the reversion is publicly owned and therefore tax exempt, a separate assessment of the leasehold to the lessee may be had.

John Tennant Memorial Homes, Inc. v. *City of Pacific Grove* (1972) 27 Cal.App.3d 372. Although not a basis for its decision in the case, a court indicated that the interest of an occupant in a retirement home exempt from property taxation pursuant to Revenue and Taxation Code section 214 did not constitute a taxable possessory interest in the tax exempt premises since the occupants were using the property for a non-taxable purpose.

Kaiser Co., Inc. v. *Reid* (1947) 30 Cal.2d 610. A shipbuilding corporation having a right under contracts with the United States Maritime Commission to the exclusive use and possession as an independent contractor, of the land and facilities of a shipyard owned by the United States and the shipbuilding facilities owned by the United States in another shipyard is a lessee of the property and its possessory interest therein is taxable.

Los Angeles County v. *Los Angeles County Assessment Appeals Board No. 1* (1993) 13 Cal.App.4th 102. The possession or use which grounds possessory interests means and requires not just some benefit from the public property, but physical possession or use of it. Thus, the county assessment appeals board was correct in limiting taxable possessory interest assessments of several car rental firms at county airports to their counters and reserved parking lots rather than on their "use" of the airports as a whole. Further rights granted by the airports, to do business at the airports and their environs, were not possessory interests but were intangibles not subject to property tax.

Lucas v. *County of Monterey* (1977) 65 Cal.App.3d 947. Upheld the assessment of a taxable possessory interest in a private berthing in a public harbor.

Mann v. *County of Alameda* (1978) 85 Cal.App.3rd 505. There is no taxable possessory interest held by students who reside in University of California family housing.

Mattson v. *Contra Costa County* (1968) 258 Cal.App.2d 205. An operator of a restaurant at a municipal golf course was held to have a taxable interest where his possession was marked by independence, durability and exclusiveness even though the basis of his rights was a contract rather than a lease.

McCaslin v. *DeCamp* (1967) 248 Cal.App.2d 13. The exclusive right to the use of a house furnished by a tax exempt irrigation district to its employee on a month-to-month basis was a taxable possessory interest even though the right was terminable with the termination of employment.

Metropolitan Stevedore Co. v. *Los Angeles County* (1972) 29 Cal.App.3d 565. Plaintiff, holder of a preferential assignment in city harbor property, contended that assessment of the assignment (a possessory interest) was discriminatory because similar interests of others had not been assessed. Court held there was no discrimination; the other interests were different, some assessments had not been made pending outcome of plaintiff's suit, and, in general, discrepancies arising from assessor's mistake or lack of information which result in some assessments not being made are not grounds for declaring all other assessments invalid.

Orange County v. *Orange County Assessment Appeals Board No. 1* (1993) 13 Cal.App.4th 524. County assessment appeals board did not err in separating cable television system's property into land and land improvements, fixtures, and personal property rather than considering all the property as one appraisal unit for valuation purposes. Section 51 does not mandate appraisal of the property as a single unit. To the contrary, applicable law suggests that rationally dividing property into component parts for valuation purposes is proper. County assessment appeals board did not err in rejecting the comparable sales approach and the income approach when valuing taxable tangible property of a cable television system. The selection of a particular method is within the board's discretion and is constrained only by fairness and uniformity. Thus, use of the income capitalization method using the annual franchise rent was appropriate for valuing the taxpayer's possessory interest, and use of the cost replacement method was appropriate for valuing the remainder of the property, where the board found that neither the comparable sales approach nor the income approach was a reliable method for the property.

Pacific Grove-Asilomar Operating Corp. v. *Monterey County* (1974) 43 Cal.App.3d 675. A nonprofit corporation organized for the purpose of managing exempt, state-owned property does not acquire a taxable possessory interest in the property where a principal-agent relationship exists, where the corporation is under state control and holds the property for the public benefit, and where possession by the corporation is not so exclusive as to amount to such an interest. In determining whether a possessory interest is taxable, the factors of exclusiveness, independence, durability and private benefit are weighted on a case-by-case basis.

Palm Springs Spa, Inc. v. *Riverside County* (1971) 18 Cal.App.3d 372. The imposition of a nondiscriminatory tax on the possessory interest of a lessee in Indian land held in trust by the federal government did not impose an undue burden on commerce with the Indians in violation of the federal Constitution, nor was it a tax directly on federal property.

People v. Donnelly (1881) 58 Cal. 144. The possessory interest of an occupant or claimant of public lands of the State or of the United States is taxable, although no part of the purchase price has been paid.

People v. *Shearer* (1866) 30 Cal. 645. Privately held interests in otherwise exempt real property are subject to the constitutional command that all property be taxed.

Rand Corp. v. *Los Angeles County* (1966) 241 Cal.App.2d 585. The right of a nonprofit corporation to use government property permanently affixed to the realty is exclusive and, hence, a taxable possessory interest. Although such right is pursuant to a yearly contract, the corporation pays no rent and cannot transfer its right without consent and the government can cancel the contract and remove the property. Since possessory interests in improvements to real property are defined as real property in sections 104 and 105 of the Revenue and Taxation Code, they are taxable as such under Cal. Const. Art. XIII, Sec. 1, although no specific statute imposes a tax on possessory interests. A provision in a contract pursuant to a government regulation that property does not lose its identity as personalty by reason of affixation to the realty does not preclude the state from classifying government property as improvements to real property for taxation purposes." The fact that the holder of a taxable possessory interest is a nonprofit corporation does not necessarily mean that the possession confers no private benefit to the holder.

Russ Building Partnership v. *City and County of San Francisco* (1988) 199 Cal.App.3rd 1496. Double taxation only occurs when two taxes of the same character are imposed on the same property by the same taxing authority within the same jurisdiction during the same time period.

Riverside County v. *Palm-Ramon Development Co.* (1965) 63 Cal.2d 534. In using the income method to value a taxable possessory interest, it is the net earnings that would be anticipated by a prospective purchaser that are to be capitalized.

San Bernardino County v. *Harsh California Corp.*(1959) 52 Cal.2d 341. In an action brought by a county to collect unsecured property taxes levied against a leasehold in land leased by the United States to defendant for construction of family dwelling units for military and civilian personnel under a federal statute consenting to local taxation with a deduction therefrom for payments made by the United States in lieu of taxes, although the outcome would not directly affect the pecuniary interest of the United States, the government may intervene because it does have an interest in sustaining its fiscal policy.

San Pedro, etc. R. R. Co. v. *City of Los Angeles* (1919) 180 Cal. 18. A leasehold estate carries a right to the possession of land, and therefore constitutes real property for purposes of taxation. Although ordinarily a leasehold is taxed to the owner of the reversionary interest, the value of the lessee's estate being treated as a constituent part of the valuation of the freehold, where the reversion is publicly owned and therefore tax exempt, a separate assessment of the leasehold to the lessee may be had.

Scott-Free River Expeditions, Inc. v. *El Dorado County* (1988) 203 Cal.App.3d 896. The exclusive and profitable use of public property for commercial rafting by a commercial rafting company constitutes a taxable possessory interest. The tax is on the company's use of the water, and the right to use water is a valuable property right upon which a possessory interest tax may be levied.

Sea-Land Service, Inc. v. *Alameda County* (1974) 36 Cal.App.3d 837. A shipping company using a city's marine terminals under a "Preferential Assignment Agreement" had a taxable possessory interest where the agreement gave the company exclusive possession against all the world, including the city, whenever it had a "business need" for the premises, where the company had continuously used and had a business need to use all of the premises, and where analysis of the entire agreement established that it was comparable to a lease.

Seatrain Terminals of California, Inc. v. *Alameda County* (1978) 83 Cal.App.3rd 69. Exclusive use of two 750 ton cargo cranes, mounted on rails specially installed on the wharf, constitutes a taxable possessory interest. The cranes were properly classified as fixtures since they were intended to be a permanent part of the wharf.

Service America Corporation v. *San Diego County* (1993) 15 Cal.App.4th 1232. A stadium food and beverage concessionaire is subject to a taxable possessory interest, the value of which does not include enterprise value as distinguished from the value of its use of the property under agreement with the stadium owner.

Shubat v. *Sutter County Assessment Appeals Board* (1993) 13 Cal.App.4th 794. The interests of a cable television distribution company in franchise agreements granting the company the right to use and occupy public rights of way for the purpose of distributing its service are property subject to property taxation since the company's use of the public rights of way constitutes a taxable possessory interest. A possessory interest may be the interest of either an easement holder or a mere permittee or licensee." A county assessment appeals board erred in ruling that a cable television company's entire franchises, which consist of two components, the right to use public streets to lay cables and the right to charge a fee to subscribers for their use of cable facilities, were nontaxable intangibles. Both the California Constitution and statutes mandate that all property must be taxed if not exempt under federal or state law, and under applicable case law the right to use public rights-of-way is an assessable possessory interest in real property.

Slade v. *Butte County* (1910) 14 Cal.App. 453. A holder of a certificate of purchase of lieu lands who has never been in possession or claimed the right of possession is not taxable thereon. The term "claim to land" contemplates an actual possession of the land claimed.

Specialty Restaurants Corporation v. *Los Angeles County* (1980) 111 Cal.App.3d 607. Possessory interests in improvements to real property are dependent for existence on real property, which in the case of a vessel can include areas aboard the vessel, the real property upon which the vessel lies, and parking areas, and an assessment of taxable possessory interests must necessarily include the value of the supporting land.

Stadium Concessions, Inc. v. *City of Los Angeles* (1976) 60 Cal.App.3d 215. A coliseum and sports arena food and beverage concessionaire meets the requirement of exclusiveness and is therefore subject to a taxable possessory interest. Under property tax Rule 21(e)(2) the interest of the concessionaire qualifies as a concurrent use.

Stanislaus County v. *Assessment Appeals Board* (1989) 213 Cal.App.3d 1445. A county assessment appeals board erred in ruling that a cable television company's entire franchises, which consist of two components, the right to use public streets to lay cables and the right to charge a fee to subscribers for their use of cable facilities, were nontaxable intangibles. Both the California Constitution and statutes mandate that all property must be taxed if not exempt under federal or state law, and under applicable case law the right to use public rights-of-way is an assessable possessory interest in real property.

State v *Moore* (1859) 12 Cal. 56. A private individual's possession of public lands for mining purposes is a taxable property interest.

Stanislaus County v. *Assessment Appeals Board* (1989) 213 Cal.App.3d 1445. This section [Revenue and Taxation Code section 107.7], which codified case law holding that a cable television company's rights-of-way under the authority granted by public entities constitute an assessable franchise subject to property tax, was inapplicable to assessments for the 1982–83 through 1985–86 fiscal years since the county's right to the taxes at issue became fixed on the lien dates of the fiscal years to which they related, which dates preceded enactment of the section.

Tilden v. *Orange County* (1949) 89 Cal.App.2d 586. A separate assessment of the possessory interest in leased public lands to a sublessee in possession is valid.

United Air Lines, Inc. v. *San Diego County* (1991) 1 Cal.App.4th 418. The purpose of this section [Revenue and Taxation Code section 107] is to protect the public domain from private profit without tax liability. And use by commercial air passenger carriers of an international airport was business use and sufficiently exclusive as to qualify as a taxable possessory interest, even though the general aviation public had concurrent landing rights.

United States v. *Fresno County* (1975) 50 Cal.App.3d 633. Occupancy of dwelling units in national forests by U.S. Forest Service employees, which consisted of nontransferable rights of possession, terminable at the will of the federal government, together with other restrictions, results in a taxable possessory interest, the value of which must be subject to the restrictive factors. The assessment is not made against the federal government but against the usufructuary interest of the employees in the units.

United States v. *Humboldt County* (1980) 628 F.2d 549. Occupancy of dwelling units on base and off base by military personnel, being neither durable nor private, does not result in a taxable possessory interest. Even if it did result in a possessory interest, any resultant tax imposed would be constitutionally impermissible as a tax imposed upon federal functions and properties.

United States v. *San Diego County* (1995) 53 F.3d 965. Exclusive, independent, and durable interest in experimental fusion device owned by the United States constitutes a taxable possessory interest. The device was properly classified as a fixture where it weighed more than 400 tons, it was annexed to the underlying land by gravity, and the land had been modified to accommodate it. It is not unconstitutional for a county to calculate the value of a taxpayer's possessory interest in an experimental fusion device by using the value of the device.

United States v. *San Diego County* (1992) 965 F.2d 691. A federal contractor had a possessory interest in a government-owned experimental fusion devise, which was properly classified as an improvement, and was not immune from ad valorem taxation under the supremacy clause of the United States Constitution. A federal contractor's possessory interest in experimental fusion device owned by the United States sufficiently distinguished contractor from the government, so that tax imposed on contractor was not tax on United States in violation of Supremacy Clause.

Wells National Services Corporation v. *Santa Clara County* (1976) 54 Cal.App.3d 579. The provision of television receivers for rental to patients at a county hospital except for two wards equipped with the hospital's own sets constitutes a taxable possessory interest. The test is not exclusive possession against all the world, including the owner. If the right of possession must be shared to some extent, it is to be considered in fixing the value but does not destroy the existence of the possessory interest.

Wrather Port Properties, Ltd. v. *County of Los Angeles* (1989) 209 Cal.App.3d 517. An extension of a lease term from 40 years to 66 years was not a change in ownership for purpose of this section [Revenue and Taxation Code section 61] where the extension was automatic under a provision of the original lease whereby the parties intended to create a possessory interest for the maximum term allowed by the city's charter; where at the time the lease was signed, a charter amendment increasing the permissible term was on the ballot for an election less than a month away; and where the assessor recognized and based his first valuation of the lease on the longer term.

GLOSSARY

Term	Definition
Ad valorem	Latin phrase meaning "in proportion to the value". In California, the property tax is considered to be an ad valorem tax.
Amortization	The process of retiring a debt or recovering a capital investment through scheduled, systematic repayment of principal; a program of periodic contributions to a sinking fund or debt retirement fund
Animal unit month	The quantity of feed that a mature l,000 pound cow or five mature sheep need for one month to sustain life and maintain good health.
Annuity	A periodic series of obligatory payments; an annuity can be level, increasing, decreasing, or a combination thereof.
Annuity factor	In yield capitalization, the number, usually obtained from financial tables, that is multiplied by an income amount to produce an estimate of present value.
Appraisal unit	That property which persons in the marketplace normally buy and sell as a unit or which is normally valued separately.
Appreciation	The increase in property value resulting from an excess of demand for a property relative to its supply.
Assessed value	The taxable value of a property against which the tax rate is applied.
Assessee	Person who owns, claims, possesses, or controls the property on the lien date.
Assessment roll	A listing of all taxable property within a county. It identifies, at a minimum: (1) the property (usually by assessor's parcel number); (2) the tax-rate area where the property is located; (3) the name (if known) and mailing address of the assessee; (4) the assessed value of the property, including separate assessed values for land, improvements, and personal property; (5) penalties (if any); and (6) the amount (if any) of specified exemptions (e.g., Homeowners', Church, Welfare, etc.). Distinct assessment rolls include the locally-assessed secured and unsecured regular assessment rolls, the locally-assessed supplemental assessment roll, and the state-assessed roll (which is added to the locally-assessed secured roll).

Term	Definition
Band of investment	A technique in which the capitalization rates attributable to components of a capital investment are weighted and combined to derive a weighted-average rate attributable to the total investment.
Base year value	In accordance with section 110.1, a property's base year value is its fair market value as of either the 1975 lien date or the date the property was last purchased, newly constructed, or underwent a change in ownership after the 1975 lien date.
Capitalization	Any method of converting expected future benefits into an indicator of present value; the discounting of projected income to a present value.
Capitalization rate	Any rate used to convert income into an indicator of value; a ratio that expresses a relationship between income and value.
Change in ownership	A transfer of a present interest in property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest.
Comparative sales approach	An approach to value by reference to sale prices of the subject property or comparable properties; under Rule 4, the preferred approach when reliable market data are available.
Contract rent	The actual amount of rent a property is earning as specified in a lease; the existing rent on property as distinguished from rent that could be expected if the property were available for rent on the open market.
Cost approach	A value approach using the following procedures to derive a value indicator: (1) estimate the current cost to reproduce or replace an existing structure without untimely delays; (2) deduct for all accrued depreciation; and (3) add the estimated land value and an amount to compensate for entrepreneurial profit (if present).
Depreciation	A decrease in utility resulting in a loss in property value; the difference between estimated replacement or reproduction cost new as of a given date and market value as of the same date. There are three principal categories of depreciation: physical deterioration, functional obsolescence, and external obsolescence.

Term	Definition
Direct capitalization	A capitalization method used to convert a single year's income expectancy into an indicator of value, either by dividing the income estimate by an appropriate rate or by multiplying the income estimate by an appropriate factor.
Discount rate	A selected yield rate used to convert expected future payments into an estimate of present value.
Discounted cash flow method	A capitalization method in which a discount rate is applied to a series of projected income payments, including the reversion, in order to arrive at an estimate of present value (i.e., current market value). The DCF method can be applied with any yield capitalization technique.
Economic life	The period of time over which improvements to real property contribute to property value.
Equity yield rate	An annualized rate of return on equity capital, as distinguished from the rate of return on debt capital or interest; the equity investor's internal rate of return
Fair market value	The amount of cash or its equivalent that property would bring if exposed for sale in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other and both with knowledge of all of the uses and purposes to which the property is adapted and for which it is capable of being used and of the enforceable restrictions upon those uses and purposes.
Fee simple estate	Absolute ownership unencumbered by any other interest or estate, subject only to the limitations of eminent domain, escheat, police power, and taxation.
Fixture	An item of tangible property, the nature of which was originally personal property, but which is classified as real property for assessment purposes because it is physically or constructively annexed to real property with the intent that it remain annexed indefinitely.
Full cash value	See *fair market value*.
Full economic cost	Cost for appraisal purposes. Includes all market costs (direct and indirect) necessary to purchase or construct equipment and make it

Term	Definition
	ready for its intended use.
Gross outgo	Any outlay of money or money's worth, including current expenses and capital expenditures required to develop and maintain the estimated income.
Gross return	Any money or money's worth which the property will yield over and above vacancy and collection losses, including ordinary income, return of capital, and the total proceeds from sales of all or part of the property.
Highest and best use	The most profitable use of a property at the time of the appraisal; that available use and program of future utilization that produces the highest present land value; must be legal, physically possible, financially feasible, and maximally profitable; see text for the distinction between highest and best use as though vacant and highest and best use as improved.
Improvements	All buildings, structures, fixtures, and fences erected on or affixed to the land; all fruit, nut bearing, ornamental trees and vines, not of natural growth, and not exempt from taxation, except date palms under eight years of age.
Income approach	Any method of converting an income stream or a series of future income payments into an indicator of present value.
Interest rate	The rate of return on debt capital; the price paid for borrowing money.
Land	Real estate, or real property, except improvements. It includes: the possession of, claim to, ownership of, or right to possession of land; and all mines, minerals, and quarries in the land, all standing timber whether or not belonging to the owner of the land, and all rights and privileges appertaining thereto.
Leaseback	A transaction in which an investor purchases property and leases it back to the seller, generally under lease terms and conditions that were negotiated at the time of the sale.
Leased fee interest (or estate)	The lessor's interest in property; an ownership interest held by a landlord with the right of use and occupancy conveyed by lease to others; the right to receive rent stipulated in the lease and to receive the property (the reversionary right) at the end of the lease

Term	Definition
	term.
Leasehold interest (or estate)	The lessee's interest in property; the right to use and occupy real property during the term of a lease, subject to any contractual restrictions.
Lessee	One who has the right to use or occupy property under a lease agreement; a tenant.
Lessor	One who holds property title and conveys the right to use and occupy the property under a lease agreement.
Leverage	The effect of borrowed funds, which may increase or decrease the return that would be realized on equity free and clear.
Lien date	All taxable property (both state and locally assessed) is assessed annually for property tax purposes as of 12:01 a.m. on January 1, which is called the lien date. It is referred to as the lien date because on this date the taxes become a lien against all real property assessed on the secured roll.
Loan-to-value ratio	The ratio between the mortgage amount and the value of the property pledged as security for the debt; usually expressed as a percentage.
Market rent	The amount of rental income that could be expected from a property if available for rent on the open market, indicated by the prevailing rental rates for comparable properties under similar terms and conditions; distinguished from contract rent, which is the actual rental for the subject property as specified in a lease; also referred to as economic rent.
Net lease	A lease in which the tenant pays all property operating expenses in addition to the stipulated rent.
Net return	The difference between *gross return* and *gross outgo*.
New construction	Any addition to real property, whether land or improvements (including fixtures), since the last lien date; any alteration of land or improvements (including fixtures) since the last lien date that constitutes a major rehabilitation thereof or which converts the property to a different use.

Term	Definition
Overall rate (R_o)	An income rate for a total real property interest that reflects the relationship between a single year's net operating income expectancy and the total property price or value.
Personal property	All property except real property (section 106).
Possessory interest	Interests in real property that exist as a result of (1) a possession of real property that is independent, durable and exclusive of rights held by others in the real property, and that provides a private benefit to the possessor, except when coupled with the ownership of a fee simple or life estate in the real property in the same person; or (2) a right to the possession of real property, or a claim to a right to the possession of real property, that is independent, durable and exclusive of rights held by others in the real property, and that provides a private benefit to the possessor, except when coupled with the ownership of a fee simple or life estate in the real property in the same person; or (3) taxable improvements on tax-exempt land.
Projection period	The holding period; a period of time over which net income is projected for valuation purposes; a presumed period of investment in property. [When the income approach is used to value a taxable possessory interest, the projection period corresponds to the reasonably anticipated term of possession.]
Purchase price	The amount of money a buyer agrees to pay and a seller agrees to accept in an exchange of property rights; sale price is based on a particular transaction, not necessarily on what the typical buyer would pay or the typical seller would accept.
Real property	The possession of, claim to, ownership of, or right to the possession of land; all mines, minerals, and quarries in the land; all standing timber whether or not belonging to the owner of the land, and all rights and privileges appertaining thereto; and improvements; in California property tax law, the term is synonymous with "real estate."
Regular assessment roll	Roll covering period starting July 1 of the current calendar year to June 30 of the next year. Assessment period for the regular roll must be completed on or before July 1.
Remaining economic life	The estimated period during which the improvements will continue to contribute to a property's value.

Term	Definition
Replacement cost	The cost required to replace an existing property with a property that has equivalent utility.
Reproduction cost	The cost required to reproduce an exact replica of an existing property.
Reversion	A lump-sum benefit that an investor receives or expects to receive at the termination of an investment. [In a taxable possessory interest, the land and improvements that revert back to the public owner at the termination of the taxable possessory interest.]
Reversionary interest	The rights of the lessor at the expiration of a lease; the estate returned or due to be returned.
Risk	Uncertainty about the outcome of future events; uncertainty about the future profitability of investments or projects; the possibility of not receiving the projected income.
Salvage value	The value of property at the end of its economic life in its present use.
Secured property	Property on the secured roll.
Secured roll	That part of the assessment roll containing state assessed property and property the taxes on which are a lien on real property sufficient, in the opinion of the assessor, to secure payment of taxes.
Structure	An edifice or building; an improvement whose primary use or purpose is for housing or accommodation of personnel, personalty, or fixtures and has no direct application to the process or function of the industry, trade, or profession.
Sublease	An agreement in which the lessee in a prior lease conveys the right of use and occupancy of a property to another.
Supplemental assessment	An assessment of the full cash value of property as of the date a change in ownership occurs or new construction is completed, which establishes a new base year value for the property or for the new construction.
Taxable value	For real property subject to article XIII A of the California Constitution, the base year full value adjusted for any given lien

Term	Definition
	date as required by law or the full cash value (market value) for the same date, whichever is less, as set forth in section 51(a). For personal property, the full cash value for the lien date each year.
Unsecured property	Property on the unsecured roll.
Unsecured roll	See definition of secured roll. Remainder of the roll is the unsecured roll. The taxes [based on an assessment on the unsecured roll] are a personal liability of the owner.
Weighted average	An average that is calculated by weighting each component by a factor that represents its relative importance to the whole, multiplying each component by its assigned weight, and adding the products; used in the band of investment method.
Yield capitalization	A capitalization method used to convert future benefits to present value by discounting each future benefit at an appropriate yield rate or by developing an overall rate that reflects the investment's income pattern, value change, and yield rate. [Also called annuity capitalization.]
Yield rate	A measure of investment return (usually annualized) that is applied to a series of incomes to obtain the present value of each; examples are the interest rate, the discount rate, the internal rate of return, and the equity yield rate.