STATE OF CALIFORNIA

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February 1, 2002

No. 2002/004

TO COUNTY ASSESSORS
COUNTY COUNSELS AND
INTERESTED PARTIES:

STATE BOARD OF EQUALIZATION
NOTICE OF RESCHEDULED PUBLIC HEARING
AMEND PROPERTY TAX RULE 21
(TAXABLE POSSESSORY INTERESTS – VALUATION)
AND DELETE PROPERTY TAX RULES 23, 24, 25, AND 26

Previously Published as Notice File Number
Z01-1211-03 on December 21, 2001

BY NOTICE dated December 21, 2001 and published in the December 21, 2001 California Regulatory Notice Register 2001, Number 51Z, the State Board of Equalization, announced that it would conduct a public hearing on February 6, 2002 to consider proposed amendment to Rule 21, Taxable Possessory Interests-Valuation, and deletion of Rules 23, 24, 25, and 26 in Title 18, Division 1 of the California Code of Regulations. A decision was made to postpone the public hearing.

A rescheduled public hearing on the proposed amendment and deletion of the regulations will be held on March 27, 2002, in Room 121, 450 N Street, Sacramento, CA at 1:30 p.m., or as soon thereafter as the matter may be heard. At the hearing, any person interested may present statements or arguments orally or in writing relevant to the proposed regulatory action. The Board will consider written statements or arguments if received by March 27, 2002.

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Revenue and Taxation Code section 107 provides for the property taxation of certain private possessory interests in publicly owned real property. Rule 20 defines taxable possessory interests for property tax purposes. Existing Rules 21, 23, 24, 25, and 26 address the valuation and assessment of taxable possessory interests.

The assessment of taxable possessory interests by the counties with respect to the determination of the "term of possession" for valuation purposes is lacking in consistency and uniformity Proposed amended Rule 21 addresses the valuation of taxable possessory interests in a unified

fashion. Rule 21 is amended and Rules 23, 24, 25, and 26 are deleted for the purpose of revising and combining existing Rules 21, 23, 24, 25, and 26 into a single, comprehensive rule. In addition, the proposed rule amendments are intended to provide guidance and uniformity in the valuation of taxable possessory interests, particularly in the area of "term of possession." The proposed rule amendments and deletions are also intended to implement the court's holding in *American Airlines, Inc. v. County of Los Angeles* (1976) 65 Cal.App.3d 325, with respect to those circumstances that will justify the use of a "term of possession" that is longer or shorter than the contract lease term for purposes of property tax valuation.

<u>Rule 21. Possessory Interest Definitions.</u> Proposed for amendment to unify, revise, and update existing Rules 21, 23, 24, 25, and 26, and to make them consistent with the court's holding in *American Airlines, Inc. v. County of Los Angeles, supra*.

<u>Rule 23. Written Agreements as to Term of Possessory Interests.</u> Proposed for deletion because its provisions have been either incorporated into the proposed amendments to Rule 21 or deleted as no longer valid.

<u>Rule 24. Possessory Interest Rights to be Valued.</u> Proposed for deletion because its provisions have been either incorporated into the proposed amendments to Rule 21 or deleted as no longer valid.

<u>Rule 25. Valuation of Post-De Luz Possessory Interests.</u> Proposed for deletion because its provisions have been either incorporated into the proposed amendments to Rule 21 or deleted as no longer valid.

<u>Rule 26. Valuation of Pre-De Luz Possessory Interests.</u> Proposed for deletion because its provisions have been either incorporated into the proposed amendments to Rule 21 or deleted as no longer valid.

COST TO LOCAL AGENCIES AND SCHOOL DISTRICTS

The State Board of Equalization has determined that the proposed amendment of Rule 21 and the deletion of Rules 23, 24, 25, and 26 do not impose a mandate on local agencies or school districts. Further, the Board has determined that the proposed rule amendments and deletions will not result in direct or indirect cost or savings to any State agency, any costs to local agencies or school districts that are required to be reimbursed under Part 7 (commencing with § 17500) of Division 4 of Title 2 of the Government Code, or other non-discretionary costs or savings imposed on local agencies, or cost or savings in federal funding to the State of California.

EFFECT ON BUSINESS

Pursuant to Government Code section 11346.5(a)(8), the Board of Equalization makes an initial determination that the amendment of Rule 21 and deletion of Rule 23, 24, 25, and 26 will not have a significant statewide adverse economic impact directly affecting business.

The proposed rule amendments and deletion will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

The proposed rule amendments and deletions will not be detrimental to California businesses in competing with businesses in other states.

The proposed rule amendments and deletions will not affect small business because they only make specific the required assessment practices of county assessors and does not impose any additional compliance or reporting requirements on taxpayers.

COST IMPACT ON PRIVATE PERSONS OR BUSINESSES

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

SIGNIFICANT EFFECT ON HOUSING COSTS

No significant effect.

FEDERAL REGULATIONS

Rules 21, 23, 24, 25, and 26 have no comparable Federal regulations.

AUTHORITY

Government Code section 15606, subdivision (c).

REFERENCE

Revenue and Taxation Code section 107 and 107.1.

CONTACT

Questions regarding the substance of the proposed rule amendments and deletions should be directed to Mr. Robert Lambert, Senior Tax Counsel, Property Tax Section, telephone (916) 324-6593, fax (916) 323-3387, email Robert.Lambert@boe.ca.gov or by mail at State Board of Equalization, Attn: Robert Lambert, MIC:82, P.O. Box 942879, 450 N Street, Sacramento, CA 94729-0082.

The Board will consider comments on the changed Rule if received by March 27, 2002. Written comments for the Board's consideration, notice of intent to present testimony or witnesses, and inquiries concerning the proposed administrative action should be directed to Diane Olson, Regulations Coordinator, telephone (916) 322-9569, fax (916) 324-3984, email Diane.Olson@boe.ca.gov or to Joann Richmond, Property Taxes Analyst, telephone (916) 322-1931, email Joann.Richmond@boe.ca.gov or by mail at State Board of Equalization, Attn: Diane Olson or Joann Richmond, MIC: 80, P.O. Box 942879, Sacramento, CA 94279-0080.

ALTERNATIVES CONSIDERED

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which this action is proposed, or would be as effective and less burdensome to affected private persons than the proposed action.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS

The Board has prepared an initial statement of reasons and an underscored version (express terms) of the proposed rule amendments and deletions. Those documents and all information on which the proposal is based are available to the public upon request. The rulemaking file is available for public inspection at 450 N Street, Sacramento, California. Requests for copies should be addressed to Ms. Diane Olson, Regulations Coordinator, (916) 322-9569, at P. O. Box 942879, 450 N Street, MIC:80, Sacramento, CA 94279-0080. The express terms of the proposed regulation (rule) amendments and deletions are available on the Internet at the Board's website http://www.boe.ca.gov.

AVAILABILITY OF FINAL STATEMENT OF REASONS

The final statement of reasons will be made available on the Internet at the Board's web site following its public hearing of the proposed rule. It is also available for public inspection at 450 N Street, Sacramento, California.

ADDITIONAL COMMENTS

Following the hearing, the State Board of Equalization may, in accordance with law, adopt the proposed rule amendments and deletions if the text remains substantially the same as described in the text originally made available to the public. If the State Board of Equalization makes modifications which are substantially related to the originally proposed text, the Board will make the modified text, with the changes clearly indicated, available to the public for fifteen days before adoption of the rule. The text of the modified rule amendments and deletions will be mailed to those interested parties who commented on the proposed regulatory action orally or in writing or who asked to be informed of such changes. The modified rule amendments and deletions will be available to the public from Ms. Olson. The State Board of Equalization will consider written comments on the modified rule for fifteen days after the date on which the modified rule is made available to the public.

Dated: February 1, 2002

STATE BOARD OF EQUALIZATION

Deborah Pellegrini, Chief
Board Proceedings Division

DP:dgo
Enclosure

~~Rule 21. POSSESSORY INTEREST DEFINITIONS.~~

~~*Reference:* Sections 107, 107.1, 107.4, Revenue and Taxation Code.~~

~~The following definitions govern the construction of the words in the rules pertaining to possessory interests.~~

~~(a) "Possessory interest" means an interest in real property which exists as a result of possession, exclusive use, or a right to possession or exclusive use of land and/or improvements unaccompanied by the ownership of a fee simple or life estate in the property. Such an interest may exist as the result of:~~

~~(1) A grant of a leasehold estate, an easement, a profit a prendre, or any other legal or equitable interest of less than freehold, regardless of how the interest is identified in the document by which it was created, provided the grant confers a right of possession or exclusive use which is independent, durable, and exclusive of rights held by others in the property;~~

~~(2) Actual possession by one intending to use the property to the exclusion of any other interfering use, irrespective of any semblance of actual title or right.~~

~~(b) "Taxable possessory interest" means a possessory interest in nontaxable publicly owned real property, as such property is defined in section 104 of the Revenue and Taxation Code, and in taxable publicly owned real property subject to the provisions of sections 3(a), (b) and 11, Article XIII of the Constitution.~~

~~Excluded from the meaning of "taxable possessory interest" is any possessory interest in real property located within an area to which the United States has exclusive jurisdiction concerning taxation. Such areas are commonly referred to as federal enclaves.~~

~~(c) "Possession" means:~~

~~(1) Actual possession, constituting the occupation of land or improvements with the intent of excluding any occupation by others that interferes with the possessor's rights, or~~

~~(2) Constructive possession, which occurs when a person, although he is not in actual possession of land or improvements, has a right to possession and no person occupies the property in opposition to such right.~~

~~(d) "Possessor" means the party in possession or having exclusive use.~~

~~(e) "Exclusive use" means the enjoyment of a beneficial use of land or improvements, together with the ability to exclude from occupancy by means of legal process others who interfere with that enjoyment. Co-tenants may each make such use of land or improvements without impairing the other's right to use the property, as this constitutes but a single use jointly enjoyed. Exclusive use is not destroyed by one or more of the following:~~

~~(1) Multiple use by persons making different uses of the same property in such a manner that they do not prevent the enjoyment of co-existing rights held by others, as, for example, the development of mineral resources by one person and the enjoyment of recreational uses by others;~~

~~(2) 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, as, for example, when two or more parties each have the independent right to graze cattle on the same land;~~

~~(3) Alternating use when the duration of each party's use is limited, as, for example, the use of premises by a professional basketball team on certain days of each week and by a professional hockey team on certain other days;~~

~~(4) Persons lawfully passing over or taking things from the land;~~

~~(5) The existence of noninterfering easements, covenant rights, or servitudes in other persons or attached to other lands;~~

~~(6) Occasional trespassers.~~

~~(f) "Contract rent" means payments in money or in kind for the right to use real property as required by the terms of the possessory interest agreement. It includes royalty payments and other rights to share in production, the value that the public owner is expected to realize from improvements erected at the expense of the possessor which will remain when the possessory interest terminates, and any other form of compensation paid or payable for the right to occupy the property. It does not, however, include payments for services such as utilities and janitorial labor or for the use of property not subject to the possessory interest.~~

~~(g) "Economic rent" means the amount that would be paid in money or kind for the right to use real property if (1) the contract rent were currently negotiated under the conditions which exist in a free and competitive market and (2) the fee owner paid property taxes on the value of the fee.~~

~~(h) "Extended or renewed" means the lengthening of the term of possession of an agreement by mutual consent or by the exercise of an option by either party to the agreement.~~

~~(i) "Created" includes (1) the addition of land or improvements not previously subject to the agreement and (2) the addition of valuable permitted uses not previously permitted.~~

~~*History:* Adopted January 6, 1971, effective February 18, 1971.~~

~~Amended December 17, 1975, effective January 25, 1976.~~

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Rule 21. Taxable Possessory Interests—Valuation

Reference: Sections 107 and 107.1, Revenue and Taxation Code

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

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

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

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

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

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

(6) The “stated term of possession” for a taxable possessory interest as of a specific date is the remaining period of possession as of that date as specified in the lease, agreement, deed, conveyance, permit, or other authorization or instrument that created, extended, or renewed the taxable possessory interest, including any option or options to renew or extend the specified period of possession if it is reasonable to assume that the option or options will be exercised.

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

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

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

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

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

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

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

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

(d) Term of Possession for Valuation Purposes

(1) The term of possession for valuation purposes shall be the reasonably anticipated term of possession. The stated term of possession shall be deemed the reasonably anticipated term of possession unless it is demonstrated by clear and convincing evidence that the public owner and the private possessor have reached a mutual understanding or agreement, whether or not in writing, such that the reasonably anticipated term of possession is shorter or longer than the stated term of possession. If so demonstrated, the term of possession shall be the stated term of possession as modified by the terms of the mutual understanding or agreement.

(2) If there is no stated term of possession, the reasonably anticipated term of possession shall be demonstrated by the intent of the public owner and the private possessor, and by the intent of similarly situated parties, using criteria such as the following:

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

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

(C) The customs and practices of the private possessor and of similarly situated private possessors.

(D) The history of the relationship of the public owner and the private possessor and the histories of the relationships of similarly situated public owners and private possessors.

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

(3) For the purposes of this regulation, a taxable possessory interest that runs from month to month, a taxable possessory interest without fixed term, or a taxable possessory interest of otherwise unspecified duration shall be deemed to be a taxable possessory interest with no stated term of possession.

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

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

(A) Direct Comparison Method

In the direct comparison method, the appraiser shall add the following to the sale price of the subject taxable possessory interest, or to the sale price of a comparable taxable possessory interest, to derive an indicator of the fair market value of the subject taxable possessory interest: (i) the present value on the sale date of any unpaid future contract rent for the term of possession; (ii) the fair market value on the sale date of any debt assumed by the buyer of the taxable possessory interest; and (iii) the present value on the sale date of any future costs that the buyer is contractually obligated to pay for the right of possession (e.g., the cost of site restoration at the end of the term of possession) less the present value on the sale date of any future benefits in addition to the right of possession or use that the buyer is contractually entitled to receive (e.g., the salvage value of, or reimbursement value for, improvements existing at the end of the term of possession). The unpaid future contract rent in (i) above shall be reduced by any expense necessary to maintain the income from the taxable possessory interest, including any element of “gross outgo” as defined in subsection (c) of rule 8.

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

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

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

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

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

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

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

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

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

Economic rent

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

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

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

Net Operating Income

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

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

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

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

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

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

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

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

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

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

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

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

~~**Rule 23.** **WRITTEN AGREEMENTS AS TO TERM OF POSSESSORY INTERESTS.**~~

~~*Reference:* Sections 107, 107.1, 107.4, Revenue and Taxation Code.~~

~~**(a)** When a written instrument creating a possessory interest specifies a period of occupancy which is to exist, the stated period shall be taken as the term of possession for purposes of valuation except as provided in this section. An option period shall be considered part of the stated period if it is reasonable to conclude that the option will be exercised.~~

~~**(b)** Should a period thus determined be in conflict with the reasonably anticipated term of possession by the possessor and any successor to or assignee of the property interest, the reasonably anticipated term of possession, whether shorter or longer, shall be used instead of the stated period. In determining the reasonably anticipated term of possession, the assessor shall be guided by the intent of the public owner and the possessor, as indicated by such evidence as (1) sale prices of the subject or similar possessory interests, (2) the history of the property's use, (3) the policy of the public agency administering the lands, and (4) the actions of the possessor. No reduction or increase of the specified period shall be based on the life expectancy of the possessor if it is reasonably anticipated that possession will continue under his successors or assigns.~~

~~**(c)** When there is no stated term of possession, the term shall be determined in accordance with subsection (b).~~

~~*History:* Adopted January 6, 1971, effective February 18, 1971.~~

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~~**Rule 24. POSSESSORY INTEREST RIGHTS TO BE VALUED.**~~

~~*Reference:* Sections 107, 107.1, 107.4, Revenue and Taxation Code.~~

~~Except as otherwise provided in sections 26 and 27 of this title, the taxable value of a possessory interest is the sum of the value of all property rights in land and improvements held by the possessor. This value is not diminished by any obligation to pay rent or to retire debt secured by the possessory interest. Stated in other terms, the taxable value of a possessory interest is the value of the fee simple estate reduced by the value of any rights, except security interests, held by the public owner (other than the right to receive rent) or granted by the public owner to other persons. Examples of rights held by the public owner are:~~

~~**(a**) The right to take possession of the property upon termination of the possessory interest by reason of expiration of the term or the happening of a condition or breach of a limitation contained in the agreement granting possession.~~

~~**(b)** The right to put the property to a higher and better use or otherwise restrict the possessor's use of the property.~~

~~**(c)** The right to terminate possession on notice.~~

~~**(d)** The right to approve a sublessee or assignee.~~

~~**(e)** The right to approve a loan secured by the possessory interest.~~

~~*History:* Adopted January 6, 1971, effective February 18, 1971.~~

~~Rule 24.~~ **~~POSSESSORY INTEREST RIGHTS TO BE VALUED.~~**

~~Reference:~~ ~~Sections 107, 107.1, 107.4, Revenue and Taxation Code.~~

~~Except as otherwise provided in sections 26 and 27 of this title, the taxable value of a possessory interest is the sum of the value of all property rights in land and improvements held by the possessor. This value is not diminished by any obligation to pay rent or to retire debt secured by the possessory interest. Stated in other terms, the taxable value of a possessory interest is the value of the fee simple estate reduced by the value of any rights, except security interests, held by the public owner (other than the right to receive rent) or granted by the public owner to other persons. Examples of rights held by the public owner are:~~

~~(a~~~~) The right to take possession of the property upon termination of the possessory interest by reason of expiration of the term or the happening of a condition or breach of a limitation contained in the agreement granting possession.~~

~~(b)~~ ~~The right to put the property to a higher and better use or otherwise restrict the possessor's use of the property.~~

~~(c)~~ ~~The right to terminate possession on notice.~~

~~(d)~~ ~~The right to approve a sublessee or assignee.~~

~~(e)~~ ~~The right to approve a loan secured by the possessory interest.~~

~~History:~~ ~~Adopted January 6, 1971, effective February 18, 1971.~~

~~**Rule 25. VALUATION OF POST-DE LUZ POSSESSORY INTERESTS.**~~

~~*Reference:* Sections 107, 107.1, 107.4, Revenue and Taxation Code.~~

~~The value of a taxable possessory interest created, extended, or renewed after December 24, 1955 (other than one for production of gas, petroleum, or other hydrocarbons) may be measured by one or more of the following methods:~~

~~**(a)** The "comparative sales approach," wherein the possessory interest is valued by either direct or indirect comparison as follows:~~

~~In the direct comparison method, the subject property is compared with itself on the date of a prior subsequent sale or with similar possessory interests which have been sold on dates prior or subsequent to the date as of which the property is being valued. To the sale price of such an interest there shall be added (1) the present worth of any unpaid future contract rents for the estimated remaining term of possession, (2) the value of any debt (other than the debt for future rents) assumed by the purchaser of the possessory interest, and (3) the present worth of any obligated costs of the purchaser, such as the cost of site restoration at the end of the term, less the present worth of any contractual benefits to the purchaser, such as salvage value of, or reimbursement for, improvements at the end of the term. The interest sold should be reasonably comparable to the possessory interest being valued in location, physical characteristics, term of possession, risk of cancellation, and permitted use.~~

~~In the indirect comparison method, the value of the possessor's rights is first measured as if perpetual by comparison with fee interests which have been sold, which have similar locations and physical characteristics, and for which the highest and best use corresponds to or is comparable with the permitted use of the property subject to the possessory interest. This value is reduced by the present worth of those rights for the period subsequent to the estimated term of possession. This method is not well suited to valuation of a short-term possessory interest when the fee interests in the comparable properties are sold at prices that appear to reflect the expectation of higher incomes after the expiration of the possessory interest than during its existence.~~

~~**(b)** The "income approach," wherein the possessory interest is valued either directly by capitalizing all future net income that the possessory interest is capable of generating under typical management during the estimated term of possession, or indirectly by first capitalizing the net income to estimate the value of the possessor's rights as if perpetual and then deducting the present worth of those rights for the period subsequent to the term of the possessory interest.~~

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

~~The net income to be capitalized is either the imputed economic rent, which may be estimated by reference to rentals recently negotiated in a competitive market or, if such evidence is inadequate, by reference to the anticipated gross income of a typical operator of the property subject to the~~

~~possessory interest, less costs of goods sold and typical management and other operating expenses. When the second of these methods of estimating economic rent is employed, the "other operating expenses" to be deducted do not include amortization, depreciation, depletion charges, debt retirement, interest on funds invested in the possessory interest, the contract rent for the possessory interest, property taxes on the possessory interest, income taxes, or state franchise taxes measured by income.~~

~~The imputed economic rent or gross income estimate is to reflect the restrictions on use inherent in the possessory interest.~~

~~When using a recently negotiated or percentage contract rent for a possessory interest as an indicator of the economic rent, the appraiser shall:~~

~~(1) include in the contract rent his estimate of the amount, if any, by which the cash or share rent has been reduced because the possessor has assumed the cost of improvements that will revert to the public owner on expiration of the possessory interest;~~
~~(2) add to the contract rent his estimate of the taxes that will be paid on the possessory interest if the capitalization rate contains a property tax component;~~
~~(3) add to the contract rent his estimate of the amount, if any, by which the contract rent was reduced because the possessor has agreed to bear the cost of restoring the property to its original condition when it reverts to the public owner, or the cost of removing improvements and restoring the site to its original condition (less any estimated salvage value), or any similar obligations.~~

~~The capitalization rate shall be derived (1) by extraction of a rate from sale prices of comparable possessory interests or from sale prices of fee interests in similar properties that are not expected to yield substantially higher incomes after expiration of the possessory interest being valued than during its existence or (2) by combining weighted components for debt and equity yields as described in section 8, subsection (g)(2) of this chapter. In either case, the capitalization rate shall include a property tax component as required by section 8, subsection (f) of this chapter when the property tax has not been netted out of the rent or other income being capitalized.~~

~~**(c)** The "cost approach," wherein the cost of replacing reproducible property with new property which offers utility that will satisfy the requirements of the possessor's permitted use, less accrued depreciation and less the present worth of the estimated value, if any, of such property at the termination of possession, is added to the value of the restricted right to occupy the land for the limited term derived by the comparative sales or income method.~~

~~*History:* Adopted January 6, 1971, effective February 18, 1971.~~

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~~**Rule 26. VALUATION OF PRE-DE LUZ POSSESSORY INTERESTS.**~~

~~*Reference:* Sections 107, 107.1, Revenue and Taxation Code.~~

~~The value of a taxable possessory interest created prior to December 25, 1955, and not since extended or renewed (other than one for the production of gas, petroleum, or other hydrocarbons) is the excess of the market value of the possessory interest over the present worth of unpaid future contract rents for the unexpired term of possession. Such value may be measured by one or more of the following methods:~~

~~**(a)** The "comparative sales approach," wherein the possessor's interest is valued either directly or indirectly as previously described in section 25, subsection (a), except that, in the direct comparison method, the present worth of unpaid future contract rents is not added to the sale price of a possessory interest and, in the indirect comparison method, the value of a fee interest is reduced by the present worth of unpaid future contract rents of the possessory interest being appraised as well as by the present worth of the property rights for the period subsequent to the estimated term of possession.~~

~~**(b)** The "income approach," wherein the possessor's interest is valued either directly or indirectly as described in section 25, subsection (b), except that, in the direct method, the unpaid future contract rents, as well as other expenses, are deductible and, in the indirect method, the present worth of unpaid future contract rents, as well as the present worth of the property rights for the period subsequent to the term of the possessory interest, is deductible.~~

~~**(c)** The "cost approach," wherein the possessor's interest is valued as described in section 25, subsection (c), and the present worth of any unpaid future contract rents for the term of the possessory interest is deducted.~~

~~*History:* Adopted January 6, 1971, effective February 18, 1971.~~

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