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No. 2014/023

April 25, 2014

TO COUNTY ASSESSORS AND INTERESTED PARTIES:

NOTICE OF BOARD ACTION

GUIDANCE REGARDING TAXABLE POSSESSORY INTERESTS PROPERTY TAX RULE 21(d), TERM OF POSSESSION FOR VALUATION PURPOSES

On April 22, 2014, the State Board of Equalization approved the following guidance pertaining to the term of possession for the valuation of taxable possessory interests (TPIs).

On May 7, 2013, the court of appeal issued its decision in *California State Teachers' Retirement System v. County of Los Angeles (CalSTRS)*¹ holding Government Code section 7510, subdivision (b)(1) unconstitutional because it taxed the publicly owned reversionary interest.²

Pursuant to Government Code section 15640 et seq., the Board periodically reviews county assessment practices to determine compliance with the Board's rules and regulations. Those reviews, known as County Assessment Practice Surveys, have revealed a substantial number of inconsistencies among counties as to the application of the standards set forth in Property Tax Rule 21.³ Due to the documented inconsistent application of Rule 21 and Assessors' Handbook Section 510, *Assessment of Taxable Possessory Interests (AH 510)* (December 2002), and the recent decision in *CalSTRS*, this Letter To Assessors (LTA) is issued in fulfillment of the Board's duties under Government Code section 15606, subdivision (g) to guide taxpayers, assessors, and assessment appeals boards (AABs) in determining the term of possession by clarifying the Board's intent in promulgating Rule 21, subdivision (d). With respect to the equalization of TPIs, county assessors and AABs must follow Rule 21 and rely on AH 510 to appraise the value of and assess property taxes on all types of TPIs.⁴

This LTA is issued to clarify that the Board interprets its rules as requiring county assessors and AABs to:

1. Rely on Rule 21(d) and AH 510 to determine the reasonably anticipated term of possession and create a base year value for a TPI based on the private possessor's right created by the TPI that excludes any reversionary interest held by the public owner in the real property; and

¹ (2013) 216 Cal.App.4th 41.

² An LTA advising county assessors that, consistent with the holding in *CalSTRS*, they may no longer assess possessory interests pursuant to Government Code section 7510(b)(1) will be issued separately.

³ Title 18, California Code of Regulations, section 21.

⁴ The *CalSTRS* court rightfully emphasized the deference that should be given to the Board on matters within its expertise when interpreting a self-promulgated regulation.

2. In the absence of a subsequent change in ownership or modification of the stated term of a TPI as described herein, decline the term of any TPI on each lien date throughout the reasonably anticipated term of possession to determine if the TPI's factored base year value is lower than its fair market value. This is required by Revenue and Taxation Code⁵ section 51.

Absent this clarification of Rule 21(d), the lack of uniformity in appraisal and assessment of TPIs will persist. Clarification of Rule 21(d) consistent with published guidance will ensure that assessors will administer and AABs will implement Rule 21 consistent with the law, guarding against violations of Article XIII, section 1 of the California Constitution, which requires assessment of all property, including TPIs, at fair market value.

On March 27, 2002, the Board adopted Rule 21, consistent with the Legislature's mandate in Government Code section 15606, subdivision (g) that the Board "[p]rescribe rules and regulations to govern local boards of equalization when equalizing and assessors when assessing with respect to the assessment and equalization of possessory interests." Rule 21 describes the rights to be valued in appraising a TPI, and the standards to be applied when assessing a TPI, including the legal standards by which an assessor must value pre- and post-*De Luz* TPIs.

As reflected in the Board's minutes of March 27, 2002,⁶ the Board adopted Rule 21 primarily to ensure that TPI assessment and appraisal is equalized throughout the state and to implement the holding of *American Airlines, Inc. v. County of Los Angeles (American Airlines)*.⁷ In *American Airlines*, the court held that the right to the possession of land, inclusive of any options to renew the leases, is defined in section 107 as a TPI. The taxpayers, however, had no such option rights following expiration of the terms of their leases.⁸

The holding in *American Airlines* is consistent with Rule 21, subdivision (b), which defines the possessory interest rights to be valued, and is the basis for Rule 21(d), which defines the reasonably anticipated term of possession as the term to be used to appraise a TPI. Thus, the "reasonably anticipated term of possession" for valuation purposes is defined by the private possessor's right, as defined in Rule 21, subdivision (a)(3), to occupy or possess the public property, and not by the taxpayer's or public owner's unsupported hope or expectation that the occupation or possession will continue.⁹ *American Airlines* established that only the taxable real property in a possessory interest is measured by the term of possession created by the public owner and private possessor. Consistent with *American Airlines*, *CalSTRS* established that the appraised value of the TPI may not include the public owner's reversionary interest in the property because it is not taxable.

On December 19, 2002, the Board approved AH 510. AH 510 was developed by the Board's staff, and adopted by the Board, to give county assessors, their staff, and other interested parties an understanding of the principles of TPI assessment to guide appraisal of TPIs. It contains the Board's interpretation of rules, laws, and court decisions on TPI assessment. AH 510 sets forth the definition of a TPI, explains how to appraise a TPI, and addresses issues with respect to TPI valuation (including particular legal issues related to Article XIII A of the Constitution) and other special concerns regarding possessory interest assessment. AH 510 also describes the

⁵ All statutory references are to the Revenue and Taxation Code unless otherwise indicated.

⁶ 2002 Minutes of the State Board of Equalization, Public Hearings, pp. 122-123.

⁷ (1976) 65 Cal.App.3d 325.

⁸ *American Airlines*, 65 Cal.App.3d at p. 329.

⁹ *American Airlines*, 65 Cal.App.3d at p. 330.

annual obligation of the assessor to decline the term of a TPI, as ascertained by Rule 21(d), on each lien date throughout the reasonably anticipated term of possession to determine if full value has fallen below adjusted base year value. Property taxes must be assessed based on the lower value.

Precise ascertainment of the reasonably anticipated term of possession ensures that a TPI's base year value is correctly appraised and property taxes are legal throughout the term of possession. This will ensure that several constitutionally based requirements are adhered to so that the appraisal assesses a TPI at full cash value and intangible value is not included in the valuation. Rule 21(d) provides for precise ascertainment of the reasonably anticipated term of possession depending on the term in a lease, franchise, or other conveyance of public land creating a TPI to ensure that the appraisal method results in a value that is consistent with the Constitutional requirement to tax property at fair market value.

TPIs with a stated term of possession. Where there is a "stated term of possession" (i.e., a lease or franchise that grants a private possessor a right of possession or occupancy for a specific period of time), the stated term of possession is deemed to be the reasonably anticipated term of possession, unless the assessor or taxpayer proves, as set forth below, that the parties have mutually modified the stated term.

TPIs where the stated term of possession has been modified. Rule 21(d)(1) states:

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.
[(Emphasis added.)]

Therefore, to use a term shorter or longer than the stated term of possession for valuation purposes to appraise a possessory interest, AH 510, the Board's interpretation of the holding in *American Airlines*, and Rule 21(d)(1) require an assessor or taxpayer to demonstrate by clear and convincing evidence that the public owner and private possessor mutually modified the stated term of possession, whether or not in writing. The party asserting the modification bears the burden of proof that the public owner and taxpayer modified the term to a shorter or longer period of time.

Although the Court of Appeal in *Charter Communications Properties, LLC v. County of San Luis Obispo (Charter)*¹⁰ found substantial evidence to support the AAB's factual finding of a modification to the stated term at issue, we stress that *Charter* does not provide any legal authority for purposes of guiding a county assessor or an AAB in determining whether clear and convincing evidence exists to establish that a modification of a stated term has occurred. As a matter of law, *American Airlines*, AH 510, and Rule 21(d)(1) provide the authoritative guidance that county assessors and AABs must look to when making such a determination. Any reading of *Charter* that is inconsistent with the advice given in this LTA should be disregarded.

¹⁰ (2011) 198 Cal.App.4th 1089.

If an assessor's appraisal of a TPI is contested, an AAB must determine if there is clear and convincing evidence that the public owner and private possessor have modified the stated term. When making this determination, the Board interprets Rule 21(d)(1) to require these principles be followed:

1. As a matter of law, the public owner and private possessor must have modified the right to possess the land in a manner that is legally cognizable under contract law principles (e.g., promissory estoppel, quasi-contract, breach of contract, a writing consistent with the statute of frauds, implied contract, detrimental reliance, etc.).
2. No party can prove by clear and convincing evidence that a modification has taken place under Rule 21(d)(1), when either party's agreement to the asserted modification constitutes an ultra vires act that renders the modification *void ab initio* (i.e., an unenforceable act that is invalid from the outset because it is beyond the scope of powers of the parties under applicable local, state or federal laws).
3. Unless allowed by the statutory scheme, the reasonably anticipated term of possession may never exceed a limit placed on the occupancy of public land by the Legislature.¹¹

TPIs with no stated term of possession. Where, under Rule 21(d), the private possessor and the public landowner have a month-to-month lease or an agreement to occupy public land with no fixed term, or one of otherwise unspecified duration, the reasonably anticipated term of possession is determined by application of factors such as those set forth in Rule 21(d)(2).

This LTA is the Board's interpretation of its self-promulgated regulation and is consistent with *CalSTRS*. The advice herein is also consistent with the California Constitution, the Revenue and Taxation Code, the plain language of Rule 21, and the Board's intention at the time of Rule 21's adoption. It is also consistent with the Board's longstanding formal interpretation of its self-promulgated Rule as reflected by its adoption of AH 510, which specifically addresses assessment of TPIs. The advice herein is also consistent with the Board's staff's consistent interpretation of Rule 21, as reflected in AH 510 and in County Assessment Practices Surveys. The Board has a constitutionally mandated responsibility to equalize property tax appraisal methods within and throughout the 58 counties. Following this LTA will ensure the TPI appraisals are equalized.

Sincerely,

/s/ John K. Thompson for

David J. Gau
Deputy Director
Property and Special Taxes Department

¹¹ See, e.g., Civil Code, section 718 (tidelands or submerged lands, granted to any city by the State of California, may be leased for a period not to exceed 66 years unless the grant from the state of the use thereof provides specifically the term for which said lands may be leased); Government Code section 25515.1 (restricting counties from entering into leases of real property for purposes of cultural, residential, commercial, or industrial use or development that exceed 99 years); Government Code section 37380 (restricting cities from entering into leases that exceed 55 years, or 99 years on certain conditions); Public Utility Code section 5850, subdivision (a) (state-issued video franchise shall only be valid for 10 years after the date of issuance).