State of California

Board of Equalization
Property and Special Taxes Department

Memorandum

To: Honorable John Chiang, Chair
Honorable Claude Parrish, Vice Chairman
Ms. Betty Yee, Acting Board Member
Honorable Bill Leonard
Honorable Steve Westly

Date: June 15, 2005

From: Mickie Stuckey for
David J. Gau, Deputy Director
Property and Special Taxes Department

Subject: ***Proposed Property Tax Rule 23.2, Valuation of Interests in Publicly Owned Ports and Harbors*** (June 30, 2005 Property Tax Committee Meeting)

In a memo dated May 4, 2005, Honorable Claude Parrish requested that proposed Property Tax Rule 23.2, *Valuation of Interests in Publicly Owned Ports and Harbors* (copy attached), be scheduled for discussion at the June 30, 2005 Property Tax Committee meeting. Mr. Parrish had Rule 23.2 drafted to remedy apparent problems in the assessment and appraisal of taxable possessory interests. In general, proposed Rule 23.2 would allow county assessors greater discretion in determining the term of possession for a taxable possessory interest in a publicly owned port or harbor.

A draft of proposed Rule 23.2 was sent to interested parties on May 13, 2005. To date, no comments have been received from interested parties on the proposed rule.

Possible Committee Action

If directed to do so, staff will commence the interested parties process with respect to proposed Rule 23.2. Important steps in this process include:

1. Circulating the draft rule to taxpayers, assessors, and others to obtain comments and suggested changes;
2. Meeting with interested parties to discuss the comments and suggested changes; and
3. Bringing proposed Rule 23.2, with any recommended modifications, back to the Property Tax Committee for further action.

Background

Publicly owned real property is generally exempt from taxation. However, under certain circumstances, the private possession and use of publicly owned real property may give rise to a taxable property interest. Such interests are called taxable possessory interests. The criteria for determining whether a taxable possessory interest exists are contained in Revenue and Taxation Code section 107; Property Tax Rule 20 elaborates on these criteria.

A taxable possessory interest is a real property interest of limited duration; it is not an interest held in perpetuity. Thus, at some point in time the private possessor's right to possess and use the publicly owned real property will expire, and those rights of possession and use will revert to the public owner. The time period over which the private possessor has the rights of possession and use is, in assessment parlance, called the *term of possession.*

The term of possession is a significant factor affecting the assessed value of a taxable possessory interest. It is particularly important when the assessor uses the "direct income method," the most widely used methodology for valuing possessory interests. Under this methodology, the value of a taxable possessory interest is estimated by discounting and cumulating the annual economic rent attributable to the taxable possessory interest over a specified term of possession. A longer term of possession means a greater number of annual rental payments to be discounted and cumulated. Thus, the longer the term of possession, the higher the assessed value.

Existing Rule 21 and Term of Possession

The determination of the length of the term of possession is currently addressed in subsection (d) of Rule 21. For the purpose of establishing a private possessor's term of possession in a possessory interest, Rule 21 divides taxable possessory interests into two categories: those with a term stated in a written agreement and those without such a stated term. Taxable possessory interests with a "stated term of possession" are those interests created by a lease, permit, or other type of instrument in which a period of possession is specified. Taxable possessory interests without a stated term of possession are interests that run from month to month or interests of unspecified duration.

Under Rule 21, a taxable possessory interest with a stated term of possession is valued using the stated term unless it can be demonstrated by clear and convincing evidence, written or verbal, that the private possessor and public owner have agreed otherwise. For example, for a given taxable possessory interest created by a lease with an initial term of 20 years, the term of possession on the initial valuation date would be 20 years. In subsequent years, the term of possession would be the term remaining on the lease.

For taxable possessory interests without a stated term of possession, Rule 21 allows the assessor greater discretion in establishing the term of possession. For this category of possessory interest, the rule provides that the term of possession must be determined by the demonstrated intent of the public owner and the private possessor, based upon criteria such as the following:

1. Sales prices for the subject and comparable taxable possessory interests;
2. The rules, policies, and customs of the subject public owner and private possessor;
3. The history of the relationship between the subject public owner and private possessor and others similarly situated; and
4. The actions of the subject public owner and private possessor, notably, investments involving the subject property made by either of these parties.

Proposed Rule 23.2 and Term of Possession

Proposed Rule 23.2 has two primary aspects: (1) the type of property to which it would apply, and (2) the way in which the determination of the term of possession for those properties would differ from the status quo as provided by Rule 21.

As proposed, Rule 23.2 would apply only to taxable possessory interests involving "terminals, cargo handling facilities, offices, retail facilities, automobile parking lots, storage and maintenance facilities and other buildings and land in publicly owned ports and harbors." A "publicly owned port or harbor" is defined in the rule as "any port or harbor owned by the federal government, the State of California, or any of its political subdivisions." In addition, proposed Rule 23.2 would apply only to taxable possessory interests created by a lease agreement—that is, only to taxable possessory interests with a stated term of possession.

Under Rule 21, the presumption that the term of possession is the term stated in the lease can be overcome by demonstrating with clear and convincing evidence that the public owner and private possessor have agreed to a different term. Proposed Rule 23.2 retains the presumption in favor of the stated term of possession; however, the burden of proof by which the presumption may be overcome is less stringent than in existing Rule 21.

Under the proposed rule, the presumption may instead be overcome by demonstrating with a preponderance of the evidence, a lesser standard of proof than the clear and convincing evidence standard, that the reasonably anticipated term of possession differs from the stated term of possession. The rule provides evidentiary criteria for establishing a term of possession other than the stated term of possession—criteria that are essentially the same as those provided in existing Rule 21 relating to taxable possessory interests without a stated term of possession. As indicated above, Rule 21 does not provide such criteria for taxable possessory interests with a stated term.

Comments

The Board adopted the current language in Rule 21 pertaining to term of possession in March 2002 (effective July 11, 2002). The language was adopted along with several other amendments relating to the valuation of taxable possessory interests. However, the proper determination of a term of possession was the only controversial issue associated with the 2002 amendments to the rule.

Essentially, this controversy involved how much discretion assessors should have when establishing a term of possession. Or, to put it another way, the controversy involved the degree to which assessors should be allowed to use some term other than the remaining term under a lease as the term of possession. Assessors argued for language providing for greater discretion in establishing the term of possession. However, the language adopted by the Board did not provide assessors with that discretion.

Subsequently, in September 2003, the California Assessors' Association formally petitioned the Board to amend Rule 21 over the same issue. In their petition, the assessors sought a lowering of

the evidentiary threshold from "clear and convincing evidence" to a "preponderance of the evidence." The Board voted unanimously to deny the assessor's petition.

Proposed Rule 23.2 would revisit the evidentiary issue again, at least with respect to publicly owned ports and harbors.

Rule 23.2 states that the unique nature of publicly owned ports and harbors requires the application of specialized appraisal techniques. Interested parties might question how taxable possessory interests in publicly owned ports and harbors differ from other taxable possessory interests, and why such types of property interests require specialized appraisal techniques.

DJG:mn
Attachment

PROPOSED RULE 23.2. VALUATION OF INTERESTS IN PUBLICLY OWNED PORTS AND HARBORS.

Authority: Section 15606(c), Government Code.

Reference: Article XIII, Section 1, California Constitution; Article XIII A, Section 2, California Constitution; Sections 51, 107, 110, and 110.1, Revenue and Taxation Code.

(a) The provisions of this rule apply to the valuation of taxable possessory interests that are interests created by a written agreement for the lease of terminals, cargo handling facilities, offices, retail facilities, automobile parking lots, storage and maintenance facilities and other buildings and land in publicly owned ports and harbors.

(b) GENERAL.

(1) The unique nature of publicly owned ports and harbors requires the application of specialized appraisal techniques designed to satisfy the requirements of article XIII, section 1, and article XIII A, section 2, of the California Constitution. To this end, taxable possessory interests in publicly owned ports and harbors shall be valued pursuant to the principles and procedures set forth in this section.

(2) Except as provided in this section, assessors will apply any appropriate valuation method described in section 21 of title 18 of this code when determining the assessed value of a taxable possessory interest in a publicly owned port or harbor.

(c) DEFINITION. For the purposes of this section:

(1) "Publicly owned port or harbor" means any port or harbor owned by the federal government, the State of California, or any of its political subdivisions.

(d) TERM OF POSSESSION FOR VALUATION PURPOSES. For the purposes of this section:

(1) The term of possession for valuation purposes shall be the reasonably anticipated term of possession. The term of possession stated in the written document creating the taxable possessory interest shall be deemed the reasonably anticipated term of possession unless it is demonstrated by a preponderance of the evidence that the reasonably anticipated term of possession is shorter or longer than the stated term of possession.

(2) Evidence demonstrating that the reasonably anticipated term of possession is shorter or longer than the stated term of possession must go beyond unsubstantiated expectations of the parties. In determining the reasonably anticipated term of possession, the assessor shall be guided by the stated term of the lease, as well as the intent of the public owner and the possessor, as evidenced by the following criteria:

(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.

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

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

(F) The remaining economic life of any improvements owned by the possessor.

(G) The stated terms of comparable possessory interests as of the date of value demonstrating the intent of the public owner.