Issue Paper Number **01-018 R**

☐ Board Meeting
☐ Business Taxes Committee
☐ Customer Services and Administrative Efficiency Committee
☐ Legislative Committee
☒ Property Tax Committee
☐ Other

BOARD OF EQUALIZATION
KEY AGENCY ISSUE

Property Tax Rule 21, Taxable Possessory Interests — Valuation

I. Issue

Which version of proposed Property Tax Rule 21, *Taxable Possessory Interests—Valuation*, should the Board adopt and authorize for publication?

II. Staff Recommendation

Staff recommends that the Board adopt a version of proposed Property Tax Rule 21 that states that the term of possession for valuation purposes shall be the stated term of possession unless there is "clear and convincing" evidence demonstrating that the possessor and the public owner have reached a mutual understanding or agreement that the reasonably anticipated term is shorter or longer than the stated term of possession.

III. Other Alternative(s) Considered

Assessors' Alternative 1

The Board could adopt a version of proposed Property Tax Rule 21 that contains alternative language stating that the term of possession for valuation purposes shall be the stated term of possession unless there is evidence "that goes beyond the unsubstantiated expectations of the parties" demonstrating that the reasonably anticipated term will be shorter or longer than the stated term of possession.

Assessors' Alternative 2

The Board could adopt a version of proposed Property Tax Rule 21 that contains alternative language stating that the term of possession for valuation purposes shall be the stated term of possession unless there is a "preponderance of" evidence demonstrating that the reasonably anticipated term will be shorter or longer than the stated term of possession.

IV. Background

General

The existing set of regulations governing taxable possessory interests comprise Property Tax Rules 20 through 28. Board staff, with the participation of interested parties, has been involved in a project to review, revise, and combine existing Rules 21, 23, 24, 25, and 26 into a proposed new rule (designated new Property Tax Rule 21) that addresses taxable possessory interest valuation in a unified fashion. Rules 20, 22, 27, and 28 are not affected by this revision.

During this revision process, staff worked with the California Assessors' Association (CAA), the California Taxpayers' Association (Cal-Tax), and other interested parties to draft the new rule. Staff and interested parties were able to reach agreement on all aspects of the proposed rule, except the proper definition of "term of possession," an important element in possessory interest valuation. This issue paper presents and discusses the competing language and viewpoints about term of possession; specifically, it compares staff's recommended language with two alternative versions proposed by the CAA. Staff's recommended language for term of possession was proposed by Cal-Tax. Staff reviewed the proposed language and was in agreement. Accordingly, Cal-Tax's language regarding term of possession is included in staff's recommendation.

[A copy of proposed Property Tax Rule 21 that includes all agreed-upon changes among interested parties, including staff's recommended language in subsection (d) concerning term of possession, is provided in Attachment 1. A side-by-side presentation of staff's recommended language for term of possession and the CAA's two proposed alternatives is provided in Attachment 2.]

Term of Possession

A taxable possessory interest is a privately held property interest in publicly owned real property that meets certain statutory criteria set forth in section 107 of the Revenue and Taxation Code. Most taxable possessory interests are created by permits and leases granting possessory rights in government land to private parties.

Since a taxable possessory interest is by definition a property interest of limited duration, an assessor valuing a taxable possessory interest must determine a "term of possession." The existing rule defines the term of possession as the "reasonably anticipated term of possession," a standard defined in terms of several criteria presented in the rule. 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).

The term of possession is a significant variable in possessory interest valuation, and the assessor reviews it on each lien, or valuation, date. The term of possession is particularly important when the assessor uses the "direct income method," which is the most widely used possessory interest valuation method. Under this method, the value of the taxable possessory interest is estimated by discounting the annual economic rent attributable to the taxable possessory interest over a specified term of possession. Since the term of possession determines the number of annual income payments that will be discounted, it significantly affects the assessed value.

The "stated term of possession" is defined as the remaining term of possession (on the valuation date) according to the agreement or permit that created the possessory interest. Under the existing rule, the reasonably anticipated term of possession determined by the assessor may be shorter or longer than the stated term of possession, provided that the assessor can support such a reasonably anticipated term using criteria in the rule. In recent years, some taxpayers have questioned the legality of the existing rule and existing practice in this regard. They believe that assessors should be limited to the use of the stated term of possession (plus any specified option periods) when determining the term of possession of a taxable possessory interest.

The cardinal difference between staff's recommendation and the two alternatives proposed by the CAA involves the evidentiary standard the assessor must meet in order to deviate from the stated term of possession and establish that the reasonably anticipated term of possession does in fact differ from the stated term of possession.

V. Staff Recommendation

Adopt staff's recommended language for Property Tax Rule 21, which contains language stating that the reasonably anticipated term of possession shall be the stated term of possession unless there is "clear and convincing" evidence demonstrating that the reasonably anticipated term will be shorter or longer than the stated term of possession.

By necessity, the adoption of the staff recommendation also requires that the Board repeal existing Property Tax Rules 21, 23, 24, 25, and 26 because the subject matter of these rules has been incorporated into proposed Property Tax Rule 21.

(Staff's proposed language regarding term of possession is shown in Attachment 2 under the heading of "Staff Recommendation." It is also shown in Attachment 1 as part of the entire text of the proposed rule.)

A. Description of the Staff Recommendation

Staff’s proposed language states that the term of possession shall be the stated term of possession 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. Following the existing rule that addresses term of possession, Rule 23, staff’s language thus retains the reasonably anticipated term of possession as the standard for determining the term of possession. Staff’s language also retains the criteria (with minor, nonsubstantive changes) for determining the reasonably anticipated term of possession in the existing rule.

Existing Rule 23 provides that the stated term of possession shall be the term of possession unless the stated term, in the assessor’s opinion, conflicts with the reasonably anticipated term as determined under the criteria in the rule. Thus, the existing rule makes it relatively easy for the assessor to set aside the stated term of possession and instead establish a term of possession based on the criteria in the rule (which are not presented as all-inclusive) for the reasonably anticipated term of possession. Under staff’s proposed language, the assessor must overcome an evidentiary barrier when setting aside the stated term of possession; thus, the stated term becomes significantly more determinative.

Under staff’s language, taxable possessory interests without a stated term of possession are excluded from the “clear-and-convincing” evidentiary requirement. Specifically excluded are taxable possessory interests than run from month to month, taxable possessory interests without a fixed term, and taxable possessory interests of otherwise unspecified duration. The assessor would establish the term of possession for these types of interests as under the existing rule, that is, by recourse to the stated criteria for the reasonably anticipated term of possession.

B. Pros of the Staff Recommendation

- *Retains reasonably anticipated standard.* The reasonably anticipated term of possession standard is ingrained in California law. For example, (1) it has been statutorily mandated as an integral part of the preferred method of valuing a cable television possessory interest in Revenue and Taxation Code section 107.7, subdivision (b)(2); and (2) the change in ownership of a taxable possessory interest is related to a renewal or extension “during the reasonably anticipated term of possession used by the assessor to value that interest” in Revenue and Taxation Code section 61, subdivision (b)(2).

The reasonably anticipated standard also has the imprimatur of several court decisions. In *Wrather Port* Properties, *Ltd. v. County of Los Angeles* (1989) 209 Cal.App.3d 517, 522-525, the court approvingly cited Rule 23's requirement that the reasonably anticipated term be tied to the "intent of the parties" and "evidence of any understandings or agreements regarding renewal." In *Dressler v. County of Alpine* (1976) 64 Cal.App.3d 557, 564-565, the court upheld a lien date assessment of a grazing rights taxable possessory interest on federal land predicated upon a demonstrated history of many years of annual re-issuances of grazing permits. The court found that this history demonstrated either a custom or a renewal policy of the U. S. Forest Service sufficient upon which to base an assessment.

- *Reflects current law concerning term of possession.* In *American Airlines, Inc. v. County of Los Angeles* (1976) 65 Cal.App.3d 325, 328-333, the court held that in order to depart from the stated term of possession, the assessor must show an "understanding" or "expectation" between the possessor and the public owner—based on statute, contract, or evidence of "real substance"—that the reasonably anticipated term of possession differs from the stated term of possession. Staff's recommended language is predicated upon the decision in *American Airlines* in the sense that the staff recommendation contains, in effect, a presumption that the stated term of possession is the reasonably anticipated term of possession subject to a strong evidentiary requirement for overcoming this presumption.

- *Clear and convincing standard appropriate.* Staff's use of a clear and convincing standard for departing from the stated term of possession is consistent with California Civil Code standards for demonstrating that a written agreement has been modified. Civil Code section 1698 states that a written contract may only be modified by a written contract, or modified by an oral agreement only to the extent that the oral agreement is executed (i.e., fully performed) by the parties. A written agreement may be modified orally if the new (i.e., orally modified) agreement is supported by new consideration. The Civil Code thus sets a higher standard than staff's language about what must be adduced in order to demonstrate that the terms of a written agreement have been enforceably modified. Staff's language does not require a showing of full performance by the parties, or even additional consideration. Moreover, Civil Code section 1698 contemplates an actual agreement, not merely an "understanding," as in staff's language.

- *Where no stated term exists, does not disturb existing practice.* Staff's language retains existing law and practice in regard to taxable possessory interests where there is no stated term of possession. Further, staff's language provides clarity, in subsection (d)(3), by explicitly stating that certain types of possessory interests should not be deemed of a stated term.

- *Promotes assessment uniformity.* The results of staff's survey of assessment practices concerning possessory interests (Special Topic Survey, "Assessment of Taxable Possessory Interests," April 2000) showed a substantial lack of uniformity among counties when establishing the term of possession. By requiring the assessor to use the stated term of possession unless there is clear evidence to the contrary, assessment will be more uniform.

C. Cons of the Staff Recommendation

- *Requires assessors to obtain more information.* Currently, there is no annual review by assessors of each taxable possessory interest of a stated term to find out whether the possessor and the public owner have reached a mutual understanding or agreement, oral or written, such that the stated term differs from the reasonably anticipated term. To do so will increase the assessor's workload.

The California Assessors' Association contends the following regarding staff's recommended language for term of possession:

- *Clear and convincing standard is inappropriate.* A preponderance of the evidence standard is preferable to a clear and convincing standard for demonstrating that the reasonably anticipated term of possession differs from the stated term of possession. (See also Section VII B, [Alternative 2, Pros.])

- *Excludes criteria for overcoming stated term presumption.* Board staff has stated orally that the criteria found in subdivision (d)(2) of its recommended language —that is, the criteria for determining the reasonably anticipated term of possession—are also applicable to a determination of whether or not the reasonably anticipated term of possession differs from the stated term of possession in subsection (d)(1) of its recommended language. Staff's language, however, does not make this clear. (See also Section VII B, [Alternative 2, Pros.])

D. Statutory or Regulatory Change

Action by the Board on attached Property Tax Rule 21 will result in the amendment of Title 18 of the California Code of Regulations, Subchapter 1.

E. Administrative Impact

None.

F. Fiscal Impact

1. Cost Impact

No additional cost.

2. Revenue Impact

See "Revenue Estimate."

G. Taxpayer/Customer Impact

None.

H. Critical Time Frames

None.

VI. Alternative 1 (California Assessors' Association)

Adopt a version of proposed Property Tax Rule 21 supported by the California Assessors' Association that contains language stating that the reasonably anticipated term of possession shall be the stated term of possession unless there is evidence "that goes beyond the unsubstantiated expectations of the parties" demonstrating that the anticipated term will be shorter or longer than the stated term of possession.

As with the Staff Recommendation, the adoption of Alternative 1 also requires that the Board repeal existing Property Tax Rules 21, 23, 24, 25, and 26 because the subject matter of these rules has been incorporated into proposed Property Tax Rule 21.

(The CAA's proposed Alternative 1 language regarding term of possession is shown in Attachment 2, with changes to staff's recommended language identified in strikeout-and-underline format under the heading "CAA Proposal – Alternative 1.")

A. Description of the Alternative

As in the Staff Recommendation and Property Rule 23, the proposed language of Alternative 1 defines the term of possession for valuation purposes as "the reasonably anticipated term of possession", a standard expressed in terms of the stated criteria in subparagraphs (A) through (E) in the proposed language. These criteria (i.e., those contained in Alternative 1) also adhere to those in the staff language and the existing rule.

In general, the language in this alternative is similar to that in existing Rule 23. Rule 23 provides that the stated term of possession shall be the term of possession unless there is evidence demonstrating that the reasonably anticipated term of possession will be shorter or longer than the stated term of possession. Unlike Rule 23, however, this proposed language also contains a general statement regarding the evidence an assessor must present in order to depart from the stated term of possession. Specifically, Alternative 1's proposed language states that such evidence "must go beyond the unsubstantiated expectations of the parties or others."

The primary difference between Alternative 1 and the Staff Recommendation is that staff's language contains a more stringent requirement for departing from the stated term of possession (i.e., "clear and convincing" evidence that the reasonably anticipated term differs from the stated term versus evidence "beyond the unsubstantiated expectations of the parties or others"). The other significant difference is that staff's recommendation (in proposed subsection (d)(3)) specifically excludes certain types of taxable possessory interests from consideration as possessory interests of a stated term; this alternative does not.

B. Pros of the Alternative

The California Assessors' Association contends that the proposed language regarding term of possession:

- *Retains the reasonably anticipated standard.* The use of the reasonably anticipated term of possession standard is ingrained in California law such that: (1) it has been expressly statutorily mandated as an integral part of the preferred method of valuing cable television possessory interests as set forth in section 107.7, subdivision (b)(2), of the Revenue and Taxation Code; and (2) the change in ownership of taxable possessory interests is statutorily tied to renewals or extensions "during the reasonably anticipated term of possession used by the assessor to value that interest in section 61, subdivision (b)(2) , of the Revenue and Taxation Code.

The proposed language also is consistent with court decisions regarding the reasonably anticipated term of possession. In *Wrather Port Properties, Ltd. v. County of Los Angeles* (1989) 209 Cal.App.3d 517, 522-525, the court approvingly cited Rule 23's requirement that the reasonably anticipated term be tied to the "intent of the parties" and "evidence of any understandings or agreements regarding renewal." Additionally, the concept of the reasonably anticipated term of possession was implicitly approved in *Dressler v. County of Alpine* (1976) 64 Cal.App.3d 557, 564-565, where the court upheld a lien date assessment of a grazing rights taxable possessory interest on federal land predicated upon a demonstrated history of many years of annual re-issuances of grazing permits. The court found that this history demonstrated either a custom or a renewal policy of the U. S. Forest Service sufficient upon which to base an assessment.

- *Ensures assessment at fair market value.* The language in this alternative is consistent with the constitutional requirement that real property be assessed at fair market value. In adherence to the reasonably anticipated term of possession standard, with its existing criteria, the CAA recognizes that market participants may consider factors other than the remaining lease term in estimating the term of possession of a taxable possessory interest, such as those factors enumerated in subsection (d)(2) of the proposed language.

  For example, market participants may analyze the stated renewal policy of a public owner and conclude that the expected period of possession is longer than the remaining lease term, that is, longer than the stated term of possession. The market participants may decide that the economic value of the possessory interest is greater than it would be if the remaining lease term were the only factor taken into consideration. In other words, the purchase price for the possessory interest may imply greater rights than those strictly indicated by the possessory interest's stated term. The language of this alternative allows the assessor to estimate a reasonably anticipated term of possession that is longer that the stated term and thereby provide a more accurate estimate of the fair market value of the possessory interest. This language, in contrast to staff's recommended language, does not stipulate a stringent evidentiary requirement in order to apply a reasonably anticipated term of possession. A de facto requirement that only the remaining lease term may be considered will lead to assessments below fair market value, which is in violation of the California Constitution, article XIII, section 1.

- *Reflects current law.* In *American Airlines, Inc. v. County of Los Angeles* (1976) 65 Cal.App.3d 325, 328-333, the court held that in order to apply the reasonably anticipated term standard set forth in Rule 23, the assessor would have to show either an "understanding" as to renewal or an "expectation" that is based upon a statute, contract, or evidence of "real substance." Subsection (d)(2) of this language contains an enumeration of the types of evidence of such an understanding or expectation that might be relevant. In recognition of the *American Airlines* decision, the proposed language contains the following requirement: "Evidence demonstrating that the reasonably anticipated term of possession is shorter or longer than the stated term of possession must go beyond the unsubstantiated expectations of the parties or others."

- *Adheres closely to existing rule.* This proposed language adheres closely to the language in existing Rule 23 with only limited substantive modifications to reflect intervening case law. Rule 23 has been in place for over 30 years. Thus, adoption of this language would continue a long-standing and consistently applied Board interpretation of property tax law concerning the term of possession of a taxable possessory interest.

C. Cons of the Alternative

The California Taxpayers' Association contends the following regarding the alternative language regarding term of possession:

- *Taxes rights that the taxpayer does not own.* This language violates the constitutional scheme for taxing property by allowing the assessment and taxation of rights the possessor does not hold. These rights are the rights to occupy the property beyond the stated term in the lease (plus any express options to renew the lease).

  For example, assume that a fair exhibitor has a one-year contract to provide food concessions for an 8-day run at a county fair. Further assume that the contract contains no options to renew, no provisions to extend, and no right of first refusal. Under the language of this alternative, if an assessor thinks it likely that the exhibitor will return for two more years, the assessor will value the possessory interest as if the possessor has a legal right to occupy the property for three years (i.e., the assessor will use a term of possession of three years). The possessor is being taxed for rights that he does not own. He is being taxed for rights that are actually held by the public owner.

- *Inconsistent with* American Airlines *case.* Despite an assertion to the contrary, the proposed language is inconsistent with *American Airlines*. That case established that the appropriate inquiry is whether an "agreement" or "understanding" exists between the public owner and the private possessor such that the stated term of possession in their agreement has been modified. To demonstrate that the reasonably anticipated term differs from the stated term, the proposed language requires only "evidence that "must go beyond the unsubstantiated expectations of the parties or others." This requirement is too general and leaves too much discretion to the assessor. The language will not prevent the assessor from establishing a term of possession that is not based on—that is, exceeds—the legal rights actually held by the possessor.

- *Allows rejection of stated term without sufficient evidence.* The language allows an assessor to ignore the stated term of possession if there is "evidence" that the possessor is likely to be in possession for a longer or shorter term than the stated term. The language would allow an assessor to ignore the stated term if there is any evidence to the contrary, no matter what legal rights are actually held by the possessor. This is deference to the stated term of possession in name only, and would allow assessors to use any term to value possessory interests.

- *Confuses cases where a stated term does or does not exist.* The language looks to criteria such as history, sales price, and others (in proposed subsection (d)(2)) to establish the reasonably anticipated term of possession. These criteria, although they may be relevant where there is no clear delineation of the rights held by the private possessor, are not usually probative of whether the parties have "agreed" or "reached an understanding" that the stated term has been modified. This confusion will lead to the overassessment of some taxable possessory interests.

- *Perpetuates lack of assessment uniformity.* The language states, essentially, that if there is a stated term of possession for a taxable possessory interest, the assessor should use the stated term, unless the assessor determines that "custom" or "policy" or "history" suggests that the possessor (or even a "similarly situated" possessor) will likely remain for a period that exceeds the remaining stated term. In other words, the language allows the assessor to ignore the legal rights actually held by the possessor, as indicated by the remaining term, and instead value the property using a longer, somewhat arbitrary term of possession. Board staff found in its own survey (Special Topic Survey, "Assessment of Taxable Possessory Interests," April 2000) that there is a significant lack of uniformity in possessory interest assessment among counties. This language will perpetuate this because it allows the assessor unjustified discretion in establishing the term of possession.

D. Statutory or Regulatory Change

Action by the Board on attached Property Tax Rule 21 will result in the amendment of Title 18 of the California Code of Regulations, Subchapter 1.

E. Administrative Impact

None.

F. Fiscal Impact

1. **Cost Impact**

   No additional cost.

2. **Revenue Impact**

   None.

G. Taxpayer/Customer Impact

None.

H. Critical Time Frames

None.

VII. Alternative 2 (California Assessors' Association)

Adopt a version Property Tax Rule 21 supported by the California Assessors' Association that contains language stating that the reasonably anticipated term of possession shall be the stated term of possession unless there is "preponderance of" evidence demonstrating that the anticipated term will be shorter or longer than the stated term of possession.

As with the Staff Recommendation and Alternative 1, the adoption of Alternative 2 requires that the Board repeal existing Property Tax Rules 21, 23, 24, 25, and 26 because the subject matter of these rules has been incorporated into proposed Property Tax Rule 21.

(The CAA's proposed Alternative 2 language regarding term of possession is shown in Attachment 2, with changes to staff's recommended language identified in strikeout-and-underline format under the heading of "CAA Proposal – Alternative 2.")

A. Description of the Alternative

The language in this alternative generally follows staff's recommended language, but there are two significant differences. First, this language requires that the assessor demonstrate "by a preponderance of the evidence" (in contrast to "clear and convincing evidence" as provided in staff's language) that the public owner and private possessor have reached an agreement such that the reasonably anticipated term of possession differs from the stated term of possession. Thus, this language sets a lower evidentiary standard than staff's for demonstrating that the reasonably anticipated term of possession differs from the stated term of possession but it sets a higher standard than that in Alternative 1.

Second, this alternative adds criteria by which the assessor may establish a new term of possession after demonstrating that the public owner and private possessor have reached a mutual agreement such that the reasonably anticipated term of possession differs from the stated term of possession; the added criteria mirror those for determining the reasonably anticipated term of possession already found in subsection (d)(2). Specifically, after stating that "[t]he mutual understanding or agreement may be rebuttably presumed to establish the term of possession after reviewing evidence that includes the following," the added language also repeats the criteria from subsection (d)(2), in a slightly different form, at the end of subsection (d)(1).

In contrast, under staff's language if the assessor successfully demonstrates that the public owner and the private possessor have reached a mutual understanding or agreement such that the reasonably anticipated term of possession differs from the stated term of possession, the modified term of possession is simply the stated term of possession as modified by the parties. ("[T]he term of possession shall be the stated term of possession as modified by the terms of the mutual understanding or agreement.") In other words, the term of possession is modified as the parties themselves have modified it; the assessor does not have the discretion to establish a new term of possession based on the criteria for the reasonably anticipated term of possession, as the assessors' language would seemingly allow.

B. Pros of the Alternative

The California Assessors' Association contends the following regarding their proposed alternative language regarding term of possession:

- *Preponderance of evidence standard preferable.* A preponderance of the evidence standard is preferable to a clear and convincing standard for demonstrating that the reasonably anticipated term of possession differs from the stated term of possession. A “preponderance” standard is fully consistent with the standard of evidence found in property tax rules (e.g., Property Tax Rule 2), sections of the Revenue and Taxation Code (e.g., Revenue and Taxation Code sections 110 and 402.1), and assessment appeals board hearings. Nowhere does the Revenue and Taxation Code, a published appellate court decision concerning property tax matters, or a property tax rule mandate a higher evidentiary standard than preponderance of the evidence.

At the September 7 interested parties meeting, CAA representatives pointed out, and Board staff acknowledged, that the use of a clear and convincing standard would make it impossible for the assessor to use anything other than the stated term of possession, no matter what the “real life” economic realities or intent of the parties might be. Use of the clear and convincing evidentiary standard artificially, intentionally, unnecessarily, and illegally constricts the ability of the assessor to perform his or her constitutional and statutory duty to value a taxable possessory interest at its full cash or fair market value, as required by Revenue and Taxation Code section 110, subdivision (b).

- *Includes criteria when departing from stated term.* Board staff has stated orally that the criteria found in subdivision (d)(2) of its recommended language —that is, the criteria for determining the reasonably anticipated term of possession—are also applicable to a determination of the term of possession when the assessor has demonstrated a mutual agreement between the public owner and the private such that the reasonably anticipated term is not the stated term. Staff’s language, however, does not make this clear. Therefore, staff’s language should include in subsection (d)(1) criteria (A) through (E), which are essentially the same criteria for determining the reasonably anticipated term of possession that appear in subdivision (d)(2) of staff’s language. (See Attachment 2.)

C. Cons of the Alternative

The California Taxpayers’ Association contends the following regarding CAA's proposed Alternative 2 language regarding term of possession:

- *Results in overassessment.* Assessors have indicated that adoption of a "preponderance" standard would not change their existing practice; thus, this language would result in overassessment of property by valuing rights that the private possessor does not own. Moreover, the “criteria” proposed to be added to subsection (d)(1) are not evidence of whether the parties have an "agreement" or "understanding"; rather, they are inquiries valid only for determining the term of possession where the public owner and the possessor have not clearly specified what rights of possession have been conveyed to the possessor. Confusion on this point will confuse assessment appeals boards and the courts.

- *Does not reflect statutory or case law.* In *American Airlines*, the court stated the following in regard to the rights held by the possessor:

> “The airlines, however, have no such right [to possession of land created by an option to renew the lease in the contract] following expiration of the term of their leases. Appellants suggest that in reality the airlines have “de facto options” to renew the leases, but the airlines insist there are no understandings or agreements providing for renewal, and appellants, who are in the best position to refute this assertion, have not tried to do so. (p.329 - 330)
>
> *
>
> “Of course, if the two parties do reach an "understanding" as to renewal, the option cases would seem to govern. And if the "expectation" of the parties is based on statute [citation omitted] or

> contract or indeed has any real substance at all, something in the nature of a defeasible interest would seem to arise and the termination cases would be relevant."(p.331)

In short, *American Airlines* requires more than just habit, custom, rules of the public owner, or even the amount invested in the property by the private lessee (p. 331). The case requires negotiations and an agreement or "understanding" between the public owner and private lessee which is tantamount to an option. To acquire the nature of a defeasible interest, the expectation must be based on statute or some "real substance." The assessors' proposed language falls well short of that concrete interest and would lead to the taxation of property rights that the private possessor does not have, that is, to the taxation of rights that are actually held by the public owner and are nontaxable.

- *Not consistent with Civil Code section 1698.* Finally, as noted above (Section I.A. (3)), Civil Code section 1698 sets a high standard for proving that a written agreement has been orally modified by the parties. The assessors' proposal is inconsistent with the standard in the Civil Code.

D. Statutory or Regulatory Change

Action by the Board on attached Property Tax Rule 21 will result in the amendment of Title 18 of the California Code of Regulations, Subchapter 1.

G. Administrative Impact

None.

H. Fiscal Impact

1. Cost Impact

No additional cost.

2. Revenue Impact

See "Revenue Estimate."

G. Taxpayer/Customer Impact

None.

H. Critical Time Frames

None.

Prepared by: Property Taxes Department; Policy, Planning and Standards Division;
Legal Division, Property Taxes Section

Current as of: 10/9/01

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

1. 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.

2. 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.

1. 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.

2. 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.

ATTACHMENT 2 - ISSUE PAPER 01-018 R
LANGUAGE DIFFERENCES REGARDING TERM OF POSSESSION

Staff Recommendation (Cal Tax Language) (as shown in Attachment 1)	Alternative 1 (CAA Standards Committee) (proposed to replace text in Attachment 1)	Alternative 2 (CAA Standards Committee) (proposed to replace text in Attachment 1)
(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	**(d) Term of Possession for Valuation Purposes** (1) The term of possession for valuation purposes shall be the ~~reasonably anticipated~~ stated 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.~~ unless there is evidence demonstrating that the reasonably anticipated term of possession will be shorter or longer than the stated term of possession. Evidence demonstrating that the reasonably anticipated term of possession is shorter or longer than the stated term of possession must go beyond the unsubstantiated expectations of the parties or others. (2) ~~If there is no stated term of possession,~~ In determining the reasonably anticipated term of possession, the assessor shall be ~~demonstrated~~ guided by the intent of the public owner and the ~~private~~ possessor, ~~and~~ as well as by the intent of similarly situated parties, ~~using criteria such as~~ as	**(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~~ a preponderance of the 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. The mutual understanding or agreement may be rebuttably presumed to establish the term of possession after reviewing evidence that includes the following: (A) The sale price of the subject taxable possessory interest. (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; however,

ATTACHMENT 2 - ISSUE PAPER 01-018 R
LANGUAGE DIFFERENCES REGARDING TERM OF POSSESSION

Staff Recommendation (Cal Tax Language) (as shown in Attachment 1)	Alternative 1 (CAA Standards Committee) (proposed to replace text in Attachment 1)	Alternative 2 (CAA Standards Committee) (proposed to replace text in Attachment 1)
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.	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 and of similarly situated public owners. (C) ~~The customs and practices of the private possessor and of similarly situated private possessors.~~ The history of the subject taxable possessory interest's use and the histories of the uses of comparable taxable possessory interests. (D) The history of the relationship of the ~~public owner and the private possessor~~ parties to the subject taxable possessory interest and the histories of the relationships of similarly situated ~~public owners and private possessors~~ parties. (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.~~ If there is no stated term of possession, the term of possession	history, alone, will be insufficient to rebut the presumption to use the stated term. (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. (2) If there is no stated term of possession, including the definition of no stated term as set forth in subsection (d) (3), 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

Staff Recommendation (Cal Tax Language) (as shown in Attachment 1)	Alternative 1 (CAA Standards Committee) (proposed to replace text in Attachment 1)	Alternative 2 (CAA Standards Committee) (proposed to replace text in Attachment 1)
	<u>for valuation purposes shall be the reasonably anticipated term of possession as determined in accordance with subsection (d)(2).</u>	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.

BOARD OF EQUALIZATION

REVENUE ESTIMATE

ISSUE #01-018R

Taxable Possessory Interests and Term of Possession

Staff Recommendation

Under the Staff Recommendation, the Board would adopt language for Property Tax Rule 21 stating that the term of possession for valuation purposes shall be the stated term of possession unless there is "clear and convincing" evidence demonstrating that the possessor and the public owner have reached a mutual understanding or agreement that the reasonably anticipated term is shorter or longer than the stated term of possession.

Alternative 1

Under the first alternative proposed by the California Assessors' Association, the Board would adopt language for Property Tax Rule 21 stating that the term of possession for valuation purposes shall be the stated term of possession unless there is evidence demonstrating that the reasonably anticipated term will be shorter or longer than the stated term of possession.

Alternative 2

Under the second alternative proposed by the California Assessors' Association, the Board would adopt language for Property Tax Rule 21 stating that the term of possession for valuation purposes shall be the stated term of possession unless there is a "preponderance of" evidence demonstrating that the reasonably anticipated term will be shorter or longer than the stated term of possession.

Background, Methodology, and Assumptions

The periods of time for which possessory interests are granted vary with the use of the properties, locations, and the policies of the public owner. Examples of taxable possessory interests include boat slips at public marinas, tie-downs and hangars at public airports, grazing land permits, employee housing on tax-exempt land, harbor leases, airline and concessionaire facilities at municipal airports, mineral rights in public lands, cable television interests in public streets, and permitted use of U.S. Forest Service property such as ski resorts, stores, and cabins. Terms range from month-to-month tenancies that are renewed each month to contract terms of 30 years or more.

A significant factor in any of the valuation methods used in valuing taxable possessory interests is the term of possession. The term of possession for valuation purposes is the reasonably anticipated term of possession, i.e., the expected remaining period of possession. For example, a possessory interest for 10 years with 4 years remaining would be valued only for the 4 years that are remaining; and would be valued for a 3-year term of possession in the following year.

There is no revenue effect under Alternative 1 since it would continue current practice.

It is difficult to gauge the revenue effect of the Staff Recommendation and of Alternative 2 without a comprehensive examination of each taxable possessory interest. Pinpointing the potential effect would require detailed information on the distribution of the form of tenancy, the expiration dates of the leases, the expected remaining terms, the valuation methods used, and the current assessed values for all interests. Much of this information can be found in the appraisal records; however, some required details may not be readily available. Also, it is difficult to predict how future agreements might be affected by either proposal. It is possible that, under these proposals, the lives of agreements written in the future would be much shorter than existing ones.

Based on data gathered for the Special Topics Survey, <u>Assessment of Taxable Possessory Interests</u>, published last year, the assessed value of taxable possessory interests totaled more than $22.5 billion in 1999. The year-to-year increase statewide between 1999 and 2000 in assessed values on the county-assessed rolls as reported by the county auditors is 8.3 percent. Assuming that the assessed value of taxable possessory interests grew at the same rate, the estimated total assessed value of possessory interests for 2000 is then:

$22.5 billion x 108.3% or $24.4 billion

Certain possessory interests in publicly owned airports are valued under section 107.9 of the Revenue and Taxation Code. There is no revenue effect for these under the Staff Recommendation or the alternative proposals since they would continue to be valued under section 107.9. According to information gathered from the counties with the major airports, the total assessed value of these interests amounts to nearly $400 million. The total assessed value of possessory interests that would be potentially affected is:

$24.4 billion - $400 million = $24.0 billion

The values of month-to-month tenancies would not be affected under these proposals. Although most possessory interests fall into this group, their average assessed value is relatively small. Based on information from Alameda, Los Angeles, San Diego, and San Mateo counties, staff estimates month-to-month tenancies comprise 15 percent of the total value of all possessory interests.

2000 assessed value for month-to-month tenancies: $24 billion x 15% or $3.6 billion

The values of a portion of the interests with long-term tenancies would be affected under the Staff Recommendation and, to a lesser extent, under Alternative 2. Assuming that about half of this group are already valued using the stated term of possession, the value of the long-term tenancies that would be potentially affected is estimated to be:

2000 Assessed value for all other lease terms: $24 billion - $3.6 billion = $20.4 billion

½ x 2000 Assessed value for all other lease terms: ½ x $20.4 billion = $10.2 billion

The reduction for long-term interests that are currently valued using a reasonably anticipated term of possession (RATP) other than the stated term is estimated to be:

Maximum term	Estimated Percent Reduction[1]
1 to 20 years	38%
21 to 40 years	28%
Total	

Assuming that for 5 to 20 percent of the long-term interests currently valued using an RATP other than the stated term there is "clear and convincing" evidence for using an RATP other than the stated term, and assuming that about half of these interests are currently valued using a term of 20 years or less and the other half are valued using a term of 21 to 40 years, the reduction in assessed value under the Staff Recommendation can be estimated as follows:

Maximum term	Reduction
1 to 20 years	½ x $10.2 billion [80% to 95%] x 38% = $1.55 - $1.84 billion
21 to 40 years	½ x $10.2 billion [80% to 95%] x 28% = $1.14 - $1.36 billion
Total	$2.69 - $3.20 billion

Under the Staff Recommendation, the total assessed value of taxable possessory interests would drop from $24.4 billion to $21.2 billion - $21.71 billion.

Assuming that for 10 to 30 percent of the long-term interests currently valued using an RATP other than the stated term there is a "preponderence of" evidence for using an RATP other than the stated term, and assuming that about half of these interests are currently valued using a term of 20 years or less and the other half are valued using a term of 21 to 40 years, the reduction in assessed value under Alternative 2 can be estimated as follows:

Maximum term	Reduction
1 to 20 years	½ x $10.2 billion [70% to 90%] x 38% = $1.36 billion - $1.74 billion
21 to 40 years	½ x $10.2 billion [70% to 90%] x 28% = $1.00 billion - $1.29 billion
Total	$2.36 billion - $3.03 billion

Under Alternative 2, the total assessed value of taxable possessory interests would drop from $24.4 billion to $21.37 billion - $22.04 billion.

[1] We assume that the vast majority of possessory interests are valued using the income approach/direct method. Under this method, the estimated market rent over the term of possession is discounted, at an appropriate rate, to a present value. We assume that the income and capitalization rate are unchanged between the alternatives; only the term of possession changes. This allows us to estimate the reduction in value using annuity factors (the present value of $1 per period) for each term of possession. For example, consider the 1-to-20 year segment. The average term of possession under the status quo is 10 years; under the Cal-Tax alternative, it would be 5 years. The present value factors are 6.14 and 3.79, respectively. The percentage reduction is the higher factor minus the lower factor divided by the higher factor (6.14 – 3.79) / 6.14 = .38, or 38%). The reduction was estimated in the same manner for the other (21-to-40 year) segment.

Revenue Summary

Staff Recommendation
The estimated decrease in annual revenues at the basic one percent property tax rate under the Staff Recommendation can be computed as follows:

Reduction in assessed value		Revenue at 1%
$2.69 billion to $3.20 billion	x 1% =	$26.9 million to $32 million

Alternative 1
There is no revenue effect under Alternative 1 since it would continue current practice.

Alternative 2
The estimated decrease in annual revenues at the basic one percent property tax rate under Alternative 2 is:

Reduction in assessed value		Revenue at 1%
$2.36 billion to $3.03 billion	x 1% =	$23.6 million to $30.3 million

Qualifying Remarks

State-assessed taxable possessory interests are not included in this analysis since they account for only about one percent of all taxable possessory interests and it is likely that any potential impact on them would be relatively minor.

Preparation

This revenue estimate was prepared by Aileen Takaha Lee, Research and Statistics Section, Agency Planning and Research Division. The estimate was reviewed by Ms. Laurie Frost, Chief, Agency Planning and Research Division, and Mr. Richard Johnson, Deputy Director, Property Tax Department. For additional information, please contact Ms. Lee at 445-0840.

Current as of October 5, 2001.