Issue Paper Number **01-024**

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

BOARD OF EQUALIZATION
KEY AGENCY ISSUE

PROPOSED PROPERTY TAX RULE 29, *POSSESSORY INTERESTS IN TAXABLE GOVERNMENT-OWNED REAL PROPERTY*

I. Issue

Should the Board authorize publication of proposed new Property Tax Rule 29, *Possessory Interests in Taxable Government-Owned Real Property*, and what should the rule include with respect to the taxable possessory interest assessment limitation?

II. Staff Recommendation

Staff recommends that the language for Property Tax Rule 29 in Attachment 1 be authorized for publication.

III. Other Alternative(s) Considered

The Board could specify that the taxable possessory interest assessment limitation in the attached proposed Property Tax Rule 29 be altered as proposed in Attachment 2.

Issue Paper Number 01-024

IV. Background

Section 3(b) of article XIII of the California Constitution exempts from property taxation "[p]roperty owned by a local government, except as otherwise provided in section 11(a)." Section 11(a) of article XIII, however, provides that: (1) Lands owned by local governments that are outside their boundaries are taxable if the lands were taxable when acquired; and (2) improvements owned by local governments that are outside their boundaries are taxable if they were taxable when acquired or were constructed by the local governments in order to replace improvements that were taxable when acquired.

Private possessory interests in government-owned real property are taxable to the private holders of such interests pursuant to California Constitution article XIII, section 1, Revenue and Taxation Code section 107, and Board Property Tax Rule 20. That these provisions are applicable to private possessory interests in government-owned real property made taxable by section 11 is confirmed in section 11(f), which provides as follows: "Any taxable interests of any character other than a lease for agricultural purposes and an interest of a local government that is subject to taxation pursuant to section 11(a) shall be taxed in the same manner as other taxable interests."

Nevertheless, unlike the case with typical taxable possessory interests in exempt government-owned real property, the imposition of a property tax on possessory interests in taxable section 11 real property creates the possibility of double taxation. This is because, with respect to section 11 real property that has been leased to a private occupant, a property tax will be imposed on both the government owner of the fee and the private holder of the possessory interest. To avoid the imposition of any double taxation in this situation, section 11(f) prescribes the following limitation on the assessable value of any taxable possessory interests in section 11 real property: "The aggregate value of all the interests subject to taxation pursuant to Section 11(a), however, shall not exceed the value of all interests in the land less the taxable value of the interest of any local government ascertained as provided in Sections 11(a) to 11(e), inclusive, of this Article." It is the interpretation of this provision that has generated controversy.

To promote consistency in the assessment of these interests, the Board directed staff to draft a new Property Tax Rule to interpret the provisions of section 11, subdivision (f) of the California Constitution. Consistent with this direction, staff worked with the California Assessors' Association (CAA), California Taxpayer's Association, Los Angeles County Assessor's Office and other interested parties to arrive at rule language. However, staff and the Los Angeles County Assessor's Office were unable to reach agreement on rule language concerning the assessment limitation amount set forth in section 11(f) as to the taxable possessory interests in taxable government-owned real property. Staff's recommended language is contained in the current draft of the proposed rule. An alternative interpretation of section 11(f) has been provided by the Los Angeles County Assessor's Office in the form of alternative text and is presented as alternative 1. The CAA supports the language proposed by the Board staff.

V. Staff Recommendation

Adopt staff's recommended language for Property Tax Rule 29, which includes language stating that the assessment limitation be calculated by subtracting the "section 11 value of the taxable government-owned real property" on the lien date from the fair market value of the taxable government-owned real property on the lien date.

A. Description of the Staff Recommendation

Staff's language provides that the assessment limitation amount for taxable possessory interests in taxable government-owned section 11 real property be determined pursuant to the following:

> The "section 11 taxable possessory interest limitation amount" means the fair market value of the taxable government-owned real property on the lien date less the section 11 value of the taxable government-owned real property on the lien date.

Under staff's recommendation, the "section 11 value of taxable government-owned real property" means the sum of: (i) the section 11 assessment amount for the taxable lands included in the real property on the lien date, computed pursuant to subdivisions (b) and (c) of section 11; (ii) the section 11 assessment amount for any taxable replacement improvements included in the real property on the lien date computed pursuant to the provisions of subdivision (d) of section 11; and (iii) the fair market value of other taxable improvements included in the real property on the lien date, if any.

B. Pros of the Staff Recommendation

The staff's recommendation is consistent with the language and intent of section 11(f) in that taxable possessory interests in taxable government-owned real property are subject to property taxation, while the possibility of any double taxation is eliminated. The staff's recommendation is also consistent with section 11(f) in the following ways:

- The staff's recommendation is consistent with the plain meaning of the language of section 11(f) in that the "value of all interests" is interpreted to mean the fair market value of the fee.
- Under the staff's recommended language, the combined "section 11 value of taxable government-owned real property" and taxable possessory interest assessments cannot exceed the fair market value of the fee; thus, no double taxation can result.
- The value of any possessory interest in improvements that are fully taxable to the municipal owner under section 11 is excluded from assessment of the possessory interest.

In other words, the staff's recommendation ensures that the taxable possessory interest assessments in section 11 taxable government-owned real property cannot exceed the partial exemption of such real property provided by section 11.

C. Cons of the Staff Recommendation

The Los Angeles County Assessor's Office contends that implementing staff's recommendation would be difficult to administer and that it results in double taxation based on the following:

- It creates an administrative problem because it requires tracking a number of items, such as the Section 11 Phillips factor value, trended base year values, and the possessory interest values.

- It results in double taxation because the "PW [present worth] of the reversion attributed to the fee portion " is included in the limitation amount.

D. Statutory or Regulatory Change

Action by the Board on the attached Property Tax Rule will add Section 29 to Title 18 of the California Code of Regulations.

E. Administrative Impact

The proposal will have a onetime administrative impact on the Los Angeles County Assessor's Office, since their current assessment practices are inconsistent with the proposal. The Los Angeles County Assessor's Office reported 32 taxable possessory interests in taxable government-owned real property. It is anticipated that the Los Angeles County Assessor's current staff can absorb the onetime increased workload required to modify assessments to conform to the proposed limitation. The proposed assessment limitation will not have an administrative impact in the remaining counties because the current assessment practices of these counties in this regard are not incongruous with staff's proposal or they do not have taxable possessory interests in taxable government-owned real property.

F. Fiscal Impact

1. Cost Impact

A onetime administrative impact to the Los Angeles County Assessor's Office is anticipated. The onetime administrative impact, however, does not appear significant and it is anticipated that it can be absorbed by the Los Angeles County Assessor's existing staff. There is no anticipated cost impact to the remaining county assessors' offices or the State Board of Equalization.

2. Revenue Impact

The proposal will result in increased revenues in Los Angeles County. There will be no revenue impact in the remaining counties for their assessment practices are not inconsistent with the proposal. (See the attached Revenue Estimate for specific details.)

G. Taxpayer/Customer Impact

Assessments of taxable possessory interests in taxable government-owned real property would increase in Los Angeles County. There is no taxpayer/customer impact in the remaining counties.

H. Critical Time Frames

There is no critical time frame for the proposed rule.

VI. Alternative 1 (Los Angeles County Assessor's Proposal)

Adopt proposed Property Tax Rule 29, with language stating that the taxable possessory interest limitation amount is calculated by subtracting the return on the enrolled section 11 land assessment from the possessory interest net operating income and discounting this figure for the term of possession. (Proposed language regarding the assessment limitation is shown in Attachment 2.)

A. Description of the Alternative

The alternative language provides that the assessment limitation amount for taxable possessory interests in taxable government-owned real property be determined pursuant to the following:

> The "section 11 taxable possessory interest limitation amount" is derived by subtracting from the possessory interest net operating income the return on the enrolled section 11 land assessment and discounting this figure for the term of possession.

The Los Angeles County Assessor's proposal is based on the premise that the possessory interest value includes some value that can be attributed to the reversionary interest of the public owner.

B. Pros of the Alternative

The Los Angeles County Assessors' Office provided the following arguments in support of its alternative:

- This method is easier to administer. The components necessary to determine this limitation amount are the "current enrolled Section 11 assessment and the net operating income of the PI." Unlike staff's recommendation, it does not require tracking of the Section 11 Phillips factor value, trended based year value, and the possessory interest values.

- This alternative ensures that no double taxation can occur. It is the Los Angeles County Assessors' assertion that staff's recommendation results in double taxation because the "PW [present worth] of the reversion attributed to the fee portion" is included in the limitation amount.

C. Cons of the Alternative

Staff contends that the language, as proposed in this alternative:

- Is inconsistent with the plain meaning of the language used in section 11(f) in that the "value of all interests" is interpreted to mean the value of the possessory interest. There is no support for this interpretation. In the staff's opinion, the value of all interests in the real property is the fair market value of the fee.

- Does not address possessory interests in taxable replacement improvements. This omission may result in the escape or double taxation ofn taxable replacement improvements depending on the readers' interpretation of the omission.

- Limits the assessor to using only the income approach to value these interests. Section 11, however, does not prescribe or preclude the use of any approach to value.

- Does not define the phrase "return on the enrolled section 11 land," which may result in inconsistent interpretations of the rule language.

- Is based upon the mistaken premise that the value of a possessory interest may contain value attributable to the reversion. By definition, however, the value of a possessory interest does not include any value attributable to the reversionary or remainder interest retained by the government fee owner. (See Property Tax Rule 20.)

The staff's position with regard to the Los Angeles County Assessors' contention concerning tracking of values is that it is section 11 and article XIIIA of the California Constitution that require such tracking, not the proposed rule. Thus, staff's recommendation should not result in an additional administrative burden. Furthermore, the degree of work required is not a basis for not complying with a constitutional provision.

Additionally, in staff's opinion, the Los Angeles County Assessors' assertion regarding double assessment and the reversion is incorrect. As long as the combined section 11 and taxable possessory interest assessments in section 11 real property do not exceed the fair market value of the fee, there can be no double taxation.

D. Statutory or Regulatory Change

Action by the Board on the attached Property Tax Rule will add Section 29 to Title 18 of the California Code of Regulations.

E. Administrative Impact

There will be a onetime administrative impact in all counties that have taxable possessory interests in taxable government-owned real property. Los Angeles County will also be impacted because this proposal is inconsistent with their longstanding practice in the assessment of these properties.

F. Fiscal Impact

1. Cost Impact

This proposal will not result in additional costs for the State Board of Equalization. The proposal will cause a onetime administrative impact to all counties with taxable possessory interests in taxable government-owned real property. It is anticipated, however, the assessors' existing staffs can absorb the onetime increase in workload.

2. Revenue Impact

The Los Angeles County Assessor's proposal will result in increased revenue from taxable possessory interests in taxable government-owned real property in Los Angeles County. The revenue from taxable possessory interests in taxable government-owned real property in all other counties will decline. (See the attached Revenue Estimate for specific details.)

G. Taxpayer/Customer Impact

It is anticipated that all the taxpayers holding taxable possessory interests in taxable government-owned real property will be affected by the Los Angeles County Assessor's proposal. It will result in increased taxable possessory interest values in Los Angeles County and a reduction in taxable possessory interest values in all other counties.

H. Critical Time Frames

There is no critical time frame for the proposed rule.

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

Current as of: July 6, 2001

BOARD OF EQUALIZATION

REVENUE ESTIMATE

ISSUE #01-024

Possessory Interests in Taxable Government-Owned Real Property

Staff Recommendation

Under the staff's recommendation, the Board would authorize publication of new Property Tax Rule 29 that would include language stating that the assessment limitation for taxable possessory interests in taxable government-owned property is calculated by subtracting the "section 11 value of taxable government-owned real property" on the lien date from the fair market value of the taxable government-owned real property on the lien date.

Alternative

Under the alternative proposed by the Los Angeles County Assessor, the Board would authorize publication of Property Tax Rule 29 that would include language stating that the taxable possessory interest limitation amount is calculated by subtracting the return on the enrolled section 11 land assessment from the possessory interest net operating income and discounting this figure for the term of possession.

Background, Methodology, and Assumptions

Properties that are owned by local governments but located outside their boundaries are taxable under section 11 of Article XIII of the California Constitution if the property was taxable when the local government acquired it. Possessory interests are private interests in publicly owned lands. Examples of possessory interests in taxable government-owned property include private interests at San Francisco International Airport and investment properties, including office buildings and shopping centers, owned by local governments.

Based on information provided by Los Angeles County, the assessed value for 2000 of possessory interests in taxable government-owned property in Los Angeles County would increase by $38.4 million from $61.3 million to $99.7 million under the staff recommendation. There is no revenue effect under the recommendation in the rest of the counties because the rule would continue current practice in those counties.

Pinpointing the revenue effect of the Los Angeles County proposal would require detailed information on the net operating income of the possessory interest, the return on the land assessment, the expected term of possession, the fair market value of the property, and the current assessed value of the possessory interest. Much of this information can be found in the appraisal records; however, some required details may not be readily available.

It is estimated that the assessed value for 2000 of these possessory interests in Los Angeles County would increase by about $13.9 million from $61.3 million to $75.2 million under the alternative proposal. Comparing the two proposals – $99.7 million for the staff recommendation vs. $75.2 million for the alternative proposal - the assessed value of possessory interests in taxable government-owned property in Los Angeles County would be about 25 percent lower under the Los Angeles County proposal than under the staff recommendation.

Based on data gathered for the Special Topics Survey, Assessment of Taxable Possessory Interests, published last year, the assessed value of taxable possessory interests totaled more than $22.5 billion in 1999 statewide; the assessed value of possessory interests in taxable government-owned property amounted to $718 million. Subtracting $60 million for Los Angeles County and $630 million for San Mateo County leaves $28 million in assessed value for these possessory interests in all counties except Los Angeles and San Mateo. 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 in government-owned property in the remaining counties for 2000 is then:

$28 million x 108.3% or $30.4 million

According to information supplied by San Mateo County, only $273 million of the estimated $680 million total assessed value of possessory interests in government-owned property in the county would be affected under the alternative proposal. The total assessed value in counties other than Los Angeles that would be affected by this proposal is then: $273 million + $30.4 million or $303.4 million. Assuming that this total would be 25 percent lower under the Los Angeles proposal, the estimated decrease in assessed value for these counties is then: $303.4 million x 25 percent or $75.9 million. The overall change in assessed value statewide under the Los Angeles proposal can be computed as follows:

Los Angeles County	$13.9 million increase
All other counties	$75.9 million decrease
Total	$62.0 million decrease

Revenue Summary

Under the staff recommendation, the estimated increase in annual revenues at the basic one percent property tax rate amounts to $38.4 million x 1 percent, or $384,000, in Los Angeles County only. There is no revenue effect in the remaining counties because current practices in those counties are not inconsistent with the recommendation.

Under the Los Angeles County proposal, it is estimated that the annual revenues at the basic one percent property tax rate would decrease by $62.0 million x 1 percent, or $620,000.

Preparation

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

Current as of July 16, 2001.

Rule 29. POSSESSORY INTERESTS IN TAXABLE GOVERNMENT-OWNED REAL PROPERTY.

Reference: Article XIII, Section 11, California Constitution.

(a) Definitions. For purposes of this rule:

(1) "Land" is defined in rule 121.

(2) "Improvements" are defined in rule 122.

(3) "Real property" is the appraisal unit of real property, as defined in section 104 of the Revenue and Taxation Code, that persons in the marketplace commonly buy and sell as a unit or that is normally valued separately.

(4) "Taxable possessory interest" is defined in rule 20.

(5) "Section 11" means section 11 of article XIII of the California Constitution.

(6) "Taxable government-owned real property" is real property owned by a local government outside of its boundaries that is taxable for property tax purposes pursuant to section 11(a).

(7) "Taxable lands" are lands owned by a local government outside of its boundaries that are taxable for property tax purposes pursuant to section 11(a).

(8) "Taxable replacement improvements" are improvements owned by a local government outside of its boundaries that are taxable for property tax purposes pursuant to section 11(a) because they were constructed by the local government to replace improvements that were taxable when acquired.

(9) "Other taxable improvements" are improvements owned by a local government outside of its boundaries that are taxable for property tax purposes pursuant to section 11(a), excluding taxable replacement improvements.

(10) "Assessed value" is defined in subdivision (a) of section 135 of the Revenue and Taxation Code.

(11) A "lease for agricultural purposes" is a lease for the purpose of the production or husbandry of plants or animals, including gardening, horticulture, fruit growing, and the storage and marketing of agricultural products.

(12) The "section 11 value of taxable government-owned real property" means the sum of: (i) the section 11 assessment amount for the taxable lands included in the real property on the lien date, computed pursuant to subdivisions (b) and (c) of section 11; (ii) the section 11 assessment amount for any taxable replacement

improvements included in the real property on the lien date computed pursuant to the provisions of subdivision (d) of section 11; and (iii) the fair market value of other taxable improvements included in the real property on the lien date, if any.

(13) The "section 11 taxable possessory interest limitation amount" means the fair market value of the taxable government-owned real property on the lien date less the section 11 value of the taxable government-owned real property on the lien date.

(14) The "total assessed value of all taxable possessory interests" means the aggregate assessed values of all taxable possessory interests in an appraisal unit of taxable government-owned real property on the lien date.

(b) Taxable possessory interests in taxable government-owned real property.

Except as set forth below in subsection (c) of this regulation, taxable possessory interests in taxable government-owned real property, excluding those created as a result of the possessor having a lease for agricultural purposes, shall be assessed and taxed for purposes of property taxation in the same manner as other taxable possessory interests.

(c) Limitation on the assessment of taxable possessory interests in taxable government-owned real property.

On each lien date, the total assessed value of all taxable possessory interests in an appraisal unit of taxable government-owned real property shall be determined. If the total assessed value of all taxable possessory interests on the lien date exceeds the section 11 taxable possessory interest limitation amount on the lien date, then the assessed values of the taxable possessory interests shall be reduced as follows: (i) if there is only one taxable possessory interest in the appraisal unit of taxable government-owned real property on the lien date, then the assessed value of that taxable possessory interest shall be reduced so that it does not exceed the section 11 taxable possessory interest limitation amount; or (ii) if there is more than one taxable possessory interest in the appraisal unit of taxable government-owned real property on the lien date, then the assessed value of each such taxable possessory interest shall be ratably reduced in the proportion that it bears to the total assessed value of all taxable possessory interests until the total assessed value of all taxable possessory interests no longer exceeds the section 11 taxable possessory interest limitation amount.

Rule 29. POSSESSORY INTERESTS IN TAXABLE GOVERNMENT-OWNED REAL PROPERTY.

Reference: Article XIII, Section 11, California Constitution.

(a) Definitions. For purposes of this rule:

(1) "Land" is defined in rule 121.

(2) "Improvements" are defined in rule 122.

(3) "Real property" is the appraisal unit of real property, as defined in section 104 of the Revenue and Taxation Code, that persons in the marketplace commonly buy and sell as a unit or that is normally valued separately.

(4) "Taxable possessory interest" is defined in rule 20.

(5) "Section 11" means section 11 of article XIII of the California Constitution.

(6) "Taxable government-owned real property" is real property owned by a local government outside of its boundaries that is taxable for property tax purposes pursuant to section 11(a).

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(8) "Taxable replacement improvements" are improvements owned by a local government outside of its boundaries that are taxable for property tax purposes pursuant to section 11(a) because they were constructed by the local government to replace improvements that were taxable when acquired.

(9) "Other taxable improvements" are improvements owned by a local government outside of its boundaries that are taxable for property tax purposes pursuant to section 11(a), excluding taxable replacement improvements.

(10) "Assessed value" is defined in subdivision (a) of section 135 of the Revenue and Taxation Code.

(11) A "lease for agricultural purposes" is a lease for the purpose of the production or husbandry of plants or animals, including gardening, horticulture, fruit growing, and the storage and marketing of agricultural products.

(12) The "section 11 value of taxable government-owned real property" means the sum of: (i) the section 11 assessment amount for the taxable lands included in the real property on the lien date, computed pursuant to subdivisions (b) and (c) of section 11; (ii) the section 11 assessment amount for any taxable replacement

improvements included in the real property on the lien date computed pursuant to the provisions of subdivision (d) of section 11; and (iii) the fair market value of other taxable improvements included in the real property on the lien date, if any.

(13) The "section 11 taxable possessory interest limitation amount" is derived by subtracting from the possessory interest net operating income the return on the section 11 land and discounting this figure for the term of possession ~~means the fair market value of the taxable government-owned real property on the lien date less the section 11 value of the taxable government-owned real property on the lien date~~.

(14) The "total assessed value of all taxable possessory interests" means the aggregate assessed values of all taxable possessory interests in an appraisal unit of taxable government-owned real property on the lien date.

(b) Taxable possessory interests in taxable government-owned real property.

Except as set forth below in subsection (c) of this regulation, taxable possessory interests in taxable government-owned real property, excluding those created as a result of the possessor having a lease for agricultural purposes, shall be assessed and taxed for purposes of property taxation in the same manner as other taxable possessory interests.

(c) Limitation on the assessment of taxable possessory interests in taxable government-owned real property.

On each lien date, the total assessed value of all taxable possessory interests in an appraisal unit of taxable government-owned real property shall be determined. If the total assessed value of all taxable possessory interests on the lien date exceeds the section 11 taxable possessory interest limitation amount on the lien date, then the assessed values of the taxable possessory interests shall be reduced as follows: (i) if there is only one taxable possessory interest in the appraisal unit of taxable government-owned real property on the lien date, then the assessed value of that taxable possessory interest shall be reduced so that it does not exceed the section 11 taxable possessory interest limitation amount; or (ii) if there is more than one taxable possessory interest in the appraisal unit of taxable government-owned real property on the lien date, then the assessed value of each such taxable possessory interest shall be ratably reduced in the proportion that it bears to the total assessed value of all taxable possessory interests until the total assessed value of all taxable possessory interests no longer exceeds the section 11 taxable possessory interest limitation amount.