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Treatment of Franchise Fees

Several companies have raised different issues regarding franchise fees. P L has questioned the appropriateness of including, in the unitary value, the value of franchises granted by the city to the corporation. The company made three points:

1. Fees paid to the city are an expense item, not a property interest;

2. The case of *Pacific Telephone and Telegraph Co. v. Redevelopment Agency of the City of Redlands*, (1977) 75 Cal. App. 3d 957, supports their position that they have no assessable interest;

3. The Board has backed off a little in its conclusion by authorizing pre-DeLuz appraisal procedures.

P raised some of these same questions in addition to the issue whether the value of these franchises are already included in the unitary value because they are such an integral part of the unit. S argued that the general franchise should be deducted from the stock and debt approach because the price of the stock already includes this element of value and it is not taxable property for property tax purposes.

We disagree with each of these arguments. memorandums of May 3, 1977, to Mr. R and May 4, 1977, to B should have disposed of most of these questions. However, I will attempt to supplement his comments with my own.

I would like to begin by discussing in general the taxability of such franchises because it seems to me this is the issue that some of the companies are raising. The 1879

Constitution provided that all property was to be taxed unless otherwise exempt. Section 1 of Article XIII listed properties that were taxable, including franchises. Section 10 of the 1879 Constitution stated that franchises of railroads are to be assessed by the State Board of Equalization. In 1910 the Constitution was changed so that the Board did not assess public utilities under a property tax, but under a gross receipts tax. The term "franchise" remained in the definition of property in Section 1.

In 1933 the Constitution was amended again, this time to change from the gross receipts tax on public utilities to an ad valorem tax. Franchises remainded in the definition of property in Section 1, but Section 14 used the phrase "other than franchises" when stating the Board was to assess public utilities on an ad valorem basis. Section 14 stated that franchises were to be taxed as a part of Section 16 of Article XIII. Section 16 permits the Legislature to levy a bank and corporation franchise tax. Section 1 of Article XIII was rewritten in 1974 and as a result the definition of property, including franchises, was eliminated from the section.

The Bank and Corporation Franchise Tax Act of 1929, as amended in 1936, as authorized by Section 16 of Article XIII, provides:

> "Taxes under this section...shall not be in lieu of any taxes or assessments upon special franchises. All such special franchises shall be annually assessed by the State Board of Equalization at its full market value beginning in March 1935."

This section is now Section 23154 of the Revenue and Taxation Code.

The argument may be made that the people intended to exempt <u>all</u> franchises of public utilities from property taxation because Section 1 of Article XIII no longer mentions franchises and because Section 14 of Article XIII seems to exempt franchises. However, the history of the bank and corporation franchise tax indicates otherwise. Under Section 16 the Legislature was given a permissive authority to tax franchises of corporations. They chose to act by subjecting general franchises to a corporation tax and leaving special franchises subject to property tax, as indicated in Section 23154 of the Revenue and Taxation Code. There is, therefore, sufficient authority to conclude that the

only franchise exempt from property tax is the general franchise granted by the State of California. From this brief review there should be no doubt in the mind of any state assessee that special franchises are taxable as part of the operating unit.

P raised the question whether it is proper to separately value these special franchises and add them to the unitary value indicator. This question arises because it is argued the franchises are such an integral part of the unit they would already be included in the unitary value indicator. For example, the argument has been made that when a company's stock is purchased, the purchaser buys these special franchises as part of the acquisiton of the stock. This position could be valid only as to the past use of that which is represented by the franchise fees. However, when the payments for the franchises continue after acquisition, the current value must include both the cost of the stock and the continuing obligation to pay the franchise fees. In other words, what is purchased is the existing assets plus rights to assets that are purchased in the future.

It would make no difference if the franchise fee was entirely prepaid. If such a fee was prepaid it would be improper to capitalize the entire fee at the time of agreement. We should treat a prepaid fee as we would one that is paid each year because the prepayment is almost entirely for future use and we cannot assess the rights until the time of enjoyment.

The question raised by S concerning the general franchise is resolved by analogizing the general franchise to the special franchise. As the value of a special franchise is not included in the stock and debt indicator neither is the value of the general franchise. The general franchise tax is paid for the right to do business in California. As to having done business in California in past years, the rights are reflected in the balance sheet as income and expenses. However, the purchase of the stock does not also include a purchase of the right to do business in California. [The right to do business in California is a continuing obligation that must be renewed annually. The most a stock investor buys is the "expectation" of doing business in California and it is this expectation which is included in the stock price not the right to do business. This expectation is as much a taxable entity as any other motive would be for paying a certain price. It is not a portion of the exempt general franchise.]

Because special franchises are taxable, the next question becomes how to value them. Since the fee ownership of the property used is in a tax exempt government entity and the use is by a private taxable party, the only conclusion that one can draw is that it must fall into the category of a taxable possessory interest and must be valued as such. The case of *DeLuz Homes, Inc. v. County of San Diego*, (1955) Cal. 2d, of course is the standard reference as to the valuation of possessory interests. Under *DeLuz* the full value of the right to use is taxable with only the reversion being exempt. One way to measure this value is to capitalize an economic rent for the private right to use the government property for the term of possession.

Section 107.1 of the Revenue and Taxation Code provides a different rule to value possessory interests created before December 25, 1955, and not since extended or renewed. In this instance, the rent paid by the entity is a deduction from the economic rent, and only the difference is capitalized into value. did not back off on his conclusion by holding that the pre-*DeLuz* formula should be applied to contracts entered into before December 25, 1955. He was merely following the law. As to contracts entered into after that date we must value according to the *DeLuz* formula.

P L cites the *City of Redondo Beach* case as support for their position. However, this case offers no support for their contentions. This case concerned the relocation of telephone equipment under orders of the Redondo Beach Redevelopment Agency. PTT refused to move the lines unless the agency paid the relocation costs. The city refused and PTT sued for reimbursement of their costs after they relocated its facilities. The court denied the relocation costs to PTT because there was no statutory authority for reimbursement. On the surface it appears some of the language in the case may be cited as supporting the company's position. However, an analysis of the case leads to the opposite conclusion.

One of the statements of the court was that:

> "While the right granted to a telephone company by Public Utilities Code section 7901 has often been termed a "franchise" ...it is not a grant of a proprietary interest in the street." 75 Cal. App. 3d 957 at 963.

A proprietary interest is an ownership interest evidenced by title. There is no doubt that the utility has no proprietary interest in the street, that is it does not own the street. The *Redondo Beach* court recognized this with its next statement: "The utility acquires only a limited right to use the streets to the extent necessary to furnish communication services to the public". I can think of nothing that better describes a possessory interest under property tax rule 21. This exclusive right to use the streets for communication purposes is equivalent to a grazing right or otherlimited right that is recognized as a possessory interest by the courts. See *Dressler v. Alpine County*, 64 Cal. App. 3d 557.

Another section of the *Redondo Beach* case which may be thought to support the company's position appears on page 464 in denying that there is a cause of action for inverse condemnation.

> "Thus, the required relocation cannot form the basis for an action in inverse condemnation. In order to state a course of action for inverse condemnation, there must be an invasion or appropriation of some valuable property right possessed by the claimant."

If this language were referring to the right to use the city streets it would indeed be significant. However, the facts are that T merely moved from one location to another location to provide the same, or maybe even increased, services. The court is merely saying that the relocation by itself is not a valuable property right, a point I think in which we can all agree. A right to use the street is a valuable and taxable right and not in any way equivalent to a relocation of facilities.

We should continue to assess special franchises in the manner described in memorandums mentioned above.

RDH:fr