STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
PROPERTY TAXES DEPARTMENT
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March 26, 2001

TO INTERESTED PARTIES:

REVIEW OF POSSESSORY INTEREST RULES
PROPERTY TAX RULES 21, 22, 23, 24, 25, 26, AND 28

Letter To Assessors 2000/032 announced a Board project to revise property tax rules relating to taxable possessory interests. As part of the revision, staff combined rules 21, 23, 24, 25, and 26 into a single rule, proposed new rule 21. Rules 22 and 28 remain unchanged. A subsequent letter, dated September 1, 2000, transmitted staff's draft of the proposed new rule to interested parties. Interested parties were asked to provide changes, in the form of alternative text, to the draft rule. Staff reviewed those changes and incorporated those that were deemed appropriate.

Enclosed are (1) a matrix summarizing proposed changes to the draft rule and (2) a revised version of the draft rule. These two documents will form the basis of discussion at the interested parties meeting. The matrix contains all proposed changes to the draft rule, originating from both interested parties and staff, together with staff's position in regard to each proposed change. The revised version of the draft rule shows, in strikethrough-underline format, how the language in the draft rule would change if all changes acceptable to staff were made.

On April 12, 2001, staff will hold a meeting with interested parties to discuss proposed changes identified on the matix. The purpose of the meeting is to reach agreement on rule language. The meeting is scheduled to start at 9:30 a.m. in Room 122 of the Board of Equalization, 450 N Street, Sacramento.

After the interested parties meeting, it is anticipated that the project will proceed as follows:

- Staff to submit issue paper and other required material for the Property Tax Committee meeting by June 6, 2001.
- The Board's Property Tax Committee will hear discussion of any unresolved issues at its June 20, 2001 meeting.

If you have any questions, please contact Paul Lane at (916) 324-5828; fax: (916) 323-8765; e-mail paul.lane@boe.ca.gov. All documents relating to this project are available on the Board's Web site (*www.boe.ca.gov*) and can be accessed through Property Tax Committee Work Plans.

Sincerely,

/s/ Richard C. Johnson

Richard C. Johnson
Deputy Director
Property Taxes Department

RCJ:
Enclosures

PROPERTY TAX RULE 21, TAXABLE POSSESSORY INTERESTS -VALUATION
MATRIX OF PROPOSED ALTERNATIVE LANGUAGE

Comments on September 1, 2000 Draft

(Note: Cal Tax = California Taxpayers' Association; CAA = California Assessors' Association; Staff = Board staff)

Item	Ref. Pg.	Ln.	Source	Proposed Language	Staff Position/Comments
1.	1	7	Staff	(1) "Real property" is ~~has the same meaning as~~ defined in rule 20(c)(1).	Revised for consistency with rule 20.
2.	1	9	Staff	(2) "Possession" is ~~has the same meaning as~~ defined in rule 20(c)(2).	Revised for consistency with rule 20.
3.	1	14	Staff	(4) "Possessor" is ~~has the same meaning as~~ defined in rule 20(c)(4).	Revised for consistency with rule 20.
4a.	1 1 1	25 27 33	Cal Tax	(7) "Contract rent" means any compensation or payments that are required to be paid or provided by a possessor in cash or its equivalent under an authorization or instrument that creates a taxable possessory interest for the <u>right to use real property</u> ~~property rights~~ provided by the taxable possessory interest. Contract rent includes the value that the public owner is expected to realize from improvements erected at the expense of the possessor that will remain when the taxable possessory interest terminates. As defined in this regulation, contract rent is net of those operating expenses necessary to maintain the income from the taxable possessory interest, whether paid by the possessor or the public owner, including those expenses within the definition of "gross outgo" under subsection (c) of rule 8. <u>The contract rent should not include compensation for items other than real property (such as intangibles, personal property, or franchise rights, or items related to the business enterprise operating on the real property, such as security, advertising, or rental of machinery or equipment used in the business.)</u>	[P1-L27] Not accepted. But staff proposes "rights in real property." (See item 4c.) [P1-L33] Not accepted. "Contract rent" is defined as a payment for rights in real property only, which makes the added language redundant.

Item	Ref. Pg.	Ln.	Source	Proposed Language	Staff Position/Comments
4b.	1 1 1	25 30 30	CAA	(7) "Contract rent" means any compensation or payments that are required to be paid or provided by a possessor in cash or its equivalent under an authorization or instrument that creates a taxable possessory interest for the property rights provided by the taxable possessory interest. Contract rent includes the value that the public owner is expected to realize from improvements erected at the expense of the possessor that will remain when the taxable possessory interest terminates, and any other form of compensation paid or payable for the right to occupy the property. It does not, however, include payments for the use of property not subject to the possessory interest or for services such as utilities and janitorial labor unless these expenses are directly related to the subject property and will eventually be netted out in arriving at the income to be capitalized. ~~As defined in this regulation, contract rent is net of those operating expenses necessary to maintain the income from the taxable possessory interest, whether paid by the possessor or the public owner, including those expenses within the definition of "gross outgo" under subsection (c) of rule 8.~~	[P1-L30] Not accepted. By definition, "contract rent" is limited to payments for the rights in real property provided by the taxable possessory interest only. [P1-L30] Accepted. Staff will change the definition of contract rent by deleting this sentence. But staff makes a similar point in discussing the direct comparison method. (See item 13b.)
4c.	1 1 1 1	25 27 28 30	Staff	(7) "Contract rent" means any compensation or payments, in cash or its equivalent, that are required to be paid or provided by a possessor ~~in cash or its equivalent~~ under an authorization or instrument that creates a taxable possessory interest for the~~property~~ rights in real property provided by the taxable possessory interest. ~~Contract rent includes the value that the public owner is expected to realize from improvements erected at the expense of the possessor that will remain when the taxable possessory interest terminates. As defined in this regulation, contract rent is net of those operating expenses necessary to maintain the income from the taxable possessory interest, whether paid by the possessor or the public owner, including those expenses within the definition of "gross outgo" under subsection (c) of rule 8.~~	[P1-L25] Reorders the sentence to read better. [P1-L27] Responds to Cal Tax's proposal in item 4a. [P1-L28] This idea is discussed at [P5-L39]. It is more appropriate there. [P1-L30] Shows acceptance of proposed CAA deletion in 4b.

Item	Ref. Pg.	Ref. Ln.	Source	Proposed Language	Staff Position/Comments
5a.	1 1	35 39	CAA	(8) [a} "Economic rent" means the estimated amount in cash or its equivalent that would most probably be paid by the possessor, as indicated by rentals negotiated in an open and competitive market~~,~~ on or near the valuation date~~ in cash or its equivalent~~, for the property rights comparable to those provided to ~~by~~ the possessor of the subject taxable possessory interest. ~~if (i) the right 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.~~ ~~As defined in this regulation, economic rent is net of those operating expenses necessary to maintain the income from the taxable possessory interest, whether paid by the possessor or the public owner, including those expenses within the definition of "gross outgo" under subsection (c) of rule 8~~.	[P1-L35] Not accepted. Staff prefers the original language, which derives from existing rule 21. [P1-L39] Accepted. As with "contract rent," by deleting this sentence, staff will change the way we have defined "economic rent." But we incorporate this point into the discussion of economic rent under Net Income to be Capitalized. (See item 23.)
5b.	1 1 1	35 36 42	Cal Tax	(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 right to use real property ~~property rights~~ provided by the taxable possessory interest if (i) the right 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. As defined in this regulation, economic rent is net of those operating expenses necessary to maintain the income from the taxable possessory interest, whether paid by the possessor or the public owner, including those expenses within the definition of "gross outgo" under subsection (c) of rule 8. The economic rent should not include compensation for items other than real property (such as intangibles, personal property, or franchise rights, or items related to the business enterprise operating on the real property, such as security, advertising, or rental of machinery or equipment used in the business).	[P1-L36] Not accepted. Staff proposes "rights in real property." (See item 5c.) [P1-L42] Not accepted. "Economic rent" is defined as a payment for rights in real property only; thus, the added language is redundant.

Item	Ref. Pg.	Ln.	Source	Proposed Language	Staff Position/Comments
5c.	1 1 1	35 36 39	Staff	(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 ~~property rights~~ provided by the taxable possessory interest if (i) the right 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. ~~As defined in this regulation, economic rent is net of those operating expenses necessary to maintain the income from the taxable possessory interest, whether paid by the possessor or the public owner, including those expenses within the definition of "gross outgo" under subsection (c) of rule 8.~~	[P1-L36] Responds to Cal Tax's proposal in item 5b. [P1-L39] Shows acceptance of CAA's proposed deletion in item 5a.
6a.	1	44	CAA	(9) "Creation" means the granting or other conveyance ~~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 conveyance of additional valuable property uses not previously permitted by the possessor.	[P1-L44] Not accepted. The proposed language is too restrictive because it requires a "grant or conveyance" to effect "creation."
6b.	1 2	44 2	Cal Tax	(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 conveyance of additional valuable property uses not previously permitted to ~~by~~ the possessor.	[P2-L2] Accepted, with modified text. Proposed change ("to" for "by") is accurate, but staff proposes additional changes. (See item 6c.)

Item	Ref. Pg.	Ref. Ln.	Source	Proposed Language	Staff Position/Comments
6c.	1 2 2 2	44 1 1 2	Staff	(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 ~~not previously permitted~~ to a preexisting taxable possessory interest ~~by the possessor~~.	[P2-L1, re "other"] Makes phrasing in (iii) parallel with phrasing in (ii). [P2-L1, re "rights"] Makes consistent with the definition of a taxable possessory interest. [P2-L2] Makes phrasing in (iii) parallel with the phrasing in (ii).
7a.	2 2	8 9	Cal Tax	**(b) Rights to be Valued**. Except as provided in subsection (f) or specifically provided otherwise by law, the property rights in ~~fair market value of~~ a taxable possessory interest are only the ~~is the value of all~~ property rights in real property held by the possessor.	[P2-L9] Accepted in concept, with modified text. See staff's proposed language, which differs slightly in item 7b.
7b.	2 2	8 9	Staff	**(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 ~~fair market value of a taxable possessory interest~~ are ~~is the value of~~ all ~~property~~ rights in real property held by the possessor.	[P2-L9] Responds to Cal Tax's proposal in item 7a.
8a.	2 2	19 26	Cal Tax	(2) Examples of property rights 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; ~~and~~ (v) the right to approve a loan secured by the taxable possessory interest; (vi) the right granted by the public owner to others to use the subject property; and (vii) rights represented by intangible assets, personal property, or franchises.	[P2-L26, at (vi)] Accepted in concept, with modified text. See staff's proposed language, which differs slightly, in item 8b. [P2-L26, at (vii)] Not accepted. The examples in this paragraph are of property rights pertaining to a taxable possessory interest; the "rights represented by intangible assets, personal property, or franchises" are not rights pertaining to a taxable possessory interest, so added language is not appropriate in context.

Item	Ref. Pg.	Ref. Ln.	Source	Proposed Language	Staff Position/Comments
8b.	2 2	19 26	Staff	(2) Examples of rights in real property ~~property rights~~ 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; ~~and~~ (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.	[P2-L19] Modified for consistency. [P2-L26] Responds to Cal Tax's proposal in item 8a.
9.	2 2	35 37	Cal Tax	(1) The term of possession for valuation purposes shall be the stated 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. Evidence demonstrating that the reasonably anticipated term of possession is shorter ~~or longer~~ than the stated term of possession must go beyond mere possibility or the unsubstantiated expectations of the parties or others.	[P2-L37] Not accepted. "Shorter or longer than" is correct. The reasonably anticipated term could be shorter or longer than the stated term.
10.	3	1	CAA	(A) The sales price ~~sale price~~ of the subject taxable possessory interest and sales prices of comparable taxable possessory interests.	[P3-L1] Not accepted. Rule 4 ("Comparative Sales Approach") uses "sale price" as the singular and "sales prices" as the plural. This is consistent with the *Assessors' Handbook Sections*.
11.	3	16	Cal Tax	(3) When valuing a taxable possessory interest by use of the stated term of possession as of any lien date after the commencement of the stated period, the stated period remaining under the written instrument as of that lien date shall be taken as the term of possession.	[P3-L16] Not accepted. Redundant because "stated term of possession" is defined in the draft rule as "the remaining term."

Item	Ref. Pg.	Ln.	Source	Proposed Language	Staff Position/Comments
12.	3	16 17	Cal Tax	(4~~3~~) If there is no stated term of possession, the term of possession for valuation purposes shall be rebuttably presumed not to exceed one year; however, the period of payment (for example, monthly, annually, etc.) may be used to establish a term of possession or rebut the presumption of a maximum term of one year ~~the reasonably anticipated term of possession as determined in accordance with subsection (d)(2)~~.	[P3-L17] Not accepted. The "reasonably anticipated term of possession" is the single standard for term of possession. There is no authority for the proposed one-year rebuttable presumption.
13a.	3	37 41	CAA	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 net 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).	[P3-L41] Accepted in concept. This is needed because of the change in the definition of "contract rent." However, staff elaborates on the meaning of "net" in the proposed language in item 13b.

Item	Ref. Pg.	Ref. Ln.	Source	Proposed Language	Staff Position/Comments
13b.	3 4	37 2	Staff	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). <u>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.</u>	[P4-L2] Responds to CAA's proposal in item 13a.

Item	Ref. Pg.	Ln.	Source	Proposed Language	Staff Position/Comments
14a.	4	4 8	Cal Tax	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 legal restriction as to use (unless rebutted pursuant to section 402.1)<u>, and restrictions on use of the real property mandated in the lease, agreement, deed, conveyance, permit, or other authorization or instrument that created, extended or renewed the taxable possessory interest,</u> 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 lien date.	[P4-L8] Accepted in concept, with modified text. See staff's proposed language, which is more concise, in item 14b.

Item	Ref. Pg.	Ref. Ln.	Source	Proposed Language	Staff Position/Comments
14b.	4 4 4	4 7 15	Staff	3. 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 ~~legal restriction as to use (unless rebutted pursuant to section 402.1)~~ 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.	[P4-L7] Responds to Cal Tax’s proposal in item 14a. (It adds use restrictions agreed to by the possessor and the public owner as an element of comparability). [P4-L15] “Valuation date” is preferable to “lien date.”

Item	Ref. Pg.	Ln.	Source	Proposed Language	Staff Position/Comments
15a.	4 4 4	17 23 25	Cal Tax	(B) Indirect Comparison Method. In the indirect comparison method, a taxable possessory interest is valued by (i) estimating the value of the possessor's property rights 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 interests in properties that are comparable to the subject property as prescribed in section 402.5 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 <u>both</u> 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) <u>and the present value of all other rights of fee simple ownership that are not provided to the possessor in the lease, agreement, deed, conveyance, permit, or other authorization or instrument that created, extended or renewed the taxable possessory interest.</u> The resulting amount is an indicator of the fair market value of the subject taxable possessory interest.	[P4-L23, 25] Accepted in concept, with modified text. The proposed addition should stop at "possessor." See staff's proposed language in item 15b.

Item	Ref. Pg.	Ref. Ln.	Source	Proposed Language	Staff Position/Comments
15b.	4 4 4 4 4 4 4	17 18 19 20 21 25 25	Staff	(B) Indirect Comparison Method. In the indirect comparison method, a taxable possessory interest is valued by (i) estimating the value on the valuation date of the possessor's ~~property~~ 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. ~~The resulting amount is an indicator of the fair market value of the subject taxable possessory interest.~~	[P4-L18] Added for consistency. [P4-L19] Modified for clarity. [P4-L20] Added for consistency. [P4-L21] Added for clarity. [P4-L25] Responds to Cal Tax's proposal in item 15a. [P4-L25] Deleted, not necessary.

Item	Ref. Pg.	Ref. Ln.	Source	Proposed Language	Staff Position/Comments
16a.	4 4	28 31	CAA	(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) subtracting the present value of the estimated improvement value <u>that reverts to the lessor</u> at the end of the term of possession, if any, from this amount. (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, certain days of the week, etc.), or is shared concurrently 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.	[P4-L31] Accepted in concept, with modified text. See staff's proposed language, which differs slightly, in item 16c.

Item	Ref. Pg.	Ref. Ln.	Source	Proposed Language	Staff Position/Comments
16b.	4 4	28 40	Cal Tax	(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) subtracting the present value of the estimated improvement value at the end of the term of possession, if any, from this amount. ~~(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, certain days of the week, etc.), or is shared concurrently 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.~~	[P4-L40] Not accepted. Why delete?

Item	Ref. Pg.	Ln.	Source	Proposed Language	Staff Position/Comments
16c.	4 4 4 4 4	28 31 31 40 41	Staff	(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 ~~subtracting~~ the estimated present value of the ~~estimated~~ improvements ~~value~~ that shall revert to or be retained by the public owner at the end of the term of possession~~, if any, from this amount~~. (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~~, etc.),~~ or is shared ~~concurrently~~ 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.	[P4-L31] Revised to improve phrasing. [P4-L31] Responds to CAA's proposal in item 16a. [P4-L40] Revised to improve phrasing. [P4-L41] More accurate. Sharing does not have to be "concurrent."

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<tr><th>Item</th><th>Ref. Pg.</th><th>Ref. Ln.</th><th>Source</th><th>Proposed Language</th><th>Staff Position/Comments</th></tr>
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9</td><td>Cal Tax</td><td>(3) Income Approach to Value. In the income approach, a taxable possessory interest is valued by discounting the future net <u>rental</u> income that the interest <u>in real property</u> 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 <u>rental</u> income that the taxable possessory interest is capable of producing under typical, prudent management for the term of possession. The resulting amount is an indicator of the fair market value of the subject taxable possessory interest.

~~(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) subtracting from this amount the present value of the those rights in the subject property for the period subsequent to the term of possession.~~ The resulting amount is an indicator of the fair market value of the subject taxable possessory interest.</td><td>[P4-L46, re "rental"] Not accepted. The income approach is not limited to the use of rental income; see rule 8.

[P4-L46, re "in real property"] Accepted.

[P5-L1, L9] Not accepted. This is a theoretically acceptable method.

[P5-L5] Not accepted, for same reason at [P4-L46].

[Additional Cal Tax comment re proposed change: "We recommend deletion of this provision [i.e., subparagraph (B)] unless it can be demonstrated that the indirect method is actually used to value taxable possessory interests."]</td></tr>
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6</td><td>Staff</td><td>~~(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. ~~The resulting amount is an indicator of the fair market value of the subject taxable possessory interest.~~</td><td>[P5-L6] Deleted, not necessary.</td></tr>
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Item	Ref. Pg.	Ln.	Source	Proposed Language	Staff Position/Comments
19.	5 5 5	9 10 14	Staff	~~(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) <u>reducing</u> ~~subtracting from~~ this <u>value by</u> ~~amount~~ the present value of ~~the~~ those rights ~~in the subject property~~ for the period subsequent to the term of possession <u>(i.e., the present value of the value of the fee simple absolute interest in such rights at the end of the term of possession)</u>. ~~The resulting amount is an indicator of the fair market value of the subject taxable possessory interest.~~	[P5-L10, and following] Makes parallel with language under "Indirect Comparison Method" at [P4-L17]. [P5-L14] Deleted, not necessary.
20a.	5 5 5 5	17 18 19 21	Cal Tax	(B~~C~~) Net Income to be Capitalized. The net income to be capitalized in the valuation of a taxable possessory interest <u>is either</u> ~~may be~~ (i) the estimated economic rent for the subject taxable possessory interest; or (ii) if such evidence is unreliable or unavailable, <u>the economic rent may be imputed by reference to</u> the estimated net operating income of a typical, prudent operator of the property subject to the taxable possessory interest. The estimated economic rent or estimated net operating income <u>from the real property</u> must reflect the restrictions on use inherent in the subject taxable possessory interest.	[P5-L18] Staff proposes "shall be." (See item 20c.) [P5-L19] Not accepted. Rental income and operating income are two separate concepts; either rental income or operating income may be capitalized into an estimate of value. The use of operating income is not simply a means of imputing, or proxying, economic rent. See rule 8. [P5-L21] Accepted in concept, with modified text. See staff's proposed language, which differs slightly, in item 20c.

Item	Ref. Pg.	Ln.	Source	Proposed Language	Staff Position/Comments
20b.	5 5 5	17 19 21	CAA	(C) Net Income to be Capitalized. The net income to be capitalized in the valuation of a taxable possessory interest may be (i) the estimated economic rent for the subject taxable possessory interest net of those operating expenses necessary to maintain the income from the taxable possessory interest, whether paid by the possessor or the public owner, including those expenses within the definition of "gross outgo" under subsection (c) of rule 8; or (ii) if such evidence is unreliable or unavailable, the estimated net operating income of a typical, prudent operator of the property subject to the taxable possessory interest. The net income to be capitalized ~~estimated economic rent or estimated net operating income~~ must reflect the restrictions on use inherent in the subject taxable possessory interest.	[P5-L19] Accepted in concept, with modified text. Language to this effect is necessary because of the earlier change in the definition of "economic rent." See staff's proposed language and placement, which differs slightly, in item 20c. [P5-L21] Accepted, with modified text. See staff's proposed language, which is simpler with the same meaning, in item 20c.
20c.	5 5 5 5 5	17 18 19 21 21	Staff	(D) Net Income to be Capitalized. The net income to be capitalized in the valuation of a taxable possessory interest shall ~~may~~ be either (i) the estimated economic rent for the subject taxable possessory interest; or (ii) if the estimated economic rent ~~such evidence~~ 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 ~~estimated economic rent or estimated~~ net ~~operating~~ 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.	[P5-L18] Responds to Cal Tax's proposal in item 20a. [P5-L19] Added for clarity. [P5-L21 re "rental income"] Existing text moved from [P6-L3]; fits better here. (See item 24c.) [P5-L21] Responds to Cal Tax's proposal in item 20a and to CAA's proposal in item 20b.

Item	Ref. Pg.	Ref. Ln.	Source	Proposed Language	Staff Position/Comments
21a.	5 5	26 28	Cal Tax	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; or (iii) contract rents for other comparable ~~fee simple absolute~~ 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; and shall have been negotiated sufficiently near in time to the valuation date of the subject taxable possessory interest.	[P5-L28] Not accepted. But see staff's proposed alternative language in item 21b.
21b.	5 5 5	26 29 34	Staff	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; ~~or~~ (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 ,~~;~~ and shall have been negotiated sufficiently near in time to the valuation date of the subject taxable possessory interest.	[P5-L29] Responds to Cal Tax's proposal in item 21a. [P5-L34] Should be comma, not semicolon.

Item	Ref. Pg.	Ref. Ln.	Source	Proposed Language	Staff Position/Comments
22a.	5 5 5	37 45 45	Cal Tax	b. When using the contract rent of a taxable possessory interest as an indicator of the economic rent of a taxable possessory interest, 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, or of removing improvements (less any estimated salvage value), or of any similar obligation. The best evidence of contract rent of a taxable possessory interest is the rent paid for the subject real property where the public owner provides no ancillary services, and the possessor does not operate a business enterprise on the real property.	[P5-L45, re "ancillary services"] Not accepted. The point about ancillary services is valid, but it should probably be rephrased for clarity and placed in a different location. Suggested language and placement? [P5-L45] Not accepted. If rent is paid for the use of the real property, how does the existence of a business on the property invalidate the rent indicator? After all, a significant portion of all real property is devoted to business use. It seems that the point about ancillary services, a valid one, is addressed in the definition of "contract rent" itself, but perhaps not.
22b.	5 5 5	37 38 44	Staff	c. When using the contract rent of a taxable possessory interest as an indicator of the economic rent ~~of a taxable possessory interest~~, 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 ~~or of~~ removing improvements (less any estimated salvage value)~~,~~ or the cost of any similar obligation.	[P5-L38] Deleted, not necessary. [P5-L44] Revised to improve phrasing.

Item	Ref. Pg.	Ref. Ln.	Source	Proposed Language	Staff Position/Comments
23.	5	46	Staff	d. The estimated economic rent must be net of 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, if the expense will be paid out of the estimated economic rent.	[P5-L46] Responds to CAA's proposal in item 5a. Adds the language and the idea that was originally included within the definition of "economic rent."
24a.	6 6	3 6	Cal Tax	~~a.~~ In deriving the net income to be capitalized, 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. ~~If there is no reliable evidence of the economic rent for the subject taxable possessory interest, however, the net income to be capitalized may be based on the estimated net operating income of the subject taxable possessory interest.~~	[P6-L6] Accepted.
24b.	6 6	3 6	CAA	a. In deriving the net income to be capitalized, 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. However, i~~I~~f there is no reliable evidence of the economic rent for the subject taxable possessory interest, ~~however,~~ the net income to be capitalized may be based on the estimated net operating income of the subject taxable possessory interest.	[P6-L6] Staff proposes modified text. See staff's proposed language in item 24c. (There are professional grammarians on both sides of this issue—that is, the proper placement of "however" when used as a conjunctive adverb.)

Item	Ref. Pg.	Ln.	Source	Proposed Language	Staff Position/Comments
24c.	6 6 6	3 6 11	Staff	~~a. In deriving the net income to be capitalized,~~ ~~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~~. ~~If there is no reliable evidence of the economic rent for the subject taxable possessory interest, however, the net income to be capitalized may be based on the estimated net operating income of the subject taxable possessory interest.~~ a. ~~b.~~ 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.	[P6-L3, re introductory phrase beginning with "In deriving"] Not necessary. [P6-L3, re clause beginning with "rental income"] Moved to discussion on Net Income to be Capitalized. (See item 20c.) [P6-L6] Shows acceptance of Cal Tax's proposed deletion in item 24a. [P6-L11] Renumbered paragraph due to other changes.
25.	6 6	11 14	Cal Tax	b. 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. To determine the net rent to the grantor of the possessory interest, the anticipated net income of the operator must further be reduced for income attributable to items other than real property (such as intangibles, personal property, franchise rights, payments for services or other items related to the operation of a business enterprise on the real property, such as advertising, security, waste disposal, or rental of business machinery or equipment, or a return to the typical operator of the property to the extent such a return is not included in the capitalization rate.)	[P6-L14] Not accepted. But see staff's proposed language, which is more concise, in item 20c.

Item	Ref. Pg.	Ref. Ln.	Source	Proposed Language	Staff Position/Comments
26.	6	16	CAA	c. 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 and a return of the value of any nontaxable property that has contributed to the gross operating income. Typical operating expenses and typical management expense include expenses that an owner/operator typically would bear but are borne by the public owner in the case of the subject taxable possessory interest.	[P6-L16] Accepted.
27a.	6 6 6	16 20 22	Cal Tax	d. When valuing a taxable possessory interest, 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 and a return of the value of any nontaxable property that has contributed to the gross operating income. In order to properly reflect the rental income to the governmental entity, the t~~T~~ypical operating expenses and typical management expense must include expenses that an owner/operator typically would bear in order to maintain the real property and continue production of income from the real property but are borne by the public owner in the case of the subject taxable possessory interest.	[P6-L20] Not accepted. This passage concerns operating income, not rental income. [P6-L22] Accepted. [Additional Cal Tax comment re [P6-L20]: "See *Appraisal of Real Estate* 11th ed., p.490."]

Item	Ref. Pg.	Ln.	Source	Proposed Language	Staff Position/Comments
27b.	6 6 6 6	16 19 20 22	Staff	b. ~~c.~~ 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 ~~and a return of~~ the value of any nontaxable property that contributes ~~has contributed~~ to the gross operating income. Typical operating expenses and typical management expense include expenses that an owner/operator typically would bear to maintain the 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.	[P6-L16] Renumbered paragraph due to prior changes. Also shows acceptance of CAA's proposed addition in item 26. [P6-L19] Deleted, not correct. "Return of" is provided for in the capitalization process. [P6-L20] Revised to improve phasing. [P6-L22] Shows acceptance of Cal Tax's proposed addition in item 27a.
	6	25		b. ~~d.~~ 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.	[P6-L25] Renumbered paragraph due to prior changes.

Item	Ref. Pg.	Ln.	Source	Proposed Language	Staff Position/Comments
28a.	6 6 6	31 33 41	Cal Tax	(E) Capitalization Rate. The capitalization rate 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 <u>Rule 8(g)(1)</u> ~~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 <u>as described in rule 8(g)(2)</u>. Consistent with subsection (f) of rule 8, if a payment for property taxes has not been netted out of the net income to be capitalized, the capitalization rate shall include an added component for property taxes.	[P6-L33] Not accepted. The citation in the draft rule does not refer to rule 8; rather, it refers to a subsection of the draft rule itself. [P6-L41] Not accepted, for same reason as directly above. However, staff proposes to cite rule 8 at the beginning of this subsection. (See item 28c.)

Item	Ref. Pg.	Ref. Ln.	Source	Proposed Language	Staff Position/Comments
28b.	6 6	31 41	CAA	(D) Capitalization Rate. The capitalization rate 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, <u>the capitalization rate shall include a component for property taxes except when the net income to be capitalized is net of property taxes. When the income to be capitalized is net of property taxes because the lessee is responsible for paying the property taxes, there is no need to add a property tax rate component to the capitalization rate</u>~~.if a payment for property taxes has not been netted out of the net income to be capitalized, the capitalization rate shall include an added component for property taxes~~.	[P6-L41] Accepted in concept, with modified text. See staff's proposed language, which differs slightly, in item 28c.

Item	Ref. Pg.	Ln.	Source	Proposed Language	Staff Position/Comments
28c.	6 6	31 41	Staff	(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, t~~T~~he 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 ~~if a payment for property taxes has not been netted out of the net income to be capitalized, the capitalization rate shall include an added component for property taxes~~.	[P6-L31] Added for general reference. [P6-L41] Responds to CAA's proposal in item 28b.
29.	var		CAA	Divide draft rule into three separate rules as follows: first rule to begin at page 1, line 1; second rule to begin at page 2, line 33; and third rule to begin at page 3, line 21.	[var] Not accepted. Staff's intent is to have a single rule that addresses the fundamental aspects of the valuation of taxable possessory interests.

Rule 21. TAXABLE POSSESSORY INTERESTS—VALUATION

Reference: Sections 107 and 107.1, Revenue and Taxation Code

(a) Definitions. For the purposes of this rule~~regulation~~:

(1) “Real property” is ~~has the same meaning as~~ defined in rule 20(c)(1).

(2) “Possession” is ~~has the same meaning as~~ 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 ~~has the same meaning as~~ 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 ~~in cash or its equivalent~~ under an authorization or instrument that creates a taxable possessory interest for the ~~property~~ rights in real property provided by the taxable possessory interest. ~~Contract rent includes the value that the public owner is expected to realize from improvements erected at the expense of the possessor that will remain when the taxable possessory interest terminates. As defined in this regulation, contract rent is net of those operating expenses necessary to maintain the income from the taxable possessory interest, whether paid by the possessor or the public owner, including those expenses within the definition of “gross outgo” under subsection (c) of rule 8.~~

(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 ~~property~~ 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. ~~As defined in this regulation, economic rent is net of those operating expenses necessary to maintain the income from the taxable possessory interest, whether paid by the possessor or the public owner, including those expenses within the definition of “gross outgo” under subsection (c) of rule 8.~~

(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 ~~not previously permitted by the possessor~~.

(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 ~~fair market value of a taxable possessory interest is the value of~~ are all ~~property~~ 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 ~~property~~ 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; ~~and~~ (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 stated 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. Evidence demonstrating that the reasonably anticipated term of possession is shorter or longer than the stated term of possession must go beyond mere possibility or the unsubstantiated expectations of the parties or others.

(2) In determining the reasonably anticipated term of possession, the assessor shall be guided by the intent of the public owner and the possessor, as well as by the intent of similarly situated parties, as evidenced by the following criteria:

(A) The sale price of the subject taxable possessory interest and sales prices of comparable taxable possessory interests.

(B) The rules, policies, and customs of the public owner and of similarly situated public owners.

(C) 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 parties to the subject taxable possessory interest and the histories of the relationships of similarly situated 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 possessor.

(3) If there is no stated term of possession, the term of possession for valuation purposes shall be the reasonably anticipated term of possession as determined in accordance with subsection (d)(2).

(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 ~~legal restriction as to use (unless rebutted pursuant to section 402.1)~~ 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 value on the valuation date of the possessor's ~~property~~ 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. ~~The resulting amount is an indicator of the fair market value of the subject taxable possessory interest.~~

(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 ~~subtracting~~ the estimated present value of the ~~estimated~~ improvements ~~value~~ that shall revert to or be retained by the public owner at the end of the term of possession~~, if any, from this amount~~.

(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~~, etc.~~)~~,~~ or is shared ~~concurrently~~ 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. ~~The resulting amount is an indicator of the fair market value of the subject taxable possessory interest.~~

(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 ~~subtracting from this amount~~ the present value of the those rights ~~in the subject property~~ 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). ~~The resulting amount is an indicator of the fair market value of the subject taxable possessory interest.~~

(C) Net Income to be Capitalized. The net income to be capitalized in the valuation of a taxable possessory interest ~~may~~ shall be either (i) the estimated economic rent for the subject taxable possessory interest; or (ii) if the estimated economic rent ~~such evidence~~ 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 net income to be capitalized ~~estimated economic rent or estimated net operating income~~ 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; ~~or~~ (iii) contract rents for comparable fee simple absolute interests in real property; (iv) or contract rents for

<u>other comparable interests in real property</u>. 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; and shall have been negotiated sufficiently near in time to the valuation date of the subject taxable possessory interest.

b. When using the contract rent of a taxable possessory interest as an indicator of the economic rent~~ of a taxable possessory interest~~, 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, <u>including the cost </u>~~or ~~of removing improvements (less any estimated salvage value)~~,~~ or <u>the cost </u>of any similar obligation.

<u>c. The estimated economic rent must be net of 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, if the expense will be paid out of the estimated economic rent.</u>

2. Net Operating Income

~~a. In deriving the net income to be capitalized, 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. If there is no reliable evidence of the economic rent for the subject taxable possessory interest, however, the net income to be capitalized may be based on the estimated net operating income of the subject taxable possessory interest.~~

<u>a. </u>~~b. ~~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.

<u>b. </u>~~c. ~~When valuing a taxable possessory interest<u> using operating income</u>, 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 ~~and a return of ~~the value of any nontaxable property that <u>contributes </u>~~has contributed ~~to the gross operating income. Typical operating expenses and typical management expense include expenses that an owner/operator typically would bear <u>to maintain the property and to continue the</u>

production of income from the property but are borne by the public owner in the case of the subject taxable possessory interest.

c. ~~d.~~ 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, t~~T~~he 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 ~~if a payment for property taxes has not been netted out of the net income to be capitalized, the capitalization rate shall include an added component for property taxes.~~

(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.