

Issue Paper Number 06-001



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

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## **PROPOSED PROPERTY TAX RULE 474, PETROLEUM REFINING PROPERTIES**

### **I. Issue**

Should the Board grant the petition to initiate the rulemaking process to adopt proposed Property Tax Rule 474 that prescribes the valuation of properties used for refining petroleum? (See Attachment 1.)

### **II. Staff Recommendation**

Staff recommends that the Board deny the petition to initiate the rulemaking process to adopt a Property Tax Rule that prescribes the valuation of properties used for refining petroleum.

### **III. Other Alternative(s) Considered**

1. The Board could commence the official rulemaking process by approving publication of a Notice of Proposed Rulemaking Action for proposed Rule 474.
2. The Board could delay a decision on the petition to initiate the rulemaking process and instruct staff to begin the interested parties process to develop a new section of the *Assessors' Handbook* relating to the assessment of petroleum refining properties.

## IV. Background

Under Government Code section 15606, subdivision (c), the Board is given the power and duty to prescribe rules and regulations to govern local boards of equalization and assessment appeals boards when equalizing and county assessors when assessing. The Honorable Claude Parrish, Chair of the Property Tax Committee, proposes that the Board, pursuant to its rulemaking authority, adopt a Property Tax Rule that prescribes valuation of real property, personal property, and fixtures used for the refining of petroleum.

Interested parties were advised of the proposed Property Tax Rule in Letter To Assessors 2005/008, dated January 14, 2005, and were invited to provide comments to staff in advance of the Property Tax Committee meeting scheduled for March 22, 2005. Staff received letters in support of the proposed rule from the Contra Costa County Assessor, Los Angeles County Assessor, and the California Assessors' Association.

On March 22, the Property Tax Committee discussed proposed Property Tax Rule 474, *Petroleum Refining Properties*. After hearing testimony, the committee referred proposed Rule 474 to the interested parties' process for further discussion. In Letter To Assessors 2005/028, dated May 5, 2005, staff invited interested parties to provide comments on the proposed rule language in advance of the interested parties' meeting to be held on August 23, 2005. The Los Angeles County Assessor and the Western States Petroleum Association submitted comments. A matrix was prepared and distributed to interested parties summarizing each position. During the course of the meeting, interested parties were given an opportunity to submit additional comments or propose alternative language.

The issue at hand is whether the Board should adopt a rule for petroleum refining properties that would include a provision establishing a rebuttable presumption that, for purposes of recognizing declines in value, fixtures and machinery and equipment classified as improvements are within the same "appraisal unit" that contains structures and associated land. The statutory and regulatory framework for recognizing changes in value, including declines in value, for property tax assessment is set forth in Revenue and Taxation Code section 51, Property Tax Rule 461 (which interprets that statute). Additionally, Property Tax Rules 468, 469, and 473 provide for differing treatment of declines in value based on the unique nature of oil and gas producing properties, mining properties, and geothermal properties.

The Western States Petroleum Association reports that there are 20 major refineries located in California. Nine of the refineries are located in two counties: five are located in Los Angeles County and four in Contra Costa County. Los Angeles County and Contra Costa County data show the total assessed value of those refineries to be over \$14 billion with approximately 79 percent (\$11 billion) enrolled as fixtures. Projecting this information on a statewide basis indicates Rule 474 potentially affects the assessment of \$32 billion of refinery property, of which \$25 billion consists of fixtures.

### ***Revenue and Taxation Code section 51, subdivision (d)***

After the passage of Proposition 8 in November 1978, the Legislature enacted comprehensive Proposition 13/Proposition 8 implementation legislation<sup>1</sup> consistent with the recommendations made by the Assembly Task Force on Property Tax Administration in their *Report on the Implementation of Proposition 13* (Report). The Report, in relevant part, stated:<sup>2</sup>

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<sup>1</sup> Chapter 242, Stats. of 1979 (Assembly Bill 1488), effective July 10, 1979.

<sup>2</sup> *Implementation of Proposition 13*, Volume 1, *Property Tax Assessment*, Assembly Revenue and Taxation Committee, October 29, 1979, page 13.

**FORMAL ISSUE PAPER**

In determining the extent of a potential decline in value, the assessor must look to the net change in value of the appraisal unit which is commonly bought and sold in the market place, or which is normally valued separately... This means that land and improvements are ordinarily treated as a unit, [footnote omitted] and that a taxpayer cannot claim a net decline in full cash value terms of an improvement due to depreciation [i.e. decline in value], without also including any appreciation in the value of the land. If the building depreciation is offset by the increase in land value, then no reduction in assessment occurs. Fixtures, however, are normally appraised separately, thus owners may claim a decline based on depreciation of the fixture without regard to the value of the surrounding land or improvements.

In accordance with the Report's foregoing finding, section 51, subdivision (d) (formerly subdivision (c)), defines an "appraisal unit" alternatively as: (1) that which "persons in the marketplace commonly buy and sell as a unit" and (2) that which is "normally valued separately." The second alternative was adopted in recognition of the fact that fixtures and other machinery and equipment classified as improvements are normally valued separately.

***Property Tax Rule 461, subsection (e)***

The Board adopted Property Tax Rule 461, *Real Property Value Changes*, in June 1978, prior to the passage of Proposition 8 and enactment of section 51. The initial version of the rule addressed only declines in value caused by disaster, but clearly allowed for base year value reductions when portions of real property were physically removed from an appraisal unit. Subsequently, on November 7, 1978, the voters approved Proposition 8 which addressed declines in value more generally.

After the passage of Proposition 8, the Board amended Rule 461 and implemented the Report's recommendation that fixtures and other machinery and equipment classified as improvements should be treated as a separate appraisal unit so that a decline in value would not be offset by value increases in land or improvements. Some assessors commented at the time that such treatment would be an administrative burden because of the more rapid depreciation in the value of fixtures and other machinery and equipment classified as improvements as compared to structures. However, there was a general recognition of the need to apply Proposition 8 in a manner rationally related to the value of the components of a given property. Both the Executive and Standards Committees of the California Assessors' Association approved the draft amendment to the rule. The Board adopted the language of subsection (e) on January 25, 1979, and it has remained unchanged since that time.

***Property Tax Rules 468, 469 and 473***

Property Tax Rules 468, 469, and 473 prescribe the assessment procedures for oil and gas, mining, and geothermal properties, respectively. In contrast to Rule 461, Rules 468, 469, and 473 provide, as an exception to the general rule of decline in value appraisal, that fixtures and other machinery and equipment classified as improvements do not constitute a separate appraisal unit. In recognition of the unique nature of these properties, these rules were promulgated to provide specialized appraisal techniques required to satisfy the requirements of article XIII, section 1, and article XIII A, section 2, of the California Constitution. Rules 468 and 469 were adopted on June 29, 1978, and Rule 473 on June 29, 1995.

## **V. Staff Recommendation**

Staff recommends that the Board deny the petition to initiate the rulemaking process to adopt a Property Tax Rule that prescribes the valuation of properties used for refining petroleum.

### **A. Description of the Staff Recommendation**

Proposed Rule 474 establishes a rebuttable presumption that the land, improvements, and fixtures and other machinery classified as improvements constitute a single appraisal unit for declines in value (except in case of disaster). Under this presumption, county assessors assess petroleum refining fixtures as part of a larger appraisal unit, so that any declines in value of the fixtures component would be offset by the increased value of other components, such as land and structures. However, staff believes that, as provided in Rule 461, depreciation of fixtures and other machinery and equipment classified as improvements at petroleum refineries should be reflected as a reduction in taxable value that is not offset by the value appreciation of the land and structures.

### **B. Pros of the Staff Recommendation**

Denial of the petition would maintain the provisions of Rule 461 and the Board's long-standing opinion that, for decline in value purposes, fixtures are a separate appraisal unit. The only exceptions the Board has made to the provisions of Rule 461 are to the unique nature of extractive/depletive properties—oil and gas (Rule 468), mining (Rule 469), and geothermal (Rule 473). Staff does not believe that petroleum refinery properties, which are not extractive/depletive in nature, have features so unique as to warrant an exception from the long-standing general provisions of Rule 461.

### **C. Cons of the Staff Recommendation**

Denial of the petition to adopt proposed Rule 474 would not allow assessors to presume that fixtures and machinery and equipment classified as improvements are actually part of a larger appraisal unit.

### **D. Statutory or Regulatory Change**

None

### **E. Administrative Impact**

None

### **F. Fiscal Impact**

#### **1. Cost Impact**

None

#### **2. Revenue Impact**

None

### **G. Taxpayer/Customer Impact**

None

## **H. Critical Time Frames**

None

## **VI. Alternative 1**

### **A. Description of Alternative 1**

The Board could commence the official rulemaking process by approving publication of a Notice of Proposed Rulemaking Action for proposed Rule 474. The proposed rule includes a rebuttable presumption that fixtures and other machinery and equipment classified as improvements are part of the larger appraisal unit. That presumption must be overcome before fixtures are treated as a separate appraisal unit for declines in value. (See Attachment 1.)

### **B. Pros of Alternative 1**

Publication of proposed Rule 474 would allow assessors to presume that fixtures and machinery and equipment classified as improvements are actually part of a larger appraisal unit. The California Assessors' Association supports the publication of proposed Rule 474.

### **C. Cons of Alternative 1**

Publication of proposed Rule 474 would allow assessors to assess petroleum refining fixtures as part of a larger appraisal unit, so that any declines in value of the fixtures component would be offset by the increased value of other components, such as land and structures. Industry believes that depreciation of fixtures and other machinery and equipment classified as improvements should be reflected as a reduction in taxable value that is not offset by the value appreciation of the land and structures.

### **D. Statutory or Regulatory Change**

This Alternative would require the Board to adopt section 474 of Title 18 of the California Code of Regulations, Subchapter 4.

### **E. Administrative Impact**

None

### **F. Fiscal Impact**

#### **1. Cost Impact**

The staff routinely drafts proposed rules and any associated costs are accommodated within the Board's existing budget. There are no other costs.

#### **2. Revenue Impact**

Adoption of Alternative 1 would have an incremental revenue impact. See attached Revenue Estimate.

### **G. Taxpayer/Customer Impact**

The adoption of proposed Rule 474 would limit reductions in the assessed value of fixtures for petroleum refining properties as a result of declines in value because such declines in value could be offset by value increases in land and other improvements.

## H. Critical Time Frames

None

## VIII. Alternative 2

### A Description of Alternative 2

The Board could delay a decision on the petition to initiate the rulemaking process and instruct staff to begin the interested parties process to develop a new section of the *Assessors' Handbook* relating to the assessment of petroleum refining properties. The assessment of petroleum refining properties is a complex matter and should be addressed in a comprehensive manner. By drafting a new section of the *Assessors' Handbook*, pertinent issues could be fully explored and a comprehensive assessment policy be published. See Attachment 2 for a list of potential handbook topics; the list was developed in conjunction with industry and the county assessors of Contra Costa, Kern, and Los Angeles.

### B Pros of Alternative 2

The drafting of a new section of the *Assessors' Handbook* will provide an opportunity for staff, along with assessors, industry, and other interested parties, to discuss all aspects of appraisal that should be addressed for petroleum refining properties. These issues should include environmental concerns, the use of spot versus rack prices for inputs and products, estimating economic obsolescence, the treatment of new and replacement fixtures, and other valuation and assessment issues.

### C Cons of Alternative 2

While Board staff recognizes the benefit of having a handbook section that prescribes assessment of petroleum refining properties to promote uniformity and equitable assessment of these properties, staff also recognizes that it will require the full participation and substantial contribution from the California Assessors' Association, industry, and other stakeholders in the drafting process.

### D. Statutory or Regulatory Change

None

### E. Administrative Impact

None

### F. Fiscal Impact

#### 1. Cost Impact

Board staff routinely drafts new sections to the *Assessors' Handbook* and any associated costs are accommodated within the Board's existing budget. There are no other costs.

#### 2. Revenue Impact

None

### G. Taxpayer/Customer Impact

None

**H. Critical Time Frames**

None

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Legal Department, Tax and Fees Programs Division: Property Taxes Section

Current as of: June 2, 2006

**PROPOSED DRAFT LANGUAGE****RULE 474. PETROLEUM REFINING PROPERTIES.**

Authority Cited: Section 15606(c), Government Code  
 Reference: Article XIII, Section 1, and Article XIII A, Section 2, California Constitution  
 Sections 51, 53.5, and 110.1, Revenue and Taxation Code

**(a)** The provisions of this rule apply to the valuation of the real, personal property, and fixtures used for the refining of petroleum.

**(b) GENERAL.**

(1) The unique nature of property used for the refining of petroleum requires the application of specialized appraisal techniques designed to satisfy the requirements of article XIII, section 1, and article XIII A, section 2, of the California Constitution. To this end, petroleum refineries and other real and personal property associated therewith shall be valued pursuant to the principles and procedures set forth in this section.

(2) Notwithstanding any other provision in this section, any appropriate valuation method described in section 3 of title 18 of this code may be applied in the event of a transfer of an ownership interest in a petroleum refining property.

**(c) DEFINITIONS.** For the purposes of this section:

(1) "Petroleum refining property" means any industrial plant, including real and personal property, used for the refining of petroleum, as identified in Standard Industrial Classification (SIC) Systems Codes 2911 and 2992, or North American Industrial Classification System (NAICS) Codes 324110 and 324191.

(2) "Appraisal unit" consists of the real and personal property that persons in the marketplace commonly buy and sell as a unit.

**(d) DECLINES IN VALUE.** For the purposes of this section:

(1) Declines in value of petroleum refining properties will be determined by comparing the current lien date full value of the appraisal unit to the indexed base year full value of the same unit.

(2) The land, improvements, and fixtures and other machinery and equipment classified as improvements for a petroleum refining property are rebuttably presumed to constitute a single appraisal unit, except when measuring declines in value caused by disaster, in which case land shall constitute a separate unit.

(3) In rebutting this presumption, the assessor may consider evidence that:

(A) The land and improvements including fixtures and other machinery and equipment classified as improvements are not under common ownership or control and do not typically transfer in the marketplace as one economic unit.

(B) When the fixtures and other machinery and equipment classified as improvements are not functionally and physically integrated with the realty and do not operate together as one economic unit.

**PROPOSED ASSESSORS' HANDBOOK SECTION ON  
PETROLEUM REFINING PROPERTIES**

**Chapter 1**

- Introduction
  - History and general background
  - Technical description of the refinery and its functions and processes

**Chapter 2**

- Comparative Sales Approach
  - Limited sales data
    - Types of assets transferred
    - Legal entity ownership changes
  - Adjustments for comparability
    - Size
    - Age
    - Functions

**Chapter 3**

- Income Approach
  - Determination of income to be capitalized
    - Forecasting production volume
    - Product pricing - spot versus rack prices
  - Determination of expenses
    - Cost of raw material
    - Transportation costs
  - Derivation of a capitalization rate
    - Risk—market and regulatory
    - Rate used to determine residual value
    - Rate used to discount future remediation costs

**Chapter 4**

- Cost Approach
  - Reproduction cost—historical cost
  - Replacement cost
    - Adjustments for comparability
  - Calculating depreciation
    - Physical depreciation
    - Functional obsolescence
    - Economic obsolescence
  - Estimating entrepreneurial profit

**FORMAL ISSUE PAPER****Chapter 5**

- Assessment Issues
  - Decline in values
    - Should fixtures be treated as a separate appraisal unit apart from land and other improvements?
    - Approaches to value for fixtures
  - New Construction
    - Capital expenditures and maintenance expenses
    - Supplemental assessment
  - Emission Reduction Credits
    - Taxable component of real property versus nontaxable intangible asset
  - Emission Control Requirements
    - Government mandates versus value added expenditures
  - Contamination
    - Treatment of remediation cost, monitoring cost and charges for future remediation
    - Effect of stigma on market value

The above list is not all-inclusive and will evolve with the drafting of the handbook.

BOARD OF EQUALIZATION  
**REVENUE ESTIMATE**

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**ISSUE # 06-001****PROPOSED PROPERTY TAX RULE 474,  
PETROLEUM REFINING PROPERTIES****Issue**

Should the Board grant the petition to initiate the rulemaking process to adopt Property Tax Rule 474 that prescribes the valuation of properties used for refining petroleum?

**Staff Recommendation**

Staff recommends that the Board deny the petition to initiate the rulemaking process to adopt a Property Tax Rule that prescribes the valuation of properties used for refining petroleum.

**Other Alternative(s) Considered**

1. The Board could commence the official rulemaking process by approving publication of a Notice of Proposed Rulemaking Action for proposed Rule 474.
2. The Board could delay a decision on the petition to initiate the rulemaking process and instruct staff to begin the interested parties process to develop a new section of the Assessors' Handbook relating to the assessment of petroleum refining properties.

**Background, Methodology, and Assumptions**

The issue at hand is whether the Board should adopt for petroleum refining properties a rule that would include a provision creating a rebuttable presumption that, for purposes of recognizing declines in value, fixtures and machinery and equipment classified as improvements are within the same "appraisal unit" that contains structures and associated land.

The proposed rule is Property Tax Rule 474, *Petroleum Refining Properties*. Under the proposed rule,

- (1) Declines in value of petroleum refining properties will be determined by comparing the current lien date full value of the appraisal unit to the indexed base year full value of the same unit.
- (2) The land, improvements, and fixtures and other machinery and equipment classified as improvements for a petroleum refining property are rebuttably presumed to constitute a single appraisal unit, except when measuring declines in value caused by disaster, in which case land shall constitute a separate unit.

Currently, fixtures are always a separate appraisal unit for the purpose of measuring declines in value under Rule 461. When fixtures are treated as a separate appraisal unit, a decline in their value, e.g., depreciation, may be independently recognized.

Under proposed Rule 474, fixtures may be considered part of a larger appraisal unit that also includes land and non-fixtures improvements. Under this treatment, a decline in the value of fixtures could be offset by an increase in the value of the associated land and improvements other than fixtures resulting in an assessed value that would be greater than or equal to the sum of the values produced under the current rules.

The revenue effect of not always treating fixtures as a separate appraisal unit for declines in value is extremely difficult to estimate due to the many factors involved and their lack of predictability. Among the factors are the following:

- 1) The amount of decrease in value of those fixtures that are not treated separately.
- 2) The amount of offsetting increase in value for the associated land and non-fixtures improvements.

The difference in assessed value for a property that is a candidate for the proposed treatment can be significant. This can be demonstrated as follows:

Property A is petroleum refining property that is purchased in year 0. Its real property assessed value in year 1 is \$1,000,000 for land; \$1,000,000 for improvements other than fixtures; and \$1,000,000 for fixtures. Suppose the market value of the land grows by \$100,000 a year for five years topping out at \$1,500,000 in the fifth year after the sale; that the fixtures remain in place and depreciate at a rate of \$100,000 a year; and that the market value of the other improvements remains unchanged. After five years, the market value of the property remains unchanged at \$3,000,000; however, the value is now allocated: \$1,500,000 for land; \$500,000 for fixtures; and \$1,000,000 for other improvements. Under the proposed rule, the assessed value in years 1 through 6 would remain constant at \$3,000,000.

When the fixtures are treated as a separate appraisal unit as in the current treatment, the assessed value of the property from years 1 through 6 is:

Year	Land & Other Imps AV	Fixtures AV	Total AV
1	\$2,000,000	\$1,000,000	\$3,000,000
2	\$2,040,000	\$900,000	\$2,940,000
3	\$2,080,800	\$800,000	\$2,880,800
4	\$2,122,416	\$700,000	\$2,822,416
5	\$2,164,864	\$600,000	\$2,764,864
6	\$2,208,162	\$500,000	\$2,708,162

In this example, the difference in assessed value between the two treatments grows from no difference in year 1 to nearly \$300,000 in year 6.

The Western States Petroleum Association reports that there are 20 major refineries located in California. Nine of the refineries are located in two counties: five are located in Los Angeles County and four in Contra Costa County. County data show the total assessment to be over \$14 billion with approximately 79 percent (\$11 billion) enrolled as fixtures. Projecting this

information on a statewide basis indicates Rule 474 potentially affects the assessment of \$32 billion of refinery property of which \$25 billion consist of fixtures.

Since the non-fixtures property value is relatively small when compared to the fixtures, any increases (short of the extreme) in their market value are easily absorbed by the depreciation in the fixtures. This means that under the proposed rule the property would be assessed at market value, except in the rare instance where the market value exceeds the Prop. 13 factored base year value.

For the 20 large petroleum refining properties in California that would be assessed by combining fixtures with other real property, the total difference in assessed value for the offsetting increase for land and structures is conservatively estimated to be: \$7 billion x 2%, or \$140 million.

## **Revenue Summary**

### Staff Recommendation.

There is no revenue impact in denying the petition to initiate the rulemaking process to adopt a Property Tax Rule that prescribes the valuation of properties used for refining petroleum.

### Alternative 1.

The total difference in assessed value under the proposed rule is estimated to be at least \$140 million. The difference in property tax from the basic 1 percent property tax rate is then \$1.4 million

The actual revenue effect could be considerably higher or lower depending on the number of properties that would be actually affected by this treatment and the actual amount of offsetting values.

### Alternative 2.

There is no revenue impact in delaying the decision on the petition and instructing staff to begin the interested parties process to develop a new section of the *Assessors' Handbook* relating to the assessment of petroleum refining properties.

## **Preparation**

This revenue estimate was prepared by Aileen Takaha Lee, Research and Statistics Section and reviewed by Mr. David E. Hayes, Manager, Research and Statistics Section. For additional information, please contact Aileen Takaha Lee at (916) 445-0840.