STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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July 13, 2005

Mr. James B. Lindholm, Jr.
San Luis Obispo County Counsel
County Government Center, Room #386
San Luis Obispo, CA 93408

Re: Cable System Franchise Assessment

Dear Mr. Lindholm:

This is in response to your letter of July 20, 2004, to Kristine Cazadd, Assistant Chief Counsel, Property Taxes, wherein you inquired concerning cable system taxable possessory interests held by LLC ("LLC") in San Luis Obispo County. We have addressed each of your questions below and have concluded that:

1. Revenue and Taxation Code section 107.7[1] establishes a preferred valuation method for cable system taxable possessory interests and confirms entitlement to reliance upon the "presumption of correctness" when the assessor uses that method. Use of that method is by choice in order to take advantage of the presumption, not mandated.

2. The "presumption of correctness" imposes upon the applicant the burden of proving that an assessment is not correct.

3. Section 107.7 does not require that the assessor use a portion of the franchise fee as the estimated economic rent for a cable system taxable possessory interest. Thus, neither the federal limit nor the state limit on cable television franchise fees establishes a limit on the economic rent of a cable system taxable possessory interest. Further, we do not view a cable television franchise fee as an enforceable land use restriction under section 402.1.

4. If a cable system franchise is operating under a current document or instrument, the presumption is that the stated term of possession constitutes the reasonably anticipated term of possession. If the document or instrument has expired, the reasonably anticipated term of possession is to be determined based on the intent of specified parties, using the criteria listed in Property Tax Rule 21[2] (d)(2)(A-E) until such time as a new document or instrument is executed.

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[1] All section references are to the Revenue and Taxation Code unless stated otherwise.
[2] All rule references are to Property Tax Rules unless stated otherwise.

5. When estimating the current market value of a cable system taxable possessory interest, the income may be capitalized to reflect a forecasted growth in future income. Any additional expenses related to the expected growth should also be accounted for.

6. The capitalization rate to be used for valuing a cable system taxable possessory interest is limited to either of the two methods set forth in rule 8(g).

7. The type of expenses allowed for valuing a cable system taxable possessory interest is as specified in rule 8(c). Expense amounts are factual, and when disputed, are to be resolved by the assessment appeals board.

Factual Background

Your letter discusses the facts and arguments made by both LLC and the San Luis Obispo County Assessor ("Assessor") with respect to the primary issues in an assessment appeals hearing. Each of these issues relates to the application of the income approach, which is the valuation method used by the Assessor in the assessment of LLC's properties. At the conclusion of your letter you summarize the issues in the form of questions. Our response focuses on these questions, which we have consolidated and paraphrased for brevity as follows:

Question 1: What is the application of section 107.7 and rule 21 to cable system taxable possessory interests?

Question 2: What is the meaning of "presumption of correctness?"

Question 3: Is the assessor required by law to use a portion of the franchise fee as the economic rent when valuing a cable system taxable possessory interest under the income approach; that is, does the federal limit with respect to cable television franchise fees establish a ceiling with respect to the economic rent of a cable system taxable possessory interest? Relatedly, does the federal franchise fee constitute an enforceable government restriction, as defined in section 402.1?

Question 4: What is the application of section 107.7 and rule 21 to the determination of the reasonably anticipated term of possession of a cable system taxable possessory interest?

Question 5: When estimating the current market value of a cable system taxable possessory interest, may the income be capitalized to reflect a forecasted growth in future income?

Question 6: Are the two methods of developing a capitalization rate described in rule 8(g) the only allowable methods for valuing a cable system taxable possessory interest, or is the proper development of a capitalization rate a question of fact to be resolved by the assessment appeals board?

Question 7: Are there any legal standards for determining an appropriate expense ratio for valuing a cable system taxable possessory interest, or is this a matter of fact to be resolved by the assessment appeals board?

<u>Applicable Law and Analysis</u>

<u>**Question 1:** What is the application of section 107.7 and rule 21 to cable system taxable possessory interests?</u>

Section 107.7 establishes a preferred valuation method for a cable system's taxable possessory interests and confirms entitlement to reliance upon the "presumption of correctness" when the assessor uses that method. Use of the method is not a mandate. It is merely a preference that is rewarded with the "presumption of correctness". Section 107.7 does not prohibit the use of any particular valuation method.

Under section 107.7, in order for an assessment to utilize the "presumption of correctness," the assessor must value cable system taxable possessory interests using the income approach and using a portion of the annual cable television franchise fee as the economic (market) rent attributable to the taxable possessory interests. Section 107.7 does not prohibit the use of other valuation methods or the use of an economic rent that is not a portion of the franchise fee, but if the provisions of the section are not followed, the assessment's presumption of correctness is lost.

Rule 21 governs the valuation of taxable possessory interests generally. As such, it is applicable to the valuation of cable system taxable possessory interests.

<u>**Question 2**: What is the meaning of "presumption of correctness?"</u>

As provided in rule 321(a), it is generally presumed that the assessor has properly performed his duty and that a property subject to appeal has been properly assessed. This presumption of correctness imposes upon the applicant the burden of proving that an assessment is not correct. In the absence of such proof, the assessor is assumed to be correct and need not offer any further evidence. In attempting to meet this burden of proof, the applicant must submit independent evidence to the assessment appeals board that is relevant to the value of the property. In the vast majority of appeals, even though an assessment benefits from the presumption of correctness, the assessor also submits evidence in support of the assessment.

Section 107.7(a) establishes an assessor's presumption of correctness in the valuation of cable system taxable possessory interests in certain circumstances. The assessment utilizes the presumption of correctness only if the value is determined by the preferred valuation method in section 107.7. If the assessor uses other appraisal methodology that does not benefit from a presumption of correctness, there is no presumption of correctness. The burden of producing evidence sufficient to avoid a ruling against them on the valuation becomes an obligation of each party, both the assessor and the applicant. (*California Evidence Code section 110.)* The assessment appeals board weighs both the assessor's evidence of value and the applicant's evidence of value solely on the evidence presented. Neither the presumption of correctness nor the loss of such presumption is evidence, and neither should be considered as such by the assessment appeals board.

<u>**Question 3** Is the assessor required by law to use a portion of the franchise fee as the economic rent when valuing a cable system taxable possessory interest under the income approach; that is, does the federal limit with respect to cable television franchise fees establish a ceiling with respect to the economic rent of a cable system taxable possessory interest? Relatedly, does the</u>

federal franchise fee constitute an enforceable government restriction, as defined in section 402.1?

Section 107.7 does not require that the assessor use a portion of the franchise fee as the estimated economic rent for a cable system taxable possessory interest. As stated in section 107(b)(2), "the annual rent shall be that portion of that franchise fee received by the franchising authority that is determined to be payment for the cable television possessory interest…or the appropriate economic rent. If the assessor does not use a portion of the franchise fee as the economic rent, the resulting assessments shall not benefit from any presumption of correctness." In other words, the consequence of not using a portion of the franchise fee as the economic rent is that the assessment loses the presumption of correctness.

In our view then, other than as provided by section 107.7, there is no legal nexus between the franchise fee and the economic rent for a cable system taxable possessory interest. Thus the federal limit on cable television franchise fees does not establish a limit on the economic rent of a cable system taxable possessory interest. Similarly, neither does the state limit on such fees establish a limit on the economic rent of a cable system taxable possessory interest. Finally in this regard, we do not view a cable television franchise fee as an enforceable land use restriction under section 402.1. As stated in section 402.1(a), "in the assessment of land, the assessor shall consider the effect upon value of any enforceable restrictions to which the use of the land may be subjected." The federal and state limits on cable television franchise fees are limits upon amounts which may be charged for cable television franchises, not restrictions to which uses of lands are subjected as section 402.1 contemplates and requires.

Staff recognizes that it can be contended otherwise, that is, that the federal and state limits on cable television franchise fees do establish a limit on the economic rents of cable system taxable possessory interests. Staff is not aware of any California court decision to that effect, however. In CAT Partnership v. County of Santa Cruz (1998) 63 Cal. App.4th 1071, the court of appeal held that rate protection provisions in the franchise agreement were "enforceable restrictions" under section 402.1, but the court did not address the matter of federal and/or state limits on cable television franchise fees in that regard. Thus, until such time as the legislature so provides or a court of competent jurisdiction so holds, we do not embrace this contention, as indicated above.

Question 4: What is the application of section 107.7 and rule 21 to the determination of the reasonably anticipated term of possession of a cable system taxable possessory interest?

Rule 21(d) governs the determination of the reasonably anticipated term of possession of taxable possessory interests generally, and the reasonably anticipated term of possession referenced in section 107.7(b)(2) should be determined in accordance with the provisions of rule 21(d).

Rule 21(d) separates taxable possessory interests into two types: those with or those without a stated term of possession. In general, a taxable possessory interest with a stated term is an interest in which a period of possession has been specified in the document or instrument that created the interest. Most possessory interests of a stated term are created by lease.

When a taxable possessory interest has a stated term of possession, rule 21 provides that the stated term of possession shall be the reasonably anticipated term of possession, unless the assessor can demonstrate by "clear and convincing evidence" that the public owner and the private possessor have reached a mutual understanding or agreement such that the reasonably anticipated term of possession differs from the stated term of possession. If so demonstrated, the rule also provides that the term of possession for valuation purposes shall be the stated term of possession as modified by the mutual understanding or agreement. "Clear and convincing evidence" is evidence so clear as to leave no substantial doubt in the mind of the trier of fact, evidence sufficiently strong to command the unhesitating assent of every reasonable mind. Clear and convincing proof demands a high probability, whereas preponderance calls for probability. (*In re Angela P.* (1981) 28 Cal.3d 908; *Lilian F.* v. *Superior Court* (1984) 160 Cal.App.3d 314; *In re Terry* (1978) 83 Cal.App.3d 890.)

For a taxable possessory interest without a stated term of possession, the assessor may determine the reasonably anticipated term of possession based upon the intent of the public owner and the private possessor, or by the intent of similarly situated parties, using criteria such as that listed in rule 21(d)(2)(A-E). Rule 21(d)(3) states that a taxable possessory interest that runs from month to month, an interest without a fixed term, or an interest of otherwise unspecified duration shall be deemed to be a taxable possessory interest with no stated term of possession.

If a cable system franchise is operating under a current document or instrument, the presumption is that the stated term of possession, defined in rule 21 as the remaining term thereunder on the valuation date, constitutes the reasonably anticipated term of possession. If the document or instrument has expired, the reasonably anticipated term of possession is to be determined based on the intent of the public owner and the private possessor, and by the intent of similarly situated parties, using the criteria listed in Rule 21(d)(2)(A-E) until such time as a new document or instrument is executed.

Question 5: When estimating the current market value of a cable system taxable possessory interest, may the income be capitalized to reflect a forecasted growth in future income?

When estimating current market value on the lien date or when establishing a base year value, the values selected for the variables in the income approach, such as expected future income, discount rate, and duration of income, should be based upon the best market information and comparable data available on that lien date. If there are data or other information that support growth in expected income, the income to be capitalized may reflect this. Of course, any additional expenses related to the expected growth should also be accounted for.

It is appropriate to note that the assessment of a cable system taxable possessory interest is subject to section 51(a), which provides that the taxable value of real property shall be the lesser of its factored base year value or its current market value on the lien date.

In general, the reasonably anticipated term of possession for a cable system taxable possessory interest declines on each lien date as the remaining stated term shortens; and, all else being equal, the current market value of the taxable possessory interest will decline over subsequent lien dates such that current market value will fall below factored base year value. However, an increase in expected income or a decrease in the discount rate may negate the declining duration of the income stream and keep current market value above the factored base year value. Which is the case will be a question of fact in each instance, determined by the quality of the valuation evidence presented.

Question 6: Are the two methods of developing a capitalization rate described in rule 8(g) the only allowable methods for valuing a cable system taxable possessory interest, or is the proper development of a capitalization rate a question of fact to be resolved by the assessment appeals board?

Rule 8(g) states that "[t]he capitalization rate may be developed by either of two means," and it goes to describe in (g)(1) and (g)(2) the specific methodology for determining capitalization rates. The "may" in this context is prescriptive, not permissive, that is, the capitalization rate must be developed by one of these two methods. These two methods are the only legally allowed methods for developing a capitalization rate.

Question 7: Are there any legal standards for determining an appropriate expense ratio for valuing a cable system taxable possessory interest, or is this a matter of fact to be resolved by the assessment appeals board?

Rule 8(c) prescribes the types of allowed expenses to be subtracted from "gross return" (i.e., gross income) to arrive at "net return" (i.e., net income). Although the rule is specific about types of expenses, it does not prescribe the level, or amount, of allowed expenses. Establishing the proper amounts for such expenses is a question of fact that is typically resolved based upon a review of historical expense data and other information relating to the operation of the subject and comparable properties, to be resolved by the assessment appeals board.

The views expressed in this letter are only advisory in nature. They represent the analysis of the legal staff of the Board based on present law and the facts set forth herein. Therefore, they are not binding on any person or public entity.

Very truly yours,

/s/ J. K. McManigal, Jr.

J. McManigal, Jr.
Senior Tax Counsel

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cc:

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