



STATE BOARD OF EQUALIZATION

450 N STREET, SACRAMENTO, CALIFORNIA
(PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
TELEPHONE (916) 322-6083
FAX (916) 323-3387
www.boe.ca.gov

CAROLE MIGDEN
First District, San Francisco

BILL LEONARD
Second District, Ontario

CLAUDE PARRISH
Third District, Santa Ana

JOHN CHIANG
Fourth District, Los Angeles

STEVE WESTLY
State Controller, Sacramento

James E. Speed
Executive Director

January 13, 2003

Re: Valuation of Property Subject to Long-Term Leases

Dear Mr. _____ :

This letter is in response to your correspondence addressed to Board of Equalization Member Claude Parrish and dated September 23, 2002. Specifically, you asked three questions regarding the appraisal of property subject to long-term leases. First, you ask whether is there any residual value from a transfer of property subject to a land lease of more than 35 years, other than a “fee simple” equivalent. Secondly you ask whether the assessor may use the term “unencumbered” relating to arms length leases where no “quid pro quo” was involved since none of the subleases in effect on the purchase date were negotiated by your clients. And, lastly, you ask whether the Property Tax Rules permit the Assessor to “adjust” the assessed values for land and improvements two years following the date of purchase without another change in ownership. Answers to your questions follow the background summary below.

Background and Facts

1. On December 31, 1991 the _____ Trust purchased the improvements and land lease of the property located at _____.
2. At the time of the sale and lease assignment there were 38½ years remaining on the land lease.
3. Despite the \$3,800,000 purchase price reported by the _____ Trust, the assessor enrolled \$7,373,752; an amount the assessor considered to be the unencumbered fee simple value of the property.

4. On July 9, 1997 the County Assessment Appeals Board (AAB) heard your appeal and made the following findings and decisions:
 - (a) Change in Ownership: The December 31, 1991 assignment of the leasehold interest with a remaining term of more than 35 years was a change in ownership which required reassessment of the entire property pursuant to subdivision (c)(1) of Revenue and Taxation Code section 61.
 - (b) Valuation: The AAB accepted the assessor's recommended value of \$6.45 million, allocated \$2.65 million to land and \$3.8 million to improvements, concluding that both of the assessor's valuation approaches were correct.
5. Affirming the value conclusion described above, the AAB relied on data that the assessor claimed was representative of the market rents at the time of purchase by the Trust, instead of relying on the actual leases of the subject property.
6. The AAB also affirmed the assessor's conclusion that there was a change in ownership of the entire property as a result of the 1991 sale and lease assignment.
7. Apart from the AAB's conclusions, you also question whether the assessor may enroll an escape assessment two years after the transaction in which the Trust acquired ownership.

You believe that in light of the California Revenue and Taxation Code, the assessor has overvalued the property owned by the Trust and that the express language of the change in ownership exclusion in section 62(g) applies to transfers or assignments of leases by lessors, not by lessees. In addition, you believe that the valuation of the property significantly above the sale price is improper. For the reasons hereinafter explained, we respectfully disagree and support the AAB's determinations on both of these matters. Nevertheless, we were not a party to this matter and you may wish to pursue an action in Superior Court.

Analysis

1. **Is there any Residual Value, for Assessment Purposes, to a Transfer of a Property Subject to a Land Lease at More Than 35 Years Other Than a "Fee Simple" Equivalent?**

No. Upon an assignment of a long-term land lease having more than 35 years remaining with options, the assignee is treated as receiving the entire present beneficial interest in the property covered by the lease. Consequently, the AAB acted correctly when it assigned no residual value to the lessor's interest.

As you may be aware, Revenue and Taxation Code section 60 defines a change in ownership as “a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest.” Whether or not a particular transaction involving real property falls within this definition depends upon the facts in each case.

To be a “change in ownership” under section 60, a particular transaction must embody the following three characteristics contained in the definition:

- (1) It transfers a present interest in real property;
- (2) It transfers the beneficial use of the property; and
- (3) The property rights transferred are substantially equivalent in value to the fee interest.

Also within that definition are the provisions of section 61(c) that include as a “change in ownership:”

(1) The creation of a leasehold interest in taxable real property for a term of 35 years or more (including renewal options), the termination of a leasehold interest in taxable real property which had an original term of 35 years or more (including renewal options), and *any transfer of a leasehold interest having a remaining term of 35 years or more (including renewal options)*; or [Emphasis added]

(2) Any transfer of a lessor’s interest in taxable real property subject to a lease with a remaining term (including renewal options) of less than 35 years.

An exclusion from the definition of a “change in ownership” applicable to the foregoing transfers under section 61(c)(1) and (2) is found in section 62(g), which provides as follows: “Change in ownership shall not include: . . . (g) Any transfer of a lessor’s interest in taxable real property subject to a lease with a remaining term (including renewal options) of 35 years or more.”

Your concern is the interpretation and applicability of the language stated in sections 61(c) and 62(g) regarding transfers by a lessee of a leasehold interest having a remaining term of 35 years or more, pursuant to section 61(c)(1). Specifically, you wish to know why the lessor’s residual interest in the property acquired by the Trust does not receive a base year value and, therefore, is not considered for assessment purposes. In your view, the value of the lessor’s residual interest should be considered in the assessor’s valuation of the trust property.

Unfortunately, this view is inconsistent with the clear intent and language of the statutory scheme pertaining to leases. That scheme is described in the “Report of Task Force,” Assembly Revenue and Taxation Committee, 1979, page 229:

If the term of a lease, including options to renew, is 35 years or more, the creation of the lease is a change in ownership and so is its expiration. *If a lessee under such a lease assigns or sublets for a term of 35 years or more, that is another change in ownership.* However, if the lease, including options is for less than 35 years the lessor remains the owner and only the transfer of his interest is a change. *In all cases, the entire premises subject to the lease in question are reappraised.* [Emphasis added]

As described above, that scheme makes the lessee of a long term land lease equivalent to the “owner” of that land for change in ownership purposes. Thus, the Legislature adopted a scheme whereby the entire fee value would be assessed to only one person in a lease situation, either the lessor or the lessee, but not both.

2. Is it within the Purview of the Assessor to Use the Term “Unencumbered” Relating to Arms Length Leases Where No “Quid Pro Quo” Was Involved? (None of the Leases in Effect on 12-31-91 Involved the Trust.)

Yes. We assume that this question relates to paragraph 10 in the AAB’s Findings and Conclusions. Property Tax Rule 2 requires assessors and appeals boards to value real property in California at full cash value which is defined as its unencumbered, unrestricted fee simple interest, as opposed to the value of the leased-fee interest encumbered by below-market rents. However, that requirement is subject to a rebuttable presumption that the consideration paid by the Trust is the full cash value.

For the purpose of appraising real property subject to property tax, Revenue and Taxation Code section 110, subdivision (a) provides the relevant value standard:

Except as is otherwise provided in Section 110.1, “full cash value” or “fair market value” means the amount of cash or its equivalent which property would bring if exposed for sale in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other and both with knowledge of all of the uses and purposes to which the property is adapted and for which it is capable of being used and of the enforceable restrictions upon those uses and purposes.

The Board has interpreted section 110 in light of relevant court decisions in Property Tax Rule 2, which provides in subdivision (a):

In addition to the meaning ascribed to them in the Revenue and Taxation Code, the words “full value”, “full cash value”, “cash value”, “actual value”, and “fair market value” mean the price at which a property, if exposed for sale in the open market with a reasonable time for the seller to find a purchaser, would transfer for cash or its equivalent under prevailing market conditions between parties who have knowledge of the uses to which the property may be put, both seeking to maximize their gains and neither being in a position to take advantage of the exigencies of the other.

When applied to real property, the words “full value”, “cash value”, “actual value”, “actual value” and “fair market value” mean the price at which the *unencumbered or unrestricted fee simple interest in the real property (subject to any legally enforceable governmental restrictions)* would transfer for cash or its equivalent under the conditions set forth in the preceding sentence. [Emphasis added.]

As indicated above, real property not subject to enforceable governmental restrictions should be valued at its fee simple absolute value. Such a value differs from the fee value when encumbered by below-market rents, also called the “leased-fee value.” The difference between the fee simple and leased-fee values is discussed on page 34 of Assessors’ Handbook Section 501, *Basic Appraisal*:

The property tax appraiser, with few exceptions, must estimate the fair market value of the unrestricted fee simple estate, unencumbered by liens or leases, based on the highest and best use of the property. [Footnote omitted] In the vast majority of assignments, the property tax appraiser estimates the value of the full bundle of rights.

The appraisal of property subject to a lease represents the most common example of the fee simple concept for property tax appraisal. If the contractual rights under a lease are less valuable than the current fair market value of the rights of possession and use (i.e., the contract rent is less than the current market rent), the market value of the leased fee interest is less than the market value of the fee simple interest. Conversely, if the contract rent is greater than the current market rent, the market value of the leased fee interest exceeds the market value of the fee simple interest. [Footnote omitted] In the former case, the value of the leasehold interest is positive; in the later case, the value of the leasehold interest is negative. In either case, the magnitude of the leasehold value (the difference between the fee simple value and the leased fee value), positive or negative, depends upon the difference between contract and market rent, and upon the length of the remaining lease term.

* * *

Since the law requires that an appraisal for property assessment purposes be based on the value of the unencumbered fee simple interest, an appraisal based on the sale price of the subject property or on the sales prices of comparable properties—where contract rents differ from current market rents—must be adjusted in order to reflect the market value of the fee simple interest.

As you can see, the statutes, regulations and advisory guidance all require both the assessor and the AAB to value this property at its fee simple value regardless of the below-market leases in effect at the time of purchase, and despite the apparent disparity between the fee simple and leased-fee values.

Subdivision (b) of Property Tax Rule 2 goes on to provide that when the property was purchased (resulting in a change in ownership), the consideration paid by the taxpayer shall be presumed to be the full cash value. This presumption was established by the Legislature (subdivision (b) of section 110 and section 167) and by the Board for the express purpose of allowing taxpayers and assessment appeals boards to rely on the total consideration paid when determining full cash value. When analyzing the statutory revisions that created the purchase price presumption, the Legislative Counsel's Digest provided the following summary:

Existing property tax law provides for a rebuttable presumption in favor of the taxpayer or assessee who has supplied all information as required by law to the assessor in any administrative hearing involving the imposition of a tax on, or the assessment of, an owner-occupied single-family dwelling.

This bill would establish an additional rebuttable presumption that the fair market value of real property on the date on which there is a change in ownership is the total consideration, valued in money, paid for the property, if the taxpayer or assessee has supplied all information as required by law to the assessor.

Thus, the burden of proving that the value of the property is greater than the purchase price is on the assessor. This burden of proof requires that the assessor overcome the presumption by a preponderance of the evidence. The Legislative Counsel's Digest prepared the following summary describing the standard of proof required to rebut the purchase price presumption:

This bill would provide that “full cash value” or “fair market value” in the context of an appraisal of real property, other than a possessory interest, which is the subject of a purchase is the purchase price paid in the transaction unless it is established *by a preponderance of the evidence* that the real property would not have transferred for that purchase price in an open market transaction.
[Emphasis added]

With regard to the purchase price presumption described above, the AAB found that the assessor presented sufficient evidence to rebut that presumption. In paragraph 10 of the Findings and Conclusions, the AAB wrote:

The applicant failed to present any evidence of value, other than his argument that the purchase price of \$3.8 million should be adopted as the fair market value. As indicated above, the purchase price did not reflect the fair market value of the unencumbered fee interest, but only the fee encumbered by substantially below-market rents. Therefore the purchase price must be disregarded.

Therefore, the assessor and AAB valued the Trust property at its unencumbered fee simple absolute value—not the fee value when encumbered by below-market rents—subject to application of the purchase price presumption found in section 110 and Property Tax Rule 2. Thus, the assessor and AAB met the requirements of appraising the real property at its

unencumbered fee simple absolute value—without regard to the existing below-market leases. Although the purchase price presumption is applicable in an appeal of that value, the AAB found that the assessor successfully rebutted that presumption.

3. Do the Property Tax Rules Allow the Assessor to “Adjust” the Assessed Values for Land and Improvements without a Transfer Occurring Two Years Following the Purchase?

Apart from the findings of the AAB, the answer to your question is “yes.” The relevant statutes require that the assessor correct errors upon the discovery of escape assessments and base year value errors. However, the legal authority for those corrections is found in the Revenue and Taxation Code—not the Property Tax Rules.

Since the property acquired by the Trust had escaped reappraisal following the change in ownership in which the trust acquired an interest in the property, section 531 requires the assessor to perform a reappraisal upon discovery of that change in ownership, regardless of the actual date of the change in ownership. Section 531 provides:

If any property belonging on the local roll has escaped assessment, the assessor shall assess the property on discovery at its value on the lien date for the year for which it escaped assessment. It shall be subject to the tax rate in effect in the year of its escape except as provided in Section 2905 of this code.

Section 532 provides the applicable statute of limitations periods for the enrollment of escape assessments. Under most circumstances, section 532 provides a four-year statute of limitations. In cases of reporting errors by property owners, an eight-year statute of limitations may apply. The assessor is required to enroll assessments resulting from a change in ownership upon discovery, in compliance with those periods.

However, even if the assessor performed a timely reappraisal following the change in ownership in which Trust acquired the property, section 51.5 subdivision (b) gives the assessor four years to correct the property’s base year values upon the discovery of an error in value judgment.

(b) An error or an omission described in subdivision (a) which involves the exercise of an assessor’s judgment as to value may be corrected only if it is placed on the current roll or roll being prepared, or is otherwise corrected, within four years after July 1 of the assessment year for which the base year value was first established.

If the assessor made a base year value error was not due to an error in valuation judgement—typically clerical errors—the assessor may correct that assessment at any time under

subdivision (a) of section 51.5.¹ However, if the assessment error was the result of the exercise of value judgment, the assessor has four years within which the correction may be made. Thus, section 51.5 provides two different statutes of limitation that may affect the property in the Trust.

As applied to the facts supplied in your question: “May the assessor ‘adjust’ the assessed values of property held by the Trust two years following the purchase?” The answer is yes. Such “adjustments” are mandated by the statutes that require the enrollment of escape assessments and by the statutes that require base year value corrections.

Conclusion

Subdivision (c) of section 61 makes the lessees of long term land leases equivalent to the “owner” of the land for change in ownership purposes, with no assessed value assigned to the lessor’s residual interest. Property Tax Rule 2 requires real property in California to be valued at its unencumbered, unrestricted fee simple interest, as the full cash value and provides a rebuttable presumption that the consideration paid by the Trust is the property’s full cash value. During your assessment appeal, the AAB found that the assessor successfully rebutted that presumption. After a change in ownership, the relevant statutes require that the assessor correct errors upon the discovery of escape assessments and errors in base year values. Assessors may make such corrections for at least four years after an error in value judgement, or longer in the case of certain base year value errors.

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

Sincerely,

/s/ Michael Lebeau

Michael Lebeau
Tax Counsel
Legal Department

MTL:lg
prop/prec/bayrcor/03/01mtl

¹ (a) Notwithstanding any other provision of the law, any error or omission in the determination of a base year value pursuant to paragraph (2) of subdivision (a) of Section 110.1, including the failure to establish that base year value, which does not involve the exercise of an assessor’s judgment as to value, shall be corrected in any assessment year in which the error or omission is discovered.