Taxable Possessory Interests

Assess all taxable possessory interests located at the county fairgrounds.

Section 107 and Rule 20 define the requirements for a taxable possessory interest. Briefly stated, these requirements are that the right of possession be independent, durable, exclusive, and provide a private benefit. Recurring uses of the county's fairground facilities by the same private persons or entities could constitute taxable possessory interests and should be reviewed for possible assessment.

Without a low-value ordinance in effect, the assessor should be assessing all taxable possessory interests located at the fairgrounds, regardless of value. Failure to assess all taxable possessory interests located at the fairgrounds may result in escape assessments.

Assess only property classified as real property as taxable possessory interests.

Rule 20(b) states that "taxable possessory interests" are possessory interests in publicly owned real property. Since a possessory interest is defined as an interest in real property, an assessment of a possessory interest would be in land and improvements only. It would not include an assessment of a possessory interest in personal property. A manufactured home not affixed or installed on an approved permanent foundation system, in compliance with Health and Safety Code section 18551, is classified as personal property. Therefore, private uses, such as employee housing, of a manufactured home owned by a government entity is not taxable.

The assessor's practice of assessing manufactured homes classified as personal property as taxable possessory interests is contrary to statute and may be causing invalid assessments to be enrolled.

Use the stated term of possession as the reasonably anticipated term of possession in accordance with Rule 21 when valuing taxable possessory interests.

Rule 21(d)(1) states, in part, "The stated term of possession shall be deemed the reasonably anticipated term of possession unless it is demonstrated by clear and convincing evidence that the public owner and the private possessor have reached a mutual understanding or agreement, whether or not in writing, such that the reasonably anticipated term of possession is shorter or longer than the stated term of possession. If so demonstrated, the term of possession shall be the stated term of possession as modified by the terms of the mutual understanding or agreement."

Rule 21(a)(6) defines the stated term of possession for a taxable possessory interest as of a specific date as "…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." Therefore, the stated term of possession declines each year. This may or may not have a material effect on the market value of the possessory interest. Thus, absent clear and convincing evidence of a mutual understanding or agreement as to a shorter or longer term of possession, the assessor must estimate the current market value of the taxable possessory interest on the lien date based on the remaining stated term of possession, compare this value to the factored base year value, and enroll the lower of the two values.

We found no evidence in the files demonstrating that the public owner and private possessor had reached a mutual understanding or agreement, whether in writing or not, such that the stated term of possession should not be deemed to be the reasonably anticipated term of possession. Therefore, the assessor should use the stated term of possession to establish the base year value of the taxable possessory interest and then, for subsequent years, periodically review the taxable possessory interest for a possible decline in value using a declining term based on the remaining term of possession. If the assessor does have clear and convincing evidence to support using a term other than the stated term of possession, then the assessor should properly document that evidence in the file.

The assessor's practice of using a term of possession different from the stated term of possession is contrary to Rule 21 and may result in incorrect assessments.

Correctly calculate base year values for taxable possessory interests by including rent escalations in the value calculations when appropriate.

Rule 21(e)(3)(C)(a) provides, in part, that the economic rent of the subject taxable possessory interest may be estimated by reference to (1) the contract rent for the subject taxable possessory interest, (2) contract rents for comparable taxable possessory interests, (3) contract rents for comparable fee simple absolute fee interests in real property, or (4) contract rents for other comparable interests in real property. Therefore, when using a contract rent as specified in the lease agreement as economic rent to value a taxable possessory interest, the assessor should recognize and include as rental income any escalations in rent over the specified term of possession.

In addition, Rule 8(b) provides that when using the income approach, an appraiser values an income property by computing the present worth of a future income stream and that the present worth depends upon the size, shape, and duration of the estimated income stream. Thus, it is incumbent on the appraiser to consider the pattern of the income stream. The pattern may be level, variable or irregular, straight-line (constant amount) change per period, or exponential-curve (constant-ratio) change per period.

By not including escalations in the estimate of economic rents, the assessor may be underassessing these taxable possessory interests.

Reappraise taxable possessory interests in compliance with section 61(b)(2).

Section 61(b) provides that a change in ownership, as defined in section 60, includes the creation, renewal, extension, or assignment of a taxable possessory interest in tax exempt real property for any term. Section 61(b)(2) further provides that the renewal or extension of a taxable possessory interest during the reasonably anticipated term of possession used by the assessor to value the interest does not result in a change in ownership until the end of the reasonably anticipated term of possession. At that time, the assessor must establish a new base year value for the taxable possessory interest based on a new reasonably anticipated term of possession as determined by the assessor.

By not reappraising taxable possessory interests at the end of the reasonably anticipated term of possession used by the assessor to initially value the interest, the assessor is not in compliance with statutory provisions and may be enrolling incorrect assessments.

Periodically review all taxable possessory interests with stated terms of possession for declines in value.

Rule 21(d)(1) states, in part, "The stated term of possession shall be deemed the reasonably anticipated term of possession unless it is demonstrated by clear and convincing evidence that the public owner and the private possessor have reached a mutual understanding or agreement, whether or not in writing, such that the reasonably anticipated term of possession is shorter or longer than the stated term of possession. If so demonstrated, the term of possession shall be the stated term of possession as modified by the terms of the mutual understanding or agreement."

Rule 21(a)(6) defines the stated term of possession for a taxable possessory interest as of a specific date as "…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." Therefore, the stated term of possession declines each year. This may or may not have a material effect on the market value of the possessory interest. Thus, absent clear and convincing evidence of a mutual understanding or agreement as to a shorter or longer term of possession, the assessor must estimate the current market value of the taxable possessory interest on lien date based on the remaining stated term of possession, compare this value to the factored base year value, and enroll the lower of the two values.

Although the assessor is not required to reappraise all properties each year, the assessor should develop a program to periodically review assessments of taxable possessory interests with stated terms of possession to ensure declines in value are consistently recognized. Failure to periodically review taxable possessory interests for possible declines in value may cause the assessor to overstate the taxable value of a taxable possessory interest.

Deduct allowed expenses from gross income when valuing taxable possessory interests by the income approach-direct method.

Assessors' Handbook Section 510, *Assessment of Taxable Possessory Interests* (AH 510), provides that allowed expenses paid by the public owner should be deducted from the estimated economic rent. Rule 21(e)(3)(c) provides that the income to be capitalized in the valuation of a taxable possessory interest is the "net return" (as defined in subsection (c) of Rule 8) attributable to the taxable possessory interest.

A public owner will incur at least some management expense with each taxable possessory interest. Some lease agreements may require the public owner to pay for insurance, maintenance, or utilities. By not recognizing these allowable expenses and subtracting them from the gross income to be capitalized, the assessor may be overstating the value of these taxable possessory interests.

Use proper methods to develop the appropriate capitalization rate when valuing taxable possessory interests.

According to Assessors' Handbook Section 510, *Assessment of Taxable Possessory Interests* (AH 510), and consistent with Rule 8, a capitalization rate for valuing a taxable possessory interest may be developed using any of the following methods:

- By comparing the anticipated net incomes from comparable taxable possessory interests with their sale prices stated in cash or its equivalent and adjusted as described in Rule 21(e)(1)(A).
- By comparing anticipated net incomes of comparable fee simple absolute interests in real property with their sale 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.
- 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.

Also consistent with Rule 8(f), the capitalization rate should include a component for property taxes, where applicable. According to AH 510, when the landlord (lessor) is responsible for paying the property taxes, the capitalization rate should include a component for property taxes. However, if the tenant is responsible for paying the property taxes in addition to rent, the capitalization rate should not include a component for property taxes. With most taxable possessory interests, the possessory interest tax is paid by the tenant (lessee or possessor) in addition to rent and, therefore, the capitalization rate typically should not include a component for property taxes.

Using improper methodology to develop a capitalization rate when valuing taxable possessory interests may cause the assessor to apply an inappropriate capitalization rate and enroll incorrect assessments.

Add the present worth of unpaid future contract rents to the sale price of a taxable possessory interest.

The direct method of the comparative sales approach is one of the generally accepted methods for valuing a taxable possessory interest and is described in Rule 21(e)(1)(A). In this method, an important adjustment to the reported sale price is the addition of the present value of the unpaid future contract rent over the remaining term of possession.

When determining the value of a taxable possessory interest, appraiser must include the total consideration paid for the taxable possessory interest. To reach that amount, the appraiser must include future sums the purchaser has an obligation to pay. If this adjustment is not made, the value indicator will reflect only the buyer's equity value in the taxable possessory interest and not the full value of the taxable possessory interest, resulting in an underassessment.

Obtain current copies of all lease agreements or permits for taxable possessory interests.

Rule 21 describes the various approaches to value and how to determine the term of possession for the valuation of taxable possessory interests. Rule 21(d)(1) explains that the stated term of possession is deemed to be the reasonably anticipated term of possession except in certain situations. Rule 21(e)(3)(C) explains how to determine the net operating income for capitalization purposes.

These steps in the valuation process cannot be completed if the contract conveying the taxable possessory interest is not reviewed. For example, the assessor may have some information relating to the initial lease term, but may not know of any renewal options contained in the lease or know the lessor/lessee expense allocations.

By not obtaining copies of current leases or permits, the assessor is unable to determine what terms were agreed to between the parties and, therefore, would be unable to accurately value the taxable possessory interests.

Properly issue supplemental assessments for taxable possessory interests.

Taxable possessory interests, like other real property, are subject to supplemental assessment whenever there is a change in ownership or completed new construction. Section 61(b) provides that the creation, renewal, extension, or assignment of a taxable possessory interest is a change in ownership. Section 75.11 provides that there shall be a supplemental assessment following a change in ownership or completion of new construction. Assessors' Handbook Section 510, *Assessment of Taxable Possessory Interests* (AH 510), advises that the supplemental assessment amount for the newly created taxable possessory interest should be based on its fair market value without offset for a prior value on the regular assessment roll.

The assessor's failure to issue supplemental assessments is contrary to statute and results in unequal treatment of taxpayers.

Properly calculate supplemental assessments for taxable possessory interests.

Section 61(b) provides that the creation, renewal, extension, or assignment of a taxable possessory interest is a change in ownership. Section 75.11 provides that there shall be a supplemental assessment following a change in ownership or completion of new construction. According to Assessors' Handbook Section 510, *Assessment of Taxable Possessory Interests* (AH 510), when a supplemental assessment is issued due to a change in ownership, the supplemental assessment amount for the newly created taxable possessory interest should be based on its fair market value without offset for a prior value on the regular assessment roll when one taxable possessory interest is terminated during an assessment year and a second (but distinct) taxable possessory interest is created involving the same land and improvements during the same assessment year.

The assessor's failure to properly calculate supplemental assessments is contrary to statute and results in a loss of revenue.