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STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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January 13, 1984

No. 84/07

TO COUNTY ASSESSORS:

VALUATION OF PROPERTY SUBJECT TO SAFE HARBOR LEASES

In Assessors' Letter 82/68 (May 7, 1982), we discussed ownership, classification, and discovery of property subject to safe harbor leases. We also stated, without elaboration, that in most cases the historical cost approach is the apparent approach for the valuation of such properties. This letter discusses the issue of whether restrictions created by safe harbor transactions affect the value of property subject to the leases.

To recap the substance of a safe harbor lease, a taxpayer wishes to purchase new business property but has insufficient net income to benefit from investment tax credits or accelerated cost recovery (formerly depreciation) available for the property. The Economic Recovery Act of 1981 (Public Law 97-34) allowed the taxpayer and a qualifying "lessor" to set up a safe harbor lease, where the lessor holds title to the property for purposes of taking the investment tax credit and accelerated cost recovery. Several income tax regulations concerning sales-and-leasebacks, leveraged leases, passage of title to the lessee, etc., were liberalized or waived for qualifying safe harbor leases. However, the various qualifying requirements must be met during the term of the safe harbor lease to avoid specified income tax consequences.

Several taxpayers have argued recently that the market value of property subject to safe harbor lease is impaired. The primary reasons given are: (1) the property will command a lower-than-normal price in the market place because the purchaser cannot take investment tax credits or cost recovery (these income tax benefits are taken by the safe harbor lessor); and (2) if the property is sold to a person or corporation outside the United States (not subject to U.S. income taxes) while subject to safe harbor lease, specified income tax consequences are applicable. The latter restriction makes it difficult to sell a property that is not currently popular in the United States but would be salable in the international market.

We cannot agree that the existence of a safe harbor lease has any effect on the market value of property.

California assessors are required to appraise a property as though the property is unencumbered by leases, loans, liens, or other private restrictions. In other words, the value of a property is the value of all the rights and benefits that are capable of private ownership. The total market value of a property is not altered even though the owner conveys some of the rights to another party.

In the case of a safe harbor property, one party owns the right to take federal income tax deductions and to receive whatever payments are specified in the lease. The other party owns all title to the property except for the income tax ownership specified by the safe harbor statute. Either interest may be sold (subject to applicable safe harbor rules), but since neither the lessee nor the lessor has complete ownership of the property, neither party can hope to sell the property for a value equivalent to the fair market value of the entire property.

Divided equity in a property does not reduce the value of the property, and the assessment is not to be divided among the various parties who may have valuable interests in the property. In The Texas Company v. Los Angeles County, 52 Cal. 2d 55, the court stated:

> "Taxation of property at its value without regard to the owner's equity therein is an established principle of ad valorem taxation. Thus, a conditional vendee or a mortgagor is taxable at the full value of the property as its owner even though he could realize little or nothing by its sale."

In Stamps v. Board of Supervisors, 233 Cal. App. 2d 258, the court stated:

> "It is well settled that the assessment of a fee in land is not reduced by the encumbrances thereon."

The principles of valuation expressed in the above court cases apply to personal property as well as real property. Except where applicable property tax laws require a different standard, every property must be appraised at its fair market value without regard to the owner's equity in the property.

Restrictions on the use of a property may or may not affect the assessable value of the property. Restrictions that are enforceable by government, such as building codes, zoning, and open-space agreements, must be recognized by the assessor. Restrictions created by private agreement, such as leases, cannot be recognized for property tax assessment purposes (see Clayton v. Los Angeles County, 26 Cal. App. 3d 390).

In the case of a safe harbor lease, the lessor and lessee have agreed to the restrictions contained in the safe harbor statute in order to gain the specified income tax benefits. The federal government is not a party to the agreement and will not enforce the agreement. The government's only role in the lease is that if the property does not qualify for safe harbor during the entire term of the lease, the income tax benefits arising from the lease will be revoked. This income tax recapture is similar in principle to the recapture rules for investment tax credit (where the person who took the investment tax credit disposes of the property before a specified time), depreciation of real property in excess of straight line (upon sale of the asset, the excess depreciation is treated as ordinary income instead of long-term capital gain), or other income tax recapture rules. These income tax rules, of course, have nothing to do with the assessable value of property.

As we stated in our previous letter, the terms of a safe harbor lease may be important for determining whether or not a change in ownership has occurred, and who should be assessed for the property. However, safe harbor leasing has no bearing on the fair market value of the property for property tax assessment purposes.

Sincerely,

Verne Walton

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Assessment Standards Division

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AL-06-1193A/W-2