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January 21, 1994

TO COUNTY ASSESSORS:

FREEPORT-MCMORAN AND PROPERTY TAX RULE 8

Recently, our legal staff analyzed the issue of whether the holding in Freeport-McMoran Resource Partners v. County of Lake 12 Cal. App. 4th 634 (1993) can be applied in the assessment of commercial real property or whether Property Tax Rule 8, subdivision (d), is controlling. This issue arose because one assessor included an additional figure for excess rent in the determination of the apparently full cash value of an office building based on the holding in Freeport-McMoran. The taxpayer contended that Property Tax Rule 8 is the appropriate guideline because Freeport-McMoran deals specifically with geothermal plants and the relationship between long term fixed price electricity contracts and the determination of the plant's full cash value for assessment purposes.

The Freeport-McMoran case arose from a dispute regarding the property tax assessment of geothermal power plants owned by the appellant, Freeport-McMoran Resource Partners ("Freeport"). The county assessor calculated the income stream for the years of the contract by reference to the fixed energy price in the contract under which Freeport sold its electricity to PG&E at rates well above present market rates. Freeport's position was that the county overvalued the property by basing its assessment on capitalization of the income stream from fixed price contracts. Freeport contended that the assessor should use the market rate of electricity in the income approach. Specifically, the issue presented was not whether the assessor misunderstood or distorted the available data, but which of two possible methods of determining the income stream to be used in an assessment under the income approach to valuation was the more appropriate given the nature of the properties and industry in question.

The trial court found that the income approach was the appropriate method by which to determine the fair market value of the property, that the county assessor's and the county board of equalization's valuation method was valid, and that substantial evidence supported the board's determination concerning the proper application of the income approach to valuation. The Court of Appeal affirmed, holding that the full value of the property included projected income at the contract rates, rather than market rates, since a prospective purchaser would be willing to pay more for the plant with the existing contracts. The court further held that the contracts were the means by which the property was put to beneficial use for purposes of assessing the property's full value.

In reaching its decision the court specifically rejected Freeport's reliance on the Board of Equalization's Property Tax Rule 8, subdivision (d), which provides:

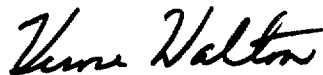
In valuing property encumbered by a lease, the net income to be capitalized is the amount the property would yield were it not so encumbered, whether this amount exceeds or falls short of the contract rent and whether the lessor or the lessee has agreed to pay the property tax.

The court explained that "Appellant extrapolates from this a rule that property must be valued without consideration of any type of contract pertaining to income to be derived from property. We are unwilling to accept appellant's broad interpretation. Rule 8, subdivision (d), is by its terms addressed specifically to leases; it serves the purpose of precluding potential manipulation by property owners of the taxable value of their property. (citations omitted). The present case presents no possibility of such manipulation, since the income to be generated by the property is fixed by contract terms that cannot be altered. Unlike leases (citations omitted) or deed restrictions (citation omitted), the contracts that determine the income to be produced by appellant's properties are regulated by the state and cannot be modified by the parties without governmental approval. In light of this regulation, capitalization of the income to be generated under the contract properly measures the value of appellant's property because it is the income a prospective purchaser of the property not only could anticipate but would be guaranteed." (Freeport-McMoran at p. 644).

In Freeport-McMoran the court dealt with site-specific commodity contracts known as standard offer 4 (S04) contracts. The S04 contracts were the means by which Freeport's properties were put to beneficial use and had to be considered in assessing the properties' full value. The court distinguished between S04 contracts and the leases referred to in Rule 8, subdivision (d), but it did not address Rule 8 as it applied to leases. Since the court did not relate its decision concerning S04 contracts to leases and did not in any way imply that its decision related to Rule 8 or to leases, in our view, Freeport-McMoran applies only to S04 contracts, not to leases. Thus, for property not subject to S04 contracts Rule 8 is controlling.

If you have any questions, please contact our Real Property Technical Services Unit at (916) 445-4982.

Sincerely,



Verne Walton, Chief  
Assessment Standards Division

VW:kmc