

## THE VALUATION OF LEASEHOLDS FOR AD VALOREM PROPERTY TAX PURPOSES— THE REASONABLE ASSESSOR STANDARD

When privately owned real estate is leased to a private person or to a non-tax exempt organization, the real property tax is usually assessed only against the lessor.<sup>1</sup> The lessor passes the lessee's share of the tax on to him through the annual rent.<sup>2</sup> When real estate is leased from a state or other tax exempt body,<sup>3</sup> however, no tax is passed on to the lessee, and questions arise whether the leasehold interest should be taxed separately, and if so how it should be valued.<sup>4</sup> These problems occur when a state or municipality offers a leasehold interest in public land to a private corporation in order to induce the corporation to locate within the governmental unit's boundaries.

A state which offers this sort of leasehold is making a very attractive offer to the corporation. First, if any corporation locates on land for which it must pay rent, the corporation is allowed a federal income tax deduction for rent as a business expense.<sup>5</sup> Further, if the corporation leases property from a tax-exempt organization certain other advantages accrue to it. Expansion or relocation aided by state financing is possible without heavy capital investment by the corporation since the state supplies the facility.<sup>6</sup> The state may raise money to aid the corporation by issuing industrial bonds with tax free interest. Income from bonds permits the state to charge the corporation a lower rent than a commercial lessor.<sup>7</sup> Finally, the corporation

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1. *Trimble v. City of Seattle*, 231 U.S. 683, 687 (1914); 2 T. COOLEY, *TAXATION* § 593 (4th ed. C. Nichols 1942).

2. *Kentucky Tax Comm'n v. Jefferson Motel, Inc.*, 387 S.W.2d 293 (Ky. 1965); *Phillips Chem. Co. v. Dumas Indep. School Dist.*, 159 Tex. 116, 316 S.W.2d 382 (1958), *rev'd*, 361 U.S. 376 (1959). Another reason given for not taxing both parties to the lease agreement is that it could be presumed that the leasehold interest had no value and therefore did not have to be taxed. *In re R.S. 54:4-16*, 21 N.J. Misc. 387, 34 A.2d 239 (Hudson County Cir. Ct. 1943).

3. Examples of other tax exempt bodies are the United States Government, municipalities, and religious, charitable, and educational organizations.

4. Kessling, *Property Taxation of Leases and Other Interests*, 47 CALIF. L. REV. 470 (1959).

5. INT. REV. CODE § 162(a)(3); P. ANDERSON, *TAX FACTORS IN REAL ESTATE OPERATIONS* 295 (2d ed. 1966).

6. Note, *The "Public Purpose" of Municipal Financing for Industrial Development*, 70 YALE L.J. 789, 790 (1961).

7. *City of Frostburg v. Jenkins*, 215 Md. 9, 136 A.2d 852 (1957). The rent is lower because, since the interest the state must pay is tax free to the recipient, it may be lower than normal commercial rates. If the state has to pay a low interest rate it does not have

may be free from ad valorem property tax assessed by a political body other than the lessor.<sup>8</sup>

Once the corporation signs the lease, the state must decide whether it will impose a property tax on the corporation, what the tax base will be, and what valuation method will be used. This note will discuss each of these problems with particular emphasis on the last one.

### I. TAXABILITY OF THE LEASEHOLD INTEREST

There are three different types of property tax exemption statutes: those exempting property in which the fee is owned by certain named public bodies regardless of the identity of the lessee or the use to which the property is put;<sup>9</sup> those exempting property used only for public purposes;<sup>10</sup> and those exempting only property owned by a public body *and* used for a public purpose.<sup>11</sup> The first type of statute presents no real problem. So long as the property is owned by an organization that fits within the statutory definition, the property is exempt.<sup>12</sup> The other two types are not so easily disposed of, however. It is not an easy task to define what use of the property constitutes a public purpose. Historically, tax exemptions granted to property used for public purposes were justified on the ground that to tax public property would result in a return to the public of public funds.<sup>13</sup> Exemptions were limited to property used for "public purposes," and public purpose was limited to such things as public roads and buildings that provided a direct and immediate benefit or convenience to the people.<sup>14</sup> Recently, however, some jurisdictions have expanded public purpose to include uses of property not strictly public in nature, but which arguably involve some public benefit.<sup>15</sup> With this extension, land leased to a private corporation for industrial and commercial development has been said to be fulfilling

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to collect as much rent to be able to pay off the debt and therefore the corporation benefits. *But see* Wall Street Journal, March 8, 1968, at 17, col. 1.

8. Note, *supra* note 6, at 790. Thus, even if one municipality leases the land to the corporation, another body such as a school district may tax it unless the lessor can persuade them to agree not to.

9. State *ex rel.* Meyer v. County of Lancaster, 173 Neb. 195, 113 N.W.2d 63 (1962); State *ex rel.* County Court v. Dumas, 148 W. Va. 398, 135 S.E.2d 352 (1964).

10. Board of Park Comm'rs v. Board of Tax Appeals, 160 Ohio St. 451, 116 N.E.2d 725 (1954).

11. Darnell v. County of Montgomery, 202 Tenn. 560, 308 S.W.2d 373 (1957).

12. *See, e.g.*, Mo. REV. STAT. § 137.100 (1949).

13. Schnell, *Real Property Tax Exemptions in Ohio—A Review and Critique*, 17 W. RES. L. REV. 824, 825 (1966).

14. Dysart v. City of St. Louis, 321 Mo. 514, 11 S.W.2d 1045 (1928).

15. Schnell, *supra* note 13.

a public purpose.<sup>16</sup> In these states the land is tax exempt to both the lessor and the lessee despite the fact that the lessee uses the land for his own profit. The public benefit that supports the finding of public purpose is the stimulation of the economy or the relief of unemployment.<sup>17</sup> Most jurisdictions, however, reject this rationale<sup>18</sup> on the ground that identity of property as public is lost when used for profit by a private corporation.<sup>19</sup> The majority also fear that corporations allowed to avoid taxes because they hold public leases may become a favored class<sup>20</sup> and secure unfair economic<sup>21</sup> advantage over competitors.<sup>22</sup> It is, of course, only in those states that deny the leasehold tax exemption that the problem of leasehold valuation arises.<sup>23</sup>

16. *City of Frostburg v. Jenkins*, 215 Md. 9, 136 A.2d 852 (1957); *Sublett v. City of Tulsa*, 405 P.2d 185 (Okla. 1965); *Holly v. City of Elizabethton*, 193 Tenn. 46, 241 S.W.2d 1001 (1951).

17. See cases cited in note 16 *supra*.

18. See, e.g., *Delta Air Lines, Inc. v. Coleman*, 219 Ga. 12, 131 S.E.2d 768 (1963); *Kentucky Tax Comm'n v. Jefferson Motel, Inc.*, 387 S.W.2d 293 (Ky. 1965); *Chun King Sales, Inc. v. County of St. Louis*, 256 Minn. 375, 98 N.W.2d 194 (1959); *State ex rel. Meyer v. County of Lancaster*, 173 Neb. 195, 113 N.W.2d 63 (1962).

19. *Delta Air Lines, Inc. v. Coleman*, 219 Ga. 12, 131 S.E.2d 768 (1963); *State ex rel. Meyer v. County of Lancaster*, 173 Neb. 195, 113 N.W.2d 63 (1962).

20. *Trimble v. City of Seattle*, 231 U.S. 683 (1914).

21. *City of Gaylord v. Beckett*, 378 Mich. 273, 144 N.W.2d 460 (1966); see *United States v. City of Detroit*, 355 U.S. 466, 470 (1958).

22. Many states decide borderline cases on the basis of public policy. They may reason that methods of assessing real estate are not adaptable, or workable, when they concern property in the nature of a leasehold. *Maricopa County v. Fox Riverside Theatre Corp.*, 57 Ariz. 407, 114 P.2d 245 (1941). Also when people have relied on the non-action of the taxing authorities no tax is imposed. *Id.* Further, courts argue that by taxing the lessee no benefit is really conferred upon the city because if there were going to be a tax, the rental would have been lowered accordingly, with no net benefit. Therefore, no tax is imposed. *People ex rel. Interborough Rapid Transit Co. v. State Bd. of Tax Comm'rs*, 126 App. Div. 610, 110 N.Y.S. 577 (1908), *aff'd*, 195 N.Y. 618, 89 N.E. 1109 (1909). A dissent in one case has gone so far as to argue that whether the lessee's property interest is taxable should be determined in a way similar to that used in determining whether he has an insurable interest in the land. If he has such an interest, the land should be taxed to him. *State ex rel. Potter v. Springfield Convention Hall Ass'n*, 301 Mo. 663, 675, 257 S.W. 113, 116 (1923) (dissenting opinion).

23. It should be noted that in making the decision to tax these leaseholds the state is giving up a possible preferred position in their ability to attract new industry to the state. If, however, the proposed treasury regulation eliminating the tax free treatment of industrial bonds is enforced, those states which do not grant the tax exemption will regain some lost ground in their ability to attract new industry into the state. See *St. Louis Post Dispatch*, March 13, 1968, § A, at 4, col. 6. But see 7 CCH 1968 STAND. FED. TAX REP. ¶ 6187A, at 71,158, (the Senate Finance Committee moved to attach a rider to the Tax Adjustment Bill of 1968 to counter the above Treasury proposal). In any case, this rule of taxation of leaseholds brings up problems as to whether the tax

## II. METHODS OF VALUATION

The courts have held that the leasehold must be assessed at market value—the amount a willing buyer, who is not obliged to buy, would pay to a willing seller, who is not obliged to sell.<sup>24</sup> Assessors have difficulty in assigning a monetary amount to this theoretical term. Although assessors use prescribed methods, much is left to their honesty, experience and familiarity with land values in the locality.<sup>25</sup>

Three methods are used to determine the market value of the lease: (1) comparison with recent sales of similar properties (the comparables method); (2) the historical or replacement cost (the cost method); (3) capitalization of income. It has been recommended,<sup>26</sup> although not yet required by statute, that the appraiser use all three methods and collate the results into a final value for the leasehold. Since all three values should be the same, this procedure places a check on the appraiser: a wide variation in values is a danger signal.<sup>27</sup>

The assessor, after finding the market value of the lease, must determine whether to deduct the actual rent being paid by the lessee. If rent is not deducted, the lessee will be taxed on the full value of what he possesses; if the rent is deducted, the tax will be imposed only on the premium value<sup>28</sup> of the lease.

The precise statutory language may determine whether rent should be deducted. If the statutory language is “full value”<sup>29</sup> or “full cash value,”<sup>30</sup>

rate for leaseholds is the same as for owners; and if not, at what rate leaseholds should be taxed. These questions are, however, beyond the scope of this note, which focuses only on the valuation process itself.

24. *Nellis Housing Corp. v. State*, 75 Nev. 267, 339 P.2d 758 (1959); *Queensbury Hotel Corp. v. Board of Assessors*, 33 Misc. 2d 302, 226 N.Y.S.2d 977 (Sup. Ct. 1962); *cf. Kentucky Tax Comm'n v. Jefferson Motel, Inc.*, 387 S.W.2d 293 (Ky. 1965); *Portland Canning Co. v. State Tax Comm'n*, 241 Ore. 109, 404 P.2d 236 (1965); *Sheraton-Midcontinent Corp. v. County of Pennington*, 77 S.D. 554, 95 N.W.2d 892 (1959); *Tuckahoe Woman's Club v. City of Richmond*, 199 Va. 734, 101 S.E.2d 571 (1958).

The value at which property is to be assessed has been described in the taxing statutes as “fair cash value,” KY. REV. STAT. ANN. § 132.190(3) (1963); “full cash value,” NEV. REV. STAT. §§ 361.025, .225 (1965); “full value,” N.Y. REAL PROP. TAX § 306 (McKinney 1960); “true cash value,” ORE. REV. STAT. §§ 308.205, .232 (1967); and “true and full value,” S.D. CODE §§ 57.0301, .0334 (1939).

25. *Delta Air Lines, Inc. v. Coleman*, 219 Ga. 12, 18, 131 S.E.2d 768, 772 (1963).

26. J. KNOWLES, JR. & J. PERVEAR, *REAL ESTATE APPRAISAL MANUAL* 6-19 (2d ed. 1966) [hereinafter cited as *KNOWLES & PERVEAR*].

27. *Id.* at 17.

28. “Premium value” is a term used to describe the market value of the lease minus contractual rent. It has also been called “bonus value.” See also notes 49 & 50 *infra*.

29. NEV. REV. STAT. § 361.025 (1965).

30. N.Y. REAL PROP. TAX § 306 (McKinney 1960).

the legislature probably intended that rent should not be deducted since to do so would be to value the property at less than its full market value. If instead a term such as "fair cash value"<sup>31</sup> appears, it might be argued that the legislature intended the use of a bonus value rather than the full value of the lease.

If the statute itself does not evidence legislative intent, policy reasons may be used to determine whether to deduct rent. An argument in favor of the deduction is that the tax should be imposed solely on the value which the lessor has not reserved for himself. Since the lessor retains the remainder interest plus the rent paid to him, all that can be taxed to the lessee is the present value of the lease less the rent.

On the other hand, it seems anomalous to hold a lease valueless merely because the lessee has agreed to pay what the lease is worth.<sup>32</sup> The fact that the market value of the lease is less than the rent agreed to be paid does not mean that the market value should not be used for tax assessments.<sup>33</sup> Property tax is on the land, not the owner;<sup>34</sup> that the owner (lessee) is paying a higher rent than the property is worth is no reason to tax him on less than its full value. Further, the tax is on the leasehold interest, not the whole property. Subtracting contractual rent from the full value of the property in essence attributes the rent to the lessor. Yet, property must be valued from the viewpoint of a willing buyer<sup>35</sup> who is interested not in the current rent, but only in the income produced by the property.<sup>36</sup> This is because a prospective lessee will not have to pay the same rent as the present lessee; because he will make his own bargain, he is interested in the full value of the lease, without deducting current rent. Since rent is, in reality, the purchase price of the lease, subtracting it from market value involves subtracting an amount similar to what the assessor is trying to determine.<sup>37</sup>

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31. KY. REV. STAT. ANN. § 132.290(3) (1963).

32. *Texas Co. v. County of Los Angeles*, 52 Cal. 2d 55, 60, 338 P.2d 440, 444 (1959).

33. It could be said that a non-exempt lessor who is imposing the lessee's share of tax as part of the rent should also take account only of market value of the leasehold and not impose a tax based solely on the rent. In other words, the lessee who rents from the taxable lessor is in a non-preferred position in that he will have a tax imposed on him regardless of whether there is a bonus value to the lease or not. The problem is that the lessor does not have the facilities or ability to determine a market value of the leasehold. The lessee must, therefore, be content to bear his share of the tax (as determined by the lessor) through his annual rent.

34. *United States v. City of Detroit*, 355 U.S. 466 (1958) (dictum).

35. *De Luz Homes, Inc. v. County of San Diego*, 45 Cal. 2d 546, 562, 290 P.2d 544, 557 (1955).

36. See text accompanying note 81 *infra*.

37. It must be remembered, however, that the initial determination of market value

### A. *The Comparables Method*

In the comparables method the property to be taxed is valued on the basis of the sale price of similar property recently sold.<sup>38</sup> The comparison property should be similar in the following respects: the remaining period of the lease;<sup>39</sup> the type of neighborhood;<sup>40</sup> the quality and type of construction;<sup>41</sup> the income produced by the property;<sup>42</sup> the type of business conducted on the property;<sup>43</sup> improvements on the property;<sup>44</sup> and the amount of annual rental.<sup>45</sup> After finding a sufficient number of sales of similar properties, the assessor derives the value of the leasehold being assessed by averaging the values of the comparison leaseholds.<sup>46</sup> The Missouri Supreme Court, in one of the rare cases that discusses the evaluation process in detail, has described use of the comparables method in assessing leaseholds in St. Louis airport property.<sup>47</sup> First, the assessor classified the space occupied into strictly airport-type space (hangar and terminal building space) and other types of space (office, cargo and shop space). The rentals for the office, cargo and shop space were compared with the rentals of other such property in the St. Louis area.<sup>48</sup> Next, the assessor compared the rentals of the terminals and hangars with the rentals for terminals and

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will be made according to the method of valuation selected by the assessor. The determination of whether rent should be deducted from market value to arrive at a bonus value is a purely supplementary decision which has nothing to do with the valuation process itself. For purposes of this note, rent was or was not deducted in the explanation of the various methods only for purposes of completeness and not to show what must or must not be done with respect to the valuation process.

38. KNOWLES & PERVEAR, at 35.

39. *Cf. State ex rel. State Highway Comm'n v. Douglass*, 344 S.W.2d 281 (Mo. Ct. App. 1961).

40. *See Bellingham Community Hotel Co. v. Whatcom County*, 190 Wash. 609, 70 P.2d 301 (1937); *cf. State ex rel. State Highway Comm'n v. Douglass*, 344 S.W.2d 281 (Mo. Ct. App. 1961).

41. *In re Melcroft Corp.*, 256 App. Div. 291, 10 N.Y.S.2d 27 (1939); *cf. State ex rel. State Highway Comm'n v. Douglass*, 344 S.W.2d 281 (Mo. Ct. App. 1961).

42. *In re Melcroft Corp.*, 256 App. Div. 291, 10 N.Y.S.2d 27 (1939); *see Bellingham Community Hotel Co. v. Whatcom County*, 190 Wash. 609, 70 P.2d 301 (1937).

43. *Cf. State ex rel. State Highway Comm'n v. Douglass*, 344 S.W.2d 281 (Mo. Ct. App. 1961).

44. *People ex rel. 379 Madison Ave. v. Boyland*, 281 App. Div. 588, 121 N.Y.S.2d 238 (1953).

45. *See In re Melcroft Corp.*, 256 App. Div. 291, 10 N.Y.S.2d 27 (1939); *Bellingham Community Hotel Co. v. Whatcom County*, 190 Wash. 609, 70 P.2d 301 (1937).

46. *St. Louis County v. State Tax Comm'n*, 406 S.W.2d 644 (Mo. 1966); AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS, *THE APPRAISAL OF REAL ESTATE* 355 (4th ed. 1964) [hereinafter cited as AIREA].

47. *St. Louis County v. State Tax Comm'n*, 406 S.W.2d 644 (Mo. 1966).

48. This was not necessarily other airport space, but rather general commercial office, cargo and shop space.

hangars in ten comparable airports. The airports chosen were the five immediately above and the five immediately below the St. Louis airport in number of enplanements. From these comparisons the assessor derived the "fair-rental value"<sup>49</sup> of the St. Louis airport facilities, which he compared to the rent actually paid<sup>50</sup> by the airlines. He defined the value of a leasehold interest in real estate as

the present worth of the rental savings where the contractual rent to be paid is less than the fair market value of the use and occupancy of the leased premises at the time of the appraisal; that is, where the fair market rental is higher than the contractual rental there is a rental saving, the value of which is determined by capitalizing the net annual rental savings over the remaining term of the lease.<sup>51</sup>

Since the contractual rental was greater than the economic rental, the value of the leasehold was zero.

The comparables method is often difficult to apply directly to leaseholds because of the lack of comparable properties with comparable leases. It is even more difficult to find a comparable recent sale because a lease rarely has a market value and is rarely sold.<sup>52</sup> However, the comparables method may be applied indirectly. The aggregate value of a leasehold and reversion should approximately equal the value of the entire property.<sup>53</sup> The comparables method is used to determine the value of the fee; actuarial tables are then used to apportion the value of the fee between the leasehold and reversion.<sup>54</sup>

### B. *The Cost Method*

The cost method is preferred when improved land is being assessed.<sup>55</sup> To determine the total cost of the property, the assessor adds the estimated value of the land to the depreciated cost of the improvements.<sup>56</sup> He then apportions the total cost to the lessee and lessor by means of appropriate tables.<sup>57</sup>

49. Fair rental value has also been referred to as "economic rent" which is defined as the amount of rent that could reasonably be expected if the property were currently available for rent. KNOWLES & PERVEAR, at 77; AIREA, at 397.

50. Actual rent has also been referred to as contractual rent; that is, the rent currently being paid by the lessee. *Id.*

51. *St. Louis County v. State Tax Comm'n*, 406 S.W.2d 644, 650 (Mo. 1966); accord, KNOWLES & PERVEAR, at 78; AIREA, at 409-12. *But see* note 37 *supra*.

52. *Kaiser Co. v. Reid*, 30 Cal. 2d 610, 184 P.2d 879 (1947).

53. AIREA, at 409; Keesling, *supra* note 4, at 482.

54. AIREA, at 396-410.

55. 1 J. BONBRIGHT, VALUATION OF PROPERTY 485 (1937) [hereinafter cited as BONBRIGHT].

56. *Id.*

57. AIREA, at 450-61.

The cost method is also applied by finding the difference between the contract rent reserved in the lease and the fair rental value of the remaining term.<sup>58</sup> To determine the fair rental value, the assessor first adds the depreciated cost of the building to the value of the land to get the present value of the whole facility. This figure is divided by the number of square feet in the building. When the quotient is capitalized at a given rate of return, the result is the fair market rental per square foot per year of the building. The assessor then computes the contractual rent per square foot by dividing the total rent reserved in the lease by the number of feet in the building. If the contractual rent is greater than the fair market rent, the market value of the leasehold is zero.<sup>59</sup> If the contractual rent is less than the fair market rent, the value of the leasehold is determined by multiplying the difference by the number of square feet and the number of years remaining in the lease.<sup>60</sup> The tax base is this sum reduced to present value.<sup>61</sup>

The assessor uses either accounting<sup>62</sup> or replacement cost.<sup>63</sup> While accounting cost is easy to ascertain,<sup>64</sup> it is not likely to reflect what a willing buyer would pay a willing seller because it takes no account of market changes that may alter the actual market value. Further, even though uniformity is a basic principle of accounting, the accountant must exercise judgment in deciding what is a capital item and what is a current expense.<sup>65</sup> If one accountant includes organizational expenses as part of the cost of the property, and another treats them as current expenses, the former property will seem more valuable than the latter. Therefore, if the appraiser uses accounting costs, his appraisals of similar leaseholds<sup>66</sup> may not be uniform unless he adjusts for variations in accounting methods.

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58. Note that in both the cost and comparables methods the difference between economic and contractual rent was determined. The difference in the two methods is how one arrives at economic rent.

59. See text accompanying note 51 *supra*.

60. *St. Louis County v. State Tax Comm'n*, 406 S.W.2d 644 (Mo. 1966).

61. Although this method of assessment was described in *St. Louis County v. State Tax Comm'n*, 406 S.W.2d 644 (Mo. 1966), the court rejected it since the assessor used an incorrect figure for the number of years remaining in the lease, and did not take into account the fact that the rent and depreciation of the buildings would change when the lease was renewed.

62. Accounting cost has also been termed historical cost and is the figure which the corporation assigns to the specific item on its books.

63. See notes 67-70, *infra*, and accompanying text.

64. BONBRIGHT, at 145.

65. C. MOORE & R. JAEDIGKE, *MANAGERIAL ACCOUNTING* 117 (1963).

66. BONBRIGHT, at 141-42.



There are three approaches to replacement cost:<sup>67</sup> (1) the substantially identical replica (identical replacement cost);<sup>68</sup> (2) the equally depreciated substitute (second-hand replacement cost);<sup>69</sup> (3) the most advantageous new substitute (best suitable replacement cost).<sup>70</sup> Replacement cost is a future cost and therefore may be too subjective to be valuable in tax assessment.<sup>71</sup> Taxes should be based on current values, not future values. Real estate appraisers have avoided this problem by figuring the replacement cost of a new building and deducting present physical deterioration and functional obsolescence to arrive at an identical replacement cost.<sup>72</sup> This method allows for market changes and also bases the valuation on what the lessee actually has at the time of the assessment.

### C. *The Capitalization of Income Method*

The capitalization of income method can be used in the absence of recent sales or of willing buyers and willing sellers on the market.<sup>73</sup> California is the only state which has adopted this method by statute.<sup>74</sup> Prior to the enactment of the statute, California first applied the capitalization of income method in *Blinn Lumber Co. v. Los Angeles County*.<sup>75</sup> Blinn had leased land for its lumber business from the city of Los Angeles. The court, in determining the value of the leasehold, imputed net income<sup>76</sup> from the use of the property and capitalized<sup>77</sup> it for the remainder of the term. This

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67. *Id.* at 152.

68. This is the amount required to replace the property and building new less book depreciation taken.

69. This is the amount required to replace the property and building with used material so that the structure is exactly the same as at the time the assessor is making his appraisal.

70. This is the amount required to replace the property and building with a totally new and modern facility in place of the present one.

71. BONBRIGHT, at 217.

72. KNOWLES & PERVEAR, at 24. Note that this is an identical replacement cost standard.

73. *Somers v. Meriden*, 119 Conn. 5, 174 A. 184 (1934).

74. CAL. GEN. LAWS ANN. § 107.1 (Deering 1963).

75. 216 Cal. 474, 14 P.2d 512 (1932).

76. Imputed income is found by estimating the market value of the fee, computing a reasonable return on the market value, and then finding the present value of that return received over the term of the lease. *County of Riverside v. Palm-Ramon Dev. Co.*, 63 Cal. App. 2d 534, 538, 407 P.2d 289, 292, 47 Cal. Rptr. 377, 380 (1965).

77. The rate of capitalization is a percentage figure arrived at by the assessor after he has considered such things as current interest rates, length of time left to run in the lease, the qualities of the property, and the stability of the value of the property. AIREA, at 269-87. In determining the capitalization rate, one would also make an allowance for risk which includes not only a mathematical risk factor, but also a psychological risk allowance. BONBRIGHT, at 262.

figure was then reduced to its present value.<sup>78</sup> In imputing net income, the court deducted amounts for the rental paid and for amortization of the lessee's improvements.

In *De Luz Homes, Inc. v. County of San Diego*,<sup>79</sup> Justice Traynor ordered several revisions of the capitalization method. The United States had leased land to De Luz Homes to supply military housing. The assessors used the *Blinn* valuation technique, but did not allow a deduction for rent in determining net income. Traynor upheld the assessor on this point, stating that neither rent nor amortization of improvements should be deducted in computing net income. Since income is determined by a capitalization rate that includes an allowance for amortization, subtracting amortization separately results in a double deduction.<sup>80</sup> No deduction for rent is permitted because the price a buyer will pay depends upon the net income he expects. His income does not depend upon the present lessee's rent because he will negotiate his own lease.<sup>81</sup>

Traynor further overruled *Blinn* by rejecting the use of imputed net income. He held that prospective net income should be used unless it could not be accurately estimated.<sup>82</sup> The capitalization method, as defined by Traynor, is a two-step process:

The first step in the process is to determine prospective net income and this is done by estimating future gross income and deducting therefrom expected necessary expenses incident to maintenance and operation of the property. . . . Since it is generally accepted that a person who agrees to receive payment in the future is entitled to interest both for waiting and the risk of partial or no receipt, the second step is to discount each future installment of income by a rate of interest that takes into account the hazards of the investment and the accepted concepts of a 'fair return.'<sup>83</sup>

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78. One may find present value by using tables which give the amount of money one must invest presently at a specified rate of return so that at the end of the lease the investor would have the capitalized figure determined.

79. 45 Cal. 2d 546, 290 P.2d 544 (1955).

80. *Id.* at 567-68, 290 P.2d at 558.

81. *Id.* at 566, 290 P.2d at 557.

82. *Id.* at 565, 290 P.2d at 556; *accord*, *People ex rel. Manhattan Square Beresford, Inc. v. Sexton*, 258 App. Div. 611, 17 N.Y.S.2d 585 (1940). See text accompanying note 76 *supra*.

83. *De Luz Homes, Inc. v. County of San Diego*, 45 Cal. 2d 546, 564-65, 290 P.2d 544, 556 (1955). An example of the capitalization of income method is given as follows. Assume property which when put to its most effective use produces annual rent of \$120 for three years at which time it becomes worthless. Expenses are \$20 per year. Assume further a 6% rate of return. Since net income is \$100 per year (\$120 less \$20), we must determine the present value of the total net income, \$300 (\$100 net income × 3 years):

The income method, unfortunately, is reliable only when the property itself is the income producer. In *De Luz*, for example, the rent from the housing supplied to the military was the only income. When industrial land is being assessed, the income does not stem solely from the land, but from such factors as skill of management, amount of goodwill, and sales volume. Since these factors are neither competent nor sufficient to establish a fair market value,<sup>84</sup> most courts hold that business profits are not a proper measure of the land value. Business profits are dependent upon too many factors having no real relation to the land itself, so that the profits cannot be said to be derived from the land.<sup>85</sup> This does not necessarily mean, however, that the capitalization of income method cannot be used when income is produced by a business on the land. California has solved this problem by using an imputed income analysis in valuing business property.<sup>86</sup>

The capitalization of income method is probably best suited for leasehold valuation because the mathematical formula leaves few judgments to the assessor's discretion. However, the majority of jurisdictions uses this method only when there is insufficient data with which to apply the comparables method.

#### CONCLUSION

The familiar phrase used to describe the value of a leasehold—what the willing buyer would pay the willing seller, neither being able to take advantage of the exigencies of the other<sup>87</sup>—is of no real benefit to the assessor. This maxim represents the ideal, which is difficult to attain in practice since there are actually few willing buyers or sellers of a specific property.<sup>88</sup>

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First year's rent	(\$100 × .8396)	=	\$ 83.96
Second year's rent	(\$100 × .89)	=	89.00
Third year's rent	(\$100 × .9434)	=	94.34
			277.30
Total value of the property			\$267.30

*Id.* at 568 n.7, 290 P.2d at 558 n.7.

84. *Aetna Life Ins. Co. v. City of Newark*, 10 N.J. 99, 89 A.2d 385 (1952).

85. *Assessors of Quincy v. Boston Consol. Gas Co.*, 309 Mass. 60, 34 N.E.2d 623 (1941). The relevance of such income may be used, however, to determine if any structural improvements, such as buildings, are suitable to the site; and whether full structural value of the building may be added to the value of the land. *People ex rel. Hotel Paramount Corp. v. Chambers*, 298 N.Y. 372, 83 N.E.2d 839 (1949).

86. *County of Riverside v. Palm-Ramon Dev. Co.*, 63 Cal. 2d 534, 407 P.2d 289, 47 Cal. Rptr. 377 (1965); CAL. GEN. LAWS ANN. § 107.1 (Deering 1963).

87. Note 24, *supra*, and accompanying text.

88. Pollock, *Improvements in Real Estate Assessment Techniques*, PROPERTY TAXES 248, 249 (1939).

The figure arrived at is usually a meaningless compromise between the owner's withholding price and a buyer's bidding price.<sup>89</sup>

As previously noted, California is the only state with a statutory scheme for leasehold valuation. Assessors in other jurisdictions employ an *ad hoc* approach, relying on the method they feel is most suited to the property in question. No matter how honest the assessor may be, however, different men are likely to disagree on the proper method to use, what factors to consider, and what weight to give the factors they choose.<sup>90</sup>

The courts have recognized that assessments are, at best, matters of the taxing official's opinion,<sup>91</sup> and valuations cannot be determined by mathematical formulae alone. Regardless of what factors are considered, no valuation can be absolutely correct. The courts apply the test that a valuation, when compared with others, must be uniform, equitable and just.<sup>92</sup> Since courts will not overturn an assessment unless it is so grossly excessive as to be entirely inconsistent with an honest exercise of judgment,<sup>93</sup> the other states should follow California's lead by enacting statutory standards. Assessors would no longer have the burden of deciding what method of valuation to use. They would be given a more firmly defined framework, and have, therefore, a less subjective task. Statutory standards would also reduce litigation by eliminating the possible inconsistencies of valuation method and the lack of uniformity within a given method.<sup>94</sup> There would still be controversies, but the issues of what method to use and how it works would be settled.

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89. *BONBRIGHT*, at 458. This analysis is true only if one accepts the idea that the property tax should be imposed on a going concern business concept rather than a bare value of the land concept.

90. *Kaiser Co. v. Reid*, 30 Cal. 2d 610, 625, 184 P.2d 879, 888 (1947).

91. *Cupples Hesse Corp. v. State Tax Comm'n*, 329 S.W.2d 696 (Mo. 1959); *May Dept. Stores Co. v. State Tax Comm'n*, 308 S.W.2d 748 (Mo. 1958).

92. *Yeoman Mut. Life Ins. Co. v. State Bd. of Assessment & Review*, 229 Iowa 320, 328, 294 N.W. 330, 335 (1940).

93. *May Dept. Stores Co. v. State Tax Comm'n*, 308 S.W.2d 748 (Mo. 1958).

94. Note 66, *supra*, and accompanying text.