Possessory Versus Leasehold Interest

By Walter R. Kuehnle, C.R.E.

A new term, *possessory interest,* purporting to describe a lessee's interest in tax-exempt real estate for ad valorem[1] tax purposes, has been coined in California. Use of the term and its application in this connection have resulted in confusion and misunderstanding of appraisal terminology and misapplication of appraisal principle. Assessment officials and courts in some other states have erroneously equated *possessory interest* with *leasehold interest* and have applied incorrect valuation procedures in appraising the market value of the lessee's leasehold interests in leases on tax-exempt property as required by constitution and/or statute.

CONFUSION OF TERMINOLOGY

Professional real estate appraisers and counselors do not object to the philosophy of taxation of tax-exempt property when leased to non-exempt entities. We do disagree, however, with efforts in some states to twist appraisal terminology and practice to accomplish this purpose by indirect methods—methods initiated by state departmental regulations or court decisions—rather than through open and forthright legislative measures to tax exempt property when leased to non-exempt entities.

How did the current situation come about? Many states of our Union have statutory ad valorem taxation of real estate. In some, leasehold interests are held to be taxable. Where tax-spending bodies are diligently seeking new sources of tax revenues, the California method of calculating the value of a lessee's possessory interest is an attractive potential source of revenue. Airlines, for example, are lessees of airport facilities from tax-exempt airport authorities, and have been a principal target.

EVOLUTION OF THE "POSSESSORY INTEREST" CONCEPT IN CALIFORNIA

In the State of California, by legal decision and later by statute, a calculated taxable possessory interest, which is greater than the market leasehold value in leased tax-exempt property, is assessed to the lessee. The effect of this

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has been to remove the tax exemption (except for a reversionary interest) of the lessor's interest when it leases its property to a non-exempt lessee. The justification for so doing is a matter of philosophy rather than appraisal technique and is a subject for another paper. However, I will observe in passing that the philosophy of exempting certain public bodies from the ad valorem tax is this: the financial advantage of tax exemption reduces the amount of taxes which these bodies must levy to cover their expenses. Tax-exempt lessors can exact a higher rental for their property from prospective lessees by passing on to them the advantage of tax exemption. California recognizes this by applying the new taxation of a possessory interest only to leases made after a fixed date. This frees lessees from double taxation when they have signed leases with public bodies which assumed complete tax exemption.

The term *possessory interest* is now a part of the California statutory property tax laws. The term is described in these laws *(Property Taxation 107)* as follows:

1) Possession of, claim to, or right to the possession of land or improvements, except when coupled with ownership of the land or improvements in the same person.
2) Taxable improvements on tax-exempt land.

Use of the term "possessory interest" in ad valorem tax law originated in the final decision of the California Supreme Court in the case of *DeLuz Homes, Inc. v. County of San Diego* (1955) 45 Cal. 2d 546. For the exact details the reader is referred to this case, but the outline of the circumstances is as follows: DeLuz Homes, Inc. contracted during World War II to build a "Wherry" housing project for the military. In order to assure lower rent to military personnel, the government leased a valuable site, which it owned, to a developer for fifty years at a nominal rental of only $100 per year.

DeLuz Homes, Inc., the lessee-developer, constructed a large apartment project on the site. Apparently the lessee claimed ad valorem tax exemption of the entire property—land and building—because the land was owned by the tax-exempt U. S. Government.

In this decision, the California Supreme Court rejected this concept and decided that when a tax-exempt lessor leases some of its real estate to a non-exempt lessee, the value of the interest leased becomes taxable to the lessee. The effect of this decision was to limit and substantially reverse the basic philosophy of tax exemption which is that leased property of public bodies, who must levy taxes to pay their operating costs, ought not to be itself taxed.

As a result of the DeLuz decision and subsequent statutes, the property of tax-exempt bodies remained exempt *only when used by the tax-exempt body itself.* As a result, the benefits of higher rentals which could be obtained by the exempt body from prospective lessees who would not be required to pay real estate taxes were eliminated. It follows that the loss of such higher rents is a charge which must ultimately be made up by additional taxes.

A further problem developed. Existing lessees who were paying these higher rents to the public body were now additionally required to pay real estate taxes. The lessee was thus paying double ad valorem taxes on the leased property. However, the State of California recognized this inequity when incorporating the decision of the DeLuz case into their property tax laws. The new law limited assessment of "possessory interests" in tax-exempt properties only to those leased subsequent to the date when decision on the DeLuz case became effective. (See. Cal. Stat. 107.1.) For pre-DeLuz decision leases, lessee's interests under existing leases from public bodies are still valued for ad valorem tax assessment on the basis of the value of the lessee's *leasehold interest,* computed in accordance with standard appraisal technique: the present value of the leasehold subject to all of the terms of the lease, *including* the lessee's obligation to pay rent. This differs from the calculation in post-DeLuz leases under which a lessee's *possessory interest* is calculated as its value subject to all of the terms of the lease *except* the lessee's obligation to pay rent.

In the DeLuz decision, Chief Justice Traynor described the case as actions to recover taxes, levied against "possessory interests" in tax-exempt land and improvements, and so forth. He states at 290 P. 2d 554-55: "Since non-exempt possessory interests in land and improvements, such as the leasehold estates involved in the present actions, are taxable property [citations omitted] they too must be assessed at 'full cash value.'" From this it appears that, by using the term "possessory interests," Chief Justice Traynor simply was trying to make his decision applicable to a broader array of property interests than just leasehold estates. It does not appear that he was trying to create anything different from what normally would be understood by the phrase "possessory interest."

Chief Justice Traynor decided that the conventional approach to valuing leaseholds and other possessory interests produced a result that was unacceptable, and so in his opinion he overruled the earlier decision of his court in *Blinn Lumber Co. v. County of Los Angeles,* 216 Cal. 474, 14 P. 2d 512, characterizing the conventional approach to valuation of leasehold interests as acceptable for appraisal or accounting purposes, but not for tax purposes.

Accordingly, the term "possessory interest," as first coined in California, seems to be used as a shorthand reference to the valuation approach espoused by Chief Justice Traynor in the DeLuz case. Of course, what he did say was that the leasehold estate should be valued by subtracting the value of the reversion from the value of the leased fee interest without taking into account the obligation of the lessee to pay rent. There does not appear to be any intent to say that the value so calculated constitutes a "possessory interest" that is different from a "leasehold." However, the Traynor approach is absolutely untenable as the proper method of valuing a leasehold interest because it attributes the right to collect rent to the tenant, whereas it is being paid by the tenant and properly belongs to the owner of the leased fee. Nevertheless, that is what Traynor did, and he has been copied by judges in other states who similarly desired to obtain tax revenue from leasehold estates *irrespective of their market value.*

The basic concept of the possessory interest has been to try to tax the market value of the property leased less the present discounted worth of the reversion of the property to the lessor at the end of the lease term. By twisting appraisal terms, certain states, their departments, and their courts have equated the value of a "possessory interest" (an interest all or partially owned by the lessor), coined and computed in California by law and statute, with the value of a leasehold interest (an interest owned by the lessee).

VALUATION OF LEASEHOLD INTERESTS IN OTHER STATES

Some states have a constitutional ad valorem basis of taxation of leasehold interests (according to their value) but have no legal basis for assessing possessory interests by the method proscribed by California statute. Efforts, successful in some states and not in others, have been made through court decisions to circumvent this lack of legal basis to assess possessory interests through this equation of the value of such computed possessory interest with the value of the lessee's leasehold interest, as was done by law in California. In appraisal practice the word "leasehold" is a term of specific meaning. The value of a leasehold interest, owned by the lessee, to be valued for taxation in most ad valorem states is the *market value* at which the lessee could sell his interest.

Appraisal Terminology and Handbook[2] defines a leasehold value as follows:

> The value of a leasehold interest; that is, right to the use, enjoyment, and profit existing by virtue of the rights granted under a lease instrument. The value of a leasehold interest is the present (discounted) worth of the rent saving, when the contractual rent at the time of appraisal is less than the current market rent. If land is improved by the lessee, then the value of the leasehold interest is the present value of the saving in ground rent, if any, in addition to the value (not cost) of the improvements of the lessee. If the contractual rent is greater than the currently established market rent, the present worth of the difference is subtracted from the value of the improvements.

The value of a leasehold interest is defined as:

> The market value of the property less the value of the lessor's interest.

In Illinois, Section 20 of the Revenue Act (in the part authorizing taxation) provides that "each taxable leasehold estate shall be valued at its fair cash value."[3]

The issue of the method of assessment of a taxable leasehold in Illinois was finally fully considered in a decision of the Illinois Supreme Court, *People ex rel. v. American Airlines,* 39 Ill. 2d 16-18. In this case the court held the lessee's leasehold should be valued for tax purposes at the capitalized value of the entire rental value of the property regardless of the rental which the lessee was paying. Judge Schaefer commented:

> "American, however, would have us construe Section 20 to authorize a tax upon the potential profit available upon assignment of that interest, *rather than upon the fair cash value* [emphasis added] of the interest. But, that is not what the statute says."

Here again we have "weasel" wording that confuses accepted real estate

appraisal terminology. The *fair cash value of the interest* to be valued is indeed the value of the interest of the lessee, his leasehold estate, when the statute provides it should be valued "at its fair cash value." This is in direct conflict with Justice Schaefer's comment that the statute does not accept as a valuation basis "the potential profit available upon assignment [sale] of the [lessee's] interest."

This prompts me to ask three questions:

1) What better measure of the fair cash value of the lessee's interest is there than its market value?
2) Would the price at which the lessee could sell his interest vary with the duration, rental, and other terms provided in his lease?
3) As the lessee owns only the leasehold interest in the lease, is it not the cash value of his leasehold interest that is to be valued for "ad valorem" real estate tax?

In Illinois, Section 26 of the Revenue Act (in the part authorizing taxation) was amended to provide that the land and improvements on exempt property "shall be listed as property of the lessee thereof, or his assignee, as real estate."[4] However, the Illinois Supreme Court held this to be a "use or privilege tax" and declared it to be unconstitutional.[5]

Therefore, the Illinois Supreme Court decision in the American Airlines case remains the present legal justification in Illinois for using the California "possessory interest" approach in computing a valuation of the leasehold interest in property owned by a tax-exempt lessor for ad valorem tax purposes.

In the State of Missouri the Supreme Court took the opposite view, i.e. that the value of the leasehold interest was its fair cash value in the market (for sale or assignment) considering the duration, rental, and other terms of the lease.[6]

So it may be noted that the term "leasehold interest," as defined in standard real estate appraisal practice, and the term "possessory interest," as defined under the California statutes (107), are not synonymous, and that in any particular case the difference between the computed value of a possessory interest, under the DeLuz decision method, and the actual fair market value of the lessee's leasehold interest may differ narrowly or widely.

VALUE OF LESSEE'S "POSSESSORY" AND "LEASEHOLD" INTERESTS DIFFER

Let us examine the DeLuz case as it applies to the valuation of real estate. As the exempt rental under the fifty-year lease was only $100 per year, the actual value of lessee's interest closely approximated the market value of the entire property, land, and building, less only the present worth of the U.S. Government's reversionary right to get the property back in fifty years. As the rental is nominal, so is the lessor's interest and the value of the leasehold was practically equal to the value of the entire property free and clear of the lease.

However, let us now assume that the circumstances were different. Suppose

the government constructed the apartment building on the land and leased the improved property to a lessee-operator at its fair current economic (full) rent. Now the lessee would have no bonus rental value in the lease and would own a leasehold interest with a market value of zero. Both the calculated value of the possessory interests and the true value of the lessee's leasehold interest, however, would be computed under the California concept at a figure that would almost equal the entire value of both land and apartment building. In this case the difference between the value of the lessee's *leasehold* interest and a *possessory* interest valuation (interest possessed), as computed by the California method, is practically equal to the entire value of the property free of lease. AIREA's textbook (6th edition)[7] has a comprehensive discussion on this point in the chapter on "partial interest."

Actually, it was not necessary to put forth the concept of "possessory interest" in the DeLuz case when the same objective and valuation would have been achieved by appraisal of the lessee's leasehold interest by correct leasehold valuation techniques. The reason for this is that a correct leasehold valuation method gives effect to only the fair market value of the lessee's leasehold interest subject to all of the provisions in the lease including the obligation to pay a stipulated rent. The California method of calculating a possessory interest value, however, gives effect not only to the market value of the interest of the lessee, but also to a principal interest of the lessor: the present worth of his right to receive the stipulated rent for the remaining term of the lease.[8] *Appraisal Terminology* defines the lessor's interest under a lease as follows:

> The present (discounted) value of the contract (lease) rents in addition to the present (discounted) value of the reversion; a leased fee.[9]

To summarize, the market value of the lessee's leasehold includes only the lessee's ownership. The "possessory interest" value calculation in California includes the market value of ownerships of both the lessee and the lessor. This is demonstrated in the following outline:

Leased Property Interest	Owned By	Resulting Value Is
1. Present worth of contract rent	Lessor	Positive
2. Present worth of reversion	Lessor	Positive
3. Present worth of bonus (or excess) rent	Lessee	Positive or negative
4. Total property value		Positive
5. Excess value (or penalty) due to favorable (or unfavorable) lease		Positive or negative

Only items 3 and 5 comprise the measure of the market value of a lessee's leasehold interest. The valuation of a lessee's "possessory interest" as computed in California, however, includes not only item 3, the market value of the lessee's leasehold interest, but also item 1, the market value of the lessor's right to receive the rent. This is demonstrated in the following hypothetical

examples showing values of interests of lessors and lessees with increasing and decreasing values (economic rent):

Example 1

Assume an owner and a prospective lessee agree on a 25-year lease of real estate with a market value of $100,000, for 25 years at an annual rental of $7,088. For simplicity, let us assume payable annually at end of year.)

Total property value	$100,000
Assuming a market interest rate of 7%, the value of the lessor's (owner's) interest may be calculated as follows:	
Present worth of 25 years' rental payments $7,000 x 11.654 (factor 7%, 25 years)	$81,600
Present worth of reversion (owner-lessor's right to recover the property free of lease in 25 years) $100,000 x .184 (factor 7%, 25 years)	18,400
Total value of the leased fee interest owned by the lessor-owner	$100,000
Value of the leasehold interest owned by the lessee	0

(See Figure A-*1.*)

Example 2

Now let us assume an *existing* lease where the remaining term and terms are the same as for the term of 25 years in *Example 1* but the property value and rental value have increased 10%. The value of the lessor's and lessee's interest in the current property value of $110,000 is as follows:

Total property value	$110,000
Present worth of 25 years' rental payments required by lessee (same as *Example 1*)	81,600
Present worth of reversion (owner-lessor's right to recover the property free of lease in 25 years) $110,000 x .184 (factor 7%, 25 years)	20,240
Total value of leased fee interest owned by owner-lessor	$101,840
Present worth of lessee's interest as a result of increase in property and resulting rental value $700 x 11.653 (factor 7%*, 25 years)	8,160
Total value all interests	$110,000

(See Figure A-*2.*)

*Same interest rate assumed for all interests. However, they may vary in an actual case.

Example 3

In this example the property value and rental value are 10% less with a remaining term and terms the same as in *Example 1.*

Total property value	$90,000
The value of the lessor's and lessee's interest in the current property value of $90,000 would now be as follows:	
Present worth of 25-year rental payments (Same as 1)	$81,600
Present worth of reversion (owner-lessor's right to get property back in 25 years) $90,000 x .184 (factor 7%, 25 years)	16,560
Total value of leased fee interest owned by lessor-owner	$98,160
Present worth of lessee's interest as a result of decrease in property value—negative ($700) x 11.653 (factor 7%, 25 years)	($8,160)
Total value all interests	$90,000

(See Figure A-*3.*)

FIGURE A

Chart Illustrating Division of Ownership
of Lessor and Lessee Under a Lease
with Increasing and Decreasing Value (Economic Rent)

1. Assume No Bonus Value in Lease

0 18.4 100 110

Current Total Value of Property—Combined Interests

V. of Rev	Value of Lease Rent

Present Value of Interest Owned by Lessor

2. Assume a 10% Increase in Property Value

0 20.4 100 110

Current Total Value of Property—Combined Interests

V. of Rev	Value of Lease Rent	Value (+) Int. LH

Present Value of Interest Owned by Lessor — Do by Lessee

3. Assume a 10% Decrease in Property Value

0 16.5 90 99.2 110

Current Total Value of Property—Combined Interests

V. of Rev	Value of Lease Rent	Value (Neg.) LH Interest

Present Value of Interest Owned by Lessor — (Neg.) Lessee

Assumptions:
1. No change in applicable risk interest rate.
2. Value of the property at reversion will be equal to current property value.
3. No depreciation of improvements.

REFERENCES

1. According to value.
2. American Institute of Real Estate Appraisers, *Appraisal Terminology and Handbook*, 5th ed. (Chicago: American Institute of Real Estate Appraisers, 1967).
3. Ill. Rev. Stat., ch. 120, par. 501 (1975).
4. *Ibid.*
5. *Dee-El Garage v. Korzen* 53 Ill. 2d 11 (1972).
6. *Frontier Airlines et al. v. The State Tax Commission of Missouri et al.*, 528 S.W. 2d 943-947.
7. American Institute of Real Estate Appraisers, *The Appraisal of Real Estate*, 6th ed. (Chicago: American Institute of Real Estate Appraisers, 1973), p.465.
8. The other is the right of reversion, i.e. repossession of the property at the end of the lease term.
9. *Supra*, note 2.