

Memorandum

To : Members of the Commission

Date : May 27, 1977

From : FAIR POLITICAL PRACTICES COMMISSION
Ted Prim

Subject: Valuation and reporting of leaseholds by the lessee.

Recently, the Commission asked the staff to consider the valuation and reporting of leasehold interests. This memo describes some of the ways that leasehold interests are valued in other contexts and comments on the relevance of these methods to the Political Reform Act.

The Internal Revenue Service has devised rules for valuing leasehold interests when the leasehold has not been purchased for a specific sum. Thus, if a taxpayer inherits a leasehold interest and subsequently sells it, the IRS needs to know the basis for the leasehold interest so that gain or loss from the sale can be computed. The general rule is that the value of the leasehold (lessee's interest) is the amount that a purchaser having a choice of lease of some other comparable property would be willing to pay to acquire the lessee's interest. Under this standard, a lease has value if the current rent is less than the amount that would be paid if a new lease were negotiated. The value of the lease is the present discounted value of the difference between the actual annual lease payments and the amount of annual lease payments which could reasonably be expected if the lease were renegotiated, times the number of years remaining in the lease. In effect, this approach provides that a lease has no value if both the lessor and the lessee are receiving full value at the time of evaluation. This approach is designed only to measure the amount of appreciation or depreciation in the value of the leasehold interest.

The IRS approach may have some relevance, however, to the Political Reform Act since the Act only requires that the equity interest in real property must be disclosed, i.e., the value of the real property minus liabilities against the property. One could argue that the value of the leasehold interest is the value of the lease (including appreciation) minus the liability of rental payments. If this approach were adopted, most leases would probably go unreported.

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The Commission must determine whether it is consistent with the policy and the language of the Political Reform Act to conclude that the phrase "any leasehold interest" as used in Section 82033 was intended to refer only to an appreciation in the value of a lease.

An alternative approach is that used by the Franchise Tax Board to calculate what portion of a corporation's assets are attributable to California. For the purpose of computing the corporation's assets, leasehold interests are capitalized at eight times the annual rental fees. See Revenue and Taxation Code Section 25130. Thus, a building which the corporation leases for \$125,000 a year is capitalized as a \$1,000,000 corporate asset for the purposes of the above-mentioned formula. This provision, unlike the provision of the Internal Revenue Code discussed above, suggests that a leasehold interest has value even if the interest has not appreciated since the inception of the lease.

For inheritance and state individual tax purposes, leases generally are assigned a value of zero regardless of whether they have actually appreciated. However, if a lease has been prepaid by the decedent, the lease will be taxed according to the value of the prepayment. This standard appears to be of little assistance in solving the problem before the Commission. For purposes of the Political Reform Act, it would seem to make little difference whether rental payments were made on a one-, three- or six-month advance basis.

Doubtless, there are other ways of treating leasehold interests in still different circumstances. However, these few examples should be illustrative of the fact that leasehold interests may be viewed in many different ways. Accordingly, the staff recommends that the Commission choose a way of valuing leasehold interests which is reasonable in light of the policies of the Act. Specifically, we suggest some variation of the approach taken in the Snyder letter.

The staff's informal advice letter of March 24, 1977, to attorney B. B. Snyder of Santa Cruz set forth a standard for evaluating a renewable one-year non-assignable lease. The letter advised that the value of such a lease was equal to the total rent payments paid during the one-year term. Thus, the letter impliedly advised that the value of a similar lease for a ten-year period would be the total rent payments for the full ten-year term. In this latter instance, the value of the lease may be overvalued since this standard does not reduce the total rent payments for the ten-year term to the present discounted value of such

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funds. However, on the other hand, this standard does not take into account the possible appreciation in the leasehold's value during the ten-year period.

The Snyder approach is premised on the notion, that for purposes of the Political Reform Act, the value of the leasehold interest is the value of the use of the property during the term of the lease. It is the cost of this "use" which the lessee logically could be expected to protect in his capacity as a decision-maker; that is, a lessee who is paying \$1,000 a month for the use of certain property will not want the value of that property to depreciate to \$700 since such a decline would mean that the lessee was paying an inflated price for the leasehold interest and that the property was no longer as suitable for the intended use. In short, the lessee may be expected to protect his interest by insuring that the property appreciates or, at least, keeps pace with inflation.

If the Commission agrees with the basic concept in the Snyder letter, but thinks that the standards set forth therein would be misleading with respect to long-term leases, it may wish to consider the following approach. The nature of the interest could be disclosed as a "ten-year leasehold" and the value as "annual rent payments of more than \$10,000" in the case of a ten-year \$1,000 per month lease. This approach has the advantage of achieving disclosure of the interest without requiring the filer to either assign an unrealistically high value to the interest or attempt to compute the present discounted value of the total lease payments.

Alternatively, if the Commission disagrees with the approaches suggested above, it could direct the staff to address questions involving leasehold interests on a case by case basis until some general standards can be formulated. Very few leasehold questions have arisen since the Act took effect and we may wish to gather more factual information before promulgating a policy on valuing leaseholds.

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