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TAXATION—PROPERTY—ASSESSMENT OF LEASEHOLD INTERESTS IN PUBLICLY-OWNED LANDS FOR PURPOSES OF THE *Ad Valorem* PROPERTY TAX—VALUE NOT TO BE REDUCED BY THE EXTENT OF INDEBTEDNESS.—*Pier 67, Inc. v. King County*, 78 Wash. Dec. 2d 48, 469 P.2d 902 (1970).

Plaintiff, a lessee of state-owned, tax-exempt harbor land,[1] brought an action to recover personal property taxes paid under protest to defendant county Plaintiff contended that defendant county was obliged to follow the long-standing rule that the value of a leasehold of tax-exempt real property for *ad valorem* property tax purposes equals its benefits less its burdens, including mortgage indebtedness and rent reserved.[2] The trial court found for the plaintiff and ordered the leasehold reassessed. The Washington Supreme Court affirmed.[3] The standards used by the defendant county in reassessing the leasehold were then challenged by the plaintiff on substantially the same grounds. The trial court once again found for the plaintiff and the defendant county appealed. The Washington Supreme Court, overruling a line of precedent, reversed. *Held*: leaseholds of tax-exempt land[4] are properly assessed by determining their market value using the same standards employed in assessing property generally with no deductions allowed for rent reserved or mortgage indebtedness. *Pier 67, Inc., a/k/a Edgewater Inn v. King County*, 78 Wash. Dec. 2d 48, 469 P.2d 902 (1970).

The *ad valorem* property tax in Washington is limited by the state constitution to provide that all taxes on the same class of property shall be uniform and that all non-exempt property in the state shall be assessed at fifty percent of its true and fair value in money [5] R.C.W § 84.40.030 requires the assessor to value each piece of property "at

1. State and federally owned property as well as that of counties, school districts, and other municipal corporations are constitutionally exempted from tax liability in Washington. WASH. CONST. art. VII, § 2.
2. "Rent reserved" refers to that portion of the rent for the entire term which has yet to be paid.
3. Pier 67, Inc., a/k/a Edgewater Inn v. King County, 71 Wn. 2d 92, 426 P.2d 610 (1967).
4. Hereinafter a leasehold of tax-exempt land will also be referred to simply as a "taxable leasehold." The term is appropriate in view of the theory of unit assessment under which the possessory leasehold interest in non-exempt property is not subject to direct taxation. *See* text accompanying notes 12-16, *infra*.
5. WASH. CONST. art. VII, §§ 1, 2.

such price as he believes the same to be fairly worth in money at the time such assessment is made."[6] The section further specifies that "the true cash value of property shall be that value at which the property would be taken in payment of a just debt from a solvent debtor." Beyond this the statute does not prescribe the method of assessment, and in practice the assessor uses one or more of three conventional methods of property valuation:[7] the comparative market data approach;[8] the cost approach;[9] and the income approach.[10]

Additional considerations arise in dealing with property under a lease agreement creating both possessory and reversionary interests. R.C.W. § 84.40.030 provides that "taxable leasehold estates shall be valued at such price as they would bring at a fair, voluntary sale for cash."[11] This provision applies only to leasehold interests in tax-exempt property, however, since the Washington Supreme Court has long recognized the rule of unit assessment[12] which provides that where both lessor and lessee are non-exempt, the assessment is based on the entire estate[13] and charged automatically to the lessor.[14] Although the state does not apportion the tax between the possessory and reversionary interests the burden is nonetheless indirectly distributed by means of the lease agreement,[15] the lessee's share being reflected in the amount

6. WASH. REV. CODE § 84.40.030 (1961).

7. *See* 1968 WASH. U.L.Q. 136. For administrative guidelines in Washington see WASH. ADMIN. CODE § 458.12.305 (1969).

8. Valuation using the comparative market data approach is based on recent sales data for similar property. *See* 1 J. BONBRIGHT, THE VALUATION OF PROPERTY (1937); 1968 WASH. U.L.Q. 136, 141.

9. Under the cost method of valuation, the value of the land is added to the original cost of improvements less depreciation. *See* 1968 WASH. U.L.Q. 136, 142.

10. Chief Justice Traynor of the California Supreme Court explains the income method as follows:

> According to this method, the value of property is the sum of anticipated future installments of net income from the property, less an allowance for interest and the risk of partial or no receipt. . . . "It involves a capitalization or discounted valuation of the realized or prospective net monetary income derivable by continuous exploitation rather than by resale" 1 Bonbright, The Valuation of Property, p. 230.

De Luz Homes, Inc. v. County of San Diego, 45 Cal. 2d 546, 290 P.2d 544, 556 (1955).

11. WASH. REV. CODE § 84.40.030 (1961).

12. *See* Trimble v. Seattle, 64 Wash. 102, 116 P. 647 (1911), *aff'd*, 231 U.S. 683 (1914); Alaska Land Co. v. King County, 77 Wn. 2d 247, 461 P.2d 339 (1969).

13. WASH. ADMIN. CODE § 458.12.325 (1969).

14. *Id.* The justification for unit assessment lies in the advantage to the state in being able to enforce the tax against a single party, the lessor, by means of a lien on the property. *See* Keesling, *Property Taxation of Leases and other Limited Interests*, 47 CALIF. L. REV. 470, 476 (1959).

15. Trimble v. Seattle, 64 Wash. 102, 104, 116 P. 647, 648 (1911).

of rent he pays. A taxable leasehold, therefore, is one which must be taxed directly because the lessor is exempt. In this event the rule of unit assessment places the entire tax liability upon the primary lessee,[16] with sublessees, if any, carrying their share of the burden by private arrangement.

Two issues involving the assessment of taxable leaseholds were raised by the Pier 67 controversy. The first was a question of the county's right to assess improvements on leased land rather than the leasehold itself. The second and more notable issue involved the standards of valuation to be used in the event the leasehold itself is assessed. The misunderstanding surrounding these issues stems largely from R.C.W. § 84.04.080, Washington's statutory definition of personal property for tax purposes. This statute is an aggregation of numerous small parts passed from time to time to meet specific legislative ends and recodified in 1961.[17] The portions of interest in the principal case are these:

> "Personal property" for the purpose of taxation, shall be held and construed to embrace and include . . . all leases of real property and leasehold interests therein for a term less than the life of the holder; [and] all improvements upon lands the fee of which is still vested in the United States, or in the state of Washington; . . . Provided, that . . . no deduction shall hereafter be made or allowed on account of any indebtedness owed.

Considering the provisions of R.C.W. § 84.04.080 chronologically one begins with the provision enacted in 1891 which classifies as taxable personal property "all improvements upon lands the fee of which is still vested in the United States, or the state of Washington."[18] In the principal case it formed the basis of the county's contention that it had the right to tax improvements made by the plaintiff at their cost in lieu of taxing the leasehold itself. The Washington Supreme Court, however, reviewed the section together with other sections of the same revenue act and decided that the legislature had intended to include as separate taxable personal property only those improvements

16. Clark-Kunzl Co. v. Williams, 78 Wash. Dec. 2d 59, 64, 469 P.2d 874, 877 (1970).

17. Ch. 15, § 84.04.080, [1961] Wash. Sess. Laws 1100-01, now codified as WASH. REV. CODE § 84.04.080 (1961).

18. Ch. 140, § 3, [1891] Wash. Sess. Laws 280.

on tax-exempt land which were "in the possession of a homesteader or a vendee of the state."[19] Since the interests of a vendee or homesteader are clearly distinguishable from those of a lessee, the court rightly concluded that the county could tax only the leasehold itself.[20]

In 1906 *Moeller v. Gormley*[21] brought before the Washington Supreme Court a challenge of King County's right to levy any tax whatever on the lease of state-owned tideland in Seattle. The court ruled that those portions of article VII, section 2 of the Washington constitution which exempt state property from taxation were not meant also to exempt a leasehold of state land which vests the lessee with rights and privileges amounting to private property. The court held, however, that rather than being taxed as personal property the lease was to be assessed as real estate since it was an "interest in lands."[22] In classifying taxable leases as real property the court foresaw difficulty because of the inadequacy of enforcement procedures under existing laws,[23] but the legislature responded the next year by unequivocally making "all leases in real property and leasehold interests therein" personal property for tax purposes.[24] Although these actions of the court and legislature were intended to cover only leaseholds of tax-exempt lands, the wording of the statute is categorical, and has from time to time been interpreted as authority for avoiding the unit assessment rule.[25] This view, however, has been clearly and consistently rejected by the Washington Supreme Court[26] and we are left with the conclusion that only leaseholds of tax-exempt land, as distinguished from leaseholds generally, are subject to direct *ad valorem* taxation specifically as personal property.

The second major question, that of which valuation standards were to be used in assessing taxable leaseholds, first reached the Washington Supreme Court in *Metropolitan Bldg. Co. v. King County*,[27] the first

19. Pier 67, Inc., v. King County, 78 Wash. Dec. 2d 48, 53, 469 P.2d 902, 906 (1970).
20. *Id.* at 54, 496 P.2d at 907.
21. 44 Wash. 465, 87 P. 507 (1906).
22. *Id.* at 469, 87 P. at 508.
23. *Id.*
24. Ch. 108, § 1, [1907] Wash. Sess. Laws 206.
25. Clark-Kunzl Co. v. Williams, 78 Wash. Dec. 2d 59, 61, 469 P.2d 874, 876 (1970).
26. *Id.* at 63, 469 P.2d at 877; Alaska Land Co. v. King County, 77 Wn. 2d 247, 253, 461 P.2d 339, 343 (1969).
27. 62 Wash. 409, 113 P. 1114 (1911).

of four cases dealing with the University of Washington's old campus in downtown Seattle.[28] Plaintiff, lessee of the state-owned tract, brought the action to prevent the county from valuing the leasehold by measuring lessee's investment over the duration of the term. The lease up to that time had proven unprofitable and plaintiff sought to have the assessment based on present actual value. The court held for the plaintiff, saying:[29]

> In determining the worth of a leasehold, the courts have universally held that it is the value of the term less the rent reserved. The value of the term is fixed with reference to present as well as prospective conditions, not speculative, but actual.

In the second and third *Metropolitan Bldg. Co.* cases,[30] decided in 1911 and 1913, the court added a further reduction allowance for mortgage indebtedness to the valuation formula in apparent contradiction to an explicit statutory prohibition of deductions for indebtedness. The last sentence of R.C.W. § 84.04.080, enacted in 1907, before the first *Metropolitan Bldg.* case, provides that "no deduction shall hereafter be made or allowed on account of any indebtedness owed."[31] This statute was ignored by the Washington Supreme Court until the fourth and final opinion dealing with the Metropolitan Tract, *in re Metropolitan Bldg. Co.* [32] In that case the court acknowledged that the meaning of the statute was an issue, but refused to modify the doctrine developed in the three earlier cases, reasoning that deduction for indebtedness could still be validly allowed as a shorthand means

28. Metropolitan Bldg. Co. v. King County, 62 Wash. 409, 113 P. 1114 (1911). *See In re* Metropolitan Bldg. Co., 144 Wash. 469, 258 P. 473 (1927); Metropolitan Bldg. Co. v. King County, 72 Wash. 47, 129 P. 883 (1913); Metropolitan Bldg. Co. v. King County, 64 Wash. 615, 117 P. 495 (1911).

29. *Metropolitan Bldg. Co.*, 62 Wash. at 410, 113 P. at 1114 (1911).

30. *See* note 28, *supra.*

31. WASH. REV. CODE § 84.04.080 (1961). Both the origin and purpose of this "no-deduction" provision are frequently misunderstood. The clause quoted in the text did not appear specifically in response to the problem of assessing taxable leaseholds. Rather it developed as a corollary to the rule that mortgages and certain other intangible interests are not treated as personal property for tax purposes. Deduction for the indebtedness of a mortgagor is inappropriate where the mortgagee is not taxed on his intangible interest under the mortgage agreement. This is made more apparent upon consideration of both portions of the proviso which qualifies WASH. REV. CODE § 84.04.080 (1961):

> *Provided,* that mortgages, notes, accounts, certificates of deposit, tax certificates, judgments, state, county, municipal and taxing district bonds and warrants shall not be considered as property for the purpose of this title, and no deduction shall hereafter be made or allowed on account of any indebtedness owed.

32. 144 Wash. 469, 258 P. 473 (1927).

of amortizing the lessee's investment in improvements which, when completed, become the property of the state.[33] Thereafter the issue did not come before the state supreme court until the first *Pier 67, Inc.* appeal in 1967. At that time the court reaffirmed its earlier position allowing the deduction, stating simply that the last *Metropolitan Bldg. Co.* case post-dated the statutory "no-deduction" provision and was therefore a valid precedent.[34]

In the principal case the Washington court reversed the lower court finding that the plaintiff's leasehold had no value because net earnings were temporarily exceeded by the sum of rent and mortgage payments due, and expressly overruled the *Metropolitan Bldg. Co.* cases and the first *Pier 67, Inc.* case, which had been decided only three years earlier. The court held that the *Metropolitan Bldg. Co.* cases had mistaken a lessee's equity, which is useful in determining damages in eminent domain proceedings, for the taxable value of the use and possession of the leasehold throughout the remainder of the term. Since the property tax is properly levied on use rather than profitability no deduction should be made except for burdens which directly and particularly affect use, such as zoning restrictions. The court further indicated that although R.C.W. § 84.40.030 does not require the use of a particular method of valuation, the no-deduction provision of R.C.W. § 84.04.080 is sufficiently clear to demonstrate that the legislature did not approve the valuation standard used in the *Metropolitan Bldg. Co.* cases.[35] In an effort to clarify the matter the court stated that the remaining life of the lease, and renewal rights were the kinds of factors to be considered in the valuation process. The chief responsibility for determining market value continued to rest with the assessor, however, and his determination, the court held, would not be upset unless there existed overvaluation so gross as to amount to fraud.[36]

The decision to abandon the standards formulated in the *Metropolitan Bldg. Co.* cases is sound. Several other states have taken

33. *Id.* at 476-77, 258 P. at 476.

34. Pier 67, Inc., a/k/a Edgewater Inn v. King County, 71 Wn. 2d 92, 97, 426 P.2d 610, 613 (1967).

35. Pier 67, Inc., v. King County, 78 Wash. Dec. 2d 48, 56-57, 469 P.2d 902, 908 (1970).

36. *Id.* at 58, 469 P.2d at 909.

similar steps in recent years,[37] and the trend toward eliminating special treatment for taxable leaseholds has received favorable comment.[38] Moreover, a liberal reading of the uniform taxation provision of the Washington constitution leads to the conclusion that special assessment standards for taxable leaseholds are inappropriate.

A problem with the holding which causes some uneasiness however, is the implicit assumption that under the earlier assessment standard leasehold taxpayers enjoyed an actual economic advantage which could equitably be withdrawn by changing the assessment standards. Unfortunately this assumption is not universally true. The rents now paid may reflect the value of the former tax advantage, and the lessee may be unable to apportion his new tax burden among his sublessees. In short there may not have been any actual economic advantage to withdraw. The short-run fairness of the principal case, then, can only be measured by asking, as to individual leases, who actually benefited under the earlier standard and whether they or someone else should assume the newly imposed burden.

Looking at the question from this perspective one would typically hope to find a situation in which the state's lessee pays rent roughly equal to the rent payments minus *indirect* taxes paid by the lessee of comparable private property. In such a case only the lessee (and his sublessees) would have been the beneficiary of reduced taxes under the old standard and would have operated with an economic advantage over the lessee of similar private property. It is true that fixed sublease agreements may present difficulties in distributing the new burden between lessee and sub-lessees. The rule of unit assessment requires the state to tax the principal lessee and allow the burden to fall as it may according to private arrangement. Until the sublease agreements can be modified the total burden will fall upon the principal lessee.

A more difficult situation arises where the state's lessee has agreed to pay a higher rent because of anticipated tax benefits. Here the state or a particular public lessor has shared in the economic advantage

37. *See* Bade v. Drachman, 4 Ariz. App. 55, 417 P.2d 689 (1966); Texas Co. v. Los Angeles County, 52 Cal. 2d 55, 338 P.2d 440 (1959); De Luz Homes, Inc. v. County of San Diego, 45 Cal. 2d 546, 290 P.2d 544 (1955); People *ex. rel.* Kucharski v. Trans World Airlines, Inc., 43 Ill. 2d 174, 251 N.E.2d 225 (1969); Portland General Elec. Co. v. State Tax Comm'n, 249 Ore. 239, 437 P.2d 827 (1968).

38. *See, e.g.*, Keesling, *Property Taxation of Leases and other Limited Interests*, 47 CALIF. L. REV. 470 (1959); 1968 WASH. U.L.Q. 136.

under the old valuation scheme by collecting rent in excess of what the property itself, exclusive of tax considerations, is worth.[39] It is of questionable fairness to hold lessees in this situation to payments of inflated rent under contracts entered into prior to the second *Pier 67, Inc.* decision, while also requiring them to pay the additional tax.

Aware of the problem of fairness, the Washington legislature has acted to delay, until the assessment year 1973, the full impact of *Pier 67, Inc.* House Bill 493, enacted during the 1st extraordinary session of the 42d legislature, amends R.C.W. 84.04.030 to provide that:[40]

> Notwithstanding any other provisions of this section or of any other statute, when the value of any taxable leasehold estate created prior to January 1, 1971 is being determined for assessment years prior to the assessment year 1973, there shall be deducted from what would otherwise be the value thereof the present worth of the rentals and other consideration which may be required of the lessee by the lessor for the unexpired term thereof: PROVIDED, That the foregoing provisions of this sentence shall not apply to any extension or renewal, made after December 31, 1970 of the term of any such estate, or to any such estate after the date, if any, provided for in the agreement for rental renegotiation.

The new legislation is further intended to facilitate renegotiation of state leases by authorizing "public lessors", at their option, to agree to modifications of leases whereby the new tax burden is absorbed by the public lessor in return for concessions from the lessees on other terms such as the duration of the lease.[41]

Following the leading California case, *De Luz Homes, Inc. v. County*

39. The test to determine who enjoyed economic advantage under the old standard involves two steps: first, economic rent, that is, the full amount paid for comparable private leases, must be determined; second, the amount of the new tax burden should then be subtracted from economic rent to produce a second figure, the value of the lease exclusive of all tax considerations. Then to the extent the state collected rent in excess of the second figure it has shared the benefit, and to the extent the lessee paid rent less than the first figure, or economic rent, it has shared the benefit. This approach has not yet been used to measure a significant number of leases but the hue and cry raised by both lessors and lessees in the wake of the principal case suggests that the question of who benefited is a complicated one differing from case to case.

40. Ch. 43 [1971] Wash. Laws, 1st Ex. Sess.

41. Section 5 of House Bill 493, Ch. 43, § 5, [1971] Wash. Laws, 1st Ex. Sess., provides:

> *NEW SECTION*. Sec. 5. A state agency, municipal corporation, or political subdivision (hereinafter referred to as "public lessor") which has entered into, prior to the effective date of the act, as lessor, a lease of real or personal property (including

of San Diego,[42] the California legislature enacted a statute[43] making application of the newly approved "no-deduction" rule prospective only. Leases and sub-leases of exempt property were to come under the new rule only as they expired and were renegotiated. Thus, uniform compliance with the "no-deduction" rule was made to await the expiration of the lease with the longest remaining term entered into prior to the decision in *De Luz Homes*. The law was subsequently upheld by the California Supreme Court.[44]

Washington's legislative response, while providing immediate short-term relief, avoided the disadvantages of the California approach. Uniformity was not unreasonably delayed and, under the authorization to renegotiate at will, public lessors are encouraged to distinguish between lessees who are genuinely injured and those who are not. However, the statute may be subject to the challenge that it violates the state constitution either as a non-uniform and unequal rate of assessment and taxation,[45] or because it constitutes an extension of the state's credit.[46]

Pier 67, Inc. will no doubt have the desirable long-term effect of standardizing state lease agreements and assessment standards so that no one receives an economic bonus at the expense of property tax revenue. House Bill 493 mitigates the immediate effect of placing an immense tax burden on lessees of exempt land. It also calls for further legislative review of methods and procedures used in assessing taxable leaseholds.[47] Because the correctness of *Pier 67, Inc.* is established by

any permit, concession agreement or other type of agreement essentially comparable to a lease) may agree to a modification of the provisions of such lease in order to allow, in whole or in part, the absorption by the public lessor of any property tax imposed upon the leasehold interest, if the lessee agrees to a suitable modification of the provisions of such lease with respect to the duration or other terms of such lease for the benefit of the public lessor; and for the purpose of allowing such modifications with respect to the duration of the lease a public lessor is authorized, if it finds it to be beneficial to itself, to extend the term of such lease for a period not to exceed five years beyond any otherwise applicable statutory limitation.

42. 45 Cal. 2d 546, 290 P.2d 544 (1955).

43. CAL. REV. & TAX. CODE § 107.1 (West 1957).

44. Forster Shipbuilding Co. v. County of Los Angeles, 54 Cal. 2d 450, 353 P.2d 736 (1960).

45. *See* WASH. CONST. amend. XIV.

46. *See* WASH. CONST. art. VIII, § 5.

47. Section 4 of House Bill 493, ch. 43, § 4, [1971] Wash. Laws, 1st Ex. Sess., provides:

NEW SECTION. Sec. 4. The legislative council in conjunction with the Department of Revenue shall review methods and procedures for the assessment and valuation of taxable leasehold estates and shall present recommendations with respect thereto to the legislature, not later than the next regular session.

the court's reasoning, and by the prevalence of the no-deduction view in other jurisdictions, the legislature should now focus on equitable implementation of the new standard and resist any further attempt to compromise the effect of the case.