STATE OF MICHIGAN

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JAMES J. BLANCHARD, Governor

DEPARTMENT OF TREASURY

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TO: Assessing Officers
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FROM: State Tax Commission

This bulletin contains direction from the State Tax Commission regarding several areas of assessment administration.

1. Clarification of approval of cost schedules published by Marshall and Swift Company.
2. The 1985 inflation rate for calculating the constitutional millage reduction rates for 1985.
3. Assessable status of LP Gas Tanks owned by an LP Gas Company.
4. Exemption of fish harvesting and wood harvesting equipment.
5. Exemption of Solar Energy Conversion devices after December 31, 1983.
6. Local assessment of communication equipment which is not exempt by virtue of assessment by the State Board of Assessors.
7. Discussion of the assessment of property which involves leases, considering the provisions of 1983 Public Act No. 254.

Attachments

(1)

APPROVAL FOR ASSESSING OFFICERS TO USE: MARSHALL VALUATION SERVICE AND MARSHALL & SWIFT RESIDENTIAL HANDBOOK WITH STATE TAX COMMISSION DEPRECIATION AND ECONOMIC CONDITION FACTORS

At its meeting on December 27, 1984 the State Tax Commission clarified its approval of the use of two manuals pursuant to section 211.721 of the Michigan Compiled Laws. The two manuals have the same publisher and have frequently been identified incorrectly by reference.

The Commission approved the use of the "Marshall Valuation Service" for the appraisal of commercial and industrial property. The Commission approved the use of the "Marshall and Swift Residential Cost Handbook" for the appraisal of residential property.

Commission approval included the cost schedules in the Marshall Valuation Service and the Marshall and Swift Residential Cost Handbook, but the Commission requires that the depreciation tables and the procedures for determining the Economic Condition Factors (ECF) be from the Michigan Assessor's Manual.

(2)

1985 INFLATION RATE

The inflation rate for determining the constitutional millage reduction fraction for local units of government for 1985 is 1.043. The 1985 millage reduction formula is:

$$\text{1985 MRF} = \frac{\text{(1984 SEV - LOSSES)} \times 1.043}{\text{1985 SEV - ADDITIONS}}$$

1985 Compounded MRF = 1984 Compounded MRF x 1985 MRF
(The compounded MRF for any year cannot exceed 1.0000.)

(3) LP Gas Containers, Assessable as Personal Property

It is the position of the State Tax Commission that the containers for Liquid Petroleum Gas leased or otherwise made available by a firm to homeowners, industrial, commercial, and other users are subject to assessment to the owner of such containers.

The containers must be shown on the personal property statements which are to be submitted annually by owners of assessable personal property. The containers are assessed where located on tax day.

The State Tax Commission position recognizes the judgment of the Michigan Tax Tribunal case, Docket Number 32006, Fuelgas Company, Inc. vs City of Midland, and the subsequent affirmation of the Tribunal decision by the Court of Appeals, Docket Number 53538, August 27, 1981.

(4) Personal Property Exemptions for Fish Harvesting and Wood Harvesting Equipment

Pursuant to section 211.9(j) of the Michigan Compiled Laws, as amended by Public Act 206 of 1984, property used specifically to harvest or raise fish is exempt from taxation.

Also, pursuant to the new section 211.9(q), added by Act 206:

> "All equipment used exclusively in wood harvesting, but not including portable or stationary sawmills or other equipment used in secondary processing operations."

shall be exempt from taxation.

> " . . . wood harvesting means the clearing of land for forest management purposes, the planting of trees, and all forms of cutting or chipping of trees and the loading of them on trucks for removal from the harvest area."

The effective date of this Act is July 9, 1984.

These exemptions would apply to the 1985 assessment and all following assessments.

(5) Solar, Wind or Water Energy Tax Exemption Certificates

A number of assessing officers have observed that the solar energy exemption provided by section 211.7h of the Michigan Compiled Laws has ended and that the State Tax Commission continues to issue exemption certificates. That may require clarification.

The language in section 7(h)(9) is as follows:

> "(9) A new solar, wind or water energy tax exemption certificate shall not be issued for a solar, wind, or water energy conversion device if installation of the device is completed after December 31, 1983. All exemptions granted shall remain in force unless revoked under subsection (7)."

The Commission has issued 3,482 solar energy exemption certificates in 1984, but in each case the application stated that installation was completed on or before December 31, 1983. There may also be a few certificates issued in 1985 for installations that are claimed to have been installed by December 31, 1983.

If the assessing officer finds that a device for which an exemption certificate was issued was installed after December 31, 1983, the exemption should not be honored.

(6) Local Assessment of Non-Regulated Telephone Equipment

The deregulation of customer premises equipment (CPE), together with the divestiture by AT&T of the Bell operating companies has created situations where property previously assessed by the State Board of Assessors and previously exempt from local taxation will now be assessed at the local level.

These situations are:

1. All CPE has been transferred from Bell operating companies to a division of AT&T, AT&T Information Services (ATTIS). This was required by the divestiture agreement. All CPE (telephones and more sophisticated terminal equipment) was transferred as of January 1, 1984 from Michigan Bell, an Ameritech Company, to ATTIS. The State Board of Assessors has determined the CPE equipment owned by ATTIS is to be reported to the local assessing officers and assessed at the local level. ATTIS had acquired some property prior to 12/31/83 and this was reported as personal property in approximately 160 Michigan governmental units in 1984.

2. CPE owned by telephone companies other than ATTIS will still be assessed by the State Board of Assessors as long as the telephone companies retain ownership. However, if the telephone company establishes a separate corporation to manage CPE, the property owned by this separate corporation is to be assessed at the local level.

(6)
Cont'd

A situation not involving the deregulation of CPE and the AT&T divestiture is the establishment of a new type of mobile telephone system known as a cellular phone system. It consists of a group of short range transmitters and receivers (computer controlled) with associated towers connected by leased telephone lines to a Mobile Telephone Switching Office (MTSO). Two franchises are issued in each service area to create a competitive situation. The mobile telephone equipment in the vehicles is owned by the customer. The State Board of Assessors has determined the equipment owned by a cellular phone company is to be assessed at the local level. There are presently two systems starting operation in the metropolitan Detroit area. One is named Detroit SMSA Limited Partnership, and the other is Detroit Cellular Telephone.

(7) <u>1982 PA 539 and 1983 PA 254 and Property Tax Appraisal Procedures</u>

Historic Review:

Prior to PA 539 of 1982, the definition of cash value as stated in MCL 211.27(1) directed the assessor to consider present economic income of structures. The 1981 Michigan Supreme Court decision, CAF Investment Co. versus Saginaw Township, defined what the term present economic income meant as the law existed at that time. This decision stated that economic income meant actual income and that under CERTAIN conditions actual income had to be used in the income approach to value. The conditions the court specified were: (1) the property is subject to a long-term lease; (2) the lease rent and terms were at the prevailing levels for the time the lease was made.

Public Act 539 of 1982, which was not effective until after the 1983 tax day, added subsection (4) to the cash value definition of section 27 of the General Property Tax Act (Act 206, PA of 1893, MCL 211.27). Act 539 revised the cash value definition and allowed the assessor to consider the use of market rent in valuing leased or rented property. This act also stated that actual income should not be controlling in all cases. Therefore, Act 539 provided for assessing to the landlord as real property both leasehold interests due to rent differences and leasehold interests due to tenant-installed building improvements.

Public Act 254 of 1983 also amended the General Property Tax Act by amending section 211.27(4) as previously added by 1982 PA 539, and also by amending section 211.8 by adding subdivisions (h), (i), and (j). The amendment to section 211.27(4) became effective before the tax day for 1984 and grand-parented protection for properties which were encumbered by leases which were not made or renegotiated after December 31, 1983.

The following is a partial review of some important effects that Acts 539 and 254 have on actual income, market rents, leasehold interests due to rent differences and building improvements, and nonprofit cooperative housing.

(7) Cont'd

Section 211.27(4), Cash Value of Property; defined:

According to 1982 PA 539:

1. In relation to the cash value definition in 211.27, subsection (1), "present economic income," means in the case of leased or rented property the ordinary, general, and usual economic return realized from the lease or rental of property negotiated under current, contemporary conditions between parties equally knowledgeable and familiar with real estate values.

2. The actual income of property shall not be the controlling indicator of its cash value in all cases.

According to 1983 PA 254:

1. MCL 211.27 as it existed prior to PA 539 of 1982 and PA 254 of 1983, applies when appraising a property which is subject to a lease entered into prior to January 1, 1984, and whose rental rate or tax liability has not been renegotiated after December 31, 1983. It also applies when appraising nonprofit cooperative housing whose regulatory agreement was entered into prior to January 1, 1984.

   MCL 211.27 as it existed prior to PA 539 and 254 was interpreted by the courts to say that the assessor must use actual income when appraising a property subject to a long-term lease which was at market rent and terms for the time it was made. Long term is generally considered to be 10 years or more.

2. Therefore, this section perpetuates, or grandparents, an exclusion of taxation on leasehold estates due to rent differences between market and contract rent on some existing improved properties. This exclusion resulted from court decisions defining present economic income as actual income when using the income approach appraisal method.

3. This section provides an end, or sunset, of the tax exclusion for property subject to a lease entered into after December 31, 1983, or subject to an existing lease whose rental rate or tax liability was renegotiated after December 31, 1983.

4. For all property leased or rented after December 31, 1983, or whose tax liability or rental rate was renegotiated after December 31, 1983, all real property items should be assessed as real including leasehold interests due to rent differences and leasehold interests due to tenant-installed leasehold improvements.

5. For "nonprofit cooperative housing," the actual income must be used for valuing projects by the income approach if the regulatory agreements with the state or federal government were entered into prior to January 1, 1984 (see #1 above).

(7)
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Section 211.8, Personal Property; defined. (Sections added by 1983 PA 254)

Subdivision (h)--Deals with tenant-installed leasehold improvements.

1. Leasehold improvements and structures installed and constructed on real property by the lessee are assessable as personal property, during the tenancy of the lessee. Provided that:

    A. The leasehold improvements add to the true cash value of the real property in spite of an existing lease agreement.

    B. The leasehold improvements value is not otherwise included in the assessment of the real property or assessed under subdivision (j).

2. Leasehold improvements assessed under this subdivision shall be assessed to the lessee.

3. The cost of the leasehold improvements on real property shall not be the sole indicator of value.

4. This subdivison only applies to value that is not included in the assessment of the real property as provided under section 211.27.

Subdivision (i)--Deals with a Leasehold Estate (LHE) created in a sandwich lease situation.

1. A sublessor's (1st tenant's) LHE is assessable as personal property where the sublessor receives net rentals in excess of net rentals required to be paid by the sublessor to the lessor (landlord).

2. This subdivision shall not apply when as follows:

    A. The rent difference is attributable to leasehold improvements which are already assessed under subdivision (h) or (j).

    B. The LHE is included in the assessment of real property.

3. An assessable LHE shall be considered to be owned by the lessee (usually a first tenant or sublessor) receiving such additional net rentals.

4. A sublessee (or second tenant) in possession (occupying the property) shall be required to provide the assessor with the name and address of its lessor (i.e., the sublessor or first tenant).

5. Taxes levied on such LHE shall become a lien against the rentals paid by the sublessee (second tenant) to the sublessor (first tenant).

(7)
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Subdivision (j)--Deals with Leasehold Estates (LHE).

This subdivision provides for the assessment of the lessee's leasehold estate created by the difference between contract and market rentals.

Subdivision (j) does not apply as follows:

1. To the extent the value is included in the assessment of real property as provided under section 211.27.
2. To property leased prior to January 1, 1984 for which the rental terms or the tax liability have not been renegotiated after December 31, 1983.
3. Nonprofit housing cooperatives.

Valuation and Assessment of Tenant-Installed Leasehold Improvements as Personal Property

It has become commonplace in the rental of various types of real estate for a tenant to lease unfinished (shell) space and then pay to finish that space to meet his or her requirements with his or her personal funds. Usually, leases state that these tenant-installed leasehold improvements become the property of the landlord upon installation. When the law allows, these leasehold improvements should be assessed as part of the real property and reflected in the appraiser's estimate of market rent when doing an income approach appraisal.

In certain instances where the courts have determined that the law does not allow these leasehold improvements to be assessed as real property, they may be assessed as personal property to the lessee as provided by P.A. 254 of 1983. The law reads as follows:

> "For the purposes of taxation, personal property shall include:
>
> "(h) During the tenancy of a lessee, leasehold improvements and structures installed and constructed on real property by the lessee, provided and to the extent the improvements or structures add to the true cash value of the real property notwithstanding that the real property is encumbered by a lease agreement, and the value added by the improvements or structures if not otherwise included in the assessment of the real property or not otherwise assessable under subdivision (j). The cost of leasehold improvements and structures on real property shall not be the sole indicator of value. Leasehold improvements and structures assessed under this subdivision shall be assessed to the lessee."

(7) Cont'd The law sets forth several cautions to be considered by the assessor. Leasehold improvements may be assessed as personal property to the lessee:

1) During the tenancy of a lessee.

2) To the extent the improvements or structures add to the true cash value of the real property in spite of the fact that the property is encumbered by a long-term lease.

3) To the extent not included in assessment of the real property.

4) To the extent not assessed under 211.8(j).

5) Provided the cost shall not be the sole indicator of value.

In accord with these cautions, the following is one possible method of valuing leasehold improvements for assessment as personal property. This method assumes we are dealing with a multi-tenant property such as a shopping center.

1) Value leasehold improvements by cost new less depreciation method, taking care to include only those items which add to the true cash value of the real property. Cost new may be actual reported costs such as when the tenant is a first tenant in a shell space. Cost new may be actual costs as adjusted for items which do not contribute to value such as the cost to remove a previous tenant's walls. Cost new may be historic costs trended to the present. Cost new may be determined through the use of a cost manual.

2) Select the property depreciation rate to apply to the cost new figure. The appraiser must consider what the nature of the leasehold improvements are and whether they will add value beyond the term of the lease plus options. Frequently, these leasehold improvements are finish items such as floor cover, wall cover, etc., which may have a shorter life than the life of the structure as a whole.

3) Appraise the total real property (excluding leasehold improvements discussed in 1) and 2) which are to be assessed as personal) by all applicable approaches to value.

4) Reconcile these approaches to value into a final value estimate.

5) Divide the Cost Approach from 3) answer by the final value estimate from 4) to obtain a ratio.

6) Multiply the various leasehold improvements cost new less depreciation estimates to be assessed as personal from 1) and 2) by the ratio established in 5). These will be the leasehold improvements value conclusions to be included on the various lessees' personal property statements.

7) For future years, trend these personal property cost new estimates to the current cost level; deduct depreciation; and again multiply by the ratio from 5) above.