PSTATE OF CALIFORNIA

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April 18, 2003

RE: ***Application of Section 68 – Comparable Property***

Dear Mr. :

This is in reply to your letter of August 14, 2002 in which you submitted additional information regarding your client's replacement property and requested clarification of the responses provided in our August 7, 2002 legal opinion concerning the comparability requirements under Revenue and Taxation Code section 68 and Property Tax Rule 462.500. The facts and questions posed in your letter are restated below, followed by our responses. Specifically, you request that we clarify our answers to Questions 2 and 3 contained in our letter dated August 7.

Facts Presented

A public entity acquired property from your client, the taxpayer. That property had been leased by the taxpayer to an automobile dealership—a commercial use—and it included land and improvements. The purchase price paid by the public entity for the property taken was $10.5 million. The property taken was zoned industrial and had a total adjusted base year value of $4.7 million, allocated $2 million to the land and $2.7 million to the improvements. Both the property taken and the replacement property are/were operated by the taxpayer as income-producing investment property.

Law and Analysis

1. **After the public entity acquired the property taken, the taxpayer built replacement improvements on land that it had already owned prior to the acquisition. You ask whether those new improvements may qualify as replacement property.**

   Yes. New improvements built on land already owned by the taxpayer at the time of condemnation will qualify as "replacement property" if they meet the requirements of Revenue and Taxation Code section 68 and Property Tax Rule 462.500

As you are aware, section 68 generally provides that taxpayers who purchase property to replace comparable property from which they are displaced may transfer their adjusted base year value from the property taken to the replacement property. See the uncodified note to section 68 reciting the Legislature's findings and declaration in this regard. Section 68 provides in part:

> For purposes of Section 2 of Article XIII A of the Constitution, the term "change in ownership" shall not include the acquisition of real property as a replacement for comparable property if the person acquiring the real property has been displaced from property in this state by eminent domain proceedings, by acquisition by a public entity, or by governmental action which has resulted in a judgment of inverse condemnation.
>
> The adjusted base year value of the property acquired shall be the lower of the fair market value of the property acquired or the value which is the sum of the following:
>
> (a) The adjusted base year value of the property from which the person was displaced.
>
> (b) The amount, if any, by which the full cash value of the property acquired exceeds 120 percent of the amount received by the person for the property from which the person was displaced.

While section 68 excludes certain acquisitions of real property from the definition of "change in ownership," it does not directly address whether new improvements built to replace property taken by the government are eligible for property tax relief. Property Tax Rule 462.500, the regulation that interprets and implements section 68, controls whether those improvements are also eligible for relief under section 68. Subsection (f) of Property Tax Rule 462.500 provides:

> Any new construction required to make replacement property comparable to the property taken shall, to that extent, be eligible for property tax relief, if such new construction is completed after March 1, 1975, and if it is completed on or after the earliest of the dates listed in subdivision (g)(3), and if a timely request is made for assessment relief.

Thus, under subsection (f) newly constructed improvements may qualify for relief. As indicated in our prior letter, the Legislature's findings and declaration for section 68 and the comparability requirements in Rule 462.500 do not prohibit the transfer of the base year value of a property taken—consisting of land and improvements—to a replacement property consisting of only improvements.

However, as indicated in the facts provided in your letter dated June 3, 2002, the taxpayer owned the land on which the replacement improvements were built *prior* to the date that the public entity began the process to acquire the original property. That land does not qualify as a

"replacement property" since the taxpayer acquired the land outside the qualifying time limits for relief. Subsection (g)(3) provides that:

> Replacement property shall be eligible for property tax relief under this section if it is acquired after March 1, 1975, and if it is acquired on or after the earliest of the following dates:
>
> The date the initial written offer is made for the replaced property by the acquiring entity;
>
> The date the acquiring entity takes final action to approve a project which results in an offer for or the acquisition of the replaced property; or
>
> The date, as declared by the court, that the replaced property was taken.

Because the taxpayer acquired the land prior to the earliest of the acquisition event dates provided in subsection (g)(3) of Rule 462.500, the taxpayer may not claim that land as replacement property for the purposes of section 68.

Despite the ineligibility of the land, the new improvements built on that land as replacement improvements would qualify for the base year value transfer if they were built on or after the earliest of those dates and provided that they meet the requirements of comparability and ownership.

2. <u>May the entire base year value of the property taken, consisting of both land and improvements, be transferred solely to land or solely to improvements?</u>

<u>Yes. As indicated in our prior letter, the Legislature's findings and declaration that accompany section 68 and the comparability requirements in Rule 462.500 do not prohibit the transfer of the base year value of a property taken--consisting of land and improvements-- to a replacement property consisting of only improvements, since there is no prohibition or restriction on allocation of the base year values.</u>

Based on the facts provided, the *property from which the taxpayer was displaced* was income-producing investment property (land and improvements) and the *property acquired* by the taxpayer is likewise income-producing investment property (newly constructed improvements on land already owned by the taxpayer). Under the facts presented, the portions of your client's property eligible for the base year value transfer are the newly constructed improvements.

Improvements built on that land as replacement improvements would qualify for the base year value transfer if they were built on or after the earliest of those dates and provided that they meet the requirements of comparability and ownership. Subsection (f) of Rule 462.500 provides that:

> [a]ny new construction required to make replacement property comparable to the property taken shall, to that extent, be eligible for property tax relief . . . if [such new construction] is completed on or after the earliest of the dates listed in subdivision (g)(3), and if a timely request is made for assessment relief.

Thus, under subsection (f), newly constructed improvements may qualify for relief even though the land on which they are situated is ineligible.

When calculating the new assessed value for the replacement property upon completion of the newly constructed improvements, the only written guidance regarding the proper allocation of base year values is found in subsection (d) of Rule 462.500:

> (d) BASE YEAR VALUE OF REPLACEMENT PROPERTY. The following procedure shall be used by the assessor in determining the appropriate adjusted base year value of comparable replacement property:
>
> (1) Compare the award or purchase price paid by the acquiring entity for the property taken or acquired with the full cash value of the comparable replacement property.
>
> (2) If the full cash value of the comparable replacement property does not exceed 120 percent of the award or purchase price of the property taken, then the adjusted base year value of the property taken shall become the replacement property's base year value.
>
> (3) If the full cash value of the replacement property exceeds 120 percent of the award or purchase price of the property taken, then the amount of the full cash value over 120 percent of the award or purchase price paid shall be added to the adjusted base year value of the property taken. The sum of these amounts shall become the replacement property's base year value.
>
> (4) If the full cash value of the comparable replacement property is less than the adjusted base year value of the property taken, then that lower value shall become the replacement property's base year value.
>
> (5) If there is no award or purchase price paid by the acquiring entity (i.e., an exchange) for the property taken, then the full cash value of the acquired property and the full cash value of the replacement property shall be determined by the assessor of the county in which each property is located for the purpose of applying the other provisions of this subdivision. The procedure set forth in subdivision (d) (1) through (d) (4) shall then be applied to determine the replacement property's base year value.

Subsection (d) of Rule 462.500 provides for the comparison between the award or purchase price paid by the public entity and full cash value of the replacement property. However, it does not prohibit or restrict the reallocation of the base year values when a

replacement property consists of only newly constructed improvements. Consequently, we believe that the assessor may transfer the entire base year value of an original property consisting of land and improvements to a replacement property consisting of only improvements.

3. The replacement improvements are located on land that is zoned industrial. The full cash value of the replacement improvements does not exceed 120 percent of the purchase price of the property taken. Does the replacement property meet the size, utility and function tests of comparability required by section 68?

Yes. From the facts provided, it appears that the replacement property meets the function, size, and utility tests.

With respect to comparability, Rule 462.500, subsection (c) provides that replacement property "shall be deemed comparable to the replaced property if it is similar in size, utility and function." Subsection (c)(1) defines "function" to mean subject to the similar governmental restrictions, such as zoning. Subsection (c)(2) further specifies that similarity in size and utility means similar use and value. Thus, the replacement improvements qualify for the base year value transfer to the extent that they are subject to the same governmental restrictions, are substantially similar in use to the property taken, and the full cash value of those improvements does not exceed 120 percent of the full cash value of the replaced land and improvements.

As stated above, subsection (c)(1) provides that "[p]roperty is similar in function if the replacement property is subject to similar governmental restrictions, such as zoning." You state that the replaced property and the replacement property are both zoned for industrial use.

As to size and utility, subsection (c)(2) provides that replacement property meets the size and utility test:

> to the extent that [it] is, or is intended to be, used in the same manner as the property taken (i.e., single-family residential and duplex, multi-family residential other than duplexes, commercial, industrial, agricultural, vacant, etc.) and its full cash value does not exceed 120 percent of the award or purchase price paid for the replaced property.

Your facts state that the full cash value of the replacement improvements does not exceed 120 percent of the purchase price of the property taken. Thus, the replacement property meets the size test.

Lastly, your client's property will qualify for a base year value transfer if it is determined that it meets the utility test, i.e., is used in the same manner as the property taken. If the replacement property, or some portion thereof, is not used in the same manner as the property taken then, to that extent, it is not considered to have similar utility and undergoes a change in ownership. Property Tax Rule 462.500, subsections (c)(2)(A) and (c)(3). (See also Annotation No. 200.0345, attached.)

In your letter dated August 14, 2002, you present additional facts describing the former use of the original property and current uses of the replacement property. Your client's original property was leased to a third party which used it as an automobile dealership, a commercial use. To replace that property, your client constructed five concrete tilt-up buildings, four of which are currently leased as distribution centers, while the fifth building remains vacant. We concur with your conclusion that these leased distribution centers are commercial uses. Consequently, we believe that they have the same utility as the original property.

Since your client's replacement property is similar in size, utility, and function to its original property, that property is eligible for a base year value transfer.

4. **Replacement improvements have been made on two or more different sites. The taxpayer intends to transfer portions of the base year value of the property taken to multiple replacement properties. Does the 120 percent of the purchase price requirement apply to the aggregated full cash value of multiple properties acquired as replacement properties?**

   Yes. Neither section 68 nor Rule 462.500 limits the availability of relief to a single replacement property.

Rule 462.500, subsection (a) provides, in part, that "the term 'change in ownership' shall not include the acquisition of comparable real property as replacement for property taken . . ." The provisions of subsection (c) of that rule define comparability in terms of size, utility and function but do not limit the number of the appraisal units that may constitute comparable property.

The views expressed in this letter are only advisory in nature; they represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity.

Sincerely,

/s/ Michael Lebeau

Michael Lebeau
Tax Counsel

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Attachment