STATE OF CALIFORNIA

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July 5, 2005

Re: New Construction Base Year Value of Your New Residence and New Construction Assessment Practices of California County Assessors

Dear Mr. :

This letter is in response to your correspondence addressed to Lou Ambrose, Senior Tax Counsel, dated May 6, 2005. In that letter, you made several inquiries regarding the new base year value of your new residence and the new construction assessment practices of county assessors throughout California.

For the reasons hereinafter set forth, it is our opinion that county assessors may use whichever approach to value listed in Property Tax Rule 3 that best estimates the "full cash value" of newly constructed property as of the date of completion. Furthermore, the Board has consistently advised assessors to consider all three major approaches to value when appraising taxable property; county assessors do not create a precedent when they choose one valuation approach over another for any particular assessment. Lastly, the Board recommends the application of the cost and comparative sales approaches to value when estimating the value of a single-family residence.

Background and Facts

As described in your letter, the following facts are relevant to this analysis:

1. You purchased a vacant residential lot during May 2003.

2. On June 28, 2004, you moved into a new residence that you had constructed on the vacant lot. The new home was not purchased at the same time that you obtained the vacant residential lot.

3. For purposes of building your new home, you employed the services of a licensed general contractor. That general contractor performed all of the activities required to bring your home to its completed state, including land tailoring, obtaining

construction permits, payment of school and road fees, and installation of utilities. You performed none of the construction activities yourself.

4. When determining the assessed value of your new home, the county assessor used two methods to estimate the value of that new construction: the replacement cost approach and the comparative sales approach.

5. Using the replacement cost approach to value, the county assessor estimated that value of your home was $15,000 more than your actual costs of construction.

6. You report that, according to the county assessor, the comparative sales approach value indicator for your new home was higher than the replacement cost approach value indicator.

7. To set the new base year value of your new home the county assessor used the replacement cost approach value indicator, even though that value indicator exceeded your actual costs of construction.

8. Prior to writing your letter you attempted to resolve this dispute directly with the assessor. However, you indicate the assessor did not agree with your arguments.

Law and Analysis

Section 1 of Article XIII of the California Constitution establishes the valuation standard for property taxation in this state:

> Unless otherwise provided by this Constitution or the laws of the United States. (a) All property is taxable and shall be assessed at the same percentage of fair market value . . . .

The Legislature has defined the concept of "fair market value" in sections 110 and 110.1 of the California Revenue and Taxation Code.[1] Subdivision (a) of section 110 states:

> Except as is otherwise provided in Section 110.1, 'full cash value' or 'fair market value' means the amount of cash or its equivalent that property would bring if exposed for sale in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other, and both the buyer and seller have knowledge of all the uses and purposes to which the property is adapted and for which it is capable of being used, and of the enforceable restrictions upon those uses and purposes.

In the context of a sales transaction, subdivision (b) of section 110 establishes a rebuttable presumption that "full cash value" or "fair market value," as defined in subdivision (a), shall be the actual purchase price if the terms were negotiated under specified conditions reflecting an "open market transaction." Absent a sales transaction, however, that presumption does not apply in the case of newly constructed improvements.

[1] All statutory references are to the California Revenue and Taxation Code, unless otherwise specified.

Subdivision (a) of section 110.1 defines "full cash value" as follows:

> For purposes of subdivision (a) of Section 2 of Article XIII A of the California Constitution, 'full cash value' of real property, including possessory interests in real property, means the fair market value as determined pursuant to Section 110 for either of the following:
>
> (1) The 1975 lien date.
>
> (2) For property which is purchased, is newly constructed, or changes ownership
>
> after the 1975 lien date, either of the following:
>
> (A) The date on which a purchase or change in ownership occurs.
>
> (B) The date on which new construction is completed, and if uncompleted, on the lien date.

As provided in subdivision (a) of section 110.1 above, the assessor is required to determine the "full cash value" of any new construction and to establish that value as the new base year value. In this regard, subsection (a) of Property Tax Rule 463, provides in relevant part:[2]

> When real property, or a portion thereof, is newly constructed after the 1975 lien date, the assessor shall ascertain the full value of such 'newly constructed' property as of the date of completion. This will establish a new base year full value for only that portion of the property which is newly constructed, whether it is an addition or alteration. The taxable value on the total property shall be determined by adding the full value of new construction to the taxable value of preexisting property reduced to account for the taxable value of property removed during construction. The full value of new construction is only that value resulting from the new construction and does not include value increases not associated with the new construction.

When determining the full cash value of property, the Board has issued advisory guidance to county assessors in Assessors' Handbook Section 501, *Basic Appraisal* (AH 501). Chapter 6, page 73, lists the approaches to value that assessors may employ to determine the assessed value of taxable property:

> The three major appraisal approaches for estimating value are the cost, comparative sales (or sales comparison), and income approaches. Rule 3 prescribes the application of one or more of the following five approaches to value in order to arrive at fair market value: (1) comparative sales approach: (2) stock and debt approach; (3) replacement/reproduction cost approach; (4) historical cost approach; or (5) income approach. The stock and debt approach is a variation of the comparative sales approach. The replacement, reproduction, and historical cost approaches are variations of the cost approach.[3]

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[2] All references to "rule" or "rules" refer to the Property Tax Rules found in Title 18 of the California Code of Regulations.

[3] Assessors' Handbook Section 501, *Basic Appraisal*, (AH501), 2002, page 73.

To estimate the full cash value of your new home, Property Tax Rule 3 requires the assessor to use one of five valuation approaches. Two of those approaches, however, are not usually applicable to the appraisal of a new single-family residence: the stock and debt and historical cost approaches. These two approaches have limited application in the valuation of property owned by legal entities and property owned by closely regulated utilities, respectively. Thus, to determine the full cash value of new construction, most county assessors may consider the cost approach, the comparative sales approach, or the income approach to value. However, because most single-family residences are owned for the amenities they provide and not for their potential rental income, the cost and comparative sales approaches are generally more appropriate when appraising this type of property.

1. **Are there any legal grounds or case law to support using verifiable and real costs to build a new house as opposed to using a replacement cost method? In other words, why should the assessor not use the actual cost to build in lieu of a replacement cost estimate? Isn't the actual total cost more reliable than the use of an estimated cost to build a new house?**

   We know of no legal authority that requires the assessor to consider actual costs when estimating the value added by new construction. Property Tax Rule 4 prescribes a preference for the comparative sales approach to value if reliable market data are available. Even in the absence of adequate sales data, a property owner's total actual costs do not necessarily represent the "typical costs" of construction or the best estimate of the value added by that construction. County assessors should employ the valuation approach(es) that best estimates the value of new construction, not merely its cost.

We are aware of no authority that would require a county assessor to use the actual costs of construction incurred by a property owner instead of replacement costs when enrolling a new base year value for a single-family residence. In fact, Property Tax Rule 4 creates a presumption in favor of the comparative sales approach to value: "When reliable market data are available with respect to a given real property, the preferred method of valuation is by reference to sales prices." In the absence of reliable market data, the application of the cost approach to value is prescribed in Property Tax Rule 6, The Reproduction and Replacement Cost Approaches to Value. Rule 6 provides that the cost approach is "preferred when neither reliable sales data, including sales of fractional interests) nor reliable income data are available. . . ."

Although your actual costs reflect the expenses you incurred to complete your home, it is the Board's position that the cost approach value indicator should reflect the "typical costs" necessary to bring the property to a completed state. Such "typical costs" may be higher (or lower) than the actual costs of any new construction activity. Chapter 6 of AH 501, page 74, provides as follows:

> There is no necessary relationship between the concept of cost and the actual costs experienced by a builder in a specific case. Builders construct homes with varying degrees of efficiency and incur varying costs. The estimate of cost by the appraiser should reflect the costs of typical producers who do the bulk of the work. This means that typical costs will be higher than those of the most efficient producers and lower than those of the least efficient. Typical costs should not reflect such items as special deals, change orders, poor management, and errors.

If the facts indicated that the actual costs of construction for your home are less than the costs of a "typical" builder, the assessor correctly disregarded your actual costs when determining the new base year value of your new home. As with any other new construction, the full cash value of a new residence may not equal the costs of construction. Therefore, the assessor should exercise caution when relying on the cost approach, and should check values derived from the actual costs against values derived from other value approaches. In your case, it is our opinion that the assessor correctly considered the comparable sales approach when enrolling an assessment for your new home.

2. <u>I have been told by another person that the county of ________ has used actual cost to build a new home as the basis [for] assessing other new homes. Is this a precedent by the county, which means that my house should be assessed using the actual cost?</u>

<u>No. County assessors are required to enroll new base year values for new construction at its full cash value, not at its actual cost. Using one approach to value in one assessment does not create an obligation for the assessor to use that approach for all future assessments.</u>

As discussed above, the California Constitution, Revenue and Taxation Code, and Property Tax Rules all require county assessors to enroll taxable property at that property's full cash value. With regard to the valuation approaches prescribed by Property Tax Rule 3, the Board provided the following guidance to county assessors in AH 501:

> Each appraisal approach utilized should be carried out independently from the others . . . . Each approach utilized should be completed on the basis of market data applicable to that approach, and all data should be derived from the market identified as relevant to the property being appraised. If each approach to value is performed independently, the resulting value indicators will define a value range and allow a rational and defensible final estimate of value.[4]

Even if the county assessor relied on the actual costs of new construction to establish a new base year value in one situation, that reliance does not create a precedent. AH 501 advises county assessors to consider the approaches to value prescribed by Property Tax Rule 3 and to enroll that value that best estimates the full cash value of the property.

3. <u>Have other counties used actual cost to assess the value of newly constructed homes?</u>

<u>Yes.</u>

We are aware of situations when other county assessors have used the actual costs of construction to enroll new base year values for newly constructed homes. In our experience those actual costs were often also compared against replacement cost and comparative sales value indicators.

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[4] AH 501, page 73.

4. <u>Should the assessor not use actual land sales as well as estimated land values from the sale of older homes? For a new home, should an assessor rely on estimated lot value from the sale of older homes or actual lot sales?</u>

<u>When estimating the value of your property as vacant, AH 501 provides that the comparative sales approach is the preferred approach. If no—or too few—sales of comparable vacant land occurred, the assessor may then rely on the allocated sales prices of improved parcels.</u>

The Board has advised county assessors to use one of six methods to estimate the value of land as vacant. Those methods are: (1) comparative sales; (2) allocation; (3) extraction; (4) subdivision development; (5) land residual; and (6) ground rent capitalization.[5] As applied to the construction of new single-family homes, county assessors would most likely apply either the comparative sales or allocation methods. Pages 67 and 68 of AH 501 provides:

> The comparative sales approach is used to value land that is vacant, or that is considered vacant for appraisal purposes. There must be a sufficient number of comparable vacant land sales in order to use this approach. The appraiser should select comparable sales that are similar to the subject in regard to the primary elements of comparison (i.e., property rights conveyed, terms of the sale, market conditions, and locational and physical characteristics.) The comparables must have the same highest and best use as the subject. Comparable sales are analyzed and adjusted for differences compared to the subject property in order to arrive at an indicator of value for the land being appraised. *The comparative sales approach produces the best indicator of value when a sufficient number of recent sales of comparable properties exist.* [Emphasis added and footnote omitted.]

If market data regarding the sales of comparable vacant land are available, AH 501 advises county assessors to use those sales to estimate the value of improved property, as if vacant. When a sufficient number of recent sales of comparable properties exist, it is the Board's position that the comparative sales approach produces the best indicator of value.[6]

AH 501 describes the allocation method as follows:

> In the allocation method, a portion of total property value is allocated to the site. This method is based on the principles of balance and contribution, which hold that a typical ratio between land value and total property value exists for similar types or classes of property, in comparable locations, at a given period of time. The allocation method is typically used to estimate the site value of an improved property, but it can also be used to estimate the value of a vacant site.
>
> To apply this method, it is necessary to estimate a ratio between land and building value. This can be done by analyzing ratios of site value to total property value in comparable neighborhoods where sales of vacant and improved properties have

[5] AH 501, page 67.
[6] *Ibid.*, page 68.

occurred. This ratio is then applied to the subject property to estimate its site value.[7]

For purposes of performing the appraisal of your new home, you letter indicated that:

> [T]he county assessor used value of the land based on estimated values of the land from appraised valuations. However, I live in an area where land is commonly sold and the appraised valuation consistently underestimated the land value by $20,000.

From your description above, we believe that the assessor used the allocation approach to value your land as vacant. To the extent that the assessor lacked adequate market data to apply the comparable sales approach to estimate the value of your land as vacant, that approach is valid. However, you indicate that you live in an area where vacant "land is commonly sold." If the assessor had evidence of comparable vacant land sales available, then it would be our position that the assessor did not use the best indicator to estimate the value of your land, as vacant. Thus, if adequate market data exists, it is our opinion that the assessor should have used the actual sales of vacant land to estimate the value of your residential lot.

5. <u>For a newly constructed house, should the replacement cost or comp [sales comparative] method be used to set the assessed value?</u>

<u>The county assessor should use whichever approach to value that best estimates the full cash value of new construction; AH 501 contemplates the application of either the replacement cost or comparative sales approaches.</u>

When establishing the new base year value of a newly constructed home, county assessors are required to apply the valuation approach that best estimates the full cash value of that home, as indicated in our answers to questions No. 1 and 2 above. Selecting which approach to apply involves a careful consideration of the data available. Page 73 of AH 501 provides as follows:

> Although all three approaches to value should be considered, the use of all three may not always be appropriate. The nature of a property, its market, and the availability of data will normally indicate which approach(es) is most applicable. *Because most single-family residences are owned for the amenities they provide and not for their potential rental income, the cost and comparative sales approaches are generally more appropriate when appraising this property type.* [Emphasis added.]

Since single family residences are not typically purchased based on their ability to generate income, the income approach is not a favored approach. However, AH 501 does recommend that county assessors consider either the cost or the comparative sales approaches to value.

Conclusions

In the case of your newly constructed home, it is our opinion that the assessor correctly considered two valuation approaches, in addition to your actual costs, when enrolling your home's new base year value. Even if the assessor has used the actual costs of new construction

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[7] AH 501, page 68.

in some situations, AH 501 advises county assessors to consider all three major approaches to value, and to subsequently enroll the value that best estimates the full cash value of the property. When appraising the value of single family residences, AH 501 emphasizes application of the cost and comparative sales approaches to value.

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,

Michael Lebeau

Michael Lebeau
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