STATE OF CALIFORNIA

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August 31, 2011

Honorable
County Assessor
Attn:

Re: Assessment of New Construction
Assignment No.: 11-026

Dear Mr. :

This is in response to your letter dated January 26, 2011, in which you seek guidance regarding the valuation of new construction. You state:

> We have a specific situation where we are valuing a neighborhood shopping center, constructed in phases, with the Income Approach. We valued each section of the property at the date of completion with the direct capitalization technique. We subtracted current land value as of the date of completion from this total value to arrive at a value attributable to the improvements. The taxpayer's representative has no trouble with this methodology, except that she contends that we should be subtracting the factored base value of the land from the total income approach value to arrive at a contributory value for the improvements, as the factored base value on the subject land is greater than the current market value of the subject land. In this case the subject property does qualify for a reduction in value under section 51(b) on the subsequent lien date. We have explained that we are valuing the new construction at full cash value as of the date of completion and that the subject land is not re-appraisable at the time. However, the taxpayer's representative further contends that our methodology allows us to value the subject property in excess of market value on the "lien date" of the completion of the new construction. We have cited Revenue and Taxation Code 71, Property Tax Rule 463 and LTA 85-75 question 7.
>
> We are looking for a written legal opinion and any further guidance on this subject.

The applicable legal authorities as well as our legal opinion with respect to this matter are set forth below.

Law and Analysis

Subdivision (a) of section 2 of Article XIII A of the California Constitution provides that the "full cash value" of real property means the county assessor's valuation of the property on the 1975-76 tax bill, or thereafter, the appraised value of the property when purchased, when newly constructed, or when a change in ownership has occurred after the 1975 assessment. Subdivision (b) of section 2 of Article XIII A provides that the full cash value base may be adjusted each subsequent year by the rate of inflation not to exceed two percent, or may be reduced to reflect substantial damage, destruction or other factors causing a decline in value.

Subdivision (a) of Revenue and Taxation Code[1] section 70 defines "newly constructed" and "new construction" to include any addition to real property or alteration of real property that constitutes a major rehabilitation thereof or that converts the property to a different use.

Section 71 provides, in relevant part, that:

> The assessor shall determine the new base year value for the portion of any taxable real property which has been newly constructed.

The base year value of the newly constructed portion is established by ascertaining its "full cash value," or "fair market value," as of the date of completion. (Rev. & Tax. Code § 110.1; Property Tax Rule[2] 463, subd. (a).) For these purposes, the "full cash value" or "fair market value" of new construction is defined in subdivision (a) of section 110 as:

> [T]he 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 the seller have knowledge of all of 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.

The date of completion is, generally, the earliest of either the date the property is available for use or the date it is occupied or used. (Rule 463.500, subd. (b).) The base year value for newly constructed property must then be entered on the roll for the lien date next succeeding the new construction's date of completion. (Rev. & Tax. Code § 50.)

The base year value of the remainder of the property which did not undergo new construction shall not be changed. (Rev. & Tax. Code § 71.) Therefore, as explained in subdivision (a) of Rule 463:

> 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.

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[1] All further statutory references are to the Revenue and Taxation Code unless otherwise indicated.
[2] All Rule references are to sections of title 18 of the California Code of Regulations unless otherwise indicated.

Section 110.5 defines "full value" as:

> "[F]air market value, full cash value, or such other value standard as is prescribed by the Constitution or in this code under the authorization of the Constitution."

Finally, a construction project constructed in definite stages or phases (e.g., a shopping center), with some portions being completed and available for use before other portions are constructed, should have base year values determined for the various portions as they are completed. (See Property Tax Annotation 610.0015 (LTA 5/8/1980); Assessor's Handbook (AH), Section 502, *Advanced Appraisal*, p. 132.)

Assuming there is no removed property here, subdivision (a) of Rule 463 mandates that the total property's taxable value is determined by adding (a) the full value of the improvements to (b) the remainder of the Property's taxable value. The rule makes a clear distinction between the "full value" of the improvements and the "taxable value" of the remainder, and as discussed above, the "full value" of the improvements is the "fair market value." (Rev. & Tax. Code §§ 110, subd. (a), 110.1, 110.5.)

Here, the assessor used the Direct Capitalization method within the income approach to derive the fair market value of the entire property (land and improvements) from a single year's income expectancy. (AH, Section 501, *Basic Appraisal*, p. 147.) The income approach is the preferred method of valuation when the property either has an established or hypothetical income stream and reliable sales data for comparable properties are not available. (*Id.* at pp. 95-96.) The assessor utilized the Building Residual Technique to determine the fair market value of the improvements, by deducting the income imputable to the land (the land value multiplied by the land capitalization rate) from the fair market value of the total property. (*Id.* at pp. 108-109.) The fair market value of the land is used during this process, because the result should reflect the fair market value of the improvements. If the assessor were to deduct from the fair market value of the entire property the factored base value of the land (which is greater than the fair market value), the resulting value of the new construction would be understated.

This error is further illustrated by the following example. Assume there are two land parcels with identical fair market values, but with different factored base year values. Identical new construction is completed on each parcel at the same time, resulting in an identical fair market value for each property. The fair market value assigned to each new construction should be identical. However, if the factored base year values are deducted from the respective fair market values, then the fair market value of the improvements would differ. This would be incorrect. Therefore, while the factored base year value of the land, i.e. the taxable value of the remainder, is used in the second step of the process to determine the total taxable value, the assessor is correct in using the fair market value of the land to ascertain the fair market value of the improvements using the Building Residual technique.

Subdivision (a) of Rule 463 further mandates that the base year value of the new construction is the full value, as of the *date of completion*, which is then entered on the roll for the succeeding lien date. (See Rev. & Tax. § 50; Property Tax Annotation 610.0001 (2/11/1980).) Therefore, the taxpayer's representative's assertion that the property will be valued in excess of market value on the lien date is immaterial, because the base year value of new construction is established as of the date of completion, not the lien date. On the subsequent lien date, the property, including the improvements, may be subject to a decline in value adjustment

pursuant to subdivision (b) of section 51. However, this would not change the base year value of the pre-existing property, as previously established, or the initial base year value of the improvements.

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/ Scott A. Claremon

Scott A. Claremon
Tax Counsel

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cc: Mr. David Gau MIC:63
Mr. Dean Kinnee MIC:64
Mr. Todd Gilman MIC:70