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June 30, 2000

Hon. Thomas W. Lanshaw
Inyo County Assessor
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P.O. Box "J"
168 N. Edwards
Independence, California 93526

***Re: Sales Price Adjustments in Applying the Comparative Sales Approach***

Dear Honorable Thomas W. Lanshaw:

This is in response to your letter of September 21, 1999 in which you pose two hypothetical situations, both involving sales transactions, and request our opinion on the usefulness of such transactions as indicia of fair market value. Please excuse our delay in responding. As set forth in more detail below, it is our opinion that – in both hypotheticals – the given transactions are so imbued with non-property-related factors and business considerations that it would be inadvisable, if other evidence is available, to accord them sole reliance in estimating fair market value for property tax purposes. While both transactions may be useful in shedding some light on property value, the appraiser first would have to determine what adjustments or "allowances" (if any) should be made in keeping with the requirements of Property Tax Rule 4(d). Even with such adjustments, however, it is our opinion that it would be preferable for the appraiser to look primarily to other comparable property sales (if available) and/or to other valuation methodologies, such as the income approach, in order to determine the fair market values of the properties in the two hypotheticals.

Hypothetical No. 1

1. Underlying Hypothetical Facts:

a. A two-person partnership owns an income-producing property.
b. One partner operates the property for the other partner.
c. The operating partner offers to sell his one-half interest in the property to the non-operating partner for an asking price of $1,000,000.
d. Annually, the property generates $1,000,000 in revenues. Recurring operating costs and overhead average $350,000 per year. Additionally, management fees add $50,000 to the operating cost of the partnership. The operating partner receives an additional $100,000 per annum as an operating fee. The two partners split the remaining net income of $500,000.

e. The partnership's revenues and overhead costs are consistent with comparable properties in the area. While the partnership has both management and operating fees, the sole owners of some of the comparable properties do their own management; thus, in those cases, there is no similar fee involved. In comparison with those comparable properties held by partnerships, however, the operating fee paid by the partnership to the operating partner is "excessive."
f. The non-operating partner believes that the current net income generated by the property – after deduction of the operating fee – only justifies a property value of $1.4 million. With the elimination of such fee, however, the property's "net income is comparable to other properties owned by other corporations and partnerships," and would justify a value of $2 million. Thus, he agrees to pay $1 million for the operating partner's interest in the partnership.

2. Hypothetical No.1 Question: What is the indicated value for the half interest of the real property (assume there is no personal property at issue)? What is the fee interest value of the real property? Should the value of the operating agreement be accounted for in the purchase price? Do the partnership management fees also represent an encumbrance that requires adjustment to the purchase price?

3. Your Position on Hypothetical No.1: "It appears to the Assessor's Office that the $1,000,000 purchase price for the half interest can be directly used to value the 100% interest (fee) by the simple doubling of the price (assuming no other facts or issues than those discussed above.) Further, the value of the real property is directly related to the purchase price, i.e. 50% is worth $1,000,000 and 100% is worth $2,000,000."

"An *alternative analysis* might be that the operating management fee has value unto itself, but is not real property. Rather, it might be described as an *intangible* that needs to be accounted for and deducted from the adjusted price. For example, after grossing up the sales price to $2,000,000, the value of the real property would be a residual, after deducting the value of the contract, $300,000; hence the real property would be worth $1.7 million."

4. Law and Analysis: With regard to the comparable sales valuation approach, section 816 of the Evidence Code provides that: "When relevant to the determination of the value of property, a witness may take into account as a basis for his opinion the price and other terms and circumstances of any sale or contract to sell and purchase comparable property if the sale or contract was freely made in good faith within a reasonable time before or after the date of valuation." Section 815 of the Evidence Code, entitled "Sales of subject property," states that: 'When relevant to the determination of the value of property, a witness may take into account as a basis for an opinion the price and other terms and circumstances of any sale or contract to sell and purchase which included the property or property interest being valued or any part thereof . . ."

In the property tax context, the comparable sales valuation approach is addressed in section 402.5 of the Revenue and Taxation Code[1] That statute provides as follows:

[1] Unless otherwise specified, all further section references shall be to the Revenue and Taxation Code.

> When valuing property by comparison with sales of other properties, in order to be considered comparable, the sales shall be sufficiently near in time to the valuation date, and the properties sold shall be located sufficiently near the property being valued, and shall be sufficiently alike in respect to character, size, situation, usability, zoning or other legal restriction as to use . . . to make it clear that the properties sold and the properties being valued are comparable in value and that the cash equivalent price realized for the properties sold may fairly be considered as shedding light on the value of the property being valued.

The board's Property Tax Rule 3, "Value Approaches," provides that: "In estimating value . . ., the assessor shall consider one or more of the following, as may be appropriate for the property being appraised: (a) The price or prices at which the property and comparable properties have recently sold (the comparable sales approach). (b) The prices at which fractional interests in the property or comparable properties have recently sold . . . ." Rule 4, "The Comparative Sales Approach to Value," specifically addresses the comparable sales approach to valuation:

> 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 using sales prices of the appraisal subject or of comparable properties to value a property, the assessor shall:
>
> * * *
>
> (d) Make such allowances as he deems appropriate for differences between a comparable property at the time of sale and the subject property on the valuation date, in physical attributes of the properties, location of the properties, legally enforceable restrictions on the properties' use, and <u>the income and amenities which the properties are expected to produce</u>... (Emphasis added.)

Fair market value means the estimated price the property would bring if offered on the open market under conditions in which neither the buyer nor seller could take advantage of the exigencies of the other. (Cal. Const., art. XIII, §1; Rev. and Tax. Code §§ 110, 401; *DeLuz Homes, Inc. v. County of San Diego* (1955) 45 Cal.2d, 546, 561-563.) In general, the use of market data on recent sales of the property to be assessed and comparable properties, when such data is available, is the most accurate way of arriving at a property's fair market value. (*Guild Wineries and Distilleries v. County of Fresno* (1975) 51 Cal.App.3d 182, 187.)

Nevertheless, even though a recent sale of a property or of a comparable property may shed light on the property's fair market value, the sale may not provide sufficient reliable data to justify complete reliance to the exclusion of other evidence. As quoted by the court in *Guild Wineries and Distilleries, supra* at 187-188:

> In any single individual transaction there are many variables, which are dependent upon the peculiar aspects of the transfer and which affect the price agreed upon by the parties. Market value, therefore, is generally established by numerous sales of the same or comparable property and, although the price paid

for property may be admissible to prove its market value, that fact alone is not conclusive. [¶] Although a single arm's length transaction does not establish market value, and the price indicated thereby is not controlling as to the value of the property, such price may be considered as one factor in arriving at the full cash value of the property in question.

In *Dennis v. County of Santa Clara* (1989) 215 Cal.App.3d 1019, the plaintiff had purchased real property in San Jose. Subsequently, the assessor revalued the property for property tax purposes at an amount substantially higher than the purchase price. While the assessment appeals board found in favor of the assessor, the trial court set aside the assessment appeals board decision, finding instead that the full value of the property was the amount of the purchase price. On appeal, the court reversed the trial court and directed that judgment be entered in favor of the assessor. Specifically, the appellate court found that: "[T]he purchase price may play a significant role in the reassessment of property upon its sale but that the purchase price is only the beginning and not necessarily the end of the inquiry." (*Id.* at 1027.)

In analyzing the case law on the comparable sales approach, the court noted that even open market transactions may involve factors that skew the purchase price and make it an unreliable indicator of fair market value. "For example, the property may be of a kind seldom exchanged. Or the transaction may be complex, comprising several components in one package. Or the purchase price may be influenced by tax consequences and other business considerations that affect the value ascribed to the property by the particular buyer and seller." (*Id.* at 1028.) Under the specific facts of *Dennis*, the court noted two problems with regard to reliance upon the subject sale to establish fair market value: "the relationship between the sellers and plaintiffs (landlord-tenant) and the fact that the subject property was generating rent at well below market for comparable property." (*Id.* at 1029.)

Thus, to sum up, for property tax purposes in this state, evidence relating to the recent sale of the subject property or of a comparable property may be relevant to the determination of the fair market value of the property as long as the evidence aids in shedding light on the issue. (Rev. and Tax. Code § 402.5; *Midstate Theatres, Inc. v. County of Stanislaus, et al.* (1976) 55 Cal.App.3d 864, 880.) Nevertheless, such evidence may not be sufficiently reliable to establish value – or even be sufficiently reliable to be given consideration -- when there are other "factors" at play that may have affected the purchase price; such factors may include the personal or contractual relationship of the parties and the presence of other "components" or "business considerations" affecting value.

In this case, of course, the sale is not of the subject property, or even of a fractional interest in the subject property, but of a fractional interest in a partnership.[2] And even in that context, there is a complication – the purchased fractional partnership interest is that held by an operating partner whose agreed-upon operating fees are, at the very least, in excess of market.

[2] Because the instant purchase is of a partnership interest and of not real property, the presumption set forth in section 110(b) that purchase price is fair market value is not applicable.

In some cases, the sale of a fractional interest in a partnership that owns property constitutes a valid and reliable indicator of the value of the property as a whole. (Property Tax Rules 3(a) and (b), 4(d); See *Savoie Building v. County of Hennepin* (1987) Minnesota Tax Court No. TC-5163 (1987).) This is particularly true when the partnership owns only the subject property and nothing else, and when there are no complicating "business considerations" such as control premiums, minority discounts, etc. In this case, however, the purchase of the partnership interest does not appear to constitute a very reliable indicator of property value. First, due to extraordinarily high operating fees, the partnership net income generated by the property appears to be substantially lower than the property is potentially capable of producing for the typical operator. Second, the purchaser is not just buying a one-half interest in the property; the purchaser is also effectively terminating the partnership so as to eliminate any future contractual requirement of payment of the referenced operating fees. These non-real property-related factors and business considerations render the instant purchase ill suited to serve as the sole and only indicator of the fair market value of the underlying property.

Nevertheless, the transaction may serve to shed some light on the value of the property, but only if appropriate adjustments are made to the purchase price -- not only to reflect the fact that only a 50 percent partnership interest was acquired -- but also as "allowances" for differences in the "income and amenities" that the partnership was generating in comparison to those that could be expected to be generated by the property. (Board Property Tax Rule 4(d).) Even with such adjustments, however, under the given circumstances, it is our opinion that it would be preferable to look primarily to other comparable property sales (if available) and/or an income approach in order to determine the value of the subject property.[3]

Thus, we disagree with both of the alternative valuation approaches set forth in your letter. We disagree with the first approach because it fails to make the allowances required by Property Tax Rule 4(d) for the above-stated anomalies. As to the "alternative analysis," it is our opinion that, even with the stated adjustment, the proposed valuation indicator is unreliable. For one thing, the sale of the partnership interest is so imbued with business considerations and non-real property-related factors that, if possible, it would be preferable to find other more reliable value indicators. And second, the indicated adjustment fails to account for the fact that the property can be expected to produce substantially more income than the partnership.[4] This is exactly the type of difference that must be accounted for under Property Tax Rule 4.

[3] Of course, in utilizing an income approach to the valuation of the property, the net income to be capitalized is that which a "reasonably well informed owner and reasonably well informed buyers may anticipate on the valuation date . . . ." (Board Property Tax Rule 8(c).) Thus, in calculating a value estimate based upon an income approach, the actual management and operating fees paid by the partnership should not be factored in as expenses if they are, in fact, excessive and unreasonable under marketplace conditions. It is not necessary, however, to assume that a prudent owner would perform his or her own uncompensated management of the property. In fact, Property Tax Rule 8(e) provides that: "When income from operating a property is used, sufficient income shall be excluded to . . . compensate unpaid or underpaid management."

[4] For one thing, your hypothetical facts seem to indicate that the so-called alternative analysis renders a value estimate that is substantially lower than the values of comparable properties.

Hypothetical No. 2

1. Underlying Hypothetical Facts:

a. An income producing property sells for $5,000,000, plus the potential to receive a contingent payment of $200,000 depending upon the results of a lawsuit.
b. The lawsuit is between the owner of the property and a tenant regarding whether or not rentals were "over or underpaid based on a contract between the owner and renter."
c. With regard to the lawsuit, "legal costs were high and the chances of prevailing were problematic."
d. "The issues are complex and disposition of the case is expected to be several years into the future."
e. Apparently, the sale of the property is accompanied by an assignment of all of the plaintiff-seller's interest in the lawsuit. Accordingly, the "seller has no obligations to contribute to future legal expenses and does not share in any losses as a result of an unfavorable disposition."

2. Hypothetical No. 2 Question: "What is the indicated value of the income producing property?"

3. Your Position on Hypothetical No. 2: "The value of the property is $5,000,000 plus the net present value of the seller's retained interest in the litigation outcome (i.e. up to $200,000 discounted for the time value of money.) Alternative #1, the value of the property is $5,200,000. Alternative #2, the value of the property if $5,000,000 less the buyer's net present value of the litigation (i.e., the net present value of future rewards less the payment of up to $200,000 or, in the alternative, the net present value of future losses.)"

"Alternative #1 assumes the additional payment will be made and no discounting is employed. This conclusion appears too speculative and violates any cash equivalency considerations. [¶] Alternative #2 assumes the net present benefits are an *intangible*; hence requiring a deduction to the sales price to reflect only the value of real property . . . . [¶] The Assessor concluded the sales price of $5,000,000 reflected the market value of the income producing property. The contingent payment was too speculative to consider and even if there were value to the litigation result, it was not directly related to the property value."

4. Law and Analysis: In valuing real property for property tax purposes, the fact that the contract rents for a property may be more or less than market or economic rents is irrelevant. (*Dennis v. County of Santa Clara, supra* at 1029.) Stated another way, an owner who does not 'command the full potential of his property" cannot "expect his fellow taxpayers to compensate him for the difference." (*Clayton v. County of Los Angeles* (1972) 26 Cal.App.3d 390, 392, fn. 3.) Property Tax Rule 8(d), addressing the income approach to valuation, is consistent:

> In valuing property encumbered by a lease, the net income to be capitalized is the amount the property would yield were it not so encumbered, whether this amount exceeds or falls short of the contract rent . . . .

Thus, the lawsuit over the amount of the contract rents due under the lease that encumbers the property is irrelevant to the fair market value of the property for property tax purposes. Nevertheless, the lawsuit and the continuing dispute over the amount of contract rentals do constitute "business considerations" within the meaning of *Dennis v. County of Santa Clara, supra* at 1029. As a consequence, it is our opinion that, rather than rely exclusively upon this transaction to establish fair market value, it would be preferable to look primarily to other comparable property sales (if available) and/or an income approach in order to determine the value of the subject property.

While, as above, the sale may be useful in shedding some light on the value of the property, the assessor would first have to determine whether or not any adjustments or "allowances" would have to be made within the meaning of Property Tax Rule 4(d). And if the assessor determined that the "contingent payment was too speculative to consider," then the unadjusted $5,000,000 might be given some consideration as evidence of value. Even in that circumstance, however, it is our opinion that it would be preferable to look at the market as a whole – or utilize an alternative valuation methodology, such as the income approach – before estimating a value for property tax purposes.

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. If you have any questions, please do not hesitate to call me at (916) 324-6593.

Sincerely,

*/s/ Robert W. Lambert*

Robert W. Lambert
Senior Tax Counsel

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