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Executive Director

May 12, 2000

In Re: Assessability of Off-Site Improvements Related to New Construction

Dear Mr. :

This is in response to your letter of April 11, 2000, to the Honorable Dean Andal, Board Member, Second District, requesting an opinion whether the assessor's added value to a parcel resulting from new construction should reflect the cost of a required off-site improvement—in this case, a freeway off-ramp—constructed at the developer's expense as a condition for development of the subject parcels.

For the reasons hereinafter explained, construction that is not an addition or alteration to the subject property is not "new construction" as that term is defined in Revenue and Taxation Code Section 70 and Property Tax Rule 463, and costs related to such off-site construction should not be used as an indicator of the added "new construction" value to the subject property. The value enhancement resulting from the construction of an off-site improvement (i.e., an improvement not located on the subject property) is only assessable when the subject property changes ownership. At that time, the enhanced value would be reflected in the marketplace and recognized in the sales price and the reappraisal.

Facts

The following facts are submitted for the purpose of our analysis:

1. In November 1997, ("HD") acquired 17 acres of unimproved land consisting of five contiguous parcels in County, with the intent to construct a shopping center with five buildable pad sites. The purchase price was $2,900,000.

2. When the purchase occurred, the assessor treated the property's sale price of $2,900,000 as the fair market value of the property and allocated that value among the five parcels.

3. Prior to the purchase, HD knew that it would be required to satisfy a traffic mitigation requirement by constructing, at its expense, a new freeway off-ramp near the site as a condition of development. At the time of purchase, the estimated cost of the required off-site improvement was $1,000,000.

4. Prior to the completion of the construction on the five parcels, which involved various land improvements, HD sold three of the parcels to three different buyers. Two of the sales contracts included negotiated percentages of the site development costs (both on- and off-site) as part of the stated consideration; one sales contract did not include any costs associated with the off-site improvements in the stated consideration.

5. When the new construction was completed on September 1, 1998, the assessor included the actual cost of the off-site improvements ($1,656,000) in the value of the assessable new construction on the five parcels, allocating a portion of this amount, as well as a portion of the cost of on-site improvements, to each of the five parcels.

6. HD filed appeal for reduction of its assessment. The only issue remaining unresolved in that appeal is the assessability of the off-site improvements. The County Assessment Appeals Board granted a continuance until May 24, 2000, in part, to obtain a legal opinion on this question from the Board of Equalization.

<u>Law and Analysis</u>

<u>Off-Site Improvements Not Assessable as New Construction.</u>

Although there are no statutory or regulatory provisions that <u>expressly</u> state how off-site improvements should be treated for assessment purposes, the Board has published advice explaining that such costs should not be included in the value of new construction. As referenced in your letter, page 131 of *Assessors' Handbook* Section 502, "Advanced Appraisal" (AH 502) briefly discusses the non-assessability of off-site improvements:

> "When using actual costs to value new construction, appraisers should distinguish between costs attributable to new construction and those costs that may enhance the value of the land but are not costs related to additions or alterations of real property [i.e., additions or alterations to the subject property]."

The example in AH 502 that illustrates this principle involves the development of a large industrial complex next to a major freeway. In order to obtain development approval, the developer agrees to pay for three off-site improvements, one of which is the construction of a new freeway off-ramp leading to the complex. While recognizing that the off-site improvement may enhance the value of the subject property--that is, the property whose development prompted the requirement for the off-site improvement--the Board's conclusion is that the value associated with such improvements should <u>not</u> be reflected in the value of the new construction assessed to the subject property.

As applied to the instant case, therefore, the costs of the off-site improvements should be considered as a value enhancement to the subject property's land value (i.e., the parcels in the HD shopping center complex). This is not assessable as new construction.

The reasoning behind this conclusion is found in the California Constitution and in the statutory definition of " *new construction*" or "*newly constructed*." Section 2(a) of article XIII A of the California Constitution states that "*full cash value*" means the March 1, 1975, full cash value, or thereafter, the appraised value of real property when purchased, *newly constructed*, or a change in ownership has occurred.[1] Revenue and Taxation Code Section 70 (a) defines "*newly constructed*" and "*new construction*" as either (1) any addition to real property, or (2) any alteration of land or of an improvement which constitutes a major rehabilitation thereof or converts it to a different use. This section thus expressly divides the definition of "new construction" into two physical categories, additions and alterations. Section 71 prescribes in general terms what is assessable as new construction and what is not. This section states that the assessor shall determine the new base year value for the portion of any taxable real property which has been newly constructed, but also states that the assessor shall <u>not</u> change the base year value of the remainder of the property which did not undergo new construction.

In order to meet the definition of "new construction" there are two fundamental requirements: (1) the construction must be either an addition to or an alteration of the land (or improvement), and (2) the addition or alteration must be made to or on the property being assessed. The second requirement is further clarified in subsection (b)(2)(A) of Property Tax Rule 463, which states, in part:

> "In any instance in which an alteration is substantial enough to require reappraisal, only the value of the alteration shall be added to the base year value of the preexisting land or improvements. Increases in land value caused by appreciation or a zoning change rather than new construction shall not be enrolled."

This subsection reflects a recommendation made in the Report of the Assembly Revenue and Taxation Committee, "Property Tax Assessment," Vol. 1, October 29, 1979, which discusses (at pages 30-33) the fact that only that portion of the property that is newly constructed should be reappraised. On page 33, the report explains the treatment of assessable new construction:

> "The apparent end result is that, given two identical homes, one of which is newly constructed and the other of which changes ownership on the <u>same</u> date,

[1] Revenue and Taxation Code Section 110.1(a) similarly provides that *full cash value* means the fair market value on the 1975 lien date or, thereafter, the value on the date on which a purchase or change in ownership occurs, or the date on which *new construction is completed.*

> the home which changes ownership will have a higher valuation, because all factors affecting value are taken into account, whereas the newly constructed home will exclude value attributed to inflationary land values." [Emphasis added.]

The legal standard therefore, established by the Legislature and implemented by Board rule is that the added full value of new construction does not include value increases attributable to general changes in economic conditions, zoning or general plan changes, or other factors that are not part of the new construction. In AH 502 (page 131) the Board, in effect, applied this legal standard to off-site improvements. That is, off-site improvements are not new construction on the subject property, and, therefore, must be treated in manner similar to value increases resulting from changes in economic conditions or "other factors".

The new freeway off-ramp in the instant case falls squarely within this category of "changes from other factors" for several reasons. First, the off-ramp is not an addition or an alteration to the land owned by HD, and, therefore, cannot qualify as "new construction" to that property. Second, adding any value to HD's parcel as the result of the $1,656,000 that it was required to spend to build the off-ramp *on other land*, would violate the standard set forth in subsection (b)(2)(A) of Rule 463—namely, that only the value of the new construction on the land being assessed shall be enrolled. Third, adding value to a parcel that results from activity not on the parcel is what the implementing statutes and rules for valuing new construction under article XIII A of the California Constitution (i.e., "Proposition 13") were intended to prevent. In this respect, HD's situation is not unlike the example set forth in subsection (b)(2)(A) of Rule 463, which illustrates that a $10,000 increase in land value upon completion of new construction cannot be added by the assessor when valuing the new construction.[2] Finally, like economic or other changes, the value added to HD's site because of the freeway off-ramp will be reflected in the market place and will be so recognized in the property's sale price—when the property changes ownership. At that time, the enhanced market value would also be reflected in the reassessment due to the change in ownership. The following discussion provides a brief explanation of how this may be accomplished.

[2] Rule 463 (b)((2)(A) – In any instance in which an alteration is substantial enough to require reappraisal, only the value of the alteration shall be added to the base year value of the pre-existing land or improvements. Increases in land value caused by appreciation or a zoning change rather than new construction shall not be enrolled, for example:

1. Land value 1975	= $10,000	
2. Land value 1978	= $20,000	
3. Value of alteration 1978	= $5,000	
4. Value of structure added 1978	= $75,000	
1979 roll value (1+3+4)	= $90,000	(must be adjusted to reflect appropriate indexing)

Reported Sale Price and Fair Market Value

Prior to the completion of the construction on the five parcels, HD sold three of the parcels to three different buyers for purchase prices that included the following negotiated percentages for reimbursement of the on– and off-site development costs: one sales contract included a percentage for the total reimbursement fee; one sales contract had a percentage with a cap on the total reimbursement; and one sales contract did not include any costs associated with the offsite improvements. Assuming the assessor uses the comparative sales approach to value the parcels on the transfer date, Section 110 and Property Tax Rule 2 require that each sale should be separately analyzed to determine whether the price paid represented fair market value, regardless of the difference in the terms of the sales contracts. The issue here is not whether HD as the seller is being proportionately reimbursed in each sale for the cost of the off-site improvements, but whether the sale price of each of the three parcels is a valid indicator of its fair market value.

Both Section 110 and Rule 2 establish a rebuttable presumption that the sale price in a transaction represents the fair market value of the property. In other words, the purchase price in a transaction presumptively, but not conclusively, represents market value. The presumption holds only if a sale is conducted under specified conditions, often referred to as "open-market" conditions. Salient elements of these conditions are the following:

1. The property is exposed for sale in the open market. This means that potential buyers have a sufficient amount of time to analyze and to bid on the property.

2. Neither buyer nor seller can take advantage of the exigencies of the other. This condition means that buyer and seller are dealing with each other at arm's length—that is, neither is influenced by special motivations or particular circumstances.

3. Buyer and seller have knowledge of all the uses and purposes to which the property is adapted. This means that buyer and seller are aware of the highest and best use of the property, that is, the lawful use that maximizes the property's value, and consider the value of the property in light of such use.

In addition, the sale price must be expressed in terms of cash or its equivalent, which means that the sale price of the subject property or sales prices of comparable properties used as evidence of market value should be stated in terms equivalent to cash. (Property Tax Rule 4.)

All comparable sales used in an appraisal, including the sale of the property being appraised, must be analyzed to determine whether the above conditions have been met, and to thereby determine whether the reported sale prices of those sales can be used as valid evidences of market value.

Based on the foregoing, a threshold question regarding comparable sales in the instant case is whether the sales occurred under the requisite conditions discussed above. The assessor may find that some or all of the sales constituted an "open-market, arm's length" transaction, and that the reported sales prices are valid indicators of market value. Alternatively, the assessor may find that one or more of the buyers were "related" to the seller through formal or informal agreements (including options) made early in the planning and/or development stages of the shopping complex, and that the sale prices were established on the basis of these arrangements. In such case, the sale price(s) of that parcel or parcels may be disregarded and each such parcel should be assessed at its fair market value on the date of sale based on other comparable sales outside of the complex.[3]

Since "fair market value" is defined in terms of "cash or its equivalent," the assessor must also adjust the sale prices of the subject properties and the prices of comparable properties to reflect amounts equivalent to cash. Under Rule 4 (d), the assessor may make adjustments allowing for the differences between a comparable property and the subject properties at the time of sale. The construction of a freeway off-ramp near the subject property in order to allow for the development and the highest and best use of the property is one of the many differences considered by the assessor in making such adjustments. As stated in Assessor's' Handbook 502, *Advanced Appraisal*, pages 41-42, the assessor must make a determination of the highest and best use of the subject property as part of the appraisal process. If the highest and best use of these three parcels is not "legally permissible" without the freeway off-ramp, then adjustments for the "use potential" of these parcels is necessary if there is a significant difference in their value without the construction of the freeway off-ramp. The determination to be made by the assessor is not whether HD as the seller "recaptures" some or all of its costs for the freeway off-ramp, but whether the final value indicator and assessment represent the fair market value.

Other types of adjustments that may be required include atypical or non-market financing, non-cash or intangible items that were included, location, physical characteristics, differences in property rights conveyed, etc. A detailed discussion of this "comparative analysis," the process by which adjustments are made, and the methodology for reconciling the value indicators into a single value estimate is found in Assessor's' Handbook 502, *Advanced Appraisal*, pages 36-54.

[3] As stated in AH 501, page 85, a sale of property that is not an "open-market, arm's length" transaction is not a valid indicator of value because there is no rational basis for comparing it to other transactions. The reason for this is that there is no method of determining the amount of the "discount" given by the seller, in order to calculate the amount of adjustment that needs to be made to the sale price. It is recommended therefore, that other value indicators, including other comparable sales (that are "open-market, arm's length" transactions) be used to reach an estimate of market 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 the present law and facts set forth herein. They are therefore, not binding on any person or entity.

Sincerely,

/s/ Kris Cazadd

Kristine Cazadd
Senior Tax Counsel

KEC:tr
prop/prec/newconst/00/02kec

Attachment

cc: Honorable Dean Andal
Honorable Claude Parrish
Honorable Johan Klehs
Honorable John Chiang
Honorable Kathleen Connell
Mr. James E. Speed, MIC:73
Mr. Timothy W. Boyer, MIC: 83
Mr. Larry Augusta, MIC:82
Mr. Dick Johnson, MIC:63
Ms. Jennifer Willis, MIC:70