WHAT'S IT *REALLY* WORTH: PECULIARITIES IN THE VALUATION OF COMMERCIAL PROPERTIES UNDER PROPOSITION 13

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Since the passage of Proposition 13 ("Prop. 13") in June 1978, many owners of commercial properties in California understandably have become complacent when it comes to property taxes. Commercial property owners may think they grasp the basics of Prop. 13, i.e., valuation based on actual purchase price or actual cost of new construction, with increases to this "base" valuation limited to 2% annually and a tax rate pegged at 1% (plus a few add-ons) of that valuation.[1] But by focusing only on these long-touted protections offered by Prop. 13, many commercial owners fail to recognize – often to their economic detriment – that the issue applicable in virtually all other states' taxation schemes, i.e., what is a property really worth under applicable law, is still very much alive in California. This article provides some suggestions for avoiding this property tax myopia and the increased tax payments that typically result from it.

1. BACKGROUND

Prior to Prop. 13, every property in California was subject to periodic revaluation, either annually or over some longer period. In addition, counties had the ability to increase the applicable tax rate, thereby magnifying the effect of any increase in valuation. Prop. 13 was designed to place limits on both these practices, and in the opinion of most property owners, it has been very effective in achieving that goal. In fact, it has been so successful that today, almost 30 years after its passage, many owners either have forgotten or are unaware of the essential dynamics of property taxation that gave rise to the initiative and which remain applicable to this day.

Prop. 13 did not change the "fair market value" approach to property taxation that has been operative in California for over 100 years; it merely placed an overlay on that system.[2] Rather than permitting unlimited annual increases in valuation and tax rates whenever the "market" otherwise supports those increases, Prop. 13 established certain triggering events ("triggers") for re-valuation of a property as well as limits on subsequent annual increases in that valuation.[3] The triggers include a change in ownership, e.g., the sale or exchange of real property ("COO"), and the completion of construction of improvements to real property ("New Construction"). But, as discussed below, the hypothetical "market" remains an important limitation in determining the resulting valuation, and the nature and extent of its impact varies with the affected trigger.

In 1978, voters were focused on ever-increasing re-valuations and tax rates; the fact that property values might actually decrease in coming years was of little concern. For that reason, Prop. 13 limits only increases in valuation and tax rate. Sponsors of the initiative quickly realized this oversight, and in November 1978, voters approved

Proposition 8 ("Prop. 8), which enables an owner to seek a temporary reduction in a property's assessed valuation ("Prop. 8 Decline") if the "market" supports a lower value. While Prop. 13 imposes a 2% annual ceiling on a valuation increase, there is no corresponding floor on a Prop. 8 Decline; thus, this third trigger in the Prop. 13 taxation scheme (albeit only with regard to decreases in valuation) is especially impacted by the long-standing concept of fair market value.

Not surprisingly, the "market" dynamics at play with respect to each of these three triggers, COO, New Construction and subsequent Prop. 8 Declines in fair market value, are different. For example, the fair market value of a property that has undergone a COO may be less than its stated purchase price, or the actual costs associated with New Construction, when added to the existing value of the land on which the improvements were constructed, may exceed the property's fair market value. By focusing on the specific trigger, it is possible to identify certain essential elements that affect fair market value in a given situation and to determine whether those factors might support a decrease in the property's valuation for property tax purposes.

2. FAIR MARKET VALUE.

Prop. 13's impact on the continued application of the historic concept of fair market value was the formulation of the specific triggers discussed above and imposition of an annual upper limit on any subsequent increases in the valuation of a property. That limit is readily determined by increasing the value that is established as of the date of either a COO or New Construction (the "base year value") by 2% annually, on a compounded basis (typically referred to as the "trended base year value"). The permitted valuation on any applicable date of value[4] is the lesser of the property's fair market value or its trended base year value.

What then is "fair market value"? As defined in the applicable regulation:

> ". . . . 'fair market value' [shall] mean the price at which a property, if exposed for sale in the open market with a reasonable time for the seller to find a purchaser, would transfer for cash or its equivalent under prevailing market conditions between parties who have knowledge of the uses to which the property may be put, both seeking to maximize their gains and neither being in a position to take advantage of the exigencies of the other. When applied to real property, . . . 'fair market value' [shall] mean the price at which the unencumbered or unrestricted fee simple interest in the real property (subject to any legally enforceable governmental restrictions) would transfer for cash or its equivalent under the conditions set forth in the preceding sentence."[5]

The first sentence embodies the standard with which all appraisers and certain owners are familiar. Yet because the rule makes no mention of recognized exclusions from the resulting "market" value, e.g., certain costs incurred in performing New Construction and non-real property elements sometimes included in a COO, many owners simply assume that the total costs of New Construction or the stated purchase price for a COO reflect the property's fair market value. More significantly, for properties that are leased or licensed

to third parties for the purpose of income generation, the impact of the qualifications set forth in the second sentence is huge. In ascertaining a hypothetical market value, encumbrances, such as in-place leases, licenses and other income contracts, as well as in-place management contracts and other expense obligations, must be ignored; and projected net operating income instead must based on market rents, license fees and related income, market expenses and market vacancies – irrespective of the trigger.

In the lexicon of property taxation, this reflects the distinction between leased fee, i.e., valuation based on in place contract rents and fees, and unrestricted fee simple valuation. While some owners are aware of the significance of this language in the context of Prop. 8 Declines, most simply cannot believe that it also could support a reduction in valuation below the purchase price for a recently acquired property or the actual construction costs for certain New Construction. Such a reduction can be achieved, however, only if an owner is able to present credible "market" evidence supporting a lower fair market value.[6] The required evidence often varies in correlation to the applicable trigger, but since a reduction in valuation for a COO and New Construction adjusts the property's base year value (and thus its trended base year value going forward), this exercise is well worth the effort.

The effects of certain recognized exclusions from "market" value as well as examples of the practical impacts of this lesser-known aspect of Rule 2, in the context of each of the three triggers, are examined in greater detail in the following sections.

3. CHANGE OF OWNERSHIP

The primary trigger for revaluation of California commercial properties is a COO. While each year, in excess of 1 million commercial properties in California are sold or exchanged to third parties, COO also includes properties owned by an entity that experiences a change in voting control. Under applicable law, upon a COO, the purchase price is presumed to reflect the fair market value of the property (Cal. Code, Rule 2(b)); however, this presumption is rebuttable (provided that the owner can prove a market value that is less than 95% of the purchase price). There are a number of factors that, if present, could enable a taxpayer to satisfy this burden.

An income-producing property that is sold in a market that has experienced either a recent sharp or a steady decline in market rents is a property tax paradox. While contract rents may make the property attractive to buyers looking to ride out the current rent cycle, thus justifying a higher price, those same elevated rents offer a tax opportunity. As mandated under Cal. Code, Rule 8,[7] "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 . . . ." Any value attributable to the over-market portion of contract rents (which must be established by evidence of lower "market" rents from the subject and comparable properties) is properly excludable from the resulting base year value. The same is true for a property whose current operating expenses, for reasons such as poor management practices or temporary spikes in certain expenses, e.g., casualty or terrorism insurance,

are less than "market" operating expenses. In either instance, it is the market, not the actual, income and expenses that will control for tax re-valuation purposes.

Often included in the purchase of commercial properties are non-assessable assets and rights classified as "intangibles" under California law. Intangibles, such as an in-place workforce, tradename or trademark, private contract rights and enterprise value, are exempt from taxation. Their fair market value can be excluded in the re-valuation process; provided, however, the presence of certain intangibles necessary to put the taxable real property to beneficial or productive use is assumed.[8] For example, the value of a reciprocal easement for parking and ingress and egress among the owners of parcels in a multi-parcel shopping center cannot be excluded since the availability of sufficient parking and access for each parcel is presumed for such a property. On the other hand, the value of a lease for parking on an adjacent parcel, when used primarily for overflow parking by the owner of the affected property, is not assessable. Establishing the existence and discrete value of the intangible item often proves challenging but rewarding since it will permanently lower the property's new base year value.

Another example of a scenario where purchase price often does not equal fair market value is the multi-property, or "portfolio," purchase. While in certain instances, buying multiple parcels, like other bulk purchases, reduces the cost of each affected parcel, more frequently a buyer will pay a premium (non-assessable) above the collective fair market value of the parcels – particularly if the affected properties are highly regarded or will enable the purchaser to gain a greater degree of control of the affected marketplace. Advance planning is essential in this situation. The purchaser carefully must ascribe a purchase price to each property (which should be reflected in all filings with the county Assessor) and should be prepared not only to demonstrate that the indicated purchase price reflects the property's fair market value at the time but also to provide any economic analysis that it employed to determine the value of the premium.

A property that undergoes a COO by reason of the transfer of a controlling interest in the entity holding title, rather than a sale or exchange to an unrelated third party, also presents both a challenge and an opportunity. The challenging aspect of this scenario is the formulation of the fair market value of the property, utilizing the criteria discussed above, as of the date of the transfer. Often the parties fail to develop sufficient contemporaneous market data, usually because they are oblivious to the issue. But since the amount paid or credited for the interest being transferred frequently is influenced by income tax or capital account considerations that have little to do with fair market value, this type of COO offers a good opportunity for establishing a new base year value lower than the purported purchase price. The required market data will vary with the property type and character; similarly, the transferee must be prepared to demonstrate why the purported acquisition price is not reflective of market value.

While many owners, upon a COO, are willing simply to equate purchase price with fair market value and thus acquiesce to the establishment of an excessive base year value, the situations discussed above are only some of the more common examples of

exceptions to this widely-held assumption. The same is true with a base year value established after completion of New Construction.

4. NEW CONSTRUCTION

Upon completion of New Construction, a property will receive a new base year value; however, unlike a COO, only the fair market value of the new improvements will be added to the base year value of the pre-existing land and improvements in setting the new base year value.[9] Many owners simply provide the Assessor with the total costs associated with the New Construction (typically in response to a request for such information) and assume that those costs will be added to the property's existing base year value. They fail to recognize that certain costs, e.g. costs of repairs or replacements and costs for specified categories of improvements to an existing structure, can be excluded from reassessment and that a somewhat arbitrary amount – known as entrepreneurial profit – likely will be added to the construction costs in setting the new base year value. It also rarely occurs to owners that the fair market value of their property post-New Construction actually may be less than the costs of such construction.

Only those costs associated with construction of completely new structures and other improvements, whether to all or a portion of a property, are assessable. Costs incurred for normal maintenance and repair, even if they involve replacement of existing elements of the property, are properly excluded unless the replacement is so extensive as to make a building or fixture substantially equivalent to new.[10] The costs for replacing steel pipes with copper and substituting aluminum windows for wood-framed ones are examples of excludable costs; tearing out existing tenant improvements and installing TIs for a new tenant is clearly a re-assessable activity. Where an element of new construction falls along this continuum often is the subject of much debate. That debate will never occur, however, unless the owner recognizes the issue and timely raises it with the Assessor.

Certain categories of costs for improvements to existing commercial structures can be excluded from assessment irrespective of the extent of the construction. These exclusions include seismic retrofitting improvements (Rev. & Tax. Code, Section 74.5), disabled person accessibility improvements (Rev. & Tax. Code, Section 74.6), installation of fire sprinkler/suppressions systems (Rev. & Tax. Code, Section 74) and installation of an active solar energy system (Rev. & Tax. Code, Section 73). Strict time deadlines exist with respect to the exclusions for seismic retrofitting and handicapped access; both require filing of written notification within thirty (30) days after completion of construction. Since all exclusions are limited to only those costs incurred in planning and constructing the excluded improvements, an owner who otherwise qualifies is well-advised to carefully identify and track those costs in separate spreadsheet during the progress of the construction.

Not surprisingly, a major element in the assessment of New Construction boosts the resulting base year value. California law presumes that no owner of commercial property held for income generation would incur the expense of New Construction

without the prospect of realizing a return on monies expended.[11] In property tax parlance, this is "entrepreneurial profit," which is defined as either the return that the owner likely would expect to recover from its invested costs or the difference between the property's fair market value and the total costs incurred in purchasing and improving the property to date.[12] Assessors typically consult current national or regional publications to determine the market rate of return on investment for similar types of properties. Entrepreneurial profit measured by the difference between fair market value and total costs incurred usually sets the upper limit on the assessable value of the New Construction. It also can present the owner with an excellent opportunity to secure a reduced new base year value if the property's then-existing fair market value is less than the total of is prior base year value plus the amounts incurred for the New Construction.

This final point cannot be over-stressed. In the current California environment of rapidly-escalating construction costs and lengthy periods for securing approvals, the fair market value of a property frequently is less than the owner's cost to purchase and improve that property. Yet many owners fail to consider this reality – and its impact -- when faced with a re-valuation after completing New Construction, and these owners typically remain unaware until the third Prop. 13 trigger occurs with respect to the property.

5. PROP. 8 DECLINES

The only basis for a Prop. 8 Decline is a showing that, as of the affected lien date, a property's fair market value is less than its trended base year value.[13] For that reason, a commercial owner is well-advised to focus on disregarding contract rents in favor of market rents and devaluing construction costs that exceed market value as a starting point in the determination of fair market value. There are also other considerations and practices, often overlooked, that can result in similar adjustments to a property's ostensible market value. Because a Prop. 8 Decline only applies for a single tax year, if not pursued in a timely manner, the opportunity for a reduced valuation is lost forever.

The portion of the preceding discussion of COOs, which focused on market rents and market expenses, was directed primarily at the subject property's income generating potential. To enhance the likelihood of demonstrating a Prop. 8 Decline, an owner should perform a similar analysis with respect to recent sales comparables. The sales comparison approach is another of the three valuation methodologies recognized in California. In a market with declining rents, a property with significant space subject to leases (for any extended period) at above-market rents typically will sell at a premium. The resulting sales price, to reflect the property's fee simple value, must be adjusted downward to exclude that portion of the price that represents consideration for the value of the over-market leased fee. Getting reliable information about a comparable property's contract rent structure and projected lease rollovers at the time of sale is often difficult, but, as in the case of a COO, it is usually more than worth the effort.

A similar adjustment will be required when examining recent sales of comparable properties to extract a market rate of return for use in the income approach. Frequently,

market data services and commercial brokers provide information only about a comparable's actual net operating income ("NOI"), using in place contract rents and actual expenses. The NOI is then divided by the stated sales price to derive a rate of return (referred to as a "direct capitalization rate" or "cap rate"). In order to convert this cap rate to a "market" cap rate, as required for property tax valuation, a hypothetical NOI, using market rents and market expenses, must be developed and the sales price must be adjusted to reflect the impact of the differing, non-market rent, expense and vacancy levels.[14] Since any increase in the market-derived cap rate will produce a lower market value, proper adjustments to the sales comparable often have a material impact on the resulting fair market value of the property experiencing a Prop. 8 Decline.

Like the anomaly that is the Prop. 13 "room," i.e., having a rigid ceiling for valuation increases but no floor for decreases, so to is the income-producing property that is experiencing above-average vacancy on the lien date. The income approach recognizes a deduction from a property's gross operating income for typical vacancy and collection losses, which usually ranges from 5% – 10% depending on property type – even if the property's actual vacancy is significantly less. With respect to a Prop. 8 Decline, however, Assessors are required to decrease the NOI for a property that is experiencing actual vacancy greater than this typical range to account for so-called excess vacancy. This practice magnifies the diminution of a property's fair market value in a weak rental market but has little or no impact in a strong or normal market.

The savvy commercial owner will analyze each of its properties annually to determine if a Prop. 8 Decline may have occurred, always remembering that with respect to the entire property, it is current market rents, expenses and vacancy rates that count.

6. SUMMARY

Prop. 13 did not replace or render obsolete the fair market value standard. It simply established triggers for the re-valuation of real property and annual limits on subsequent increases in that value. If an owner can demonstrate by competent evidence a property's hypothetical fair market value as of the trigger date, that value must be utilized for assessment purposes, even if less than the stated purchase price for a COO or the actual costs of New Construction or, in the case of a Prop. 8 Decline, when lower than the trended base year value. For many commercial properties, this hypothetical market value then becomes what it is really worth.

[1] California Constitution, Article XIII A.

[2] Prop. 13, which added Article XIII A to the California Constitution, did not repeal or in any way alter the provisions of Constitution Article XIII pertaining to taxation according to fair market value. State Board of Equalization v. Board of Supervisors (1980) 105 Cal. App. 3d 813.

[3] Permitted increases in the tax rate above the 1% limit established under Prop. 13, typically implemented by way of local initiative, are not addressed in this article.

[4] Dates of value are (i) with respect to both a COO and New Construction, the date on which such event actually occurs and (ii) for each tax year thereafter (a tax year extends from July 1 – June 30), January 1 of the calendar year in which the tax year commences (commonly referred to as the “lien date”). Cal. Rev. & Tax. Code, Sections 51, 71 and 110.1.

[5] 18 California Code of Regulations (“Cal. Code”), Rule 2(a).

[6] 18 Cal. Code, Rule 321.

[7] Cal. Code, Rule 8 sets forth guidelines for use of the income approach, one of the three recognized methodologies in California. Under this approach, an appraiser values an income property by computing the present worth of a future income stream.

[8] See Cal. Rev. & Tax. Code, Section 212.

[9] Cal. State Board of Equalization, California Assessor’s Handbook 502, Advanced Appraisal, Chap. 6, p.130.

[10] 18 Cal. Code, Rule 463(b)(4).

[11] Cal. State Board of Equalization, California Assessor’s Handbook 502, Advanced Appraisal, Chap. 2, pp. 13-14.

[12] Rev. & Tax. Code, Section 401.6(b).

[13] Rev. & Tax. Code, Section 51(a)

[14] Cal. State Board of Equalization, California Assessor’s Handbook 502, Advanced Appraisal, Chap. 4, pp. 77-80.