# TAX REASSESSMENTS UPON SALE: THERE MUST BE SOME MISTAKE!!

True or false – upon an arm's length sale of a California investment property, the new assessed value, for property tax purposes, cannot exceed the purchase price? If you're like most other real estate professionals who have responded, you said "true." And like those other very savvy respondents, you are shocked to learn the correct response. Unfortunately, Assessors throughout California know the answer, and they are prepared to issue a supplemental assessment upon sale well above the purchase price. How can they do that, and what can you do about it?

Under Proposition 13, a property in California can be reassessed only upon sale or other transfer or new construction; otherwise, the Assessor is limited to a 2% annual increase in value. When a sale occurs, current law provides that the new value, commonly referred to as the "base year value," shall be set at the property's fair market value on the date of sale. For virtually all single-family residential property in California, the purchase price for property sold in an arm's length sale is the best indicator of fair market value; in essence, the price reflects the value to the purchaser of the right to live in the property. Makes sense, doesn't it?

The same rationale applies in the case of the sale of an owner-occupied commercial property, e.g., a corporate headquarters or a branch bank building. The purchase price arguably reflects the value to the buyer of the right to conduct its business in the property. As with virtually all sales of single-family residences, Assessors throughout California readily will accept the purchase price in an arm's length sale of owner-occupied commercial property as the best indicator of the property's fair market value on the date of sale and usually will enroll the price as the base year value.

Investment property – office buildings, apartment complexes, shopping centers, etc. – presents a different scenario. A purchaser is buying the right to receive cash flow from operation of the property, and the purchase price in an arm's length sale ostensibly reflects the value to the purchaser of that right, not the right to occupy the property. The typical indicator of cash flow, net operating income (NOI), is based upon <u>actual</u> rents and <u>actual</u> expenses at the time of sale. Those rents and expenses may have little relation to "market" rents or expenses, however, particularly in a red-hot rental market like that in the S. F. Bay Area over the past eighteen (18) months. Believe it or not, applicable law gives the Assessor the right to set the new base year value on the basis of <u>market</u> rents and <u>market</u> expenses.

In response to the inevitable cries of unfairness, Assessors point to what they call "leasehold" or "bonus" value, i.e., the difference between actual rents and market rents. Theoretically, one party, either the landlord or the tenant, has the right to benefit from this "bonus" value, either through subleasing or assignment, in the case of a tenant, or recapture or sub-rental participation, in the landlord's case. In either event, the argument goes, the differential has value; and California law clearly empowers the Assessor to establish a new base year value on the basis of all components of value, not just the

owner's "equity." Furthermore, applicable regulations provide that voluntary encumbrances, like leases, licenses and easements, can be ignored in setting the base year value. The result: the new assessed value may be significantly higher than the purchase price, particularly for properties saddled with numerous below-market leases.

So what can a buyer of investment property do to minimize the new base year value and its impact on NOI. First and foremost, act quickly. Many Assessors do not issue the resulting supplemental assessment until up to 18 months after the sale. As a result, the ability to recover the full amount of property tax pass-throughs from tenants who vacate during that period is compromised. Next, assemble all available data for use in negotiations with the Assessor. Although the law provides the right to set the new base year value above the purchase price, it also establishes a presumption that a cash purchase price in an arm's length sale reflects the fair market value of the property. The Assessor can rebut that presumption, but only with competent evidence of market data as of the date of sale, a burden that he/she often is unable or unwilling to meet – particularly when the buyer has provided compelling evidence to the contrary. Finally, be realistic and flexible with both existing and new tenants and the Assessor; the new base year value, the resulting tax increase and the extent to which it can be recouped are subject to negotiation, not hard and fast rules.

We recently have assisted numerous buyers of S.F. Bay Area investment properties in minimizing their new base year values through a very proactive approach. Each owner understood the value of taking the matter to the Assessor <u>before</u> the supplemental assessment was issued, thereby minimizing lost revenues and greatly reducing the likelihood of a contentious, prolonged assessment appeal. With rents continuing to climb off the charts, we trust that buyers will confront the issue long before they receive that "mistaken" supplemental tax bill.