



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	02/16/11	Bill No:	<a href="#">Senate Bill 464</a>
Tax Program:	Property	Author:	Anderson
Sponsor:	San Diego County	Code Sections:	RTC 74
Related Bills:		Effective Date:	Upon enactment

### BILL SUMMARY

This bill would expand the new construction exclusion for the installation of fire safety devices installed in an existing building to devices included in the construction of a new building, provided it was built to replace a property damaged or destroyed in a misfortune or calamity.

### ANALYSIS

#### CURRENT LAW

**Fire Safety Devices.** The California Constitution, Article XIII A, Section 2(c)(2) gives the Legislature the authority to exclude from the definition of new construction “[t]he construction or installation of any fire sprinkler system, other fire extinguishing system, fire detection system, or fire-related egress improvement, as defined by the Legislature.”

The Legislature enacted Revenue and Taxation Code Section 74 to set forth the detailed definitions and requirements granting the new construction exclusion for fire-related improvements. The provisions of Section 74 currently limit its provisions to improvements made to an **existing** building or structure.

The types of improvements that would not be subject to property tax if constructed or installed in an existing building include:

- fire sprinkler systems,
- fire extinguishing systems,
- fire detection systems, and
- fire-related egress improvements.

**Disaster Reconstruction.** The California Constitution, Article XIII A, Section 2(a) provides that “ ‘newly constructed’ does not include real property that is reconstructed after a disaster, as declared by the Governor, where the fair market value of the real property, as reconstructed, is comparable to its fair market value prior to the disaster.”

Section 70(c) provides that “where real property has been damaged or destroyed by misfortune or calamity, ‘newly constructed’ and ‘new construction’ does not mean any timely reconstruction of the real property, or portion thereof, where the property after reconstruction is substantially equivalent to the property prior to damage or destruction.” Any reconstruction of real property, or portion thereof, that is not “*substantially equivalent*” to the damaged or destroyed property, is treated as new construction. If this occurs, only that portion that *exceeds* what is deemed to be substantially equivalent reconstruction would be assessed at current market value.

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**Disaster Reassessments.** Revenue and Taxation Code Section 170 provides that property taxes may be reduced following a disaster, misfortune, or calamity in those counties where the board of supervisors has adopted an ordinance authorizing these provisions. These provisions apply to both Governor-declared disasters and site-specific disasters such as a home fire. Disaster relief is provided by allowing the county assessor, under specified conditions, to reassess the property as of the date of the disaster to recognize the loss in a property's market value and the loss in value must be at least \$10,000. The prior assessed value of the damaged property is reduced in proportion to the loss in market value; the new reduced value is used to calculate a pro-rata reduction in taxes. The affected property retains its lower value, with reduced taxes, until it is restored, repaired, or reconstructed. Generally, taxpayers have up to 12 months to file a request for reassessment.

#### PROPOSED LAW

**New Building – Disaster Reconstruction.** This bill would amend Section 74 to add subdivision (f) to provide that the fire safety new construction exclusion also applies to fire sprinkler systems, other fire extinguishing systems, and fire detection systems that are constructed or installed in a *new* building if:

- The new building is built upon land or improvements that were originally constructed prior to January 1, 2011. §74(f)(3)(A)
- The land or improvements qualified for reassessment pursuant to Section 170. §74(f)(3)(A)
- The construction and installation of the fire safety system is completed on or after January 1, 2012. §74(f)(4)

**Nonresidential New Buildings.** The proposed expansion of the new construction exclusion to new buildings would *not* apply in the case of the construction of a “*nonresidential*” building if the improvements are *required* by Title 24 of the California Code of Regulations (California Building Standards Codes) or any local ordinance. For instance, if a multi-story office building is constructed, and a fire sprinkler system is required, the associated value of these improvements would not be excluded from property tax under this bill. §74(f)(3)(C).

**Residential Buildings – Full Application.** With respect to the construction of new residential types of properties (for example, single and multi-family residences, apartment buildings, hotels and motels) the exclusion would be available whether or not the systems are required by the California Building Standards Code or local ordinances. §74(f)(3)(C).

**Administration.** The owner would be required to file a claim for the new construction exclusion with the assessor. The assessor would reduce the base year value of the new building by an amount equal to the value of the excluded improvements subject to this bill.

**Operative Date - January 1, 2012.** This bill is keyed as a tax levy and would be effective immediately. However, proposed Section 74(f)(4) provides that its provisions would only apply to construction or installations completed on or after January 1, 2012.

### IN GENERAL

**Property Tax System.** Article XIII, Section 1 of the California Constitution provides that all property is taxable at the same percentage of “fair market value,” unless specifically exempted, or authorized for exemption, within the Constitution. Article XIII A, Section 2 of the California Constitution defines “fair market value” as the assessor’s opinion of value for the 1975-76 tax bill, or, thereafter, the appraised value of property when purchased, newly constructed, or a change in ownership has occurred. This value is generally referred to as the “base year value.” Barring actual physical new construction or a change in ownership, annual adjustments to the base year value are limited to 2% or the rate of inflation, whichever is less. Article XIII A, Section 2 provides for certain exclusions from the meaning of “change in ownership” and “newly constructed” as approved by voters via constitutional amendments.

**Constitutional Amendments.** Over the years, voters have approved constitutional amendments to exclude certain types of construction activity from assessment as “new construction.” Consequently, while these improvements may increase the value of the property, the additional value is not assessable.

Specific to this bill, Proposition 8 (1978) provided that reconstruction after a disaster would not be considered new construction and Proposition 31 (1984) provided that adding certain fire protection systems and fire-related egress improvements would not be considered new construction.

Prop	Election	Subject	Code
<b>8</b>	<b>November 1978</b>	<b>Disaster Reconstruction</b>	<b>§70(c)</b>
7	November 1980	Active Solar Energy Systems	§73
23	June 1984	Seismic Safety (Unreinforced Masonry)	§70(d)
<b>31</b>	<b>November 1984</b>	<b>Fire Safety Systems and Fire Egress</b>	<b>§74</b>
110	June 1990	Disabled Access Improvements (Homes)	§74.3
127	November 1990	Seismic Safety Retrofitting & Hazard Mitigation	§74.5
177	June 1994	Disabled Access Improvements (All Properties)	§74.6
1	November 1998	Environmental Contamination Reconstruction	§74.7
13	June 2010	Seismic Safety Retrofitting & Hazard Mitigation (changes Proposition 23 and 127)	§74.5

**New Construction Exclusion – Disaster Relief.** Pursuant to Proposition 8, Revenue and Taxation Code Section 70(c) provides that “where real property has been damaged or destroyed by misfortune or calamity, ‘newly constructed’ and ‘new construction’ does not mean any timely reconstruction of the real property, or portion thereof, where the property after reconstruction is substantially equivalent to the property prior to damage or destruction.” Any reconstruction of real property, or portion thereof, that is not “*substantially equivalent*” to the damaged or destroyed property, is treated as new construction. If this occurs, only that portion that *exceeds* what is deemed to be substantially equivalent reconstruction would be assessed at current market value.

Consequently, a property that is rebuilt after a fire will continue to be assessed at the same amount even though the property has been entirely newly constructed. Anything deemed to exceed the prior improvements would be assessed as new construction (the underlying land assessment would be unchanged.)

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### LEGISLATIVE HISTORY

Proposition 31 was approved by voters at the November 6, 1984 general election. It was placed on the ballot by SCA 58 (Resolution Chapter 56, Statutes of 1984). A similar constitutional amendment had failed passage two years earlier at the November 1982 general election: Proposition 7 which was placed on the ballot by ACA 53 (Res. Chap. 49, Statutes of 1982).

The intent of the exclusion was to benefit the owner of the building in which the detection system is installed, by providing a shield against any increase in property taxes that might otherwise result from retrofitting the building with fire safety equipment. According to the analysis of the Assembly Committee on Revenue and Taxation, dated June 4, 1984, local ordinances were requiring that buildings be retrofitted because of a number of fire tragedies. Of particular concern was the cost of retrofitting hotels and motels. Consequently, the California Hotel and Motel Association sponsored the proposed changes to the Constitution to reduce the overall cost of making the fire safety improvements.

**AB 1239 (2007, Garrick)** would have expanded the new construction exclusion for the installation of fire safety devices installed in an existing building to additionally include these devices if included in the initial construction of an entirely new building, as specified. Furthermore, it would have extended the exclusion to the first purchaser of the new building if the owner-builder did not intend to occupy or use the property. Unlike this bill, it was not limited to post-disaster reconstructed properties. This bill was held in the Senate and Revenue Taxation Committee.

**SB 1569 and SCA 19 (2008, Kehoe)** would have placed a constitutional amendment before voters to provide that assessable “new construction” for property tax purposes does not include the construction or installation of any fire safety *retrofitting* improvements that meet fire safety building standards in an existing building. This bill was never set for hearing.

### COMMENTS

- 1. Sponsor and Purpose.** This bill is sponsored by San Diego County to exclude from property tax assessment the value of fire safety devices in new construction by disaster victims who are rebuilding their previously existing home or buildings and adding new rooms or structures.
- 2. Issue.** The current new construction exclusion for fire safety devices is limited to improvements made to an existing building or structure. This bill expands the new construction exclusion to qualified components of a new building provided it was built to replace a property damaged or destroyed in a misfortune or calamity. This issue has arisen in San Diego County, given the mass disaster reconstruction occurring due to the various wildfires of recent years, and building codes that now require fire sprinklers and other fire safety devices. The sponsors state that fire safety features should be encouraged and thus not subject to additional assessment in the case of reconstruction after a disaster.
- 3. Replacement properties that are substantially equivalent.** A property's pre-disaster Proposition 13 protected value will be reinstated if a substantially equivalent home is constructed on the property pursuant to Section 70(c). In practical application, when a property owner rebuilds a similar (i.e., substantially equivalent)

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home that includes a fire sprinkler system, the additional feature of a fire sprinkler system in the home would likely be considered incidental and still fall within the “substantially equivalent” classification.

4. **Replacement properties that are not substantially equivalent.** If a larger home is built as a replacement, then only the additional square footage is assessable as new construction and its value is added to the property’s pre-disaster assessed value. The portion of value added by new construction would be assessed and a Section 74 exclusion would not apply since it is limited in scope to improvements added to “existing buildings.”
5. **Assessment practices in San Diego County.** According to the sponsor, when the overall reconstruction was considered substantially equivalent to the property that existed prior to the fire, then no additional assessment was made regardless of whether the property previously had sprinklers. But in those cases where the reconstructed property was not substantially equivalent, the incremental value added by fire safety devices was assessed but limited in scope to the additional square footage areas.
6. **This bill would give property owners certainty that including these improvements in the reconstruction of a previously erected building or structure will not result in increased property taxes.** The determination as to whether reconstruction activity after a disaster is assessable as new construction is made on a case-by-case basis. While there are some basic guidelines in the statutes, property tax rules, and Assessors Handbooks, the various 58 local county assessors may differ in what they consider to be “substantially equivalent.” The treatment of a replacement property with a new feature, such as a fire sprinkler system, could differ depending on the county. It is possible that the entire value of a fire sprinkler system in the new house (rather than limited to the additional square footage, such as in San Diego) would be treated as new construction. Given the subjective nature of the determination of assessable new construction, this bill would give property owners some measure of certainty that property taxes will not be any greater if they include these fire safety devices in new buildings after a disaster.
7. **With this bill, reconstruction above and beyond “substantial equivalency” would still be subject to property tax assessment as new construction, but the incremental value added by the sprinklers would be excluded.** For example, in the case of a property assessed at \$200,000 before a disaster, when a substantially equivalent home with sprinklers is reconstructed on the property, the assessment will remain at \$200,000 regardless of actual market value. However, if the replacement home is 500 square feet larger, and thus not considered to be substantially equivalent, the additional square footage is subject to assessment as new construction. Where the additional value of the square footage is \$50,000 -say \$100 per square foot and the sprinklers contribute \$2 per square foot - this bill provides for the assessed value for new construction to be \$49,000 rather than \$50,000. And, the total assessment after reconstruction would be \$249,000 rather than \$250,000. At the 1% tax rate, the tax savings for the property owner would be about \$10 annually.
8. **Reassessment under Section 170.** This bill requires that the land or improvements qualify for reassessment pursuant to Section 170. One county does not have a Section 170 reassessment ordinance and another county provides for

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reassessment only for governor declared disasters. Thus, property owners in these two counties may not benefit from the provisions of this bill.

9. **“New building” definition and future disasters affecting homes and other structures first built after January 1, 2011.** As currently drafted, the bill would not apply to property originally constructed after January 1, 2011 and subsequently destroyed by a misfortune or calamity (i.e., a home first built in 2011 and destroyed by a fire in 2013.). It is unclear if this is intentional in order to limit the scope of the bill or merely an oversight. Additionally, the use of the term “land” in conjunction with the phrase “originally constructed” in the definition would benefit from revision, depending upon the bill’s intent, since all land would have been in existence prior to January 1, 2011. The definition of “new building” in Section 74(f)(3)(A) reads:

“New building” means any building, structure, or portion thereof that is newly constructed upon land or improvements that were originally constructed prior to January 1, 2011, and that qualified for reassessment pursuant to Section 170.

10. **Suggested Refinements.** Presumably, the property owner should report cost information and the assessor would determine its value. Also, because of the new construction exclusion available under Section 70(c), a “new” base year value may not be established for the replacement property – instead the former base year value is restored. A new base year value is only established for replacement properties that are not substantially equivalent. And, only the increase in value attributable to items such as extra square footage, additional features, or improved quality is given a “new” base year value. The following amendments are possible corrections:

(f)(1)(A) The owner of the building shall file a claim with the assessor and provide the assessor any documents necessary to identify the value-cost of attributable to the fire sprinkler system, other fire extinguishing system, and fire detection system included in the price-cost of the new building.

(B) The assessor shall evaluate the claim and determine the portion of the value of the new building that is attributable to the fire sprinkler system, other fire extinguishing system, and fire detection system. If a new base year value is required to be established for any portion of the new building, the assessor shall then reduce the new base year value for that portion of the new building by an amount equal to that portion of the value in that portion of the new building attributable to the fire sprinkler system, other fire extinguishing system, and fire detection system.

## **COST ESTIMATE**

With respect to administration, the BOE would incur insignificant costs in informing and advising local county assessors, the public, and staff of the law changes. These costs are estimated to be under \$10,000.

## **REVENUE ESTIMATE**

### **BACKGROUND, METHODOLOGY, AND ASSUMPTIONS**

For the purposes of this estimate, the revenue impact will be addressed separately for single-family residential units, multi-family residential units and non-residential units. Additionally, staff estimates that of all the fire protection devices defined under this bill, fire sprinkler systems will be the required device in most cases.

**Single-family Residential Property.** According to the Federal Emergency Management Agency's United States Fire Administration, the cost of a home sprinkler system is targeted at approximately \$1.60 per square foot in new construction. Assuming on average 360 homes per year were rebuilt after a disaster to include a fire sprinkler system, and the average size of the home was 2,500 square feet, and further assuming deduction for fire safety devices would not be recognized without this bill, the assessed value loss can be computed as follows:

$$\$1.60 \times 360 \times 2,500 = \$1,440,000$$

**Multi-family Residential Property.** The cost of constructing or installing fire protection devices in new multi-family residences is estimated to be two percent of the total building cost on average. According to CIRB, the 2011 forecast cost for all multi-family new construction is \$6 billion. Staff estimates that no more than 0.1 percent, or \$6 million of that amount will be affected by this bill. The assessed value loss can be computed as follows:

$$\$6 \text{ million} \times 2\% = \$120,000$$

**Non-residential Property.** For non-residential property, the average cost range for fire protection devices is estimated at \$1.50 to \$4.00 per square foot. The estimated average cost of non-residential property per square foot in the state is \$200. Therefore, the cost range of fire safety devices on average as a percentage of total square footage is  $[\$1.50 \text{ to } \$4.00] / \$200$ , or 0.8% to 2.0% of the total non-residential property cost. According to CIRB, the 2011 forecast cost for all non-residential new construction is \$4 billion. The assessed value loss can be computed as follows:

$$\$4 \text{ billion} \times [0.8\% \text{ to } 2.0\%] = \$32 \text{ million to } \$80 \text{ million}$$

Under this bill however, where fire protection devices are required by law for non-residential property, no exclusion will apply. While it is difficult to determine what percentage of non-residential property would qualify for this exclusion, staff estimates that no more than 0.1 percent, or between \$32,000 and \$80,000 of non-residential assessed value will be affected by this bill.

The revenue impact at the basic 1% property tax rate is then:

Single-family Residential Property	$\$1,440,000 \times 1\% = \$14,400$
Multi-family Residential Property	$\$120,000 \times 1\% = \$1,200$
Non-residential Property	$[\$32,000 \text{ to } 80,000] \times 1\% = \$320 \text{ to } \$800$

#### REVENUE SUMMARY

This bill would reduce annual property tax revenues at the basic 1% property tax rate by about \$16,000 annually. This exclusion would only apply until a change in ownership occurs.

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