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JUN 10 1998

DEPUTY DIRECTOR
 PROPERTY TAXES

June 9, 1998

Dear Mr. :

Travis Fullwood, Professional Advisor to Board of Equalization Member Ernest Dronenburg, has forwarded your April 24, 1998 fax transmittal to the Board Legal Division for review and response. In your correspondence, you provided a summary of a series of fractional interests in real property, and asked us to review the issue of reassessment of fractional interests in property, especially the treatment of reductions in value as set forth in Letter to Assessors No. 86/04, issued by Board Staff on January 8, 1986. We have done so, and again come to the conclusion that the procedures set forth in LTA 86/04 are not only authorized, but are compelled by the provisions of Revenue and Taxation Code section 51.

You relate the following summarized situation: Three family members own equal one-third tenant in common interests in a commercial building. The indexed base year value was \$3 million. In mid-1990, one owner transferred his one-third interest in a manner resulting in a change in ownership of that one-third interest. At the time of that transfer, and also on the March 1, 1991 lien date, the market value of the building was \$6 million. Accordingly, the transferred one-third interest was reassessed at \$2 million, resulting in an aggregate base year value of the building of \$4 million (\$2 million for the transferred one-third interest and \$1 million each for the two other one-third interests).

By 1992, the market value of the building had fallen to \$4.5 million. At that time, the factored base year value of the building was about \$4.1 million. The owner of the one-third interest reassessed in 1990 sought a Proposition 8 (California Constitution, Article XIII A, Section 2, Subd. (b)) reduction in the 1992 assessed value of that interest from about \$2 million (indexed) to \$1.5 million (one-third of \$4.5 million), which would have reduced the assessed value of the building to \$3.6 million. The Assessor denied the reduction because the aggregate base year value of \$4.1 million was still less than the aggregate market value of \$4.5 million, citing LTA 86/04, which advises that the aggregate base year value of the entire property must be considered for Proposition 8 purposes, even though a fractional interest in the property has previously been reassessed after a change in ownership. It is your contention that LTA 86/04 is inconsistent with Section 51, subdivision (d).

We do not agree. In our view, LTA 86/04 correctly states the law and, indeed, the procedure set forth therein is compelled by the provisions of subdivision (d) of Section 51, which, as you note, provides as follows: "For purposes of this section, 'real property' means that appraisal unit that persons in the marketplace commonly buy and sell as a unit, or that is normally valued separately."

You note that the concept of "real property" is treated differently in an initial change in ownership reassessment, in which only the fractional interest transferred is reassessed, than in the Proposition 8 situation you describe, in which the value of the whole property, not its fractional interests, is compared to the comparable factored base year value. Your observation is correct; however, this differentiation is compelled by the provisions of Proposition 13 (Article XIII A) and Section 51, subdivisions (a), (d), and (e).

Article XIII A, section 2, subdivision (a) requires a reassessment of real property upon its change in ownership. This necessitates that when a change in ownership occurs with respect to a fractional interest in real property, that fractional interest be reassessed and the value indicated thereby added to the base year value of the subject real property. See Revenue and Taxation Code sections 110.1, 50, and 65.1, which implement section 2, subdivision (a).

On the other hand, Article XIII A, section 2, subdivision (b) authorizes a reduction in the full cash value base to reflect a decline in value. This subdivision has been implemented by the Legislature in Section 51, subdivision (a), which specifically applies to "each lien date *after* the lien date in which the base year value is determined pursuant to Section 110.1 . . .". Section 51, subdivision (d), of course, contains the appraisal unit requirement quoted above, a provision comparable to which, it must be noted, does not appear in Section 50, the statute providing for reassessment upon change in ownership. Applicable there, instead, are the provisions of Section 65.1 (" . . . when an interest in a portion of real property is purchased or changes ownership, only the interest or portion transferred shall be reappraised . . ."). But section 51 does not authorize the separate assessment of fractional interests in real property for purposes of Proposition 8 reductions in value (Section 51, subdivisions (a) and (e)), unless such fractional interests constitute appraisal units that persons in the marketplace commonly buy and sell as a unit, or that are normally valued separately. (Section 51, subdivision (d)).

We acknowledge your argument that persons do, in fact, buy and sell fractional interests in real property for various reasons. However, we would disagree that a fractional interest constitutes an "appraisal unit" as that phrase is understood by assessors when assessing. The concept of appraisal unit connotes the identification of the combination of items or parcels of property that are commonly or most likely to be sold as a unit if the property were exposed to the market. See Assessors' Handbook Section 501, Basic Appraisal, pages 10 and 11, copy enclosed. For example, land and improvements are typically sold together, and priced as a unit. They would therefore constitute the appraisal unit. Similarly, a farm may be composed of several parcels, but operated together as a single unit. If, in the market, it would most likely be sold as a unit, the parcels taken together, rather than each parcel individually, would be appraised as the appraisal unit. On the other hand, if individual condominiums or cabins are the units typically bought and sold, each condominium or cabin would constitute a separate appraisal unit, even if it was a part of a larger parcel or property that is not commonly bought and sold as a unit.

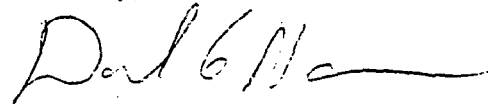
June 9, 1998

Viewed in this context, it is clear that an undivided interest in real property cannot constitute an appraisal unit as that term is utilized in Section 51 for Proposition 8 decline in value determinations.

Therefore, upon further review of LTA 86/04, in light of the statutory and constitutional provisions set forth above, we are of the view that the analysis and conclusions of LTA 86/04 continue to be sound and accurate.

The views expressed in this letter are, of course, 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.

Sincerely,



Daniel G. Nauman
Tax Counsel

DGN:jd

h:/property/precednt/13general/1998/98002.dgn

Enclosure

cc: Hon. Ernest J. Dronenburg, Jr.
Mr. Travis S. Fullwood
Hon. Gregory J. Smith,
San Diego County Assessor
Mr. Dick Johnson - MIC:63
Mr. Randy Bischof - MIC:64
Mr. David Gau - MIC:64
Ms. Jennifer Willis, MIC:70

ASSESSORS' HANDBOOK
SECTION 501

BASIC APPRAISAL

SEPTEMBER 1997

CALIFORNIA STATE BOARD OF EQUALIZATION

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market with a reasonable time for the seller to find a purchaser, would transfer in 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.

In short, market value is the value in exchange *under certain stipulated conditions*. Each selling price an appraiser uses as an indicator of market value should be investigated to determine whether these conditions were present at the time of the sale. If any of the conditions stipulated in the definition of market value is absent, the appraiser must determine whether—and to what extent—this influenced the selling price. Important aspects of the relationship between fair market value and open market conditions covered in the above definitions are:

- The amount the property would bring in cash or its equivalent
- Exposure on an open market for a sufficient amount of time
- Neither the buyer nor the seller able to take advantage of the exigencies of the other
- Both parties seeking to maximize their gains
- Both buyer and the seller having full knowledge of the property and acting prudently

From the viewpoint of economics then, value is a ratio of exchange. Economic theory recognizes that changes in this ratio of exchange are expressed in increased or decreased prices, and that the same amount of a commodity commands a greater or smaller number of dollars. In formulating the concept of market value in property tax law, the courts have stressed that this value is the most probable price *in terms of money*. Thus, we have an economic concept and a legal concept of value that are compatible.

✓ APPRAISAL UNIT

Market value, with some exceptions, is the standard of valuation for property tax appraisals in California. It follows that the property to which this standard is applied must be identified.

This identification of the property to be appraised is an integral part of the appraisal process.¹² Part of the process of identifying the property is identifying the "appraisal unit." The appraisal unit is also referred to as the "unit to be appraised," "unit to be valued," "unit of appraisal," or "unit of value."

In most cases the identification of the appraisal unit is obvious and causes few or no problems. Since the objective of the appraisal is to determine the market value of the property, the market also provides the appraisal unit. The proper unit to be valued is the unit that people in the market typically buy and sell. For example, single family homes are sold as a combination of land and buildings. Buyers and sellers do not negotiate separate prices for the land and the buildings but

¹² The appraisal process is discussed in Chapter 5.

negotiate a price for the combination of the land and buildings. The combination of land and buildings, therefore, comprises the appraisal unit, and the appraisal of this type of property must reflect the value for this unit.¹³

In some cases though, the identification of the appraisal unit may not be as easily discernible as with single family homes. For example, unimproved residential subdivision lots may be sold individually or in groups. Also, a farm property may consist of several parcels that could be sold separately or as a single farm unit. In these cases, the appraiser must use judgment to determine the proper unit. Decisions should be based on consideration of ownership, use, location, and, most importantly, highest and best use. These decisions must reflect, as faithfully as possible, the unit most likely to be sold if the property were exposed to the open market.

The necessity of defining the appraisal unit is common to all appraisals. The definition is more problematic, however, with property tax appraisals. When an appraisal is made to obtain a loan, for example, the appraisal unit is usually well defined by the lending institution ordering the appraisal. The property tax appraisal, on the other hand, does not have the benefit of such a prior definition. Also, property tax law imposes some requirements, limitations, and exceptions to the general principles relating to the appraisal unit.¹⁴

PRINCIPLE OF UNIT VALUATION

The principle of unit valuation is also based on the concept that the appraisal unit should be the unit most likely to be bought and sold in the market. The market may value certain properties according to the benefits that will be generated by the entire operating unit rather than the sum of the values of the individual parts. This principle presumes that value accrues to the assets because of their ability to generate benefits as a team rather than as a sum of the parts.

When using the principle of unit valuation, the appraiser segregates the operations (revenues and expenses) and the assets of the owner that operate as a team or as an aggregate from unrelated operations and assets. The team assets are called "unitary" property and are appraised as a whole, while unrelated assets are called "nonunitary" and are appraised as separate appraisal units.

This principle does not create any substitute for the fair market value standard discussed throughout this manual and is consistent with the discussion above. Appraisers usually refer to the unit concept when appraising a multi-parcel ranch but refer to the principle of unit valuation when appraising properties of a type that are geographically extensive or operationally integrated, such as railroads, gas and electric, and telephone companies that cross county lines, or large industrial or mineral operations.

¹³ California property tax law requires separate *assessments* of land and improvements but does not require separate *appraisals* of these different components of a property. The separate assessment of land and improvements is usually an allocation of the total value of the appraisal unit, which, in the case of a single family residence, is the combination of the land and buildings (improvements).

¹⁴ For example, under section 51(b) and rule 461(d), when considering declines in value caused by a calamity, land, improvements, and fixtures are separate appraisal units.