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August 14, 2007

Honorable  
County Assessor

**Attn: Chief Appraiser**

**Re: Valuation - Union Pacific Railroad Company v. State Board of Equalization**

Dear Mr. :

This is in response to a November 2, 2006, e-mail from Mr. of your office to Ms. of the Board of Equalization's Property and Special Taxes Department regarding the County Assessment Appeals Board's interpretation and application of the *Union Pacific Railroad Company v. State Board of Equalization*, (1989) 49 Cal.3d 138 (*Union Pacific*) decision.

As explained below, it is our opinion that the Assessment Appeals Board has misinterpreted *Union Pacific* with regard to the potential relevance of evidence of the development plans of purchasers of allegedly comparable properties. In our opinion, when such evidence reflects a market perspective on the highest and best use of an allegedly comparable property or reasonably sheds light on the highest and best use of such property, then it may be relevant to the inquiry.

**Factual Background**

The subject of this memorandum is an October 26, 2006 Statement of Decision and Findings of Fact by the County Assessment Appeals Board (AAB), in *In re Nordstrom Incorporated*, where the applicant asked the AAB to lower the assessed value of a department store.

In that appeal, the applicant presented evidence of the sales prices of allegedly comparable properties. In an attempt to rebut the applicant's comparable sales evidence, the county assessor's staff offered evidence of the "purchaser's development plans, including development of the properties by the purchaser after the purchase, i.e., comparable sales date, of

the properties." (*In re Nordstrom Incorporated, supra* at 15.) At page 15-16 of the Statement of Decision and Findings of Fact, the AAB states the following:

The Board did not consider or rely on such evidence because:

C. The purchaser's strategic plans for future acquisitions [are] not relevant to the assessment of existing property for fair market value. (See *Union Pacific Railroad Company v. State Board of Equalization* (1989) 49 Cal.3d 138 .... Though the facts in *Union Pacific* differ from the facts in this case, the principle is the same that property is valued on its valuation date "As Is" without consideration of future development plans for the property that may have existed on its acquisition date.) ..... The context of [Board Assessor's Handbook Section 501: Basic Appraisal – January 2002 (AH)] on this principle is that an appraiser can consider future benefits to be produced by the same subject property in its existing condition on its appropriate valuation date. This principle, as set forth in the context of AH, does not support the interpretation that an appraiser may consider for any given valuation date the future potential development plans of the property, including its demolition and redevelopment into [an] entirely new complex or facility. Consequently, in light of AH and *Union Pacific*, the Board did not consider the Assessor's evidence of post-acquisition-date development of Applicant's comparable sales.

In summary, as we understand the situation, the applicant offered evidence of the sales prices of comparable properties to establish the value of the property. In rebuttal, the assessor attempted to distinguish these sales from the subject property by offering evidence of the purchasers' development plans for the comparable properties. Specifically, evidence was introduced that at least one purchaser of a comparable property intended to demolish the improvements and redevelop the property. Citing *Union Pacific*, however, the AAB refused to consider the assessor's proffered evidence.

In *Union Pacific, supra*, 49 Cal.3d at 148-155, the Board of Equalization used an income approach to value Union Pacific Railroad property. The railroad had confidential plans to acquire more property after the valuation date. The Board wanted to include in its valuation a capitalization of the projected net income from these planned acquisitions. The Court refused to allow the Board access to this confidential information, however, citing Property Tax Rule<sup>1</sup> (Rule) 8, subdivision (c), which states "The amount [of income] to be capitalized is the net return which a reasonably well informed owner and reasonably well informed buyers may anticipate on the valuation date that the taxable property existing on that date will yield under prudent management." The Court went on to explain, "[t]he reason that only income from existing property can be considered is that possible income from property not yet acquired would have no effect on market value, i.e., the value to prospective purchasers." Furthermore, the court states that, since it was undisputed that the company's strategic plan was confidential, it could not

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<sup>1</sup> Property Tax Rules are promulgated under title 18 of the California Code of Regulations.

"have affected the value of the company's stock. Thus, even if stock market price were a proper measure of taxable value ... the plan would not be relevant." *Ibid* at 149.<sup>2</sup>

In summary, in its October 26, 2006 decision, the AAB held that *Union Pacific* stood for the principle that "property is valued on its valuation date 'As Is' without consideration of future development plans for the property that may have existed on its valuation date." Applying this principle, the AAB refused to consider evidence of the purchasers' stated future plans to develop the comparable properties.

### Analysis

The comparative sales approach relies upon the principle of substitution. "In the comparative sales approach, the appraiser: (1) selects comparable properties based on their similarity to the property being appraised (i.e., the subject property); (2) compares the selected properties to the subject property; and, (3) adjusts the sales prices of the comparable properties to reflect significant differences between the subject and comparable properties." (Assessor's Handbook, Section 502, *Advanced Appraisal*, p. 34 (December 1998).) The comparable properties are evaluated by elements of comparison, set forth in section 402.5 and Property Tax Rule 4, subdivision (d), and the Assessor's Handbook.

Section 402.5 allows the use of a property as a comparable if it is sufficiently similar such that its sale would shed some light on the value of the subject property. The properties must be alike in character, size, situation, suitability, and zoning or other legal restrictions.

Once comparables are selected, Rule 4, subdivision (d) allows the assessor to make adjustments for differences in the properties relating to "physical attributes of the properties, location of the properties, legally enforceable restrictions on the properties' use, and the income and amenities which the properties are expected to produce."

The Assessor's Handbook, Section 501, *Basic Appraisal*, p. 89 (January, 2002) provides two more elements of comparison: highest and best use and any non-real property components of the sale. "In order to qualify as a property's highest and best use, the use must meet four criteria. The use must be: (1) legally permissible; (2) physically possible; (3) financially feasible or probable; and (4) most productive." (*Ibid* at 48.) Under the fair market value concept, properties are not necessarily to be valued at their present uses but instead must be valued at their highest and best uses – which of course, are dependent upon legal, physical, and financial feasibility – as well as market determinations of maximum productivity. (See *Sacramento Southern R. Co. v. Heilbron* (1909) 156 Cal. 408; *Pacific Mutual Life Ins. Co. v. County of Orange* (1985) 187 Cal.App.3d 1141; *Dressler v. County of Alpine* (1976) 64 Cal.App.3d 557; Rev. & Tax. Code §110; American Institute of Real Estate Appraisers, *The Appraisal of Real Estate*, Ninth Ed., (1987).)

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<sup>2</sup> *Union Pacific* involved the attempted discovery of secret and confidential income projections of future projects for use in an income valuation approach. As the projections were secret, they presumably would not be reflected in the market's estimation of present stock or property value.

Consequently, the market may determine that a presently zoned R-1 (single-family residential) property actually has a more intensive C-3 (heavy commercial) highest and best use potential and value the existing R-1 property accordingly. In such case, the appraised fair market value of the property may be much higher than other R-1 properties and also much higher than indicated by the property's present use. In any case, it is axiomatic that the market – together with legal, physical, and financial feasibility – determines both highest and best use and fair market value.

In *Union Pacific*, the Court held that the Board could not obtain a taxpayer's secret and confidential information concerning anticipated future net income that might stem from planned future acquisitions and utilize such projected net income to value the taxpayer's property. Here, on the other hand, in applying the comparative sales valuation approach, evidence has been proffered regarding the stated development plans of the purchasers of allegedly comparable properties.

While we agree that such subjective intentions are not, in and of themselves, necessarily relevant at the AAB hearing, we are not prepared to advise that they have no possible relevance whatever to the issue of what highest and best use the market would assign to the comparable properties. For example, in valuing the subject property under the comparative sales approach, the highest and best uses of such property and any allegedly comparable properties are relevant. If the properties have inconsistent highest and best uses, then the properties are not comparable and the proffered sales are not relevant to value. If, on the other hand, the highest and best uses are consistent, then the properties may be comparable for purposes of application of the comparative sales approach.

In our opinion, evidence concerning the development plans of the purchasers of allegedly comparable properties may be relevant to the issue of the proper application of the comparative sales approach to the extent that such evidence reflects a market perspective or otherwise sheds light on the highest and best uses of such properties. In this regard, it is obvious that evidence of actual steps towards development or new construction (i.e., contracts, financing, permitization, etc.) carries more potential relevance than mere unsupported testimony of future intentions. Furthermore, to the extent that subjective development plans are found not to accurately reflect a market perspective or otherwise reasonably relate to highest and best use, they properly may be found irrelevant and either may be excluded from evidence at the hearing or disregarded by the AAB.

### **Conclusion**

Based on the foregoing analysis, in our opinion, the AAB misinterpreted *Union Pacific* in its October 26, 2006 decision. To the extent that evidence of the development plans of the purchasers of allegedly comparable properties reflects a market perspective or otherwise sheds light on the highest and best uses of those properties, such evidence may be relevant in determining whether or not the proffered properties are, in fact, comparable and whether or not the comparative sales approach properly may be utilized.

The views expressed in this letter are only advisory in nature and 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,

*/s/ Daniel M. Paul*

Daniel M. Paul  
Tax Counsel

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