

ASSESSORS' HANDBOOK
SECTION 501

BASIC APPRAISAL

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FOREWORD

This edition of the Assessors' Handbook Section 501, *Basic Appraisal*, is an update of the manual, which was rewritten in September 1997. The manual (formerly entitled *General Appraisal Manual*) was originally written in 1960 and revised in 1975 and 1982. The 1997 rewrite of the manual includes a complete reorganization of topics, the expansion and clarification of some portions of the existing text, and the addition of material concerning subjects not previously covered. The rewrite was undertaken by staff members of the Policy, Planning, and Standards Division (PPSD) in conjunction with the staff of the Property Taxes Section of the Legal Division of the State Board of Equalization and is the product of staff writing at the direction of the Board.

The objective of this manual is to give the beginning property tax appraiser, and other interested parties, an understanding of the basic principles of property assessment and real and personal property appraisal for tax purposes. It is not designed to be a complex or highly technical treatment of the subject or a detailed analysis of a particular type of appraisal or valuation approach. If there is an inconsistency resulting from the absence of technical data in this basic and general manual and more advanced information in another more specific manual, the more specific manual controls. Moreover, in the interest of accuracy and thoroughness, appraisers and other interested parties are advised to consult with qualified experts and other authoritative sources regarding the technical aspects of valuing any complex property.

As part of the process of producing this manual, meetings were first held with industry representatives and then with assessors. Conflicts regarding the content of the manual were identified and most were resolved. Those issues not resolved by meeting with industry and assessors were voted on by Members of the Board of Equalization after hearing testimony from interested parties and Board staff. The results of the voting are reflected as Board positions on issues in the manual. The Board originally approved this particular manual in September 1997, and adopted this update in January 2002. All citations and legal references were current as of the writing of this publication.

Under Government Code sections 15606 et seq., the Board is charged with the duty of administratively enforcing and interpreting the statutes governing the local assessment function. While regulations adopted by the State Board of Equalization are binding as law, Board-adopted manuals are advisory only. Nevertheless, courts have held that they may be properly considered as evidence in the adjudicatory process.¹

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¹ *Coca-Cola Co. v. State Board of Equalization* (1945) 25 Cal.2d 918; *Prudential Ins. Co. v. City and County of San Francisco* (1987) 191 Cal.App.3d 1142; *Hunt Wesson Foods, Inc. v. County of Alameda* (1974) 41 Cal.App.3d 163.

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CHAPTER 1: THEORY OF VALUE

WHAT IS AN APPRAISAL?

In an economic context, "appraisal" is the process of estimating the value of specific property at a stated time and place. The word "valuation" is also used in this sense, as a synonym for appraisal. A leading appraisal text defines appraisal as "the act or process of estimating value."²

While anyone can make an informal estimate of economic value, a formal appraisal is supportable based on the facts and data presented and the methods used. A formal appraisal is also supported by some form of written documentation or appraisal report.

Formal appraisals are made for a variety of reasons. Many appraisals are required by economic transactions, including the purchase and sale, financing, leasing, and insurance underwriting of property. Other appraisals are required as part of private legal actions such as divorce, bankruptcy, and lawsuits involving property. Governmental actions, including income tax matters and condemnation proceedings, may also require appraisals. Perhaps the largest government involvement with appraising is in the area of property taxation. *The duty of the appraiser is to prepare appraisals for property tax purposes using recognized methods and techniques that are consistent with property tax law.*

Three fundamental problems arise in any appraisal or valuation of property. The first problem is to obtain a clear definition of value acceptable for the purpose of the appraisal. The second problem is to obtain a clear definition of the property rights or interests that are to be valued. The third problem is to determine the proper method, or methods, by which the defined value will be estimated. This manual attempts to address these three fundamental problems in the context of appraisal for property tax purposes. Accordingly, this first chapter begins with a discussion of the general nature of value and definitions of some important value concepts.

NATURE AND PREREQUISITES OF ECONOMIC VALUE

In economics, material or immaterial things which satisfy human desires, and are external to people, are called goods. All goods are classified as either free or economic goods. Free goods have no value and do not command a price; economic goods have value and a price. Before any good can have value, it must meet all of the following four prerequisites:

- Utility
- Scarcity
- Capacity for private ownership
- Demand, or effective purchasing power

² *The Appraisal of Real Estate*, Eleventh Edition, (Chicago: Appraisal Institute, 1996), 11. Quoting from The Appraisal Foundation, *Uniform Standards of Professional Appraisal Practice*, "Definitions" section.

Utility. Utility is the capacity of goods to evoke desire for possession. Some economists simply say it is the quality of "wantedness" or "desiredness." British economist Alfred Marshall defined utility as the want-satisfying power of a commodity. All of these definitions indicate the essential nature of utility: It is psychological and depends upon the views or perceptions of *individuals*. Thus, value does not reside in objects or goods themselves; rather, it represents an attitude by people toward things. While goods have value because of their perceived capacity to perform useful services for individuals, utility does not necessarily mean everyday usefulness. One may question whether a diamond ring is useful, but no one will argue that it does not have utility in many settings or markets. In most cases, utility derives from the perceived benefits of an object, monetary or otherwise. Real estate, for example, has utility because prospective purchasers know of the productive services that real estate can provide.

Scarcity. Although utility is a necessary condition for value, it is not the exclusive condition. Some things may have immeasurable utility, and yet have no value. The air we breathe has a great deal of utility, but ordinarily it is not an economic good. The reason for this is that air is not scarce—it is freely available to all in unlimited quantities. Without scarcity, a good cannot have value. A good is scarce only in relation to the desire or demand for it. In order to have value, a good must require time and effort to obtain and be scarce enough so that it is necessary to economize on its use.

Capacity for Private Ownership. Before a good can have value, it must be capable of private ownership. Value in an economic sense thus assumes the social institution of private rights in property. The value of a good means value to an individual who has or may have an ownership interest in it. A good has economic value only if its attributes of utility and scarcity can be exploited by exercising the power of ownership through exclusive use or sale.

Demand or Effective Purchasing Power. A final prerequisite of value is demand, or effective purchasing power. If a good has utility and scarcity, this implies a desire on the part of people to obtain it. However, to create economic value, this desire must be supported by effective purchasing power. People must be ready, willing, and able to purchase the good at some price.

Value is a market phenomenon resulting from the interaction of supply and demand. In turn, supply and demand are functions of relative scarcity and utility, respectively. Land, buildings, and other goods have economic value because they have utility, are relatively scarce, are capable of private ownership, and are the objects of demand in a market context.

ECONOMIC CONCEPT OF MARKET VALUE

MARKET VALUE DEFINED

Economists define market value, also known as value in exchange, as the power of a commodity to command other commodities in exchange. Value in exchange means that the purchasing power of a commodity can be expressed in terms of other commodities. It is the relative

desirability of a commodity as evidenced by the actions of buyers and sellers in an open market at a particular time.³

For example, in a barter economy, a farmer might find that one tractor can be exchanged for three horses. The value of tractors is expressed in terms of horses, and vice versa. If the exchange ratio changes and one tractor now equals four horses, what is the effect on the power of a tractor to command horses in exchange? The answer is that the value of a tractor, in terms of horses, has increased. This may have happened because the value of tractors has remained constant in terms of all other goods while the value of horses has decreased, or because the value of both tractors and horses has changed in terms of all other goods. In either case, value in exchange is determined by the exchange ratios among goods or commodities.

In an industrial economy, market value is generally measured in terms of the commodity known as money. In these terms, market value is the price (the amount of money) that a property will bring when it is sold in a market. The general economic concept of market value, as described above, forms the basis for the precise legal standard of market value for property tax purposes that is presented in Chapter 2.

SUPPLY AND DEMAND AND MARKET VALUE

What determines market value? A partial answer to the question has already been given in the preceding paragraphs. Value is determined by the utility of the property, as manifested through the purchasing power of those who are interested in acquiring it; the relative scarcity of the commodity; and the difficulty involved in overcoming this scarcity (i.e., the time and effort required to obtain the commodity). In other words, value is determined by supply and demand. Supply and demand are the market effects of scarcity and utility. In *The Appraisal of Real Estate*, these concepts are discussed as follows:

Demand for a commodity is created by its utility and affected by its scarcity. Demand is also influenced by desire and the forces that create and stimulate desire. Although human longing for things may be unlimited, desire is restrained by effective purchasing power. Thus, the inability to buy expensive things affects demand.

Similarly, the supply of a commodity is influenced by its utility and limited by its scarcity. The availability of a commodity is affected by its desirability. Land is a limited commodity, and the land in an area that is suitable for a specific use will be in especially short supply if the perceived need for it is great. Sluggish purchasing power keeps the pressure on supply in check. If purchasing power expands, the supply of a relatively fixed commodity will dwindle and create a market-driven demand to increase the supply.⁴

³ A market may be defined as the organized action between potential buyers and sellers that permits trade.

⁴ Appraisal Institute, *The Appraisal of Real Estate*, 29.

Market demand and market supply interact in a competitive market to determine the price and quantity of the good traded. When the quantity demanded and the quantity supplied are equal, there is a state of balance known as equilibrium. From an equilibrium position, if market demand increases while market supply remains constant, price tends to increase. On the other hand, if market supply increases while market demand remains constant, price tends to decrease.

A change in just one of the many variables affecting supply or demand is likely to create a price and/or quantity movement in the market. The relative strength of the market forces underlying demand and supply determines whether price increases or decreases, and whether quantities demanded and supplied increase or decrease.

Thus, neither demand nor supply alone determines value. British economist Alfred Marshall illustrated this by asking the rhetorical question: Which blade of the scissors cuts the cloth? The answer, obviously, is that both blades cut it. Similarly, in a competitive market both demand and supply interact to determine value. A change in one of the variables affecting *either* supply or demand is likely to create a price movement in the market.

The essence of market value is that it is market derived. In a market subject to the interaction of supply and demand, value is determined by the actions of buyers and sellers bidding, and seeking bids, in competition with each other. The market value concept presupposes that: (1) there is competition for the acquisition of similar properties; (2) market participants have alternative choices; and (3) prospective purchasers make rational decisions. The ideal market reflects conditions of perfect competition.

A perfectly competitive market requires: (1) many buyers and sellers, none of whom can affect market price through their own singular efforts; (2) a standardized product; (3) no artificial restrictions; (4) easy entry and exit into the market by buyers and sellers; (5) complete knowledge and information regarding bids and offers; and (6) the mobility to take immediate action. The stock market and some agricultural markets may be the closest approximations of perfectly competitive markets, but few other markets meet these ideal standards. The real estate market, for example, trades in a non-standardized product with buyers and sellers frequently lacking complete information.⁵ In addition, many markets are subject to governmental interventions or restrictions that disrupt the natural market determination of price and quantity traded.

ECONOMIC CONCEPT OF USE VALUE

It is important to distinguish between the concept of market value and another value concept known as use value or value in use. The concept of use value is concerned with the value of property based on its utilization by a particular owner or group of owners. *The Appraisal of Real Estate* defines and describes use value as follows:

⁵ The real estate market is discussed further in Chapter 4.

Use value is the value a specific property has for a specific use. In estimating use value, the appraiser focuses on the value the real estate contributes to the enterprise of which it is a part, without regard to the property's highest and best use or the monetary amount that might be realized upon its sale.⁶

As already discussed, market value, as opposed to use value, presupposes a value determined by relevant market forces, such as supply and demand, scarcity, and utility, in a competitive market in which the participants act prudently, rationally, knowledgeably, and for self-interest. These market forces and the interactions of buyers and sellers ensure that market value will be the value of the property when put to its most profitable or "highest and best" use.⁷

Property tax appraisers in California, with certain exceptions set forth in the next chapter, are required by the California Constitution, statutes, and regulations to appraise property at market value. This requirement means that appraisals of both real and personal property must be based on the most productive, or highest and best use of the property. A section in the following chapter will discuss the issue of market value as opposed to use value in the context of appraising limited-market properties.

OTHER VALUE CONCEPTS

PRICE, COST, AND VALUE

Appraisers should not confuse the concepts of *price*, *cost*, and *value*.

Price is the amount actually paid for a property in a particular transaction. Price is a historical fact; it is not a prospective concept. The price paid is the amount a particular buyer has agreed to pay and a particular seller has agreed to accept under the conditions surrounding their transaction.

Cost refers to production, not exchange. It is the expenditure required to produce property, such as the cost of constructing a building. Cost can be a historical amount, a current amount, or a prospective amount. Appraisers also distinguish among *direct costs*, *indirect costs*, and *development cost*.

Direct costs are the expenditures for labor and materials, sometimes called *hard costs*, or *brick and mortar costs*. Direct costs include the general contractor's overhead and profit, as well as payments to subcontractors.

Indirect costs are expenditures for items other than labor and materials. Indirect costs include administrative costs related to a project, professional fees (e.g., payments for architectural, engineering, or legal services), construction financing costs, property taxes and insurance during

⁶ Appraisal Institute, *The Appraisal of Real Estate*, 24.

⁷ The principle of highest and best use is discussed further in Chapter 4. Briefly, highest and best use is the legally permissible, physically possible, financially feasible or probable, and maximally productive use that produces the highest residual land value. It is the use that produces the greatest long term net return to the owner.

construction, and lease-up or absorption costs necessary to reach normal occupancy (e.g., marketing expenses, leasing commissions, or expenditures made by the property owner for tenant improvements). Indirect costs are also called "soft costs."

Development cost is the all-inclusive cost necessary to develop the property. It includes all direct and indirect costs, plus the cost of the land and the entrepreneurial profit (which may also be viewed as a necessary cost) required by the developer to bring the project into existence.

The Dictionary of Real Estate Appraisal defines *value* in a general sense as "the monetary worth of a property, good, or service to buyers and sellers at a given time."⁸ In contrast to cost, the concept of value has a prospective aspect, in that the value at a given time reflects an anticipation of benefits to be received in the future.

The precise legal definition of value for property tax purposes in California is discussed in the next chapter.

VALUE AS THE PRESENT WORTH OF FUTURE BENEFITS

In the income approach to value, which will be discussed in Chapter 6, the appraiser estimates the value of income-producing property by converting the estimated future benefits of ownership into an indicator of present value. The premise is that present value is a function of future benefits or income. This leads to a definition of value as "the present worth of future benefits."

This definition of value is not inconsistent with other general definitions of value which have been discussed, such as market value or use value. It is merely a different perspective. For example, market value is determined in a market by the actions of buyers and sellers, but their actions reflect their calculations regarding the expected future benefits or income of the property traded based upon its most profitable or productive use.

VALUE AND THE PRICE LEVEL

Modern societies use money as a medium of exchange and a standard of value, with values expressed in terms of money. However, it is important to remember that money itself changes in value. The purchasing power of the United States dollar was quite different in 1986 than 1996. Since the value of goods is measured and compared in terms of money, the real value of a good may not have changed, even though its nominal value as measured in dollars has changed.

For example, if the dollar value of property "A" is \$100,000 in 1986 and \$150,000 in 1996, what does this mean? It may mean that the real value of property "A" has increased. Alternatively, it may mean that the value of money has decreased due to an increase in the general price level, and that there has been no change in the real value of property "A" relative to other goods. It is impossible to interpret what the difference in dollar measurements means unless the change in the general price level is considered. If the general price level has changed, it is necessary to adjust the dollar measurements of value from different time periods to determine the real change

⁸ Appraisal Institute, *The Dictionary of Real Estate Appraisal*, Third Edition, (Chicago: Appraisal Institute, 1993), s.v. "value."

in value. This is typically done by inflating or deflating the dollar measurement of one of the goods, typically by means of a price index, to the price level at which the other good is being measured. It is important to remember that value is a real concept (in the sense of the exchange of real goods) and not a money concept.

OTHER TYPES OF VALUE

A few additional types of value which the property tax appraiser may encounter are briefly discussed below.

Assessed value is the value of property on the current tax roll, or the value that was on the assessment roll for a particular tax year.

Book value is the amount (usually reduced by accounting depreciation charges) reflecting property cost as shown on financial statements.

Investment value is the value of an investment to a particular investor, not to the market in general. It is a variant of use value.

Going-concern value is generally the total value of an operating business enterprise. It includes the value of the real property, tangible personal property (e.g., machinery and equipment), labor, the marketing operation, and intangible assets and rights. It includes the incremental value of the business concern, which is distinct from the value of the real property.⁹ This subject is addressed in depth in Assessors' Handbook Section 502, *Advanced Appraisal*.

Salvage value is the value of property at the end of its economic life in its present use.

Insurable value is the amount of insurance that should be carried on the destructible portion of real estate to compensate the owner adequately in case of loss.

⁹ However, it is important to note that other sources use the term "going concern value" in different contexts; for example, in Revenue and Taxation Code section 107.7(d), it is specific to the valuation of cable television interests; under Revenue and Taxation Code section 110, it relates to the unit principle of valuation and the treatment of intangible assets and rights; and in *ITT World Communications, Inc. v. San Francisco* (1985) 37 Cal. 3d 246, it applies to the unitary assessment of public utilities where Proposition 13 is not applicable. (Unless otherwise indicated, all references to "code" in this manual refer to the Revenue and Taxation Code; all references to "section" or "sections" refer to sections of the Revenue and Taxation Code; and all references to "rule" or "rules" refer to the Property Tax Rules found in Title 18 of the California Code of Regulations.)

CHAPTER 2: STANDARD OF VALUE FOR PROPERTY TAX APPRAISAL

FAIR MARKET VALUE STANDARD

In the appraisal of property for tax purposes, economic concepts of value must be reconciled with value as defined in property tax law. The value standard for property tax purposes is market value. However, the term "market value" is itself subject to some ambiguity. To resolve this ambiguity, the Legislature and the courts have attempted to express the market value concept for property tax purposes in precise terms.¹⁰

Section 1 of article XIII of the California Constitution establishes the foundation for the fair market value standard:

Unless otherwise provided by this Constitution or the laws of the United States.
(a) All property is taxable and shall be assessed at the same percentage of *fair market value*. When a value standard other than fair market value is prescribed by this Constitution or by statute authorized by this Constitution, the same percentage shall be applied to determine the assessed value. The value to which the percentage is applied, whether it be the fair market value or not, shall be known for property tax purposes as the *full value*. (Emphasis added.)

In a benchmark decision, the California Supreme Court amplified the statutory definition of market value as follows:

It provides, in other words, for an assessment at the price that property would bring to its owner if it were offered for sale on an open market under conditions which neither buyer nor seller could take advantage of the exigencies of the other. It is a measure of desirability translated into money amounts...and might be called the market value of property for use in its present condition.¹¹

The Legislature has expressed the concept of market value in sections 110 and 110.1. Section 110(a) states:

Except as is otherwise provided in Section 110.1, "full cash value" or "fair market value" means the amount of cash or its equivalent that property would bring if exposed for sale in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other, and both the buyer and seller have knowledge of all the uses and purposes to which the property is

¹⁰ Market value for property tax purposes is referred to in the code and rules as "fair market value," "full cash value," "cash value," "full value," or "actual value." These terms are used synonymously.

¹¹ *De Luz Homes, Inc. v. County of San Diego* (1955) 45 Cal.2d 546.

adapted and for which it is capable of being used, and of the enforceable restrictions upon those uses and purposes.

Subdivision (b) of section 110 establishes a rebuttable presumption that "full cash value" or "fair market value," as defined in subdivision (a), shall be the actual purchase price if the terms were negotiated under specified conditions reflecting an "open market transaction." Under subdivision (c), this rebuttable presumption shall not apply where a taxpayer has failed to provide certain information about the conditions of the transaction.

Subdivisions (d), (e), and (f) of section 110, added by legislation effective January 1, 1996, provide the statutory expression of the concept that intangible assets and rights that relate to the activities of a business may not enhance the value of taxable property. While intangible assets and rights are not themselves taxable, property that is otherwise taxable may be valued by assuming the presence of intangible assets or rights necessary to put the property to beneficial or productive use.

Subdivisions (a) and (b) of section 110.1 define value as follows:

(a) For purposes of subdivision (a) of Section 2 of Article XIII A of the California Constitution, 'full cash value' of real property, including possessory interests in real property, means the fair market value as determined pursuant to Section 110 for either of the following:

(1) The 1975 lien date.

(2) For property which is purchased, is newly constructed, or changes ownership after the 1975 lien date, either of the following:

(A) The date on which a purchase or change in ownership occurs.

(B) The date on which new construction is completed, and if uncompleted, on the lien date.

(b) The value determined under subdivision (a) shall be known as the base year value for the property.

Subdivisions (c) through (e) of section 110.1 provide for the establishment of 1975 base year values. Subdivision (f) provides that once a base year value is established, it shall be annually adjusted by an inflation factor not to exceed 2 percent.¹²

Rule 2 interprets the above statutory definitions of market value, as follows:

In addition to the meaning ascribed to them in the Revenue and Taxation Code, the words "full value," "full cash value," "cash value," "actual value," and "fair market value" mean the price at which a property, if exposed for sale in the open

¹² The inflation factor is determined pursuant to subdivision (a) of section 51.

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.

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.¹³ 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

¹³ 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.¹⁴

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.¹⁵

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.

¹⁴ 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).

¹⁵ For example, under section 51(b) and rule 461(e), when considering declines in value caused by a calamity, land, improvements, and fixtures are separate appraisal units. Similarly, the Legislature declared leach pads, tailing facilities, and settling ponds on mining property to be separate appraisal units for valuation purposes, pursuant to section 53.5.

The practical difference between appraising a ranch and appraising, for example, an interstate telephone company is that when appraising a ranch, the appraiser can usually find units of comparison that provide direct indicators of market value of the taxable property, such as sales and rents of similar ranches. When appraising a telephone company, the unit valuation process begins with analysis of data relating to the entire telephone operating unit, including all the taxable tangible property, nontaxable tangible property, and nontaxable intangible assets and rights that are used to generate benefits. The appraiser then has to make a variety of adjustments so that the fair market value of any nontaxable property (i.e., intangible assets and rights and nontaxable tangible property) within the unit is removed. Of course, as is true with any other property, the taxable property is valued by assuming the presence of the intangible assets and rights necessary to put the taxable property to beneficial or productive use.

The principle of unit valuation is used by the State Board of Equalization (SBE or Board) when appraising properties it is required to assess pursuant to article XIII, section 19, of the California Constitution, such as public utilities and railroads. Section 723 specifically provides, "[t]he board may use the principle of unit valuation in valuing properties of an assessee that are operated as a unit."

STAGE OF PRODUCTION

Economic goods develop into finished goods, that is, goods used by the ultimate consumer. The development process can be divided into stages or levels of production. At each stage, utility is added to the goods. Economists call this production. The producers add utility of one or more of the following types: *form, place, time, and ownership*.

A business firm that turns a log into finished lumber changes the form of the substance and creates form utility. A firm that transports the finished lumber from the mill to the lumber yard creates place utility. If a firm stores or holds lumber from one date to a later date when the lumber has a greater capacity to satisfy human wants, it creates time utility. Individuals engaged in activities that transfer ownership of goods are increasing the capacity of the commodities to satisfy human wants. Some economists call this type of commerce the creation of ownership utility.

While the economic principles of production apply generally to all economic goods, certain basic differences between real property and personal property complicate the application of these principles in the appraisal process. The stage of production concept applies equally to real and personal property *until the final form of the product is achieved*. Personal property or consumer goods then follow a precise, easily definable marketing pattern from production to final consumption. At each stage or level of production, a measurable amount of utility is added, although a stage of production in this sense is better termed a "trade level" since the product does not actually change form as it passes from manufacturer to consumer via wholesaler and retailer. The changes in utility encompass changes in place, time, and ownership and are reflected primarily through the change in the size of the market unit traded at each level. In regard to real property, however, trade level is virtually the same as the appraisal unit. When the appraiser determines the unit to be appraised, the trade level of that real estate is reflected in the appraisal

unit. The appraiser's decision thereby captures the most probable unit to be traded on the market based on the data supporting that decision.

In distinguishing between the terms "trade level" and "stage of production" as they apply to the appraisal process, rule 10 uses trade level to denote any specific level within the standard production and marketing framework for tangible personal property and provides that property shall be valued according to its trade level. Stage of production is an all-encompassing economic term readily applicable to real property to indicate a stage of physical development at a specific time. For example, land being developed as a subdivision will pass through various stages of production as the bare land is converted into residential sites. Although the trade level concept is not generally applicable to real property, a property's physical stage of production is vitally important in the appraisal of real property. Once the unit to be appraised is defined, the stage of production governs what level of market data is relevant in determining the final value estimate. The property must be valued according to its stage of production.

One further requirement must be considered when establishing a property's stage of production. By law, the assessor must value all locally assessable real property as of: (1) the date of the change in ownership; (2) the lien date during the course of construction; (3) the date of completion of new construction; or (4) March 1, 1975, whichever is later. The appraiser must determine the stage of production at that point in time.

VALUATION OF LIMITED MARKET PROPERTIES

Ordinarily, determining market value, while not easy, is a relatively straightforward process of examining property transactions that take place in the market and inferring value indicators for the property being appraised from the examined data. For some unique properties, however, there is a very small market. In these cases, there is little or no market data from which to draw value inferences. Such properties are called "limited market" properties. *The Appraisal of Real Estate* states:

*A limited-market property is a property that has relatively few potential buyers at a particular time. It may be a limited-market property because of unique design features or changing market conditions. Large manufacturing plants, railroad sidings, and research and development properties are examples of limited-market properties that typically appeal to relatively few potential purchasers.*¹⁶

When appraising a type of property that is not commonly sold or rented, the issue of market value as opposed to use value may arise. Limited-market properties should be appraised at market value based on their current use or the most likely alternative use. The appraiser should assume that there is a market composed of potential buyers and sellers who would use the property in a manner similar to the way the present owner uses it, unless it is clearly apparent that

¹⁶Appraisal Institute, *The Appraisal of Real Estate*, 25.

the market would adapt the property to an alternative use. The appraiser should consider the potential uses to which the property would be put if sold, ultimately making the use determination based on the highest and best use of the property. Limited market properties may require consideration of a wider geographic market. For instance, a property use not common in the immediate region may be the highest and best use and may require comparison on an industrywide basis. The market may be national or international in scope. If the appraiser determines that the property's use would remain the same, the market value for property tax purposes should be estimated based upon the present use. If the property's use would likely change to an alternative use, the value for property tax purposes should be based upon the alternative use.

As part of the highest and best use determination, the appraiser should study economic data relating to the business or industry of the owner and should estimate the likelihood that the current owner or a similar owner would continue the present use of the property. A knowledgeable owner in a stable or growing industry increases the likelihood that the owner would continue the present use or that a purchaser would do so. A less competent owner in a weak industry, on the other hand, may indicate that a change in use is likely.

The utility of the property for its intended use should also be studied in the context of highest and best use. Most properties, other than new state-of-the-art facilities, suffer some functional problems that are not serious enough to render the improvements obsolete and in danger of an imminent change of use. Severe functional problems with a property, however, may signal an impending change in use.

After studying these elements, if the appraiser determines that the current use of a limited-market property is the highest and best use and that this use is likely to continue, it is appropriate to consider the current use value (i.e., the value of the property based upon its current use) as the property's market value. If, on the other hand, the appraiser determines that the current use is not the highest and best use and that this use is not likely to continue, the property must be appraised based upon the alternative use that is the highest and best use.

Several court cases demonstrate how the concepts discussed above have been applied. In *Michael Todd Co. v. Los Angeles County* (1962) 57 Cal.2d 684, the assessor had valued the original negative of a successful motion picture based on its depreciated production costs, while the taxpayer asserted that, since the copyright could not be assessed, the value of the negative should be a mere \$1,000, representing the salvage or scrap value of the film. In upholding the assessed valuation, the court stated that market value for assessment purposes is the value of property when put to beneficial use and is not the residual value remaining when the property is reduced to its constituent elements (e.g., a film negative should be valued as a motion picture, not merely as film). However, citing *De Luz Homes, Inc. v. County of San Diego* (1955) 45 Cal.2d 546, the court further noted that the absence of an "actual market" for a particular type of property does not mean that the property has no value or that it may escape the constitutional mandate that all property shall be taxed according to its value, but only that the assessor must utilize other pertinent factors such as replacement cost and income analysis in making the valuation.

In *Pacific Mutual Life Insurance Company v. Orange County* (1985) 187 Cal.App.3d 1141, the court held that when a property has extra value only to the particular owner, such as a prestigious "landmark" type building, it is improper to use a method of valuation designed solely to capture its utility to the property owner. In this case, an insurance company's home office, a "monument" type building, was appraised by the assessor using the reproduction cost approach. The court stated that income data from other office buildings were available and should have been used and that "using a method of valuation designed solely to capture the specific utility of property to a particular owner is contrary to law," where the building was not so unique that it could not be considered as an ordinary office building for normal uses.¹⁷

In contrast to the Pacific Mutual case, in *McDonnell Douglas Corporation v. County of Los Angeles* (1990) 219 Cal.App.3d 715, the court held that a property owned by an aircraft manufacturer and located next to a major airport was not valued based on its unique value to that manufacturer when it was appraised as an aviation industrial property. Rather, since prospective purchasers would likely use the property for aviation industrial purposes, the property had properly been appraised based on its general value in the marketplace. The court stated that it was correct to consider the property's "peculiarly suitable location" in conjunction with determining its highest and best use, which in this case was for aviation industrial purposes. The court noted that the appeals board was entitled to consider the prior and current uses of the property in making a determination of the highest and best use.

In summary, California law requires the property tax appraiser to appraise all property at market value. Market value for assessment purposes is not the value when the property is broken down into its constituent elements, but the value when the property is put to beneficial use. The absence of an actual market does not mean that a property may escape taxation. Property must be appraised for assessment purposes at its highest and best use as recognized in the market for such properties. Also, the appraiser may not use a method of valuation designed solely to capture the specific utility of a property to a particular owner, but may consider location and other current characteristics of the property that would be recognized in the general marketplace when determining the highest and best use of the property and in estimating its market value to potential purchasers.

EXCEPTIONS TO THE FAIR MARKET VALUE STANDARD

In appraising for property tax purposes, there are certain exceptions to the fair market value standard. These fall under the "restricted value" concept, as defined in rule 460(b)(3):

Restricted value means a value standard other than full cash value prescribed by the Constitution or by statute authorized by the Constitution.

¹⁷ This captures the meaning of use value as defined in Chapter 1.

For properties subject to a restricted value standard, the law sets aside the general concept of fair market value in favor of specific value limitations. In some cases, the appraisal formula is a compensation for the owner's agreement to limit the future use of the property; that is, the property value is premised on the restricted use rather than the most profitable or productive use.¹⁸ The types of restricted value properties are discussed below.

OPEN SPACE PROPERTY

In 1965, the Legislature enacted the California Land Conservation Act (CLCA, or Williamson Act) in an attempt to preserve agricultural lands for the production of food and fiber products. The act provided for the creation of "agricultural preserves" and for certain contractual agreements between property owners and counties. Such agreements limit the use of lands to agricultural purposes for a specified number of years. The Legislature's action was ratified by the electorate in 1966. Subsequent legislation prohibited the assessor's use of sales information on property subject to open-space restrictions and required an appraisal based only upon a property's income-producing ability. A property subject to open-space restrictions is now assessed at the lowest of: (1) its restricted value (its value determined by income capitalization with a nonmarket rate); (2) its factored base year value; or (3) its current market value. Legislation adopted in 1998 added a further reduction in assessment for land restricted by contract for a term of 20 years and designated as a "farmland security zone" per section 423.4.

In 1973, wildlife habitats were added to the list of lands subject to open-space restriction agreements. The Legislature decided that these properties are to be valued by a "restricted comparative sales approach."

Beginning with legislation adopted in 1974 special appraisal consideration must also be given to qualifying open space easements granted to a city, county, specified district or nonprofit organization, or regional park, as defined in section 421(e). In 1994, the Legislature added conservation, trail or scenic easements granted to a public agency or a nonprofit corporation to section 402.1(a), requiring appraisers to consider the effect of such enforceable restrictions on the use to which the land may be subjected. Effective in 1996, new provisions codified in sections 421.5 and 422.5 authorize for special appraisal consideration agricultural conservation easements as enforceably restricted properties. Scenic restrictions must conform to the criteria set forth in the statutes. Section 8 of article XIII of the California Constitution and sections 421 through 430.5 pertain to the valuation of open space properties.

HISTORICAL PROPERTIES

Owners of certain historical or architecturally significant properties may also benefit from limitations placed on the assessor's valuation.

The property must be on the National Register of Historic Places or in a historic district. If not, the property can still qualify if it is listed on the official register of the state, a county, or a city as a historic or architecturally significant site, place, or landmark.

¹⁸ The concept of highest and best use is discussed in Chapter 4.

The owner must enter into a contract with a city or county that provides for the preservation of the property for a specified period of time. The contract may also call for the owner to restore or rehabilitate the property in conformance with the rules and regulations of the Office of Historic Preservation of the Department of Parks and Recreation, with the contract binding on any successor to the owner.

When valuing restricted historical property, an assessor may not consider sales information on similar property. Instead, the property must be valued by the capitalization of annual income method set forth in the statute.

Section 8 of article XIII of the California Constitution and sections 439 through 439.4 pertain to the valuation of historical properties. Section 439.2 is explicit in its instructions as to the estimation of the income to be capitalized and the rate used to capitalize the income.

CERTAIN GOLF COURSES

Section 10 of article XIII of the California Constitution places limits on the manner in which the assessor may value certain golf courses. A golf course qualifies for special appraisal treatment if the real property *consists of a parcel of 10 acres or more and has been used exclusively for non-profit purposes for at least 24 consecutive months before the lien date*. Although the assessor may use all traditional appraisal approaches, no factors other than those relative to a golf course use may be considered. The appraisal must be based upon its use as a golf course even if the property has realistic potential at a higher and better use. The assessor must consider the value of any rights to minerals upon the property.

Golf courses that qualify for the treatment described above receive the benefit of both the base year value provisions of Proposition 13 *and* the restricted valuation treatment. Thus, proper appraisal of qualified nonprofit golf courses means that not only are annual increases in base year value limited to a maximum of 2 percent, but also the value to which those annual increases is applied is determined according to a restricted value standard under article XIII, section 10, rather than fair market value.¹⁹

CERTAIN SINGLE FAMILY RESIDENCES

Section 9 of article XIII of the California Constitution and section 401.4 place a restriction on the valuation of certain owner-occupied single-family residences. The dwelling must be the owner's principal place of residence, and the land must be zoned either exclusively for single-family residential use or for an agricultural use that permits single-family residences. The provision prevents such properties from being assessed at any value greater than that reflecting single-family use of the site.

TAXABLE GOVERNMENT-OWNED PROPERTY

Under certain circumstances, land and improvements that are owned by local governments but are located outside their boundaries are taxable. Article XIII, section 11 of the California

¹⁹ *Los Angeles Country Club et al v. Tax Assessor of the County of Los Angeles* (1985) 175 Cal.App.3d 278

Constitution generally provides that lands, water rights, and any other interests in lands owned by a local government that are outside its boundaries are taxable if they were taxable when acquired by the local government. Section 11 also provides that improvements owned by a local government are taxable if they were taxable when acquired or were constructed by the public owner to replace improvements that were taxable when acquired. Whether land or improvements, these taxable government-owned properties are generally referred to as "Section 11" properties *and* are subject to a special valuation procedures prescribed by section 11.

TIMBERLAND PRODUCTION ZONES

Lands in a Timberland Production Zone (TPZ) are subject to 10-year contractual restrictions. Specifically, land use within a TPZ is restricted to growing and harvesting timber and compatible uses approved by the county. In return, valuation of timberland under a TPZ is based on the restricted use. Section 435 pertains to the valuation of TPZ properties.

CHAPTER 3: PROPERTY CONCEPTS

"PROPERTY" DEFINED

"Property" includes all matter and things, real, personal, and mixed, capable of private ownership. Real property includes the possession of, the claim to, the ownership of, and the right to the possession of land and improvements. Personal property includes all property except real property. The concept of property is much more than a property's physical description. Property includes the concepts of property rights and property ownership. *The definition of property, contained in the provisions relating to property taxation in the code, controls the classification of property for tax purposes.*

The concepts of property, rights, and ownership are thus closely linked. In addition to its physical nature, property includes the rights that are legally associated with property, and the ownership of one or more rights in property. A succinct definition of property is that it is anything capable of being owned, including the thing itself, the legal property rights in that thing, and the ownership of the thing and its associated rights.

From a strict legal viewpoint, property is defined as an aggregate of rights that are guaranteed and protected by the government. Property is the highest right an individual can have to lands or tenements, goods or chattels, which does not depend on another person's courtesy. Ownership is the collection of rights to use and enjoy property, including the right to transfer it to others.²⁰ Thus, in one sense, property is used to indicate one's exclusive right, title, or control of a thing to the exclusion of others, and in another sense, property is used to designate the thing in which there is possession or ownership.

The fundamental rights associated with property ownership are the rights to possession, control, enjoyment, and disposition (or transfer). The right of possession refers to the right to exclusive occupancy. The right of control concerns the right to alter the property physically. The right of enjoyment protects the property owner from interference from others. The right of disposition refers to the right to transfer, or convey, the rights in the property, in whole or in part.

The existence of property implies the existence of the social institution of law, which defines property and provides the vehicle for society's enforcement of property rights. In order for the concept of property to have significance, the property object must have economic value.

An important distinction in a free enterprise economy is made between public and private property. Private property is owned and controlled by individuals or groups for their exclusive use. Public property is owned and controlled by government vesting no exclusive use in any individual or group.

Property is divided into two primary categories: real property and personal property. Real property refers to ownership interests in land, whatever is growing upon or affixed to land, and to

²⁰ *Black's Law Dictionary*, Fifth Edition, s.v. "property" and "ownership."

fixtures. (A fixture is an item that was once personal property but has been attached to an item of real property in such a manner that it is regarded in law as real property.) Personal property, as noted, is defined as all property that is not real property. The statutory definitions of property under California property tax law are provided in the sections below.

WHAT PROPERTY IS TAXABLE?

Section 1 of article XIII of the California Constitution states that "[a]ll property is taxable and shall be assessed at the same percentage of fair market value." Section 201 further provides that "[a]ll property in this State, not exempt under the laws of the United States or of this State, is subject to taxation under this code."

Thus, all property not exempted under federal or California law is subject to taxation. Exemptions of real property are contained in the California Constitution, which does not grant to the Legislature the discretion to exempt real property. However, pursuant to section 2, article XIII, the Legislature has the authority to exempt personal property by a two-thirds vote of both houses. This is one reason that the distinction between real and personal property is important.

TAXABLE REAL PROPERTY

Section 103 defines property all inclusively: "'Property' includes all matters and things, real, personal, and mixed, capable of private ownership." This definition is more comprehensive than definitions found in other provisions of California law.

The definition of real property is also broad and is not limited to fee interests.²¹ Section 104 provides:

"Real estate" or "real property" includes:

- (a) The possession of, claim to, ownership of, or right to the possession of land.
- (b) All mines, minerals, and quarries in the land, all standing timber whether or not belonging to the owner of the land, and all rights and privileges appertaining thereto.
- (c) Improvements.

Contrary to common appraisal usage, the above code section defines "real estate" and "real property" synonymously. Real estate and realty in appraisal practice are commonly used to refer to the actual physical object, that is, land and buildings, for example, rather than the ownership right in the object, which is real property. *The Dictionary of Real Estate Appraisal*, for example, defines real estate as "the physical land and appurtenances attached to the land, e.g., structures. An identified parcel or tract of land, including improvements, if any."²²

²¹ Property interests are discussed in a later section of this chapter.

²² Appraisal Institute, *The Dictionary of Real Estate Appraisal*, s.v. "real estate."

Taxable forms of real property include, but are not limited to, the following: land; improvements; fixtures; improvements located on tax exempt land; possessory interests in publicly owned real property; timber, mineral, and water rights. These are discussed generally below. Assessors' Handbook Section 504, *Assessment of Personal Property and Fixtures* contains an expanded discussion of the classification of property for property tax purposes.

Land

One ordinarily thinks of land as the dirt a farmer tills or the natural property upon which people erect buildings. For property tax purposes, "land" also includes such things as proved petroleum reserves, mines, quarries, proved geothermal reserves, natural vegetation, natural trees, standing timber, air rights, water rights, unpaved roads, wells, alfalfa, and artichokes.

Rule 121 provides a definition and description of land, but not a strict definition. Rather, land is said to consist of the ownership interests in it, that is, the possession, claim to, ownership, or right to possession.

Rule 124 provides typical examples of items normally classified as land or as improvements. This rule requires a careful reading in borderline cases, and the assessor may not follow it only when there are persuasive distinguishing facts that warrant other classification.

The California Constitution requires that land and improvements be separately assessed.²³ The proper classification of real property as land or improvements is often an important issue with certain plants and agricultural developments to land. Although a detailed discussion of the classification issue involving land and improvements is beyond the scope of this manual, it is important to recognize that this issue is sometimes complex and, in many cases, can have a significant effect on current and future assessments and property taxes.²⁴ In some instances, for example, special taxes may apply to improvements but not to land. Thus, proper classification is important both because the law requires it and because of the tax consequences of the classification.

Improvements

Section 105 provides:

"Improvements" includes:

- (a) All buildings, structures, fixtures, and fences erected on or affixed to the land.
- (b) All fruit, nut bearing, or ornamental trees and vines, not of natural growth, and not exempt from taxation, except date palms under eight years of age."

Rule 122 contains the criteria for determining what constitutes an improvement. The rule draws a fine distinction between the definition of land and improvements.

²³ California Constitution, article XIII, section 13.

²⁴ For a discussion on classification of property see Chapter 2 of the Assessors' Handbook Section 504, *Assessment of Personal Property and Fixtures*.

Fixtures

Fixtures is a category of improvements that is often troublesome because, in many cases, it is difficult to determine whether an item is a fixture or personal property. A fixture is classified as real property. Because of possible differences in the taxation of real property and personal property, classification as a fixture may be significant.

Rule 122.5(a) defines "fixtures" and sets forth three tests for determining what constitutes a fixture as opposed to an improvement:

- (1) A fixture is an item of tangible property, the nature of which was originally personalty, but which is classified as realty for property tax purposes because it is physically or constructively annexed to realty with the intent that it remain annexed indefinitely.
- (2) The manner of annexation, the adaptability of the item to the purpose for which the realty is used, and the intent with which the annexation is made are important elements in deciding whether an item has become a fixture or remains personal property. Proper classification, as a fixture or as personal property, results from a determination made by applying the criteria of this rule to the facts in each case.
- (3) The phrase "annexed indefinitely" means the item is intended to remain annexed until worn out, until superseded by a more suitable replacement, or until the purpose to which the realty is devoted has been accomplished or materially altered.

Although a complete discussion of classification as a fixture is beyond the scope of this manual, it is important to develop a framework for applying the three tests in rule 122.5. The first test, described in subdivision (b), concerns whether or not the item is physically annexed to the land or improvements. In applying the physical annexation test, the question is whether the item is permanently installed or cannot be removed without substantial damage. Rule 122.5(b)(1) states that "[p]roperty is physically annexed if it is attached to, embedded in, or permanently resting upon land or improvements in accordance with section 660 of the Civil Code, or by other means that are normally used for permanent installation." Subdivision (b)(2) provides further that "[p]roperty may be considered physically annexed if the weight, the size, or both are such that relocation or removal of the property would be so difficult that the item appears to be intended to remain in place indefinitely."

The second test, described in subdivision (c), relates to the purpose of the item, that is, whether or not the item is a necessary or working part of the real property. Under the constructive annexation test, the question is whether the item "is a necessary, integral, or working part of the realty," even though it is not physically attached. The concept of constructive annexation is closely related to the adaptability test noted above.

The third test, described in subdivision (d) and by far the most important, is the intent of the owner in annexing the fixture. Since the primary test is the intent of the owner, the question is whether the owner intends to leave the property annexed to the underlying property when it is sold. Intent is manifested by the appearance of the property indicating that the item will remain annexed indefinitely. Rule 122.5(d)(1) states that "[i]f the appearance of the item indicates that it is intended to remain annexed indefinitely, the item is a fixture for property tax purposes. Intent must be inferred from what is reasonably manifested by outward appearance."

Numerous examples of fixtures are given in rule 122.5(e). These include a huge printing press, so large that it cannot be moved without substantial damage to the building; a walkway and stair permanently bolted to a large machine; or a vault door in a bank.²⁵

Improvements Located on Tax Exempt Land

Improvements placed on governmentally owned tax exempt land for a private individual's use and purposes are taxable. Thus, private individuals or entities that lease federal, state, or locally owned lands and any improvements on such lands must pay property tax based on the value of their possessory interest. This is not inconsistent with the immunity principle for federal lands, since taxation is based on the value of the possessor's interest in the property and improvements. An exception is private property on land that is recognized as a federal enclave; such property is exempt regardless of ownership or use.²⁶

In regard to the taxable value of the improvements on tax exempt land, it is sometimes necessary to determine whether title to the improvements is with the federal, state, or local government that owns the land, or whether title is with the private lessee. While improvements are generally part of the land, there is a question in cases where the lessee constructed the improvements. The answer depends on the terms contained in the lease agreement between the government and the lessee and whether the lessee has the right to remove the improvements at the end of the lease term. California statutes and application of the general legal doctrine of accession require that permanent improvements to land become part of the land itself, unless the lessor and lessee have agreed otherwise and have given the lessee the right to remove the improvements. For this reason, the lease agreement is important.

Possessory Interests

Possessory interests are defined in section 107. For property tax purposes, a taxable possessory interest is a right to possess or use publicly-owned real property. Section 107 states, in part:

²⁵ In *Crocker National Bank v. City and County of San Francisco* (1989) 49 Cal.3d 881, the California Supreme Court held that bank electronic data processing equipment not physically attached to the building by permanent connections, but merely by standardized "quick disconnect" plugs inserted into the power source, was not a fixture but personalty where: (1) neither the equipment nor the building was designed or modified for each other and factors showing a lack of annexation; and (2) adaptability were not outweighed by other objective manifestations of permanence (i.e., the interrelation between the purpose and structural form of the building and the capacity and physical characteristics of the equipment, and the equipment's weight and size).

²⁶ A federal enclave is property over which the federal government retains exclusive jurisdiction.

"Possessory interests" means the following:

(a) Possession of, claim to, or right to the possession of land or improvements that is independent, durable, and exclusive of rights held by others in the property, except when coupled with ownership of the land or improvements in the same person. For the purpose of this subdivision:

(1) "Independent" means the ability to exercise authority and exert control over the management or operation of the property or improvements, separate and apart from the policies, statutes, ordinances, rules, and regulations of the public owner of the property or improvements. A possession or use is independent if the possession or operation of the property is sufficiently autonomous to constitute more than a mere agency.

(2) "Durable" means for a determinable period with a reasonable certainty that the use, possession, or claim with respect to the property or improvements will continue for that period.

(3) "Exclusive" means the enjoyment of a beneficial use of land or improvements, together with the ability to exclude from occupancy by means of legal process others who may interfere with that enjoyment. For purposes of this paragraph, "exclusive use" includes the following types of use in property:

(A) Sole occupancy or use of property or improvements.

(B) Use as a co-tenant.

(C) Concurrent use by a person who has a primary or prevailing right to use property or improvements at any time.

(D) Concurrent uses by persons making qualitatively different uses of property or improvements.

(E) Concurrent use by persons engaged in similar uses that diminish the quantity or quality of the property or improvements.

(F) Concurrent use that does not diminish the quantity or quality of the property or improvements, if the number of those concurrent use grants is restricted.

A use of property or improvements that does not contain one of the elements in subparagraphs (A) to (F), inclusive, shall be rebuttably presumed to be a nonexclusive use.

(b) Taxable improvements on tax-exempt land.

A taxable possessory interest is a possessory interest in publicly owned real property. Typically, the fee interest is owned by the federal, state, or a local government. Taxable possessory interests

are appraised and assessed separately from the publicly-owned fee simple interest. A possessory interest located within an area in which the United States has exclusive jurisdiction (so-called "federal enclaves") is excluded from the meaning of "taxable possessory interest" and is immune from taxation. In the context of a taxable possessory interest, "possession" of real property is defined under rule 20(c)(2).

For example, a lessee of real property from an entity of government holds a taxable possessory interest in publicly owned real property. The person holds limited rights, not the full bundle of rights a fee owner holds, and holds these rights usually for a limited duration, as a conveyance from the governmental entity.

Mineral Rights and Timber

Real property includes "[a]ll mines, minerals, and quarries in the land, all standing timber whether or not belonging to the owner of the land, and all rights and privileges appertaining thereto."²⁷

Mineral rights held as possessory interests are taxable real property. Oil and gas leases are specifically excluded from the definition of possessory interests, but the value of oil and gas proved reserves is taxable real property.²⁸

Standing timber is now generally exempt from an ad valorem property tax.²⁹ The ad valorem tax on timber was replaced with a timber yield tax under a 1974 constitutional amendment and subsequent legislation.³⁰ Under this system, timber is taxed at the time of harvest to the timber owner.

Water Rights

A water right is the legal right to take water and put it to reasonable and beneficial use. The types of water rights recognized under California law and court decisions include riparian, overlying, appropriative, and pueblo rights. Water rights are often ancillary to the land. The value of the land often includes the value of the water rights, and, in most cases, water rights are not separately assessed. In some cases, however, it may be necessary to separately value and assess water rights, such as where the rights belong to a water company or are appurtenant to other property.

The subject of water rights is complex. A discussion of the types of water rights and their valuation is set forth in Part II of section 542 of the Assessors' Handbook, *Assessment of Water Companies and Water Rights*.

²⁷ Section 104(b).

²⁸ Section 107.

²⁹ "Ad valorem" means according to or based on value.

³⁰ California Constitution, article XIII, section 3(j); section 38101 et seq.

Transferable Development Rights

The Appraisal of Real Estate defines a transferable development right as "a development right that is separated from a landowner's bundle of rights and transferred, generally by sale, to another landowner in the same or a different area."³¹ Buyers of transferable development rights (TDRs) may use the rights to develop at higher densities than zoning regulations might otherwise allow. Ownership of TDRs is a taxable property interest, and the conveyance of TDRs is a change of ownership requiring reappraisal of this property interest for property tax purposes.³²

TAXABLE PERSONAL PROPERTY

Section 106 provides that "[p]ersonal property' includes all property except real estate." Thus, personal property is defined as all property other than real property.

Regarding the taxation of personal property, the California Constitution, article 13, section 2 states:

The Legislature may provide for property taxation of all forms of tangible personal property, shares of capital stock, evidences of indebtedness, and any legal or equitable interest therein not exempt under any other provision of this article. The Legislature, two-thirds of the membership of each house concurring, may classify such personal property for differential taxation or for exemption. The tax on any interest in notes, debentures, shares of capital stock, bonds, solvent credits, deeds of trust, or mortgages shall not exceed four-tenths of one percent of full value, and the tax per dollar of full value shall not be higher on personal property than on real property in the same taxing jurisdiction.

As noted earlier, in contrast to real property, the Legislature has the power to exempt personal property from taxation or to allow differential taxation of personal property.

Tangible Personal Property

Rule 123 defines tangible personal property as "[a]ll property that may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses, except land and improvements...." In general, all tangible personal property is taxable. Exceptions include business inventories, household furnishings, and pets. Manufactured housing not affixed to a permanent foundation is classified as personal property and is subject to local property taxation (except for manufactured homes sold prior to July 1, 1980, and still under license).³³

³¹ Appraisal Institute, *The Appraisal of Real Estate*, 148.

³² The fair market value of TDRs may be estimated using the comparative sales and/or the income approach. These approaches to value are discussed in Chapter 6. The base year values of both the seller's and the buyer's properties may be affected by a transfer of such rights. See also *Mitsui Fudosan v. Los Angeles County* (1990) 219 Cal.App.3d 525, Letter To Assessors 91/12 regarding transferable development rights.

³³ The assessment of manufactured housing shares many of the concepts of real property assessment. See section 5800 et seq. The assessment of manufactured housing is discussed in Chapter 8 of this handbook section and in Assessors' Handbook Section 511, *Assessment of Manufactured Homes and Parks*.

Treatment of Intangible Assets and Rights

Intangible assets and rights include, but are not limited to, incorporeal (non-material) items such as notes, shares of stock, copyrights, patents, and enterprise or goodwill values. Article XIII, section 2, of the California Constitution exempts all intangible property not listed therein. Under that section, the Legislature may provide for the taxation of certain types of intangible personal property. Under section 212 of the code, taxable property may be assessed and valued by assuming the presence of those intangible assets or rights necessary to put the property to beneficial and productive use.

Section 212 states, in part:

- (a) Notes, debentures, shares of capital stock, solvent credits, bonds, deeds of trust, mortgages, and any interest in that property are exempt from taxation.
- (b) Money kept on hand to be used in the ordinary and regular course of a trade, profession, or business is exempt from taxation.
- (c) Intangible assets and rights are exempt from taxation and, except as otherwise provided in the following sentence, the value of intangible assets and rights shall not enhance or be reflected in the value of taxable property. Taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use.

Subdivisions (d), (e), and (f) of section 110 also provide guidance regarding the treatment of intangible assets and rights. Subdivision (d) provides that: (1) the value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance or be reflected in the value of the taxable property; (2) if the principle of unit valuation is used to value properties that are operated as a unit, then the fair market value of the taxable property contained within the unit shall be determined by removing from the value of the unit the fair market value of the intangible assets and rights contained within the unit; and (3) the exclusive nature of a concession, franchise, or similar agreement is an intangible asset that shall not enhance the value of taxable property, including real property.

However, in applying the above principles, it is important to note that the Legislature stated at the beginning of subdivision (d) that its provisions are expressly subject to the language in subdivision (e). Subdivision (e) repeats the language used in section 212(c), and states: "Taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the property to beneficial or productive use."

Finally, subdivision (f) of section 110 provides that for the purpose of determining "full cash value" or "fair market value," any intangible attributes of real property shall be reflected in the

value of the real property, and that these attributes include zoning, location, and other such attributes that relate directly to the real property involved.³⁴

Possessory Interests in Personal Property

There is only one situation where a taxable possessory interest exists in personal property; all other possessory interests concern real property only. Section 201.5 provides that possessory interest in property acquired by or for the California Pollution Control Financing Authority, whether personal or real property, shall be subject to taxation.

EXEMPT PROPERTY

Sections 3 through 5 of article XIII of the California Constitution list the exemptions from real property taxation. Specific categories of exemptions are set forth in the Revenue and Taxation Code and are located at section 202 and following. There are more than 100 property tax exemptions, 30 of which require claims to be filed and the others requiring notification to the assessor. In some cases, the exemption may be for a partial rather than a full value of the property.

In addition, certain property, while not exempt, is given preferential treatment through special assessment ratios or methods of valuation. For example, certain commercial sportfishing vessels are appraised for assessment purposes at only 4 percent of their fair market value, and other properties, the "restricted properties" such as open space lands, historical properties, etc., discussed in Chapter 2, are appraised using a value standard based on the restricted or permitted use rather than fair market value.

For a complete discussion of the exemptions from the property tax, reference to the constitutional and statutory sources previously noted and to other sections of the Assessors' Handbook is advised.³⁵

IMMUNE PROPERTY

The United States Constitution restricts the power of a state to tax federal property. These restrictions are treated as immunities from taxation, as distinguished from the exemptions specifically granted by the California Constitution and the Revenue and Taxation Code. All federal property, unless the United States government has consented to its taxation, is immune from property taxation by the states. This includes property owned by federal agencies or instrumentalities, public lands, and personal property of the federal government. However, possessory interests held by lessees or other users of federal property are generally taxable, with the notable exception of possessory interests in property within a federal enclave. Federal agencies frequently issue revocable permits or licenses to individuals or organizations,

³⁴ Valuation issues pertaining to property that may include intangible assets and rights are discussed in Assessors' Handbook Section 502, *Advanced Appraisal*.

³⁵ See Assessors' Handbook Section 265, *Cemetery Exemption*; Assessors' Handbook Section 267, *Welfare, Church, and Religious Exemptions*; and Assessors' Handbook Section 504, *Assessment of Personal Property and Fixtures*, Chapter 6.

transferring to the permittee or licensee the right to use land for a specific purpose, such as timber harvesting, livestock grazing, or water and power development. A taxable possessory interest in the described land is generally created by the issuance of such a permit or license.

As a general rule, when property is owned by an organization that is under the control of the federal government, the property is immune from property taxation for the duration of time it is under the government's jurisdiction. A notable exception is property that has been transferred to the Resolution Trust Corporation (RTC), an instrumentality of the United States General Services Administration, as the result of bank foreclosures and loan defaults. Because of a decision made by the federal government not to assert its immunity, property owned by the RTC is subject to property taxes, if the taxes are based on the property's value only.

WHAT REAL PROPERTY RIGHTS AND OWNERSHIP INTERESTS ARE TO BE APPRAISED?

People usually visualize property as a tangible or physical thing, such as a house, a parcel of land, or an airplane. However, as discussed at the beginning of this chapter, property is also the set of rights associated with something that can be owned. Ownership may take many forms, and may be divided and shared under a number of possible arrangements. The rights constituting the full bundle of rights can be split off and conveyed separately or in packages. When a property right is separated from the complete bundle of rights and conveyed, a partial or fractional interest is created. A property interest may be described in terms of the property right, legal (ownership) interest, and form of property ownership involved, as discussed below.

SURFACE, ABOVE-SURFACE, AND SUB-SURFACE PROPERTY RIGHTS

Real estate, the physical property, includes three spatial levels: the surface area, the above-surface space, and the sub-surface space. Property rights may exist in each of these levels. In addition, land bordering waters may give rise to forms of water rights. Each of these property rights may be owned or possessed separately.

The surface rights are the most obvious, consisting of rights to use the earth and everything attached to it. Surface rights include rights in land, buildings and other improvements, and crops.

The above-surface space extends from the surface upward into space. Above-surface rights, also known as air rights, may be acquired to build transportation improvements (e.g., roads and railways) or to construct one building over another. Air rights may also include the right to sunlight and natural ventilation. Tall structures, for example, may encroach on the air rights of adjacent land.

The sub-surface space includes the area encompassed by lines drawn from the property's surface boundaries to the center to the earth. Mineral and petroleum rights are perhaps the primary form of subsurface rights.

Finally, water rights involve rights in land that borders waters (i.e., streams, rivers, lakes, or oceans). The landowner's rights may or may not include the right to utilize the adjacent waters.

LEGAL (OWNERSHIP) INTERESTS

Ownership or beneficial interests in land are referred to as estates in land and are classified into three major categories: freehold, or ownership, estates; possessory, or leasehold, estates; and non-possessory estates. The estate is the totality of the ownership interest that a person has in a property and represents the condition or circumstance of ownership in which the owner stands with regard to his property. The grantor is the party who transfers the property interest or estate; the grantee is the party who receives the interest.

Freehold Estates

A freehold estate is the highest order of all estates in that it represents a full and present ownership interest in real property. Freehold estates must possess: (1) immobility, that is, the property involved must be real property; and (2) indeterminate duration, that is, the ownership must be for an indefinite period of time. Freehold interests are the equivalent of fee interests, which constitute estates of inheritance. As such, they include the full present beneficial interests and rights, such as the right to the income of the property. A future estate (estate in expectancy), which includes reversionary and remainder interests, is an estate in which possession or the right to profits is postponed to a later date. Thus, it does not confer a present beneficial interest in the property, even though it may possess similar characteristics. Proper treatment of these ownership interests for property tax purposes is set forth in change in ownership statutes and rules.³⁶

Estates in *fee simple* (defined in Civil Code section 762 and sometimes called "fee simple" or "fee") and other freehold estates (defined in Civil Code section 765) are the most complete forms of ownership allowed by law. Fee simple or freehold estates must: (1) possess absolute ownership unencumbered by any other interest, (2) be subject to the limitations imposed by government, and (3) be capable of inheritance.

Present estates include: (1) fee simple absolute estates; (2) qualified, or defeasible, fee simple estates; and (3) life estates. The *fee simple estate* (sometimes called the "fee simple absolute," or simply the "fee") is the most complete form of ownership allowed by law. Fee simple estates are subject only to the powers of government: taxation, eminent domain, police power, and escheat. They are subject only to limitations imposed by government: police power; right to taxation; right to eminent domain; and right of escheat. These limitations are discussed below.

- *Police power.* The police power serves the interests of public health, safety, morals and/or general public welfare in the development and utilization of real estate. Building codes, zoning laws and regulations, property subdivision ordinances, and restrictions in coastline development are examples of the police power.

³⁶ Change in ownership is addressed in sections 60-69.5, and in rules 462.001-462.500.

- *Taxation.* The power or right to tax real property has been retained by the states and delegated to various levels of local government. In the event of nonpayment of taxes, legal remedies are available to government.
- *Eminent domain.* Many public entities may exercise the right of eminent domain, which is the right to acquire private property for such public purposes as public buildings, parks, streets, and other public uses. This right has been delegated to some private entities, such as public utilities, for situations in which the services provided are of general public benefit. The legal action to acquire property through eminent domain is known as "condemnation," and the Constitution requires that just compensation be paid for properties acquired through the condemnation process.
- *Escheat.* Escheat is seldom used. It applies only when property is unclaimed after a reasonable period of time. The property then escheats, with title passing to the state.

A qualified, or defeasible, estate is less than fee simple in that the owner's interest can be defeated in the future should a stated event or condition occur. It is a present interest dependent for its continuation on the occurrence or nonoccurrence of some future event. If the condition or event occurs, the present owner loses his or her interest in the property, and the fee interest reverts to someone else. A determinable estate for life, as in the case of a widow who is granted an estate as long as she remains unmarried, is an example. Whenever the contingency occurs (i.e., when the widow marries), the estate is absolutely determined, and the property transfers to the remainderperson.

The life estate is a relatively common freehold estate, with duration limited to the life of the person holding it or some other person's life. A life estate also involves a future, or remainder, interest for the grantor or some other person. Generally, the grantor conveys a qualified fee simple interest to the grantee for the grantee's lifetime. When the grantee's life expires, the fee simple interest passes to some other person, known as the remainderperson. For example, A may grant a life estate to B, with C, the remainderperson, receiving the fee simple interest when B dies. The holder of the life estate is obligated to maintain the property in a manner sufficient to protect the interest of the remainderperson.

Possessory or Leasehold Estates

The holder of a possessory, or leasehold, estate has possession but not ownership of the entire fee interest. The grantor of a leasehold estate is known as the lessor; the grantee as the lessee. If the lessee subleases his or her interest to a sublessee, the interest created is known as the subleasehold interest; the holder of this interest is the sublessee.

The creation of a leasehold interest separates the full bundle of property rights into: (1) the leased fee interest, the interest retained by the lessor or landlord; and (2) the leasehold interest, the interest held by the lessee or tenant. The lessee obtains the right to possession and use while the lessor retains all other ownership rights, including the right to regain possession at the termination of the lease.

Types of leasehold estate include an estate for years, an estate from period to period, an estate at will, and an estate at sufferance. Types of leasehold estates are also referred to as tenancies. An estate (or tenancy) for years is an interest for a specified period of time; examples are a one-year lease of an apartment or a three-year lease of office space. An estate (or tenancy) from period to period is created when the lessor and lessee agree to continue their relationship from year to year or month to month, with the provision that the leasehold interest is to continue unless terminated with proper notice by either party. An estate (or tenancy) at will is an interest of unstated duration; it may be terminated at any time by either party to the lease. An estate (or tenancy) at sufferance exists when a leasehold interest of any of the prior types expires and the tenant refuses to relinquish possession.

Other Property Interests

Other property interests involve lesser interests than either freehold estates or possessory estates. Other property interests include private and public restrictions on ownership such as security interests, easements, licenses, profits, and restrictive covenants or deed restrictions.

Security Interests or Liens

A lien is the right held by a creditor to secure payment of a debt from the debtor's property. It is a security interest in property that is enforced only if the debt it secures is not paid. Liens can be voluntary or involuntary. A voluntary lien is placed on property by the owner; an involuntary lien arises from the claim by an outside party.

The most commonly known form of voluntary lien held in real property is a mortgage. A mortgage is the right conveyed by the mortgagor to the mortgagee to secure repayment of the sum borrowed.³⁷ The real property, in effect, is legally pledged to satisfy the debt. Common involuntary liens include mechanics' liens, judgment liens, and tax liens.

The existence, per se, of a mortgage or other lien interest in property does not affect an appraisal for property tax purposes. For property tax purposes, a property is valued as if free and clear of all debt. However, sales prices involving security interests that reflect non-market financing terms may require adjustment to reflect the cash equivalence of existing financing.³⁸

Easements

An easement is a right of use over the real property of another. The two traditional easements are an easement appurtenant and an easement in gross. Easements can be terminated by certain legal procedures; however, they are generally permanent in nature and run with the land. Easements may be created by express grant, by necessity, or by prescription.

An easement appurtenant exists when the easement is legally connected to adjoining property. The parcel benefiting from the easement is known as the dominant estate and the parcel burdened

³⁷ In California, a trust deed is used instead of a mortgage, but the principle is the same. Even in this state, a trust deed is loosely referred to as a mortgage.

³⁸ Cash equivalence is discussed in Chapter 6 under "Comparative Sales Approach."

is the servient estate. A common example of an appurtenant easement is a grant of a permanent, irrevocable right of way allowing the owner of a land-locked parcel to cross a specific portion of another owner's parcel to get to a public street. Another example is a parking lot easement that allocates a specific number of parking spaces in a shopping center parking lot to a restaurant parcel.

An easement in gross exists where there is no dominant estate, only a servient estate. For example, a powerline right-of-way easement granted to a utility company is an easement in gross. There is no adjoining parcel of land that is legally related to the easement.

While most easements do not constitute separate property interests, some types of appurtenant easements may be components of the taxable appraisal unit that is recognized by the appraiser. In order for the grant of an easement to qualify as a change in ownership and subject the property to reappraisal, it must satisfy the three part definition in section 60.

Licenses

A license is the revocable right to use the land of another for a specific purpose. The essential element of a license, whether it is verbal or written, is that it must be assented to by the property owner, the licensor. The holder of the license, the licensee, may acquire such rights in the property as are related to the licensee's permitted activities on the property. Because the benefit to the licensee and the burden on the landowner are temporary, the license is automatically revoked by any attempt to transfer it.

The right to park one's automobile or to attend a sporting event, as legally evidenced by the possession of a permit or ticket, are examples of licenses that are nontaxable. However, if a federal agency issues a license to an individual or legal entity to use, develop, or occupy government land for a mountain cabin, a ski facility, or an electrical transmission project, the right granted to the licensee is a taxable possessory interest in the property described under the license.

Profits

A profit (or *profit à prendre*) is an interest in real property that permits the holder to remove something from the land, such as soil, minerals, or oil and gas. A profit must be sufficiently described in writing and must explain the removal rights. While an easement allows the use of the lands of another, a profit allows the holder to remove something from the land of another.

Restrictive Covenants or Deed Restrictions

Restrictive conditions, covenants, and restrictions (CC&Rs) are contractual promises made by property owners to restrict the use of property in some way. Typically, covenants are recited in deeds (the legal instruments for conveying property) or in recorded subdivision maps or plats.

For example, CC&Rs may restrict the size, architectural style, and perhaps even the color scheme of houses in a subdivision. Covenants cannot be unreasonable or unlawful.³⁹

IMPORTANCE OF THE FEE SIMPLE CONCEPT IN PROPERTY TAX APPRAISAL

All appraisers value a set of defined property rights. Examples of these rights, which were described above, include the rights to sell, lease, encumber, gift, grant an easement, restrict access to a property, etc. *The property tax appraiser, with few exceptions, must estimate the fair market value of the unrestricted fee simple estate, unencumbered by liens or leases, based on the highest and best use of the property.*⁴⁰ In the vast majority of assignments, the property tax appraiser estimates the value of the full bundle of rights.

The appraisal of property subject to a lease represents the most common example of the fee simple concept for property tax appraisal. If the contractual rights under a lease are less valuable than the current fair market value of the rights of possession and use (i.e., the contract rent is less than the current market rent), the market value of the leased fee interest is less than the market value of the fee simple interest. Conversely, if the contract rent is greater than the current market rent, the market value of the leased fee interest exceeds the market value of the fee simple interest.⁴¹ In the former case, the value of the leasehold interest is positive; in the later case, the value of the leasehold interest is negative. In either case, the magnitude of the leasehold value (the difference between the fee simple value and the leased fee value), positive or negative, depends upon the difference between contract and market rent, and upon the length of the remaining lease term.

If the contractual rights are less valuable than the current rights of possession and use (i.e., if the actual rent is less than the current rental value of the property on the open market), the prudent buyer will pay a price that is lower than the value of the unencumbered property rights because the full property rights will not be acquired. The converse is true if the contractual rights are more valuable than the current rights of possession and use. Since the law requires that an appraisal for property assessment purposes be based on the value of the unencumbered fee simple interest, an appraisal based on the sale price of the subject property or on the sales prices of comparable properties—where contract rents differ from current market rents—must be adjusted in order to reflect the market value of the fee simple interest. Sales used as indicators of market value should be investigated to determine whether the rights conveyed were equivalent to the rights that are to be assessed (i.e., the fee simple interest).⁴²

Generally, the value of the entire fee simple estate or interest in the subject property and identified property rights is assessed to the owner of record. This practice is a great

³⁹ CC&Rs are also discussed, in the context of highest and best use, in Chapter 4 under "Legally Permissible."

⁴⁰ The concept of highest and best use is discussed in Chapter 4.

⁴¹ As discussed earlier, the leased fee interest includes the right to receive rents for the lease term and the right to regain full possession and use of the property when the lease terminates. The leasehold interest includes the tenant's rights of possession and use over the term of the lease.

⁴² See rule 4(b)(2).

administrative convenience and has the sanction of the courts.⁴³ While theoretical justification exists for the position that only those rights actually held by the owner of record should be assessed to him or her and that other partial interests should be assessed to their respective owners, it is not generally feasible to differentiate all interests in a property for separate assessment. In effect, property rights are appraised as a unit, and any division of tax responsibility must be made among the owners of the various partial interests. In any event, the sum of the assessments of the multiple interests in a property should not exceed the value of the entire fee simple interest in the property.

FORMS OF OWNERSHIP

Single and Concurrent Ownership

Ownership in real estate can be held in four primary ways:

- Single Ownership
- Tenancy in Common
- Joint Tenancy
- Community Property

In *single ownership* ("ownership in severalty"), no division of the bundle of property rights is involved. Property ownership is vested in a single person or in a single legal entity (corporation, partnership, trust, etc.).

The three remaining forms of ownership listed above are forms of *concurrent ownership*, that is, ownership vests in two or more persons. Multiple or concurrent owners are known as co-owners or co-tenants.

Tenants in common hold separate, undivided (rather than specified) interests in the entire property. Each co-owner may sell, pledge, or pass on to heirs his or her separate interest. There is no right to survivorship as in joint tenancy.

In a *joint tenancy*, each tenant receives the same estate or interest and each is considered to own the whole property subject to the interests of the other joint tenants. A significant feature of joint tenancy is the right of survivorship. At the death of one of the joint tenants, the rights of the deceased vest in the surviving joint tenants. Although a joint tenant cannot devise his interest by will (because of the right of survivorship), the joint tenant can transfer his interest during his lifetime, thus creating a tenancy in common.

Nine states, including California, recognize a form of ownership between husband and wife known as *community property*. In these states, all property acquired during marriage is considered property of the "marriage community." Under Family Code section 438, property

⁴³ *Three G Distillery Corp. v. Los Angeles County* (1941) 46 Cal.App.2d 498; *Graciosa Oil Co. v. Santa Barbara County* (1909) 155 Cal. 140. But the assessment to either the vendor or the vendee under a conditional sale contract is not valid. *Sherman v. Quinn* (1948) 31 Cal.2d 661.

ownership is presumed to be owned in undivided interests between the husband and the wife, and the consent of both spouses is generally required to transfer community property. "Community property," is defined in Civil Code section 687, and Family Code section 760 presumes beneficial ownership in both spouses regardless of legal title. Under Civil Code section 682.1, if any transfer instrument created/recorded on or after July 1, 2001 expressly declares on its face that when one spouse dies the property will pass to the survivor, then the property interest of the deceased spouse will transfer to the surviving spouse without estate administration – subject to the same procedures applicable to joint tenancy. Under certain conditions, one spouse may hold property that is not subject to the interest of the other spouse; this is termed "separate property." For example, property acquired before marriage or by gift or inheritance may be considered separate rather than community property.

The concurrent interests of tenancy in common and joint tenancy are important to the property tax appraiser because they form separate, taxable property interests. The creation or transfer of a joint tenancy or tenancy in common may involve a change in ownership for property tax purposes, requiring the reassessment of the fractional interest transferred. This creates a separate base year value for each fractional interest. Thereafter, each interest must be tracked so that future changes in ownership can be correctly processed. The base year value of the total property interest, in effect, becomes a summation of the base year values of the separate, concurrent interests.⁴⁴

Condominium, Cooperative, and Timeshare Ownership

Condominium, cooperative, and timeshare are three specialized forms of concurrent ownership. In the *condominium* form of ownership, owners hold fee simple ownership in their individual units and tenancy in common ownership in regard to the common areas of the project (e.g., sidewalks, greenbelts, swimming pools, and recreational areas) maintained by the condominium owners' association. All states, including California, have statutes governing the formation and operation of condominium projects. Statutes found in sections 66426 et seq. of the California Government Code provide for condominium declaration, which describes the individual units and common areas; the bylaws, which provide for how a condominium project will be governed; and individual grant deeds used to convey title of each individual unit. Each unit is a separate assessment parcel for property tax purposes.

In the *cooperative* form of ownership, which is relatively rare in California, a corporation holds title to the project real estate, with shares in the corporation in turn owned by the project's occupants. Ownership of shares provides the right to lease (a "proprietary" lease) and use one of the project's dwelling units. The owners also hold leasehold interests in specific units combined with proportional ownership of the shares in the cooperative housing corporation. The owner/occupants, by virtue of their ownership interests in the corporation, run the cooperative through a board of directors. Each dwelling unit may be a separate assessment parcel.

⁴⁴ See Letter To Assessors No. 85/85.

Timeshare ownership is a form of concurrent ownership in which ownership is divided according to specific time periods. Timeshare ownership is used primarily for resort properties. Timeshare properties may be organized either as fee interest or right-to-use timeshares. In fee interest timeshares, owners receive fee simple title to units for specific time periods (e.g., a specific week of the year). In right-to-use timeshares, occupants acquire a leasehold interest rather than fee simple ownership. This interest provides the holder with the right to use a unit for a specified time period. In addition to the purchase of the timeshare interest itself, the holder of the interest usually also pays annual fees for management and maintenance. For property tax purposes, timeshare interests are separate taxable interests.⁴⁵

Legal Entity Ownership

As discussed above, real property interests can be held by one or two or more persons. In addition, real property interests can be held by legal entities. Six types of legal entities commonly used to hold title to real estate are:

- General partnership
- Limited partnership
- Corporation
- Limited liability company or limited liability partnership
- Land trust
- Real estate investment trust

Discussion of each of the above forms of legal entity ownership is beyond the scope of this manual; however, it is important to note that different forms of legal entities are used as ownership vehicles of real property for a variety of economic and legal reasons. Economic reasons include the ability to pool capital, the availability of professional property development and management services for individual investors, and income tax characteristics of each ownership form, which can be used to maximize tax benefits for targeted investor groups. An important, perhaps the primary, legal advantage is limited liability (except in the case of the general partnership) for individual owners. A change in control under section 64(c) in which a transferee acquires more than 50 percent of the interests in a legal entity, or a change in ownership under section 64(d) in which the transferors who are "original co-owners" cumulatively transfer more than 50 percent of the legal entity interests, requires reappraisal of the real property owned by the entity, unless an exclusion applies.⁴⁶

⁴⁵ Any of the approaches to value discussed in Chapter 6 can be used to value a real property timeshare interest. However, the fair market value of the timeshare estate may not include the value of personal property or any non-real property items, such as vacation exchange rights, vacation conveniences and services, and club memberships. Also see section 998, rule 472, and Letters To Assessors 82/92 and 99/67.

⁴⁶ Section 64.

CHAPTER 4: ECONOMIC FRAMEWORK FOR REAL PROPERTY APPRAISAL

NATURE OF THE REAL ESTATE MARKET

One of the most important aspects of appraisal is understanding how the real estate market evaluates the properties under appraisal. In order to analyze comparable sales and other market data, the appraiser must have information about the market conditions that surrounded the transaction. Additionally, since an appraisal is based on an estimate of a property's future productivity or benefits, knowledge of the market forces that may affect the supply of and the demand for property similar to the property being appraised is critical.

While the following discussion focuses on the real estate market, appraisers should understand and recognize similar or analogous aspects in the personal property market.

DEFINITION AND FUNCTIONS OF A MARKET

A market can be defined as the organized action between buyers (demand) and sellers (supply) that permits trade. In *The Appraisal of Real Estate*, the real estate market is defined as "the interaction of individuals who exchange real property rights for other assets, such as money."⁴⁷ The study of a market should include all factors of supply and demand that affect the price and quantity traded of the property type being appraised. Real estate markets may be classified in several ways: (1) by geographic area; (2) by property type; or (3) by the scope of prospective market participants.

Real estate markets are often defined by broad geographic boundaries, because the value of most real estate, due to its immobility, is strongly influenced by local market forces. For example, one might refer to the real estate market in San Diego or the market in the San Francisco Bay Area Peninsula. A neighborhood is an example of a highly focused, geographically defined real estate market in which all properties are subject to common value influences.

Real estate markets may also be defined by the property type traded. Real estate markets are often broadly described in terms of commercial, industrial, agricultural, or residential market segments, each representing a broad type of property. In turn, each of these broad property types may comprise several subtypes. For example, the commercial category includes—but is not limited to—office and retail properties, while the residential category includes single-family residences, apartments, condominiums, and other subtypes.

Real estate markets may also be defined by the scope of their participants. While the buyers and sellers of most houses reside in the community in which the property is located, the buyers and sellers of some properties—such as large office buildings, industrial properties, or agricultural tracts—may be individual investors or financial intermediaries from far outside the local area. Some properties trade in markets that are regional, national, or even international in scope.

⁴⁷ Appraisal Institute, *The Appraisal of Real Estate*, 19.

The basic function of any market is to effect exchange. In a barter economy, goods are exchanged for other goods; in a money economy, goods are exchanged for money and money for other goods. The result of exchange is the distribution and allocation of economic resources. Because of the scarcity of resources, all people in a society cannot have everything they want at whatever time they wish. Every economic system must make decisions about what to produce, how to produce it, and how the produced goods and services will be allocated. In a free-enterprise economy, these decisions are largely made in a competitive market through the voluntary interactions between buyers and sellers using the price mechanism.

The real estate market performs functions similar to those performed in other competitive markets. In particular, the real estate market: (1) establishes price; (2) distributes existing real estate resources among potential users; (3) contracts or expands the supply of real estate in response to changing market conditions; and (4) determines land use.

Price is established in a competitive market through market transactions. Price is established through the interaction of demand and supply, and it responds to the forces affecting market demand and supply. The appraiser should examine each transaction used in an appraisal to determine whether the conditions of fair market value, discussed in Chapter 2, have been met.

Real estate resources are distributed, or allocated, among potential users through the price mechanism. In a free, competitive market, real estate is allocated based on the ability to pay, either in the form of rent or purchase price.

The supply of real estate resources is affected by the same market mechanism that influences the supply of other goods. In the real estate market, producers (developers) respond to increased demand—as signaled by higher purchase prices and/or rents—by increasing the supply of real estate through either remodeling or new construction. With a decrease in demand, the opposite occurs. The market mechanism also allows a change in the character of demand to bring about a change in the character of supply. For example, if there is increased demand (as reflected in higher prices) for homes with three bathrooms, developers will respond by constructing a greater quantity of homes with three bathrooms. Supply thus reflects the wants and desires of consumers.

Finally, in a free market, competitive bidding among buyers and sellers determines the utilization of each parcel of real estate. In general, the most productive use of a parcel of land, subject to legal and physical constraints, will prevail over other competing uses. This use, which is determined by market forces, is referred to as a property's highest and best use.⁴⁸ In the long run, this process of land use determination at the parcel level also determines the patterns of land use over much wider geopolitical areas.

⁴⁸ Highest and best use is discussed in a later section of this chapter.

SPECIAL CHARACTERISTICS OF REAL ESTATE

Real estate has special characteristics that distinguish it from other economic goods. These characteristics are:

- Immobility
- Uniqueness
- Durability
- Large transaction size
- Long development or production period

Immobility

Since real estate is immobile (it cannot be separated from its location), its value is closely related to the current and future economic prospects of the community or neighborhood in which it is located. Simply put, real estate cannot be moved to a better market.

The immobility of real estate means that the value of a given parcel of land is strongly affected by factors outside its boundaries. These factors include the uses that are made of neighboring parcels; the availability and quality of off-site improvements or infrastructure (e.g., water, sewer, utility, and transportation systems); and the quality of public services, including schools and police and fire protection. All of these off-site factors exist *outside of* a particular parcel of real estate.

Uniqueness

Each parcel of real property is unique, which often makes comparison with other parcels difficult. For example, residential properties with desirable views or water frontage may sell for much more than otherwise comparable properties that lack such attributes, even if the properties are in close proximity. Similarly, a house on a busy street may sell for significantly less than the same model on a quiet street. Since no two parcels are identical, the appraiser's task is to find properties with characteristics as similar as possible to those of the property being appraised.

Durability

The durability of real property is apparent. New structures usually have a long life expectancy, and land exists in perpetuity. Thus, real property yields benefits over a long period of time. Since the value of real estate is based on the market's expectations of its future productivity, the appraiser must estimate the benefits of a property over this future period.

Large Transaction Size

A characteristic of real estate related to its durability is its large average transaction size. For most families, a home is their largest investment, and investment-type properties typically require even larger outlays. The economic size of most real estate transactions creates, in most cases, a large financing requirement. Therefore, the cost and availability of financing has a strong effect on the real estate market.

Long Development or Production Period

From conception to completion, real estate projects often take years to complete. From a market standpoint, this means that the supply of real estate is typically slow to adjust to an increase in market demand. An increase in demand often results in rapid price increases in the short run. Similarly, the supply of real estate is also slow to adjust to a decrease in market demand. A significant decrease in demand leads to price decreases.

Thus, the real estate market departs significantly from the ideal of a purely competitive market, largely due to the characteristics of real estate discussed above. Specifically, in the real estate market:

- 1) The product is differentiated. Each real estate parcel has special physical characteristics and a unique location. This makes comparable sales and other data difficult to obtain for some types of properties.
- 2) Buyers and sellers often have unequal information. Some buyers may not be fully aware of the forces and trends which affect value and of the full potential for a parcel. Complete information about all transactions is hard to obtain, particularly for commercial and industrial properties.
- 3) There is a long lead time for planning and building new property improvements. This delays the supply response to an increase in demand. In a perfectly competitive market, supply and demand are rarely far out of balance. The long life of most building improvements also means that supply cannot be reduced with a decrease in demand.
- 4) The large financing requirement for most real estate means that both real estate demand and supply are significantly affected by credit conditions. The level of interest rates affects the demand for real estate and real estate value. Interest rates also affect the supply of real estate through the impact on new construction.

FORCES AFFECTING THE VALUE OF REAL PROPERTY

Real estate markets at the neighborhood, community, regional, and national levels are subject to broad forces that affect demand and supply. The dynamic interaction of these forces create trends in the real estate market. Professional appraisers have classified these forces into four major categories: (1) physical, (2) demographic, (3) economic, and (4) governmental.

Physical Forces

Physical (or environmental) forces are the most noticeable because they can be observed. On a macro level, these forces have played a large part in the location of cities. On a micro level, their influence is felt down to the individual parcel. Physical and environmental forces are either natural or man-made. Important natural forces that affect real property value are topography; soil; climate; natural resources (such as water); scenic beauty or view; and flood or earthquake fault zones. Important physical forces are the size and shape of a parcel; infrastructure; and the accessibility of the parcel to other desirable destinations (e.g., schools, commercial areas, recreation areas, employment centers, etc.).

Demographic Forces

Demographic forces are exerted primarily through the characteristics and customs of people. Examples of these forces are general population trends; attitudes toward household formation (e.g., living alone or with others, having children, etc.); household characteristics (e.g., family size and age groupings, etc.); changes in lifestyles and living standards; neighborhood characteristics; and attitudes of people toward government, property development, ecological issues, and education.

Economic Forces

A strong argument can be made that cities developed largely as a result of economic forces—namely, the manufacture and exchange of goods. Because economic forces strongly affect city growth or decline and property values, appraisers should study economic forces influencing present and anticipated demand for and supply of property.

Examples of demand forces are trends in employment and income; the availability of financing; the level of interest rates; and trends in a community's economic base (e.g., industrial expansion or contraction). Examples of economic forces that affect supply are the availability of vacant and improved properties; rental and price patterns of existing properties; construction planned or in progress; and construction costs.

Governmental Forces

Governmental forces are broadly construed to include political decisions made by all levels of government and by the courts. The demand for and supply of real estate, and hence its value, are strongly influenced by governmental actions and controls. Governmental influences include zoning and building codes; development regulations; environmental regulation; police, fire, and health protection; the construction of physical infrastructure (e.g., utilities and transportation networks); and public school systems. Specific legislation, such as rent control, may influence real estate markets. Federal monetary policy and federal and state fiscal policies also influence real estate markets.

DEMAND AND SUPPLY FACTORS IN REAL ESTATE MARKETS

The determinants of demand and supply are those variables or factors within a defined real estate market or submarket that cause demand and supply to shift and lead to price changes. The primary determinants of real estate demand are population, income, buyers' tastes and preferences, price changes of other goods, the cost and availability of financing, and the expectations of buyers and sellers about the future. Perhaps the three strongest determinants of demand are *population*, *income*, and *availability of financing*.

Population is important not only in terms of its sheer size, but also in terms of its demographics (e.g., age distribution, educational status, and size of household). Equally important is the fact that population moves or migrates. Changes in population are most often tied to employment opportunities, although other factors such as the general desirability of an area and its amenities can be of primary concern to retirees and well-to-do individuals. Increases or decreases in

population strongly influence real estate values. A growing level of income increases the demand for real estate, while a declining level of income decreases demand. Income growth creates business expansion and increased demand for commercial real estate. An increase in household income increases the demand for residential real estate. Finally, since most real estate transactions require a significant level of financing, demand for real estate is strongly affected by the cost and availability of financing. A significant increase in borrowing costs may impede demand. Because real estate markets are largely local, changes in population and income are often more influential at the local or regional level than at the national level. When income and population are increasing in a community or region, the demand for real estate increases and values also tend to increase.

The primary determinants of real estate supply are the *costs of production inputs* (including financing), *advances in technological know-how*, and *expectations regarding future demand*.

Increases in the cost of production inputs reduce the quantity of real estate supplied at a given price. Real estate production inputs include land, labor and materials, and the cost of financing. If land is not available at a price that permits a profit, then development cannot occur. Moreover, land is not useful for development unless a suitable infrastructure is in place. The cost and availability of financing is a significant determinant of supply as well as of demand. Advances in technological know-how also affect the cost of production. Advances which decrease costs tend to increase the quantity supplied.

Perhaps the single most important determinant of supply is the expectation of developers regarding future demand. If developers are optimistic about future demand, then the quantity supplied tends to increase and vice versa. Developer expectations typically derive from forecasts regarding national, regional, and local economic activity.

NATURE OF REAL ESTATE PRODUCTIVITY

The importance of utility as a prerequisite of value was previously discussed in Chapter 1. In the context of real estate, "productivity" can be used as a synonym for utility. This section identifies and describes the primary sources of real estate productivity and includes many examples of intangible attributes of real property that are to be considered by appraisers under section 110(f).

Real estate is part of the productive process for most goods and services. Not only agricultural products, but practically all commercial activities involve real estate. Residential real estate provides a direct product—housing or shelter—for its occupants. Through the services it provides, real estate is a productive asset. But what is the nature of this productivity?

Economist Richard Ratcliff answered the question in this way:

Space as such has no value; but space in the right location and combined with the right input of man-made improvements has great utility. Basically space is valuable in urban areas because it gives room for man's activities.⁴⁹

Real estate is productive and provides utility in two major ways: (1) in its physical capacity to provide services appropriate for a particular use; and (2) in its convenience or location relative to other parcels and interdependent uses. These two characteristics of real estate productivity are discussed in greater detail below.

PHYSICAL CHARACTERISTICS AFFECTING REAL ESTATE PRODUCTIVITY

The physical aspect of real estate productivity concerns: (1) the natural characteristics of the land itself; and (2) the man-made improvements made to the land, including both on- and off-site improvements.

Natural Characteristics

Natural characteristics can be roughly divided into surface and subsurface characteristics. Surface characteristics include topography (including the susceptibility to flooding), size, shape, soil fertility, vegetation, and exposure (in the sense of exposure to good or bad views, noises, etc.). Subsurface characteristics include load-bearing capacity, drainage capacity, and the presence or absence of extractable mineral deposits.

Natural features determine the suitability of the land for urban, agricultural, or extractive uses. The load-bearing capacity of the land is important in the construction of all structures, particularly high-rise structures. The general elevation of a parcel and whether or not it lies within a floodplain significantly affect development potential and costs. Steep terrain or topography is generally not suitable for commercial development due to high development costs, but it may be suitable for residential development where favorable views can significantly enhance value. Finally, soil fertility and drainage are of obvious importance for agricultural uses.

Man-made Characteristics

To a great extent, land is a manufactured product. When raw land is combined with the other factors of production, "developed land," a product of greater utility and value than undeveloped land, is created. Physical changes made to raw land can add great utility and value. Such changes include streets, sewage systems, structures, and other types of improvements.⁵⁰

Man-made characteristics of real estate fall into two categories: off-site and on-site improvements. Off-site improvements are located outside the subject property and are often termed "infrastructure." They include such important works as transportation systems; sewage, water, and drainage systems; and facilities for electric and gas power and telephonic

⁴⁹ Richard U. Ratcliff, *Real Estate Analysis*, (New York: McGraw-Hill Book Company, Inc., 1961), 52.

⁵⁰ Ratcliff, *Real Estate Analysis*, 54.

communication. Off-site improvements or infrastructure can be constructed privately or by government, but in either case the costs must be paid by the property owner/buyer in some manner, either in sales prices, bond obligations, property taxes, or some combination of these. The productivity of property as a result of off-site improvements must be considered in light of what the owner paid in standard fair market value appraisals. However, most off-site improvements are not assessable new construction. See Chapter 6 of the Assessors' Handbook Section 502, *Advanced Appraisal*.

On-site improvements include the primary structure and other improvements located on the subject property. Other improvements include grading and drainage work done on the site; landscaping; retaining walls, walkways, driveways and other paved areas; and utility connections. There may also be auxiliary structures and recreational improvements such as tennis courts and swimming pools. Some on-site changes, such as contamination, may result in negative physical effects and can impair a property's utility and value.

The primary structure is usually the most important on-site improvement. For most urban uses of real estate, shelter from the elements is the primary concern. Ratcliff groups the value-generating characteristics of a building into three categories: (1) functional efficiency; (2) durability; and (3) attractiveness or aesthetics.

Functional Efficiency. Functional efficiency (or utility) refers to the degree to which a building is suited for its intended use. Although the relationship of a structure to its site is a factor in functional utility (residences require outdoor areas, and retail stores often require on-site parking), the internal layout of the building is often the primary factor in functional utility. Attributes such as the sizes and shapes of rooms, ceiling height, circulation patterns, number of stories, privacy, and storage capacity are primary in determining a property's functional efficiency. Since functional utility is analyzed in relation to intended use, each use will have its own set of functional criteria.

The dynamic aspect of functional efficiency should be emphasized. With social, economic, and technological changes, functional requirements for a given use are also subject to change. For example, changes in the tastes and preferences of consumers may have a major effect on the functional criteria for residential real estate, and a change in manufacturing technology may have a significant effect on the functional criteria for industrial real estate.

As noted in an earlier section, real estate is designed to provide services over a long period of time. The ability to anticipate potential changes in the functional requirements of a building under evaluation, and knowledge of the degree to which a building can be economically modified to meet functional requirements or be adapted to another use, are important appraisal skills.

Durability. For purposes of analyzing the value-generating characteristics of a building, durability refers to the capacity of a structure to remain productive exclusive of functional considerations. In this context, durability refers to construction quality. A high quality structure will resist deterioration, have lower maintenance costs, and, assuming it remains functional, have

a longer economic life. The quality and condition of a building's structural components and subsidiary systems are the primary determinants of construction quality.

Attractiveness or Aesthetics. Although attractiveness is a somewhat subjective characteristic, the aesthetics of a property definitely affect its value. Extreme designs not in keeping with the surrounding area (in either a residential neighborhood or a commercial district) generally have a shorter period of market acceptance. What is considered attractive is also subject to the changing tastes and preferences of market participants.

LOCATIONAL CHARACTERISTICS AFFECTING REAL ESTATE PRODUCTIVITY

The locational aspect of real estate productivity concerns the relative convenience of transferring people, goods, and services from one site to desired activities at other sites. Fundamentally, locational characteristics are concerned with spatial relationships among parcels of real estate. As Ratcliff explains:

The essence of location derives from one of the elemental physical facts of life, the reality of space. We cannot conceive of existence without space; if there were no such thing, all objects and all life would have to be at one spot. If this happened to be the case real estate would have no such quality as location; all real estate would be at the same place, equally convenient to every other piece of real estate and to every human activity and establishment.⁵¹

The cost of moving people, goods, and services from one location to another is measured by such factors as travel time required, transportation costs incurred (including parking requirements), and perhaps the personal aggravation involved (e.g., waiting in traffic). These factors, which economists refer to as "costs of friction" or "transfer costs," greatly influence the land use of any given parcel.

Recurring interactions between different land uses at different geographic points are referred to as "linkages." For example, a supermarket has linkages with the customers in its trading area and with its suppliers. A household has linkages with schools, employment centers, shopping districts, etc. A manufacturer has linkages with its sources of raw materials, its labor force, and the buyers of its product. Each land use has its own linkage requirements.

The use to which a given parcel of real estate is put largely determines its total transfer cost. An assumption about use must be made in order to estimate total transfer cost and to compare total transfer costs among competing sites. Total transfer cost is a function of the number of linkages involved and their frequencies. An expensive linkage may be relatively insignificant in terms of total transfer cost because it is infrequent. For example, in the case of a supermarket, the relatively expensive transfer cost associated with the periodic delivery of goods is less important than minimizing the transfer costs of customers within its trade area. It is more important to this business to be close to its customers. Within legal and physical constraints, each land use seeks a location that will minimize its total transfer cost. In a competitive or nearly competitive real

⁵¹ Ratcliff, *Real Estate Analysis*, 62.

estate market, various land uses bid against each other for available sites. The "winning use" for a given location is able to outbid other uses because of greater savings in total transfer cost. Thus, the value of a given parcel of real estate is in significant measure determined by its transfer or locational characteristics.

In a competitive market, different uses bid for sites based on their physical and locational characteristics (i.e., their productivity). The land use that can make the most economic use of a site (as determined by the suitability of its physical characteristics and the relative saving in total transfer cost) outbids other uses and gains control of the site. In this manner, physical and locational characteristics directly affect a property's value.

HIGHEST AND BEST USE

VALUE AS A FUNCTION OF USE

Obviously, land is capable of alternative uses. A site may be used for an apartment building, a service station, a single-family residence, an orchard, a retail store, or a variety of other uses. Structures, to the extent they can be remodeled or adapted, are also capable of alternative uses.

The productivity or benefits derived from real property depend upon its use. Since value is a function of the present worth of the anticipated future benefits, value also depends upon use. Accordingly, real property must be appraised on the basis of its use or uses. The United States Supreme Court expressed this principle as follows :

[T]he value of property results from the use to which it is put and varies with the profitableness of that use, present and prospective, actual and anticipated. There is no pecuniary value outside of that which results from such use. The amount and profitable character of such use determine the value and if property is taxed at its actual cash value it is taxed upon something which is created by the uses to which it is put.⁵²

It is possible for lands that are contiguous to have substantially different uses and consequently different values. In *Wild Goose Country Club v. County of Butte* (1922) 60 Cal.App. 339, the court stated:

Proof that one taxpayer's lands are assessed at a higher value than those of his neighbors does not justify the inference that there is any inequality in the assessments, in the absence of proof of the relative market values of the lands compared.

The court also stated:

There is no doubt as to the correctness of appellant's contention that lands of the same quality and similarly situated should be assessed at the same value. The

⁵² *Cleveland, C.C. and St. L. Ry. Co. v. Backus* (1894) 154 U.S.445

quality and situation of the property, however, must be understood to include all the elements which combine to establish its market value. Plaintiff's lands are not of the same quality as the surrounding lands.

HIGHEST AND BEST USE DEFINED

Highest and best use is perhaps the most fundamental concept in real estate appraisal. All of the fundamental principles of real estate market analysis come together in this concept. Highest and best use is that use, among the possible alternative uses, that is physically practical, legally permissible, market supportable, and most economically feasible. In *The Appraisal of Real Estate*, highest and best use is defined as follows:

[T]he reasonably probable and legal use of vacant land or an improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value.⁵³

An appraisal of fair market value for property tax purposes is based on a property's highest and best use. The appraiser must make a determination of highest and best use as part of the appraisal process.⁵⁴

Since buyers and owners generally attempt to maximize value and develop property to its highest and best use, the existing use is likely to be the highest and best use. But this is not always the case. Properties are typically devoted to particular uses for long periods of time and economic change may render certain uses in specific locations either less profitable or totally obsolete. The highest and best use of a parcel is subject to change over time.

CRITERIA FOR HIGHEST AND BEST USE

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. These criteria apply to both the highest and best use of the land as though vacant and the highest and best use of property as improved. The following discussion generally refers to the analysis of highest and best use of land as though vacant.

Legally Permissible

The highest and best use must be a legal use. Government significantly limits land use. The highest and best use must be a use that is—or will be—allowed by government. A property should not be appraised on the basis of a use that is illegal.

Enforceable Governmental Restrictions

The property tax appraiser must consider the effect that any enforceable governmental restrictions may have on the value of a property. Property subject to an enforceable governmental

⁵³ Appraisal Institute, *Appraisal of Real Estate*, 297.

⁵⁴ However, statutory exceptions to the highest and best use assumption in property tax appraisal were discussed in Chapter 2.

restriction must be valued based on its restricted use. However, property may be appraised on the basis of a use other than that permitted under enforceable governmental restrictions if there is reason to believe that the restrictions will be terminated. In this event, the property should be appraised at the highest and best use that the probable change would allow, taking into account the expenditures required to make the change and the time period required to accomplish it.

Section 402.1 states, in part:

(b) There is a rebuttable presumption that restrictions (which include zoning) will not be removed or substantially modified in the predictable future and that they will substantially equate the value of the land to the value attributable to the legally permissible use or uses.

(c) Grounds for rebutting the presumption may include, but are not necessarily limited to, the past history of like use restrictions in the jurisdiction in question and the similarity of sales prices for restricted and unrestricted land....

(g)... [T]he further purpose and intent of the Legislature in enacting this section and Section 1630 is to avoid an assessment policy which, in the absence of special circumstances, considers uses for land that legally are not available to the owner and not contemplated by government....

Further, section 1630 states:

(a) Any real property owner the use of whose land is subject to an enforceable restriction placed upon it by a local agency may apply to the governing body of the local agency for a written statement declaring the present intention of the governing body to refrain from removing or modifying any such restriction in the predictable future.

(b) The written statement of intention may be granted or denied by the governing body at its discretion. A reasonable fee not to exceed ten dollars (\$10) may be charged for each such statement.

(c) The written statement may be presented to the county board of equalization as evidence that a restriction on the use of the taxpayer's land exists and that such restriction should be considered in assessing the value of the land.

(d) The written statement shall constitute a rebuttable presumption that the governing body does not intend to remove or modify the restriction in the predictable future.

Section 401.4 places an additional restriction on the valuation of certain single-family residential properties as discussed in Chapter 2.

Enforceable Contractual Land Use Restrictions

Deed restrictions that restrict the uses of a property are not the same thing as governmentally-imposed restrictions discussed above. Deed restrictions are rights reserved by private persons as opposed to limitations imposed by government. In most cases, the property tax appraiser should not recognize deed restrictions when analyzing highest and best use. The rights to be assessed are the fee simple rights without encumbrances, subject only to the limitations imposed by government. A division of the fee simple rights would require a separate assessment on each portion, and the assessment of only one portion of the rights would result in the illegal exemption of the balance.⁵⁵

In general, private parties cannot reduce the taxable value of their property by imposing their own restrictions upon it. Exceptions to this general rule are discussed below.

Section 402.1(a)(8) requires that the assessor consider the effect upon value of "a recorded conservation, trail, or scenic easement, as described in section 815.1 of the Civil Code, that is granted in favor of a public agency or in favor of a nonprofit corporation organized pursuant to Section 501(c)(3) of the Internal Revenue Code that has as its primary purpose the preservation, protection, or enhancement of land in its natural, scenic, historical, agricultural, forested, or open-space condition or use." As applied to a property encumbered by a conservation easement under this statute, the rights to be appraised are the rights of the owner subject to either the limitations imposed by government or to the grant of the easement in favor of the non-profit corporation.

When a deed, final subdivision map, or other instrument irrevocably dedicates a public road or right of way to a governmental entity and the government entity officially accepts such right of way (by resolution or ordinance of the governing body), Government Code sections 27280 and 27281 provide that the right of way, improvements, or area of land described becomes exempt from taxation when official acceptance occurs. The value of the land and/or improvements allocated to the dedicated strip of land should be deducted from the area of the parcel through which it passes.

There are no change in ownership statutes or rules dealing specifically with the private grant of an easement or right of way from one landowner to another. Although an easement or right of way generally does not constitute "a transfer of value substantially equivalent to the fee" to the benefited person, as discussed in Chapter 3, courts have determined that a recorded permanent transfer of a present beneficial property right from one parcel to another can be a reassessable event. (*Mitsui Fudosan, Inc. v. Los Angeles County*, 219 Cal.App.3d 525.). Where the agreement between the property owners documents a recorded permanent grant of an appurtenant easement that includes present beneficial interests in that property described that are in fact substantially equivalent to the value of the fee, it qualifies as a change in ownership of the easement transferred, per section 60. Most easements do not meet the change in ownership test in section

⁵⁵ See Letter to Assessors 85/111 and *Alfred E. Carlson v. Assessment Appeals Board I for the County of Santa Clara* (1985) 167 Cal.App. 3d 1004.

60 and therefore remain taxable to the property owner; however, they may need to be considered when determining the legally permissible highest and best use for appraisal purposes.

When a lease between two or more private parties restricts the use of a property, the property is nevertheless appraised on the basis of its highest and best use, with the restricted use considered as one of the possible uses. An exception to this occurs in the case of a taxable possessory interest, where the restriction on use constitutes a property right retained by a public entity.

Finally, the appraiser should be aware of conditions, covenants, and restrictions (CC&Rs) often found in subdivisions. They are typically administered and enforced by an association of the property owners. CC&Rs are similar to zoning in that restrictions are imposed on the use of properties within the subdivision. In most cases, CC&Rs are more restrictive than zoning. Since CC&Rs are private deed restrictions rather than governmentally-imposed zoning, they are not enforceable restrictions pursuant to section 402.1. However, if the CC&Rs are actually enforced, the market will value the properties in a manner that reflects both the existence of these restrictions and the maintenance of effective land use planning, similar to that described in section 402.1(g).

Physically Possible

The highest and best use must be physically possible. Pertinent physical factors regarding a property include its size and shape, topography, load-bearing capacity, and availability of utilities. For example, uses that require a larger site than the subject property or utilities that are not available to the subject property should be eliminated from consideration. The highest and best use of a property as improved also depends on physical factors, since the costs of any modifications to the improvement depends on the existing property's characteristics and condition.

In addition, highest and best use should be based either on existing land ownership or on an existing use that combines parcels under separate ownership. If parcels are separately owned and separately used, they should not be combined for appraisal purposes (or for the purpose of highest and best use analysis). For example, the appraiser should not consider plottage value, which arises from the combination of two contiguous parcels held in different ownership.⁵⁶ However, for example, in the case of a shopping center comprising several parcels under different ownerships, the parcels interact to create value as reflected by the rent levels and trade volume of the entire center. Thus, the value of an individual parcel in the center (and its highest and best use) arises from the parcel's function as part of the economic unit, which is the entire shopping center.

⁵⁶ Plottage is the process of combining two or more sites under a single ownership in order to develop one site that has greater utility and value than the two parcels considered as separate entities. The incremental addition to value is known as plottage value.

Financially Feasible or Probable

The highest and best use must be probable, not speculative or conjectural. There must be a demand for the use in the market; the use must be financially feasible given market conditions of supply and demand. All uses that produce a positive return (i.e., a gross income greater than the amount needed to satisfy operating expenses, debt service, and investment recapture or amortization) are regarded as financially feasible.

Most Productive Use

The highest and best use must be the most productive use. Of all the financially feasible uses, the one that produces the highest land value (again, on a risk adjusted basis) is the highest and best use of the land as though vacant. It is the most productive use among the financially feasible uses. Generally, it is a use that is most profitable over a reasonable period of time. For example, a use that yields a very high current income, but quickly depletes the productivity of the property, may not be the highest and best use. The highest and best use analysis should determine whether a non-depleting use that yields a lower but more sustained income will in fact produce a higher land value. The land value resulting from a given use can be estimated using two techniques: (1) by estimating the total property value (land and improvements) of the proposed use and subtracting the full cost of producing the improvements for that use; or (2) by capitalizing the residual income to the land (i.e., the income that remains after income attributable to the improvements has been subtracted).⁵⁷

HIGHEST AND BEST USE AS THOUGH VACANT AND AS IMPROVED

There are two distinct concepts in highest and best use analysis: (1) the highest and best use of the land as though vacant; and (2) the highest and best use of the property as improved. These concepts are discussed below.

Highest and Best Use of Land as Though Vacant

The concept of highest and best use of the land as though vacant derives from land residual analysis used in classical economics. From this perspective, land value is based on the income that remains after returns to the other factors of production have been subtracted. The land residual method is discussed in Chapter 6 under the income approach to value.

Land should be valued based on its most profitable potential use, subject to certain criteria that are discussed below. Any existing improvements can be torn down. In fact, in the case of an improved property, demolition is economically appropriate when the market value of the land as if vacant exceeds the current market value of the improved property. At this point, the existing

⁵⁷ In *Mola Development Corporation v. Orange County Assessment Appeals Board No.2* (2000) 80 Cal.App. 4th 309, the condition of a contaminated property and the price it would bring in that condition must be considered in determining its resultant value.

improvements no longer add value to the land, and the utilization of the site should succeed to a higher use.⁵⁸ Economists refer to this as the process of land use succession.

The analysis of highest and best use as though vacant attempts to answer these questions: On a risk-adjusted basis (i.e., after adjusting for the varying risks of potential uses), what is the most productive use of the subject parcel as vacant? What type of building or other improvement should be constructed on it? When should it be constructed? What type of development will produce the highest residual income to the land, and hence the highest land value?

In addition, the analysis of highest and best use as though vacant is necessary in order to select comparable properties used in the appraisal approaches to value. Comparable properties should have the same highest and best use of the land as though vacant as the subject property.

Highest and Best Use of Property as Improved

Although the appraiser is generally concerned with the concept of highest and best use of land as though vacant, the analysis of highest and best use of property as improved is also important. This analysis addresses how an already improved property should be utilized. The analysis of highest and best use as improved attempts to answer the following questions: Should the existing use be intensified (e.g., by expansion or renovation of the existing improvements)? Should the existing use be changed (e.g., by converting a residential use to a commercial use)? If the existing use is changed, should the existing improvements be demolished or significantly modified?

The course of action that produces the highest rate of return on a risk-adjusted basis (again, taking into account the varying risks of alternative uses) is the highest and best use of the property as improved. This action will also produce the greatest increase in the owner's wealth. Changes in the current utilization of an improved property may or may not require additional investment. No investment may be required if the property is simply converted to another use; additional investment is required when the existing use is expanded or converted to another use requiring physical changes in the improvements. Obviously, additional investment is also required if the existing improvement is demolished and replaced with an alternative improvement.

In addition to solving the problem of property utilization, the analysis of a property's highest and best use as improved is used to select comparable properties. Improved comparable properties should have the same highest and best use as improved as the property being appraised.

SPECIAL SITUATIONS IN HIGHEST AND BEST USE ANALYSIS

The following sections describe several special situations associated with highest and best use analysis.

⁵⁸ This is somewhat simplified because the cost of demolishing existing improvements should also be considered in the analysis.

More Than One Highest and Best Use

Highest and best use is not necessarily just one specific use. It is possible that several uses will prove equally profitable. For example, two different uses may return the same net income to a property.

Interim or Transitional Uses

A property's highest and best use may be prepared to change in the foreseeable future. The use to which a parcel is put before its transition to a future highest and best use is known as an *interim* or *transitional* use. An interim use typically continues for a relatively short period of time before converting to a succeeding use. Interim uses appear in transitional areas where older uses are yielding to new ones. For example, given appropriate zoning and growth trends, an agricultural area on the outskirts of a city may be in transition to residential use. The current agricultural use is an interim use. Or, an older residential district in a city may be in transition to commercial use. The current residential use is an interim use. As a final example, in downtown areas, vacant lots are often used for parking; however, as market conditions warrant, the lots will be developed and utilized much more intensely. In such cases, the parking lot use is an interim use.

The total market value of a property in transition is based on both its interim and succeeding use. The total value of transitional property is the sum of: (1) the present worth of the net real property benefits from the interim use over the period of interim use; (2) the present worth of the salvage value of the interim improvements, if any, at the termination of the interim use (or the negative present worth of the cost of removing the improvements, if this exceeds the salvage value); and (3) the present worth of the net future real property benefits from the succeeding highest and best use.

However, an interim use may or may not contribute to current property value. An interim use contributes to current property value if the gross income derived from the use exceeds operating expenses related to the use. For example, an interim agricultural use of land often produces a net return above that of unused vacant land, thereby contributing to the total market value of the transitional property.

Consistent Use

For some improved properties, the highest and best use of the land as though vacant may have changed from one use to another. For example, for a given improved property the highest and best use of the land as though vacant may have changed from residential to commercial use. In such cases, the improvements under the lower intensity use will be worth less than if situated on a site appropriately zoned for them.

For example, consider a residence with a total property value (i.e., land and improvement) of \$250,000. If the lot as though vacant, based on a determination of its highest and best use as commercial, has a market value of \$200,000, the contributory improvement value is \$50,000 (\$250,000 - \$200,000). However (assuming total property value is still \$250,000), if the

residential improvement were located on a \$50,000 residential lot, its contributory value would be \$200,000 (\$250,000 - \$50,000).

It would be incorrect to value the residential improvement on the commercial lot at \$200,000. Under the principle of consistent use, the improvement should be valued on a basis consistent with the site's highest and best use as though vacant. Thus, the improvement should be valued at \$50,000.

Excess and Surplus Land

A parcel may have more land than is economically needed to support its existing improvement (in the case of an improved property) or its highest and best use (in the case of a vacant parcel or a parcel analyzed as though vacant). Such land is beyond that required by normal market standards, and may be defined as either *excess land* or *surplus land*.

Excess land either allows for the expansion of the existing use or is separately marketable and hence possesses significant utility and value. Although it is still part of the same assessment unit, excess land should be clearly identified and appraised separately. In contrast, additional land that does not economically support the existing improvement but cannot be utilized to expand the current use or be sold separately is defined as surplus land. Surplus land cannot be separated from the appraisal unit. Surplus land should also be identified by the appraiser and assigned an independent value considering its limited utility. The utility of the surplus land may be so severely limited that little or no value is added to the appraisal unit.

FUNDAMENTAL APPRAISAL PRINCIPLES

Based on observation and analysis of real property markets, appraisers have developed principles that attempt to describe how real estate markets operate. These fundamental principles work in combination; seldom does only one principle apply to an appraisal problem. The following discussion divides the fundamental appraisal principles into two general categories: principles of real estate productivity and principles of real estate marketability. Several of the principles also apply in some degree to personal property markets.

PRINCIPLES OF REAL ESTATE PRODUCTIVITY

Anticipation

The principle of anticipation holds that an estimate of value should always be based primarily on future expectations rather than historical performance. Property is valuable because of the future benefits it is expected to provide. A person invests in property, real or personal, in anticipation of future benefits. This principle is particularly relevant to real property because of the anticipated long life of most improvements. Future benefits can take the form of amenities, income, profits on resale, or a combination of these. Historical information should not be ignored, but is useful only to the extent that it sheds light on expectations about the future.

Surplus Productivity, Balance, and Contribution

The net income that remains after costs of the other factors of production (labor, entrepreneurship, and capital) have been satisfied is sometimes called the "residual" return to land, or the surplus productivity of land. The amount of this residual or surplus return is the basis for land value.

Related to surplus productivity is the principle of balance, which states that the overall return (and the return to land) will be highest when the optimum balance is struck among the factors of production. *The Appraisal of Real Estate* states: "The principle of balance holds that real property value is created and sustained when contrasting, opposing, or interacting elements are in a state of equilibrium."⁵⁹

Elements both internal and external to a property must be in balance for maximum value to be attained. Internally, the proper combination of land and building is critical to economic balance. Externally, a property should be in balance with surrounding properties. For example, an expensive home built on a low-value lot in a modest neighborhood may not sell for its full cost of production.

The principle of contribution applies the principle of balance to property components. This principle states that the value of a property component is measured in terms of its contribution to the value of the entire property, that is, how much it contributes to the total value by its presence or detracts by its absence. It is an application of the economic concept of marginal analysis. For example, if a swimming pool, based on an analysis of market data, contributes an added value of \$10,000 to a residential property, it has a value of \$10,000 even if its cost of construction was \$25,000.

Factors or Agents of Production

The production of real estate requires the inputs of the four factors or agents of production: *land*, *labor*, *capital*, and *entrepreneurship*. The balance of these factors affects the productivity of the real estate asset.

Land includes the ground, the airspace, and the natural resources found on the surface or in the sub-surface of the earth. Labor includes human work directed toward production—that is, all wages and other operating expenses involving human work. Capital is composed of goods (e.g., equipment and buildings) and intangible assets and rights (e.g., working capital and franchises) used in the production process. Unlike other factors of production, capital must be produced before it can be utilized in the production process. Human capital is the productive power of individuals developed through education and training. Entrepreneurship is the act of visualizing needs and taking the necessary action and risk to produce products that fulfill such needs. In real estate development, entrepreneurship is synonymous with the development function.

⁵⁹ Appraisal Institute, *The Appraisal of Real Estate*, 44.

When real property is utilized with labor and other agents of production in a business to produce goods and services, the real property itself becomes a factor of production with property rent as its income or return.

Increasing and Decreasing Returns

The principle of increasing and decreasing returns is closely related to the principles of balance and contribution. When the four agents of production—land, labor, capital, and entrepreneurship—are in economic balance, maximum value is attained.

There is a theoretical point of balance in each property where the agents of production will produce the greatest net return. As the agents of production are increased, the result is a greater net income up to a certain point (producing profit maximization).

In the terminology of economics, additional investment (of the agents of production) is economically justified as long as marginal benefits equal or exceed marginal costs. This principle has a practical application to decisions regarding property additions or remodeling. For example, a property owner may consider installing an elevator in a two- or three-story rental building. The decision should depend on the additional net rental income to be generated in relation to the additional cost of the elevator. If the elevator will add value (as measured by an increase in net rental income) at least equal to its cost, it is economically justified.

Consistent Use

The principle of consistent use states that a property should be valued on the basis of a single use for the entire property. It is incorrect to value a property based on one use for the land and another use for the improvements. This principle is especially applicable to property in transition from one use to another, which was discussed earlier in conjunction with highest and best use.

PRINCIPLES OF REAL ESTATE MARKETABILITY

Substitution

The principle of substitution states that the upper limit of value tends to be set by the cost of acquiring an equally desirable substitute (either by purchase or construction). When there is a significant delay in acquiring the substitute, the cost of the delay must be taken into consideration; a significant delay, in effect, raises the cost. The principle of substitution is closely related to the economic concept of opportunity cost, which holds that the true cost of an economic choice is measured by the opportunity foregone as a result of the choice.

The principle of substitution is fundamental to the cost, comparative sales, and income approaches to value. Regarding the cost approach, the principle of substitution provides that value can be estimated by the cost of constructing, without undue delay, a property of equal utility. Regarding the comparative sales approach, the principle provides that value can be estimated using the sales prices of properties with equal utility (i.e., comparable properties) as value indicators. Finally, regarding the income approach, the principle states that value can be

estimated by the investment necessary to acquire, without undue delay, a substitute property offering a comparable income stream.

Conformity

The fact that real estate is immobile causes its value to be influenced to a great degree by the surrounding area. The principle of conformity holds that maximum value accrues to a property when a reasonable degree of homogeneity is present in the neighborhood or surrounding land uses. This principle implies reasonable similarity, not monotonous uniformity, and recognizes that economic and/or psychological benefits may arise from grouping similar land uses.

Regression and Progression

Closely related to the principle of conformity, the principle of regression maintains that between dissimilar properties, the value of the superior property is adversely affected by the presence of the inferior. For example, higher-value homes tend to suffer or decrease in value if in proximity to lower-value homes. The principle of progression is opposite the principle of regression: lower-value homes tend to benefit or increase in value when in proximity to higher-value homes.

Change

The principle of change recognizes the dynamic nature of real estate markets. Local, regional, national, and even international trends have strong effects on property values. The principle of change is closely related to the principle of anticipation. Change affects not only individual parcels, but also entire neighborhoods, communities, and regions. All property is in a state of transition, with the difference among properties being only the rate of change.

Supply and Demand and Competition

In a free-market economy, price is determined by the competitive interaction between market demand and supply. Market demand and supply are derived by totaling, at each possible price, the individual demands of buyers and individual supplies of sellers. When market supply is greater than market demand there is excess supply, causing price to decrease. When market demand is greater than market supply there is excess demand, causing price to increase.

Externalities

The principle of externalities states that activities or land uses external to a given property, and over which its ownership has very limited or no control or responsibility, can have negative or positive effects on the property's value. Negative effects are known as negative externalities; positive effects are known as positive externalities. For example, a sewage treatment plant may produce negative externalities for downwind parcels in a residential subdivision. A new community park may produce positive externalities for residential parcels located a few blocks from it. The concept of external obsolescence, important in the cost approach to value, is closely related to the principle of externalities.

CHAPTER 5: MEASUREMENT OF VALUE

STEPS IN THE APPRAISAL PROCESS

The appraisal process is a systematic method for arriving at an estimate of value. It is a standardized procedure developed by professional appraisers for applying the fundamental principles of valuation to a given property.

There are seven steps in the appraisal process:

1. Definition of the appraisal problem
2. Preliminary analysis and data collection
3. Highest and best use analysis
4. Land value estimate
5. Application of the approaches to value
6. Reconciliation of value indicators and the final value estimate
7. Reporting the final value estimate

DEFINITION OF THE APPRAISAL PROBLEM

The definition of the appraisal problem is the first step in the valuation process. This step should eliminate any ambiguity regarding the nature of the appraisal. The definition of the appraisal problem contains five substeps: (1) identification of the property being appraised; (2) identification of the property rights involved in the appraisal; (3) determination of the purpose of the appraisal; (4) establishing the effective date of the appraisal; and (5) obtaining the definition of value for the appraisal.

Property Identification

A property can be physically identified in several ways: street address, legal description, or assessor's parcel number. In property tax appraisal, the primary means of property identification is the assessor's parcel number (APN). The street address and legal description are secondary means of identification.⁶⁰ For personal property appraisals, account numbers may be used as the identification where the property cannot be tied to a specific location, as is often the case with making a single assessment where the taxpayer has equipment at more than one location.

Property Rights and Interests Involved

The appraiser must obtain a precise definition of the property rights to be valued. In most cases, an appraisal for property tax purposes reflects the value of full fee simple unencumbered interest of the property premised on the property's highest and best use.

⁶⁰ Assessor's maps as a means of property identification are discussed below under "Land Valuation."

Purpose and Function of the Appraisal

The purpose of all appraisals is to estimate value of some sort. An appraisal for property tax purposes renders a valuation, consistent with property tax law, that will be used as the basis for assessing the property.

Date of Appraisal

An opinion of value is valid as of the specified date of the appraisal. For most real property in California, the relevant appraisal date for property tax purposes is the date on which a change in ownership of property occurred or new construction was completed. The statutory lien date, January 1, is also a relevant date of appraisal in many instances.⁶¹

Definition of Value

A critical aspect of an appraisal is to obtain a precise definition of value pertinent to the purpose of the appraisal. Excluding several exceptions noted in Chapter 2, the value to be estimated for property tax purposes is fair market value. The statutory definition of fair market value was provided in Chapter 2, which also discusses the exceptions to the fair market value standard.

PRELIMINARY ANALYSIS AND DATA COLLECTION

The preliminary analysis phase develops a logistical plan for the appraisal. This step includes a preliminary inspection of the property and its surroundings; a list of the data, time, and resources needed; a preliminary estimate of the property's highest and best use; and a selection of the primary approaches to value that will be used.

A competent appraisal is supported by information from the real estate market. This information is referred to as "market data." All relevant data about the property should be considered, including primary data collected in the field and data from secondary sources. Market data may be divided into three categories: general, specific, and comparative.

General data pertain to information about trends in the environmental, social, economic, and governmental forces that affect property value. Trends occur at the national, regional, community, and neighborhood level. Comparative data pertain to the physical, financial, and operating characteristics of comparable properties that will be used in the appraisal. Specific data pertain to the subject property itself. For example, both the site and its improvements are examined to gather information regarding their utility. Financial and operating information about the property is also obtained, as is information about any restrictions or easements that affect the possible future uses and/or utility of the property. All appraisal methods require the collection and verification of data by appraisers, and the collection and maintenance of appraisal data is a primary concern of assessors' offices.

⁶¹ All taxable property (both state and locally assessed) is assessed annually for property tax purposes as of 12:01 a.m. on January 1, which is referred to as the *lien date*. It is referred to as the lien date because on this date the taxes become a lien against all real property assessed on the secured roll.

HIGHEST AND BEST USE ANALYSIS

After determining the data requirements and collecting the data, the appraiser analyzes the property's highest and best use in light of market forces and conditions. The value estimate is premised on the assumption that the highest and best use has been identified. Under competitive market conditions there is a strong tendency for property to be used in the most productive manner; that is, there is a high probability that the current or existing use is also the highest and best use of the property. The determination of highest and best use is also necessary in order to select the comparable properties used in the appraisal.

LAND VALUE ESTIMATE

Land value is directly related to the highest and best use determination. In fact, the determination of the highest and best use of the land as though vacant requires a land value estimate. A separate estimate of land value is needed for at least two reasons. First, an estimate of land value under its highest and best use as though vacant is required in some appraisal approaches or techniques. Both the cost approach and the building residual technique in the income approach, for example, require separate land value estimates. Second, the property tax appraiser is required to allocate the total property value between land and improvements, which may be accomplished through a separate estimate of land value. This also produces an estimate of the contributory value of the improvements. The estimation of land value is discussed later in this chapter.

APPLICATION OF THE APPROACHES TO VALUE

An important step in the appraisal process is the determination of the appropriate method or methods by which the value will be estimated. Typically, the appraiser considers three primary approaches to value. Each approach, from a different perspective, simulates the thought processes of the typical buyer in a competitive market. The three approaches are the cost, comparative sales, and income approaches.

In the cost approach, the appraiser estimates the market value of a property by: (1) estimating the cost of either reproducing the existing improvements with duplicate improvements or replacing the existing improvements with improvements of equivalent utility as of the appraisal date; (2) reducing that estimated cost by the amount of depreciation, or loss in value; and (3) adding the estimated value of the land or site to the depreciated cost of the improvements. The cost approach thus requires a separate estimate of land or site value. The cost approach is primarily based on the principle of substitution.

In the comparative sales approach, the appraiser estimates market value by comparing the subject property to comparable properties of similar utility that have recently sold under competitive market conditions. The sales prices of comparable properties provide indicators of the market value of the property being appraised. The comparable sales prices are adjusted to reflect differences in utility from the property being appraised. The comparative sales approach is also primarily based on the principle of substitution.

In the income approach, the appraiser estimates value by first estimating the future income to be produced by the property and then discounting or "capitalizing" the future income into an estimate of current market value. The income approach is premised on the concept that value is equal to the present worth of future benefits. The income approach is primarily based on the principle of anticipation. Each of the three approaches to value is discussed in more detail in Chapter 6.

RECONCILIATION OF VALUE INDICATORS AND THE FINAL VALUE ESTIMATE

The reconciliation of value indicators from the separate approaches to value and the resulting final value estimate is the next step in the appraisal process. Theoretically, the approaches to value should produce identical value indicators. In practice, however, this is rarely the case, and significant differences may occur. To produce a final value estimate, the appraiser reconciles the indicators from each approach utilized. Value indicators should be reconciled considering: (1) the appropriateness of the approach given the purpose of the appraisal; and (2) the adequacy and reliability of the data available to perform the appraisal. The appraiser should examine and reconcile all value indicators.

The final value estimate is not a simple average of the value indicators; one or two approaches often have greater significance and are given greater weight by the appraiser. The final value estimate must reconcile all available indicators in an analytical manner. While the final value estimate is an opinion of value, it should be a reasoned and defensible opinion based on verified market data. Reconciliation in the appraisal process is also discussed in Chapter 6.

REPORTING THE FINAL VALUE ESTIMATE

The final step in the appraisal process is reporting the final value estimate. An appraisal may be reported in a letter, a form, or a narrative. In appraising for property tax purposes, form reports are generally used although short narrative reports may be used for complex properties and in assessment appeals cases.

LAND VALUATION

A separate appraisal of land may be conducted for several reasons. First, and most obvious, the subject of an appraisal may be vacant land, rather than improved property. Second, since land and improvements are evaluated as separate economic components in some appraisal techniques, a separate estimate of land value is often needed as part of an improved property appraisal. For example, the cost approach and some income capitalization techniques require separate estimates of land value. Finally, an appraisal for property tax purposes requires an allocation of value between land and improvements, even though the property is appraised as an integral unit.⁶² This allocation is generally accomplished by making an estimate of land value.

⁶² Regarding the separate assessment of land and improvements, see California Constitution, article XIII, section 13; and section 607.

A distinction should be made between site value and undeveloped, or raw, land value. A site may be defined as a parcel of land that has been improved for its intended use. Undeveloped land exists in its natural state and has not been improved. For example, a residential site must have access, utilities, drainage, etc., and the value of the site must reflect these factors over and above the value of an undeveloped but otherwise similar parcel. When appraising most improved sites, the appraiser is more precisely concerned with site value rather than raw land value. The land value used in the cost approach and some techniques of the income approach is actually a site value.

In this section, the general topic of land or site valuation is divided into three subtopics: (1) land identification and description; (2) land analysis; and (3) methods of land appraisal.

LAND IDENTIFICATION AND DESCRIPTION

Before a property can be appraised, it must be identified and described. Property tax appraisers should be generally familiar with legal methods of describing property for property tax purposes and with the assessment parcel identification system. All are discussed below.

Legal Descriptions

A proper identification of real property is essential for all documents that affect title. The legal conveyance of title by deed requires a precise legal description that specifies the property's exact boundaries. Three methods commonly used to legally describe land are metes and bounds, rectangular survey, and subdivision maps. A legal description may also be a hybrid of these methods. For property tax purposes, other methods are permitted by law. The delineation of parcels according to the assessment parcel identification system commonly used in assessors' offices is also based on legal descriptions contained in recorded deeds and other documents.

Metes and Bounds

The oldest form of legal description is by metes and bounds. "Metes" means measurements or distances, and "bounds" means boundaries. Metes and bounds continues to be used, particularly for irregular parcels. A metes and bounds description gives the distance and compass direction of each boundary line of the property. It starts at a "point of beginning" and traces all the way around the property boundary back to that point. The earliest metes and bounds descriptions did not use compass directions or distances, but instead referred to identifiable physical features such as rivers or fences that "bounded" the property in question. Any parcel of land can be described using a metes and bounds description, for example,

Beg. At a point 30 ft. N. Of the S. W. Cor. Of Sec. 18,T. 6 S.R. 8 E. Mt. Diablo B. & M., th. N. along the section line 396.36 ft., th. N. 89° 35' E. 210.14 ft., th. S 396.36 ft., th. S.89° 35' W. 210.14 ft to beg.

Rectangular Survey

In 1785, the United States Congress approved a method of land description, known as the government or rectangular survey system, for the purpose of describing and disposing of lands in

the public domain. Land description in all states west of the Mississippi (except Texas) and several states east of the Mississippi is based on this method.

The rectangular survey system is based on principal meridians running north and south and base lines running east and west, located by the original surveyors to intersect at established landmarks. Most of the land area of the United States can be described using principal base lines and meridians as primary reference points. California has three principal base lines and meridians: Humboldt, Mt. Diablo, and San Bernardino.

Land on each side of a principal meridian is divided into six-mile-wide strips known as ranges, which are numbered consecutively, east or west, from the principal meridian. Range lines run north and south. Lines running parallel to a base line and six miles apart are called township lines. Township lines run east and west. Range and township lines form the basic unit of the system, the township, which is six miles square. A township is referred to by the intersection of a principal base line and meridian—for example, Township 5 North, Range 3 West, San Bernardino base line and meridian. This description uniquely references a quadrant of approximately 36 square miles. The area is an approximation because of the curvature of the earth.

Finally, each township is divided into 36 sections of approximately one square mile (640 acres) each. Section 1 is in the northeast corner of the township. Section numbers proceed westward to the boundary of the township, then southward 1 section, and eastward again. The process continues until all the sections are numbered. Sections may be further divided into fractional portions, for example,⁶³

W 1/2, SW 1/4, SW 1/4, SE 1/4, Sec. 12 T. 3N., R2 W M.D.B. & M, which would equal 5 acres.

Subdivision Maps

A common modern method of legal description is based on recorded subdivision maps. This method is also referred to as description by lot and block or by recorded plat. Most local governments, as part of the land development process, require the preparation of a subdivision map showing the streets and lots in the new development. A subdivision map divides the property into lots and, for larger subdivisions, into blocks of lots. Each block and lot on the map is identified by a number, and the subdivision map itself is also given a number. When the subdivision map is approved by the local jurisdiction, the map is recorded and becomes a part of the public record. Recorded maps are filed using a system of books and pages. A legal description using this method contains the lot number, the block number (if applicable), and the number of the subdivision map. A legal description by recorded map is short and easy to understand, for example,

Jones Sub., M.B. 16-86, Lot 16 Blk. 10 (read as: Jones Subdivision, Map Book 16-86, Lot 16 of Block 10).

⁶³ Appendix B contains a depiction of a section.

Condominium units are described using a slight variation of the subdivision map method. A condominium map is recorded and filed, dividing the property into condominium units. Each unit is given a number on the condominium map. The map also shows the areas of the project under common ownership. A legal description using this method contains the unit number of the condominium, the number of the condominium map itself, and a reference to the fractional share of the common area that is owned by a particular unit.

Spanish Land Grants

When the federal government first surveyed California lands, Spanish land grants (or "ranchos") were excluded from the survey. Because they were privately owned when California became part of the United States, only the exterior boundaries of the ranchos were surveyed when sectionalizing all adjoining lands. However, many ranchos were sectionalized by property owners, who hired private surveyors.

If a Spanish land grant has been sectionalized according to the rectangular survey system, it is not sufficient to describe the property by section, township, and range. Since it was not surveyed under the authority of the United States, it is necessary to also give the name of the rancho, for example,

Rho. El Sobrante Sec. 16 T.8 S., R. 12 W., M. D. B. & M. (describing 640 acres).

The rancho name should always be used in a description of property within a rancho unless the description is by reference to a subdivision or plat map.

Official Maps

Official maps are drafted by city engineers or county surveyors under the direction of a city council or board of supervisors. Each map must be properly certified and filed. The size and scale of maps are not specified by law.

Owner's Maps

Owner's maps are filed under the provisions of section 326 by the owner, claimant, or user of the land. They must contain enough information to clearly identify the land and must be properly filed with the assessor or the State Board of Equalization.

Hybrid

A legal description is sometimes a combination of the above methods. The rectangular survey method works well for describing large tracts of land. However, the method is less suitable for use in urban areas, where lot sizes are much smaller. A legal description of a smaller parcel might use a combination of rectangular survey and metes and bounds. For example, a rectangular survey description might be used to get to the point of beginning of a metes and bounds description used thereafter. As another example involving an urban lot, a combination of descriptions by metes and bounds and subdivision map might be used. A metes and bounds

description may be used to first describe the boundaries of the entire subdivision, with individual lots described using a subdivision map.

A special case arises if individual parcels or subdivisions (e.g., for condominiums or offices) are created and acquired by air rights. Typically, air lots are described by identifying and describing the ground parcel (e.g., by metes and bounds description), and then noting the vertical measurements of the airspace above the ground lot. Vertical measurements refer to a known point of vertical height known as a datum. A subdivision map could then follow from this description.

Assessment Parcel Identification Systems

In property tax appraisal, the primary means of real property identification is the assessor's parcel numbering system, which links property ownership, the assessor's maps, and the assessment roll entry. In essence, it is the taxpayer's account number, uniquely identifying each parcel in a manner that is less cumbersome than the legal descriptions described above.

All assessors maintain a set of assessor's maps for identifying property. These maps are created from the legal descriptions contained in recorded documents; they are based on the several methods of legal description described above. The assessor's parcel numbering system consists of a map book number, a page number within the map book, a block number (if applicable, as in urban areas), and the parcel number within the block. Each parcel is uniquely identified by an assessor's parcel number (APN). By such a system, each county is divided into geographical map books, each map book is in turn divided into map pages, each map page is divided into blocks (if applicable), and each block is divided into individual parcels. The State Board maintains a similar mapping system for state-assessed property. However, land may not be described by assessor's parcel map or Board map in any deed or conveyance unless the map has been filed for record with the county recorder.⁶⁴

LAND OR SITE ANALYSIS

As this manual has stressed, land has value because of its productivity related to a purpose or use. For property tax purposes, with few exceptions, land is valued at its highest and best use, and the appraiser is concerned with the factors that affect highest and best use. For the purpose of this discussion, these factors are divided into three general categories: (1) governmental restrictions; (2) physical characteristics; and (3) locational characteristics.

Governmental Restrictions

Governmental restrictions place legal constraints on property use that significantly affect the utilization of land and hence its value. There are many types of governmental restrictions on land use. They include zoning, building and safety, subdivision, and environmental regulations.

⁶⁴ Description of land for property tax purposes is addressed in sections 321 through 328. Also, see Assessors' Handbook Section 215, *Assessment Map Standards*.

The zoning regulations of local governments are the most significant form of governmental restriction. Zoning regulations address permitted uses of land, density or intensity of use, setback or sideyard requirements, building height restrictions, on-site parking requirements, and other land use matters. Zoning ordinances also stipulate the conditions under which variances from zoning restrictions are granted and how non-conforming uses are treated.⁶⁵

Building and safety regulations include housing codes, building codes, plumbing codes, electrical codes, etc. The requirements contained in these regulations may affect the financial feasibility of proposed development.

Subdivision laws set requirements for lot density and design, grading and drainage, and on- and off-site improvements (e.g., streets and utilities).

Environmental regulation is a final category of governmental restrictions. These restrictions include water and sewer system connection moratoria, flood zone or geologic hazard zone designations, remediation requirements for toxic wastes, etc.⁶⁶

Physical Characteristics

The physical characteristics of land significantly affect its development potential and hence its value. Important physical characteristics include parcel size and shape, frontage, topography, soil and subsoil conditions and drainage, site orientation, and existing on-site and off-site improvements. Some of these characteristics were discussed in Chapter 4.⁶⁷

Locational Characteristics

The most important single attribute of land is its location. As also discussed in Chapter 4, the essence of location involves space and the need to transport people, goods, and services from one geographic location to another. The locational requirements of a given parcel depend upon its use, which relates to the linkages required by the subject parcel with other parcels.

METHODS OF LAND APPRAISAL

Land or site value can be estimated using the six methods of land valuation discussed below. These methods are: (1) comparative sales; (2) allocation; (3) extraction; (4) subdivision development; (5) land residual; and (6) ground rent capitalization.

Comparative Sales

The comparative sales approach is used to value land that is vacant, or that is considered vacant for appraisal purposes. There must be a sufficient number of comparable vacant land sales in

⁶⁵ A non-conforming use is an existing use not allowed under the current zoning ordinance, but which either preceded the current ordinance or exists under a conditional use permit.

⁶⁶ In *Mola Development Corporation v. Orange County Assessment Appeals Board No.2* (2000) 80 Cal.App.4th 309, the court held that the assessor must recognize the cost of toxic waste cleanup which has reduced the fair market value of property - under section 110. See also *Dominguez Energy, L.P. v. County of Los Angeles* (1997) 56 Cal.App.4th 839; and *Firestone Tire & Rubber Co. v. County of Monterey* (1993) 12 Cal.App.4th 634.

⁶⁷ See Chapter 4 under "Nature of Real Estate Productivity."

order to use this approach. The appraiser should select comparable sales that are similar to the subject in regard to the primary elements of comparison (i.e., property rights conveyed, terms of the sale, market conditions, and locational and physical characteristics). The comparables must have the same highest and best use as the subject. Comparable sales are analyzed and adjusted for differences compared to the subject property in order to arrive at an indicator of value for the land being appraised. The comparative sales approach produces the best indicator of value when a sufficient number of recent sales of comparable properties exist.⁶⁸

Comparable sales prices (pre- or post-adjustment for the elements of comparison) are often converted into units of comparison in order to derive indicators of value. Units of comparison are components into which a property may be divided for purposes of comparison and should be selected by the appraiser based on what is typically used by market participants. Five units of comparison used in the appraisal of vacant land are: sale price per front foot; sale price per square foot; sale price per acre; sale price per building site; and sale price per units buildable.

Comparison by *sale price per front foot* assumes that frontage is a primary determinant of value. A front foot is a strip of land one foot wide that fronts a street, freeway, or body of water. This unit of comparison is useful in the appraisal of commercial sites that benefit from drive-by or other visibility. It is infrequently used in the appraisal of residential properties. Comparison by *sale price per square foot* is applicable in industrial and commercial properties in which square footage is a good measure of development potential and frontage is not the dominant factor. Comparison by *sale price per acre* is typically used in the valuation of large industrial or commercial sites, subdivision land, and rural and farm properties. Comparison by *sale price per building site* assumes that buyers purchase a site with limited concern for small differences in front footage or square footage, and are instead primarily concerned with the site's overall desirability (e.g., views or exposure) for residential purposes. Finally, comparison by *sale price per units buildable* assumes that market participants value land based on its development potential on a units-buildable basis, for example, sale price per apartment unit, condominium unit, or single-family lot.

Allocation

In the allocation method, a portion of total property value is allocated to the site. This method is based on the principles of balance and contribution, which hold that a typical ratio between land value and total property value exists for similar types or classes of property, in comparable locations, at a given period of time. The allocation method is typically used to estimate the site value of an improved property, but it can also be used to estimate the value of a vacant site.

To apply this method, it is necessary to estimate a ratio between land and building value. This can be done by analyzing ratios of site value to total property value in comparable neighborhoods where sales of vacant and improved properties have occurred. This ratio is then applied to the subject property to estimate its site value.

⁶⁸ The comparative sales approach in regard to improved property is discussed in Chapter 6. Much of that discussion is also applicable here.

Extraction

The extraction method is a variation of the allocation method. In this method, site value is estimated by subtracting the value contribution of the improvements from total property value. The contributory value of the improvements is typically based on an estimate of depreciated cost (i.e., replacement cost new less depreciation). This method is most reliable for properties with limited improvements, and it may be used to derive site value indicators for vacant sites or improved properties.

Subdivision Development

The subdivision development method is also known as the land development or anticipated use method. It is primarily used to value vacant land that is ready for development to a higher use, for example, land changing from agricultural to residential or commercial use.

This method involves the hypothetical development of land. First, the appraiser estimates the number of lots or sites that can be produced and their market values. This allows an estimate of the gross market value of the project as if developed. Second, the appraiser estimates the total development cost for the project. Total development cost includes all direct and indirect costs of development: the cost of construction (i.e., labor and materials, contractor's overhead and profit); land planning, engineering, and other professional fees; property taxes and financing charges during construction; entrepreneurial profit; anticipated sales marketing expenses; and other applicable costs. Finally, total development costs are subtracted from the projected gross sales prices of the developed lots to derive an estimated value for the vacant land.⁶⁹ The subdivision method should generally be used only when the comparative sales method cannot be used, or in conjunction with other methods.

Land Residual

The land residual method is similar to the subdivision method in that it hypothesizes a highest and best use of the site upon which the indicator of land value is premised. It requires: an estimate of building value under the premise of highest and best use; an estimate of annual net operating income under the premise of highest and best use; and market-derived capitalization rates for the land and building.

To apply the method, the appraiser first estimates the highest and best use of the site as though vacant. Second, based on this hypothetical use, the appraiser estimates the annual net operating income of the property. Third, the appraiser estimates, using the building capitalization rate, the portion of total property income attributable to the building, and subtracts this amount from the

⁶⁹ This discussion is simplified. A more detailed treatment would also consider the time value of money.

net operating income. What remains is the income attributable, or residual, to the land. Finally, the appraiser capitalizes this residual income into an estimate of land value using the land capitalization rate.⁷⁰

Ground Rent Capitalization

The ground rent capitalization method is also an application of the income approach. Ground rent is the rent paid for the use of land. In this method, the appraiser capitalizes the ground rent into an indicator of land value. The method can be used to estimate the value of vacant land or to estimate the site value of improved property. The method requires: an estimate of the market rent for the subject land; an estimate of any expenses paid by the landowner; and a market-derived capitalization rate for the land.

To apply the method, the appraiser capitalizes the estimated market rent, less any anticipated expenses of the owner, into an indicator of value using the land capitalization rate. Since ground rent by definition is income imputable only to the land, an income attributable to improvements is not subtracted as in the land residual method.

Land Value and Improvement Bonds

General

Local governments assist private parties in financing the development of land by participating in the formation of local special assessment districts. These districts issue improvement bonds to the general public that are used in the construction of land improvements, or infrastructure, such as roads, schools, and utility services, that generally enhance land value. To obtain improvement bond financing, land parcels benefiting from the improvements must be pledged as security for the bond debt. These liens run with the land. The bonds are typically repaid over a period of years by special levies against the parcels collected along with property taxes.

Appraisers should be familiar with two categories of bonds: (1) improvement bonds issued under the Improvement Bond Act of 1911, the Municipal Improvement Act of 1913, or the Improvement Bond Act of 1915; and (2) improvement bonds issued under the Mello-Roos Community Facilities Act of 1982.

Bonds Under the 1911, 1913, or 1915 Acts

According to subdivision (b) of section 110 "[t]here is a rebuttable presumption that the value of improvements financed by the proceeds of an improvement bond resulting in a lien imposed on the property by a public entity is reflected in the total consideration, exclusive of that lien amount, involved in the transaction. This presumption may be overcome if the assessor establishes by a preponderance of the evidence that all or a portion of the value of those improvements is not reflected in that consideration." For example, otherwise similar properties

⁷⁰ The land residual method is an application of the income approach. The income approach is discussed in Chapter 6. The net operating income referred to here is the same as net income before taxes and recapture as defined in Chapter 6.

may sell for the same sale price regardless of the existence or nonexistence of 1911, 1913, or 1915 Act bonds. If this is the case, the appraiser may conclude that the fair market value of the subject property encumbered with a 1911, 1913, or 1915 Act bond is equal to its nominal sale price and not its adjusted sale price that includes the fair market value of the 1911, 1913, or 1915 Act bond.

The nominal sale price of a property encumbered by an outstanding 1911, 1913, or 1915 Act improvement bond is not necessarily the "purchase price" of the property as defined in section 110(b). Since purchase price is defined as "the total consideration provided by the purchaser or on the purchaser's behalf, valued in money, whether paid in money or otherwise," where this type of improvement bond is present, the total consideration provided by the purchaser is in part "paid in money" and in part "paid otherwise." The "paid otherwise" consideration in the case of a property that sells subject to a 1911, 1913, or 1915 Act bond is the fair market value of the outstanding improvement bond.

A bond, until retired, remains an encumbrance against the property. The existence of the bond may influence the sale price, and, as a result, the sale price may not reflect the property's market value. The appraiser should be aware of this when considering the sale price as an indicator of market value or when selecting comparables in areas where this type of financing is used.

Rule 4(a) requires that the appraiser "convert a noncash sale price to its cash equivalent by estimating the value in cash of any tangible or intangible property other than cash which the seller accepted in full or partial payment for the subject property and adding it to the cash portion of the sale price...." As an application of this general requirement, the sale price of a property encumbered by a 1911, 1913, or 1915 Act bond must be adjusted to reflect the fair market value of the outstanding bond. The fair market value of the outstanding improvement bond to be added to the sale price, if any, may be determined by the following methods: (1) reference to sales of comparable properties; or (2) by discounting the bonds to a cash equivalent amount. The adjusted sale price is arrived at by adding the market value of the improvement bond to the sale price of the property. The sale price so adjusted is the "purchase price" of the property as defined in section 110(b).

Mello-Roos Bonds

In contrast to 1911, 1913, or 1915 Act improvement bonds, Mello-Roos bond obligations should not be included in the value of land subject to Mello-Roos encumbrances.

In the case of the 1911, 1913, or 1915 Acts, the bonded indebtedness is tied to specific parcels; in other words, at any point in time it is possible to determine and to pay off the exact bond principal outstanding against each parcel. Furthermore, the additional taxes are levied for the express purpose of retiring a specific debt against a specific parcel. Finally, improvements authorized under these Acts are generally for a somewhat limited range of capital improvements that provide a specific benefit to specific parcels.

But Mello-Roos Bonds differ from the above on all counts. First, although the bond debt is secured by a lien against the property, the principal amount of Mello-Roos bonds is normally not tied to specific parcels. Second, the tax rate or levy for Mello-Roos bonds may be in excess of what is needed to retire the bonds. This gives Mello-Roos bonds the potential to provide greater security to bondholders than improvement bonds would in financing comparable facilities. Finally, Mello-Roos bonds are authorized for a wider variety of facilities and services than under the 1911, 1913, or 1915 Acts. Mello-Roos bonds require no test of benefit and are authorized for the construction of governmental facilities that the legislative body creating the district is authorized by law to construct, own, or operate. As such, levies under Mello-Roos are similar to a general property tax levy for general fund purposes.

CHAPTER 6: APPROACHES TO VALUE

APPLYING THE APPROACHES TO VALUE

The three major appraisal approaches for estimating value are the cost, comparative sales (or sales comparison), and income approaches. Rule 3 prescribes the application of one or more of the following five approaches to value in order to arrive at fair market value: (1) comparative sales approach; (2) stock and debt approach; (3) replacement/reproduction cost approach; (4) historical cost approach; or (5) income approach. The stock and debt approach is a variation of the comparative sales approach. The replacement, reproduction, and historical cost approaches are variations of the cost approach.

In the absence of reliable sales data, the cost and income approaches assume greater importance. If a property is owned for the purpose of obtaining rental income or providing space for an owner-operated business, and if there is an active rental market for similar facilities, the income approach becomes more applicable. However, if there are neither comparable sales nor rents paid for comparable properties, the cost approach assumes greater weight.

Each appraisal approach utilized should be carried out independently from the others. A value indicator from the cost approach, for example, should not be forced to agree with a value indicator from the comparative sales approach. If this is the case, a proper application of the cost approach did not actually occur; rather, the cost approach was discarded in favor of the comparative sales approach, mislabeled as a cost approach. Each approach utilized should be completed on the basis of market data applicable to that approach, and all data should be derived from the market identified as relevant to the property being appraised. If each approach to value is performed independently, the resulting value indicators will define a value range and allow a rational and defensible final estimate of value.

Although all three approaches to value should be considered, the use of all three may not always be appropriate. The nature of a property, its market, and the availability of data will normally indicate which approach(es) is most applicable. Because most single-family residences are owned for the amenities they provide and not for their potential rental income, the cost and comparative sales approaches are generally more appropriate when appraising this property type. Commercial properties may be appraised using all three methods, but limited sales of closely comparable properties may render the cost and income approaches more appropriate and reliable when appraising commercial properties.

The appraiser, therefore, should analyze all the data available on a subject property and utilize the most applicable approach(es) in the appraisal. This is supported by rule 3, which states, in part:

In estimating value as defined in section 2, the assessor shall consider one or more of the following [approaches to value], *as may be appropriate for the property being appraised*. (Emphasis added.)

Independent application of the approaches utilized will lead to separate indicators of value. The final analytical step in the appraisal process is to reconcile the separate indicators into a final value estimate. In the reconciliation process, each indicator is reviewed and reconsidered. Consideration should be given to factors influencing value that are not reflected or only partially reflected in the indicators. One should not make a simple arithmetic average of the several values. The greatest weight should be given to the approach(es) that most reliably measures the type of benefits sought by buyers in the market for the subject property.

COST APPROACH

INTRODUCTION

In the cost approach, the value of an improved property is estimated by adding the estimated land (or site) value and the estimated cost new of the improvements less depreciation. The cost approach can also be used to estimate the value of personal property. Appraisers should refer to Chapter 6 of Assessors' Handbook Section 502, *Advanced Appraisal*, for additional information about the use of the cost approach to estimate the assessable value of new construction.

The cost approach is the most universally applied approach in appraisal for property tax purposes and, under rule 6, is preferred when neither reliable sales nor income data are available. The cost approach is the only approach that can be applied to all improved real property and personal property. Many properties are rarely sold and/or do not have calculable incomes, but costs are incurred for all properties. Furthermore, particularly in the case of real property, it is frequently desirable to first perform the cost approach because important facts can be learned about the subject property that will be useful when performing the comparative sales and/or income approach.

Rule 6(a) directs when to use the cost approach:

The reproduction or replacement cost approach to value is used in conjunction with other value approaches and is preferred when neither reliable sales data (including sales of fractional interests) nor reliable income data are available and when the income from the property is not so regulated as to make such cost irrelevant. It is particularly appropriate for construction work in progress and for other property that has experienced relatively little physical deterioration, is not misplaced, is neither over- nor underimproved, and is not affected by other forms of depreciation or obsolescence.

There is no necessary relationship between the concept of cost and the actual costs experienced by a builder in a specific case. Builders construct homes with varying degrees of efficiency and incur varying costs. The estimate of cost by the appraiser should reflect the costs of typical producers who do the bulk of the work. This means that typical costs will be higher than those of the most efficient producers and lower than those of the least efficient. Typical costs should not reflect such items as special deals, change orders, poor management, and errors.

RELATION BETWEEN COST AND VALUE

The rationale for the use of the cost approach is based upon the economic principle of substitution. As discussed in Chapter 4, this principle holds that a rational person will pay no more for a property than the cost of acquiring a satisfactory substitute, assuming no costly delay. The condition of no costly delay must be satisfied, or the cost of the delay must be added to the cost of a substitute property. If a property owner would not, or economically should not, construct a replacement for the existing property if it were destroyed, then a value indicator from the cost approach has little relationship to market value. This occurs when reconstruction would not be economically feasible.

Real property cost tends to equal value only when the improvement is new and reflects highest and best use. The cost approach is most reliable when the property being appraised is relatively new and has experienced little depreciation. The reliability of the approach decreases as depreciation of the property increases (typically with the age of the property), due to the difficulty of estimating depreciation.

COSTS TO INCLUDE

Full Economic Costs

Costs for appraisal purposes may be thought of as full economic costs. Full economic costs are defined as the payments that must be made to secure the supply of all the necessary agents of production. Costs necessary to construct a property and make it ready for its intended use may be classified as either direct or indirect costs. *Direct costs* are expenditures for the labor and materials required to construct the property. They include expenditures for permits, materials and labor, and contractor's overhead and profit. *Indirect costs* are expenditures not included in the direct construction of the property. They include expenditures for the developer's administrative expenses, professional fees, construction financing, construction insurance, property taxes during construction, and marketing, sales, and lease-up costs incurred to achieve initial occupancy or sale. For personal property, some or all indirect costs may be included in the selling price. In addition to direct and indirect costs, the appraiser must also recognize, as part of the cost of creating a property, the return to the entrepreneur for his or her development expertise and risk-taking. This component of cost is referred to as entrepreneurial profit and is distinguished from contractor's overhead and profit, a direct cost noted above. Full economic cost includes market-supportable entrepreneurial profit as well as all direct and indirect costs.

In the case of real property, improvement cost is the total cost of development of the improvements added to a site, exclusive of the cost of items classified as land. This includes the cost of labor and materials, contractor's overhead and profit, building permits, inspection fees, bonding costs, architect's fees, cost of insurance during construction, interest on invested and borrowed capital during construction, marketing and lease-up expenses, and entrepreneurial profit. Cost is the sum of all payments made to achieve the creation of the improvement. In the case of personal property, total cost includes (but is not limited to) the cost of the asset, freight, sales tax, and installation.

The general principle is that the costs of all functions necessary to place the property in the hands of the consumer are part of the total cost of production. "Necessary" should be emphasized. If a house is painted several times because the owner cannot decide on a color scheme, this would create an unnecessary cost, and only the cost of one painting should be included in the cost estimate. Other costs that do not represent normal costs should also be excluded. Abnormal costs include those generated by strikes, lockouts, floods, excessive overtime pay, unforeseen hardships, etc.

Certain costs, while often not explicit, are nonetheless included in total cost. For example, if an owner/builder provides his or her own labor, he or she may not consider it a cost, but it should be a part of the appraiser's cost estimate. If an owner/builder provides construction capital (i.e., there is no outside construction financing), the cost of construction financing, based on current market rates and terms, should be imputed as a necessary cost of production.⁷¹ The initial sale of a property from the builder to the first user is also a necessary economic function, and the cost of this transfer should be included as part of total cost (subsequent transfers, however, are merely transfers of an already-produced commodity). Cost factors for residential property usually provide for this initial transfer cost, but it may be necessary to separately add transfer costs for other types of real property and for personal property. Other valid components of cost, such as feasibility studies, planning expenses and fees, leasing expenses (all indirect costs), and entrepreneurial profit vary widely in amount according to property type and the circumstances surrounding development, and the appraiser should determine whether these costs are included in any standard cost tables used. If not included, the appraiser should separately add them to arrive at an estimate of total cost.⁷²

The existence of entrepreneurial profit should be confirmed by reference to other market indicators of value. Section 401.6(a) provides special instruction concerning a cost component for entrepreneurial profit in the case of special use properties. It states, in part:

In any case in which the cost approach method is used to value special use property for purposes of taxation, the assessor shall not add a component for entrepreneurial profit unless he or she has market-derived evidence that entrepreneurial profit exists and has not been fully offset by physical deterioration or economic obsolescence.

The section goes on to define "special use property" as "a limited market property with a unique physical design, special construction materials, or a layout which restricts its utility to the use for which it was built."

⁷¹ This only applies to financing costs during the construction period. Financing costs, actual or imputed, attributable to the holding of the property after the completion of construction, including purchase financing, should not be included in the cost of construction.

⁷² When making the cost estimate of a building, for example, it is important to be certain that standard cost factors used are based only on the costs to replace the subject building, and that the factors do not include extraneous costs.

REPRODUCTION COST, REPLACEMENT COST, AND HISTORICAL COST

Rule 3 prescribes more than one type of cost approach that the appraiser may use. The three variations of the cost approach provided in the rule are reproduction cost, replacement cost, and historical cost.

Reproduction Cost

Reproduction cost is the cost to replace an existing property with a replica as of a particular date. Strictly construed, reproduction cost calls for identical materials and quality of workmanship. This variation of the cost approach is of limited usefulness because it is frequently not possible or desirable to duplicate an existing property, due either to the lack of certain materials or trade skills, or to the functional obsolescence of an older property. The difficulty of using reproduction cost increases as a property ages. Certain structural and design features in older properties are obsolete and would not be replaced in a substitute property. Such features may have been desirable at the time the property was built, but today would add cost and produce little utility or value. For example, a modern commercial or industrial building, because of advances in structural design and materials, would not include two-foot-thick masonry walls. Similarly, in the case of personal property, improvements in a manufacturing process may eliminate the need for some components of a machine or line of equipment.

The fact that a property would probably not be duplicated renders reproduction cost less valid as an indicator of market value, since the cost approach, as noted, is based upon the principle of substitution. This lack of validity can be overcome if depreciation is accurately estimated. However, the depreciation estimate, discussed later in this chapter, is somewhat difficult and is the most subjective portion of the cost approach.

Rule 6 provides two methods of estimating reproduction cost: (1) by adjusting a property's original cost for price level changes; and (2) by applying current costs to a property's cost components to arrive at an estimate of full economic cost. The estimate of reproduction cost must be reduced by estimated depreciation to arrive at an indicator of fair market value.

Replacement Cost

Replacement cost is the cost to replace an existing property with a property of equivalent utility as of a particular date. The replacement cost concept is the most meaningful as far as the principle of substitution is concerned.

In the replacement cost approach, elements of a property that would clearly not be included in a substitute property of equal utility are excluded from the estimated replacement cost. The procedures to be followed in replacement cost estimating vary somewhat depending upon whether the property is industrial, commercial, rural, or residential real property, or tangible personal property.

The replacement cost method is difficult to apply in the case of complex, one-of-a-kind structures or highly specialized equipment. Such properties often include many necessary features that are either not evident or for which current replacement costs are not readily available.

Applying current costs to the property's cost components creates an estimate of full economic costs. The estimate of replacement cost must be reduced by the amount of estimated depreciation to arrive at an indicator of fair market value.

Historical Cost

The essence of historical cost is that it reflects the level of cost at the time of a property's original construction or acquisition. Historical cost is often the reported book cost, but in some cases book cost must be adjusted to reflect the full economic cost of the property as of the date of construction or acquisition. Historical, or original, cost appears in rules 3 and 6 in two contexts: (1) as a method of estimating reproduction cost; and (2) as the historical cost approach used in the valuation of rate-regulated properties.

Under rule 6(b), historical, or original, cost is used as a method of estimating reproduction cost using price indices or factors. The estimate of reproduction cost must be reduced by the amount of estimated depreciation to arrive at an indicator of fair market value.

Under rule 3(d), if a property generates income that is effectively regulated by law and the regulatory agency uses historical cost or historical cost less depreciation as a rate base, the actual historical amount invested in the property or the amount invested less the amount of depreciation (i.e., investment amortization or recapture) allowed by the regulatory agency may be a valid indicator of value.⁷³ This approach is referred to in the rule as the "historical cost approach." This variation of the cost approach is frequently applied to investor-owned, regulated public utilities assessed by the Board's Valuation Division, and to private water companies regulated by the California Public Utilities Commission and assessed by county assessors.⁷⁴

METHODS OF ESTIMATING COST

Under rule 6, there are two primary methods of estimating *reproduction cost*: (1) using trended, or factored, historical cost; and (2) applying current prices to the components of cost. *Replacement cost* may be estimated using method (2) above. Selection of a cost estimating method may depend on the type of property, the use of the appraisal, or the appraiser's knowledge of construction.

Trended Historical, or Original, Cost Method

In this method, which can be used to estimate reproduction cost, the appraiser obtains the historical, or original, cost of the property, verifying that it represents the full economic cost of reproduction. The appraiser then factors this historical cost to the date of the appraisal using a price index. The result is an estimate of current reproduction cost. The greater the time interval between original construction and the appraisal, the less reliable this method becomes because of the difficulty of measuring cost changes over long periods. If the historical cost is actually the

⁷³ Rate base is the dollar amount established by a regulatory agency upon which a return is allowed.

⁷⁴ With respect to state assessed properties, see *Unitary Valuation Methods*, (revised March 2000), and regarding private water companies, see Assessors' Handbook Section 542, *Assessment of Water Companies and Water Rights*, Part I.

full economic cost, and the index accurately measures the change in cost over time, then the factored cost is a reliable estimate of the current cost of reproducing the existing property. However, frequently the appraiser does not know whether the historical cost represents full economic cost, and all price indices only approximately measure the change in cost over time. Despite these limitations, factored historical cost may be useful to the appraiser, particularly in dealing with unusual types of construction. Historical cost can also be used at the time of construction as a direct estimate of reproduction cost as of that date. In this case, obviously, no factoring or indexing is necessary.

Applying Current Prices to the Components of Property Cost

In this method, which can be used to estimate either reproduction or replacement cost, the appraiser applies current prices to a property's labor and material components, with appropriate additions for contractor's overhead and profit, construction financing costs, other indirect costs typically incurred in bringing the property to a finished state, and entrepreneurial profit (if applicable). This method typically involves the following submethods: quantity survey; unit-in-place; and square foot costs.

Quantity Survey Method. The quantity survey method is the most comprehensive and accurate form of cost estimating. It also requires the most time and detailed construction knowledge to complete. Under the quantity survey method, all necessary materials and labor for the project are identified and priced. The total material and labor costs are combined to indicate the direct cost of the building. All of the required indirect costs are then added to this total to derive a total cost estimate of the improvement. Although highly accurate, this is generally too time consuming for regular use by assessors.

Unit-in-Place Method. The unit-in-place method is a condensed version of the quantity survey method. Under the unit-in-place method, total costs of installing a common unit of construction are applied to the number of units in the project. The units of measure may be different depending on the construction component involved, such as square yards for floor covering or lineal feet for baseboard. The unit is not limited to measurements but can also be a count, such as number of plumbing fixtures or number of doors. Usually there will be several costs for each unit of construction with the difference accounting for variations of quality or complexity of installation. All unit costs are totaled to provide the total estimated direct costs for the entire improvement. Indirect costs are then added to arrive at an estimate of the full economic cost of the property.

Square Foot Method. The square foot method combines all of the construction costs into one unit of measure—price per square foot—that is applied to the square footage of the subject property. Cubic feet are also used as a unit of measure for industrial buildings, which may have large variations in ceiling height. It is important that the building from which the costs are derived be similar in size, intended use, construction type, and quality as the subject being valued. Any indirect costs not included in the square-foot cost factor must be added in order to arrive at an estimate of the full economic cost of the property.

The square-foot cost tables published in Assessors' Handbook Section 531 (AH 531), *Residential Building Costs*, are constructed and arranged to be used with the Assessors' Standard Classification System. This is a system of tabulating and arranging known costs according to physical variations in buildings that cause cost differentials. The following characteristics are considered in this arrangement:

- Design type
- Construction type
- Quality class
- Area class
- Shape class

Basic building costs are estimated by classifying buildings according to these five characteristics and using this classification as a reference to a table for a square-foot cost to be applied to the building area. The use of the Standard Classification System is explained in detail in the AH 531.

SOURCES OF COST DATA

Building costs are constantly changing. Therefore, the collection and classification of cost information is a continuing process for appraisers. The typical sources of property cost information are published property cost tables, building contractors, manufacturer's catalogs and price lists, and costs of comparable new construction. All of these sources should be considered. The appraiser should verify which costs are included in the data and which costs may need to be added.

DEPRECIATION

The most difficult aspect of the cost approach is the estimation of depreciation.⁷⁵ Depreciation in an appraisal sense is defined as a loss of value from any cause. Depreciation is the total measure of the reduced value experienced by a property compared to a hypothetical new and similar property that has not suffered any loss in value. Depreciation estimates are best verified by sales and income analyses.

The accountant's approach to and calculation of depreciation is quite different from the appraiser's. For accounting purposes, the rate of depreciation is established when the asset is new, based on a preselected life for the asset that determines the periodic depreciation charge. By the end of its preselected life, the value of the asset has been depreciated to a salvage value (often zero or a nominal amount). The capital amount at which the asset is shown on the accounting records, its book value, is the asset's acquisition cost reduced by the amount of accumulated depreciation charges against it. In this manner, the accountant attempts to match the cost of the asset against future revenues. By contrast, for the appraiser, depreciation is the loss in value from any cause. The appraiser attempts to estimate the remaining value of the property (compared to its cost when new), as evidenced by the market as of the date of the appraisal. The property's

⁷⁵ Depreciation, in an appraisal context, is sometimes referred to as accrued depreciation.

remaining value is likely to be different, either higher or lower, than the book value indicated by the accounting records. Also, for some properties, the appraiser will recognize that the economic life of a particular asset is tied to the remaining economic life of the entire appraisal unit.

Depreciation is a decrease in utility. The decrease in utility occurs in two different ways. First, and probably most important, the remaining economic life of a property may decline. Instead of yielding benefits for ten years, for example as when new, a property may now have only eight years of remaining service. Second, there may be a reduction in net benefits from the property. Either fewer benefits are provided, or the same benefits are provided at a higher cost. Thus, a decline in the remaining life or the efficiency of property causes depreciation.

There are three generally recognized sources of depreciation: physical deterioration, functional obsolescence, and external obsolescence.⁷⁶

Physical Deterioration

Virtually all properties deteriorate as they age, lowering their utility and reducing their value. This is known as physical deterioration and may be the result of wear and tear either from use or from the forces of nature. Peeling of paint, wearing out of water heaters, termite infestation, worn machine parts, metal fatigue, and water damage are all illustrations of physical deterioration. Good maintenance slows the process of physical deterioration while lack of maintenance hastens it.

Most physical deterioration can be corrected. However, the relationship between the cost involved and the economic benefit derived determines whether it is economically feasible to correct or repair physical deterioration. An element of physical deterioration is considered *curable* when the cost to correct the deficiency is less than the economic benefit resulting therefrom. When the cost to correct the deficiency is greater than the resulting economic benefit, the element of physical deterioration is considered *incurable*.

Physical factors have not, in general, been the major determinant of the economic life of properties in California. Typically, the life of properties has been ended by obsolescence (discussed below) and not by physical deterioration. With proper maintenance, properties have a slow rate of physical deterioration and can last, physically, for a very long period of time.

Functional Obsolescence

Functional obsolescence is the loss of value in a property caused by the design of the property itself. When the capacity of a property to perform the function for which it was intended declines, functional obsolescence begins. Functional obsolescence may be less tangible or visible than physical deterioration, but it may be more significant. Functional obsolescence may be attributable to changes of taste in the marketplace, changes in building construction techniques, or to poor initial design. An element of functional obsolescence is considered *curable* when the cost to correct the deficiency is less than the economic benefit resulting therefrom. When the cost

⁷⁶ External obsolescence is also referred to as economic obsolescence.

to correct the deficiency is greater than the resulting economic benefit, the element of functional obsolescence is considered *incurable*.

Most structures experience some functional obsolescence with the passage of time. As improvements become older, they may go out of style. Functional obsolescence due to changes in consumer tastes and building techniques occurs in most structures as they age. In addition, some structures suffer a loss in value because of poor design not related to the passage of time. Cases of inadequacy, superadequacy, and poor functional plans may create functional obsolescence even in relatively new structures. Examples of poor design in residential property include inadequate room size, lack of closet space, and an insufficient number of bathrooms. In addition, a few buildings incorporate outmoded exteriors and architecture at the time of construction.

Changing technology may also create functional obsolescence for personal property. Older machines, and sometimes even newer machines or entire lines of equipment, may be made obsolete by new technologies and manufacturing processes. Management may choose to continue operating the existing equipment. However, even though the equipment is still in use, its market value may be reduced because of functional obsolescence.

External Obsolescence

Adverse factors that are external to the property being appraised cause external obsolescence and a loss in value. These external factors usually affect more than one property in the area and cannot be controlled by an individual property owner. External obsolescence may be caused by environmental factors, illustrated by industrial encroachment on a residential neighborhood, or by the shifting of the economic base of employment away from a community. Losses in value attributable to external obsolescence are usually beyond the power of any single property owner to influence and cannot be cured by making changes to the subject improvement. This type of depreciation affects both real and tangible personal property, but not all properties experience external obsolescence during their economic lives.

External obsolescence can be identified by studying the overall market conditions for a property. For example, if the output of a machine is superseded in the marketplace by output of a different material (e.g., fiberglass for metal or plastic for wood), and the market no longer absorbs the superseded output, then the machinery has suffered external obsolescence.

A property may suffer from one or more of the three forms of depreciation at a given time. Under certain circumstances, the source of the decrease in utility may be difficult to classify. For example, the loss in value sustained by a residential overimprovement contains elements of both external and functional obsolescence. It is important to remember that classification of the forms of depreciation is only an aid to the appraiser. Identifying the type of depreciation helps in recognizing and considering depreciation in all its forms, but is not an end in itself. The appraiser's goal is to determine the total loss in value attributable to all forms of depreciation.

MEASUREMENT OF ACCRUED DEPRECIATION

There are several methods of estimating depreciation, and an appraiser will often use more than one method when determining the total depreciation from all causes. Discussed below are: (1) the straight-line or age-life method; (2) the sales data or market method; and (3) the breakdown method.

Straight-Line or Age-Life Method

The straight-line or age-life method is a measurement for determining the effective age of an improvement (or personal property) and is based on the relationship between the physical age of an improvement and its estimated economic life. In the case of real property, the economic life of an improvement is the period of time during which the improvement contributes to the total value of the real property. This is usually less than the physical life of the improvement.

In this method, depreciation is estimated by dividing the effective age of the improvement by its estimated economic life. Effective age is the "age indicated by the condition and utility of a structure."⁷⁷ Because there may be a large variation in the condition of improvements having the same age, the effective age is the best indicator of the market's perception of age for the improvement.

Sales Data or Market Method

When adequate sales data are available, the sales data, or market, method is the most direct and preferred method of measuring depreciation. This measurement of depreciation is taken from the actions of buyers and sellers in the market. In this method, in the case of real property, the appraiser analyzes a number of sales of improved properties and subtracts the estimated land value for each sale from the selling price. The remainder is the building's contribution to the sale price, which is then compared to the current cost of a new building. The difference is the total depreciation. The total depreciation divided by the estimated cost new of the improvement gives the depreciation in a percentage form. These points may then be plotted on a graph or analyzed with a regression analysis program to create a depreciation curve. This method is also generally applicable to business personal property.

Breakdown Method

The breakdown method is a comprehensive and detailed way to measure depreciation. The breakdown method is used to measure all items of depreciation individually (i.e., physical, functional, and external). In this method, total depreciation is determined by adding together all the individual estimates of depreciation. Techniques used to calculate the different types of depreciation in the breakdown method include the cost to cure technique and the capitalization of rental loss technique, which are discussed below.

⁷⁷ Appraisal Institute, *The Dictionary of Real Estate Appraisal*, s.v. "effective age."

Cost to Cure Technique

This technique may be used to measure physical deterioration and curable functional obsolescence. It requires the appraiser to estimate the cost to cure items of physical deterioration and functional obsolescence that are in fact curable. However, the cost to cure technique cannot measure incurable functional obsolescence or external obsolescence.

Capitalization of Rental Loss Technique

The capitalization of rental loss technique may be used to measure loss of value from any cause. This technique is based on the premise that any loss in value of the property would also be reflected by a loss in either the amount or duration of rental income (actual or imputed) to the property. To use this technique, the appraiser must identify the actual cause of depreciation and estimate the loss of rental income due to this cause of depreciation.

PERCENT GOOD

The complement of depreciation, when measured as a percentage, is percent good. For example, if the total depreciation of an improvement is 20 percent, then the percent good is 80 percent. The percent good concept is used in the appraisal process for two reasons: (1) it focuses the appraisal on the benefits remaining or the economic life remaining in the property rather than the benefits used; and (2) it saves one arithmetical operation when estimating depreciation. The percent good concept is applicable to both real and personal property.

Percent Good Tables

In a mass appraisal program, depreciation estimates may be made using percent good tables. Percent good tables are used for both real and personal property. These tables are based on data for properties of different quality levels and use types. They have validity only to the extent that a subject property has experienced the usual depreciation for its age, quality, and use type.

Any depreciation or percent good table should be used only as a guide in the estimation of value. A percent good table may reflect more or less depreciation than the market indicates. Therefore, wherever possible, the appraiser should verify replacement cost new less depreciation by other approaches to value before accepting the table as the best indicator of value.

LIMITATIONS OF THE COST APPROACH

Like the other approaches to value, the cost approach is not valid unless it is made as of a specific date. Changes in the purchasing power of money, efficiency of labor, techniques of production, and other economic factors may cause costs to vary over time. It is essential to specify that costs are as of a certain date in order for the principle of substitution to be meaningful. The more current the costs, the more reliable and valid the cost approach is for current market value appraisals.

Current costs are developed from data relating to the present and the recent past. As such, they may reflect a temporary situation in which some contractors are not covering all overhead and earning the required return on investment. This may occur in times of economic recession when

jobs are bid low in order to keep crews together, minimize fixed costs, and utilize on-hand inventories. The converse may occur during an economic boom because of demand far in excess of supply. Because these temporary imbalances eventually yield to a more normal long-range situation, the appraiser should ensure that such short-run costs are used only if they are typical and if construction activity is actually occurring.

In general, the newer the property, the more reliable the cost approach will be as an indicator of value. When a property is a new and proper improvement, replacement, historical, and reproduction costs will usually coincide. Depreciation in most new or almost new properties will be minimal, and this decreases the significance of the most subjective portion of the cost estimate. In such cases, the appraiser can attach a greater weight to the cost approach in the value conclusion. However, the same may not be true for machinery and equipment that is subject to rapid technological advancement. In this case, even relatively new items may be subject to functional obsolescence.

COMPARATIVE SALES APPROACH

INTRODUCTION

The comparative sales approach may be defined as an approach that uses direct evidence of the market's opinion of the value of a property. In this approach, the appraiser estimates the market value of the subject property by comparing it to similar properties that have recently sold. In addition to actual sales, the appraiser may consider listings, offers, options, and the opinions of owners, real estate agents, and other appraisers as to the selling prices that comparable properties might command. The comparative sales approach is based on the premise that the fair market value of a property is closely and directly related to the sales prices (under the conditions of fair market value) of comparable, competitive properties.

The comparative sales approach is not the only approach that utilizes market data. Construction costs and income information are also market data. However, significant differences exist in the nature of the market data in the cost and income approaches in contrast to the comparative sales approach. Neither costs nor incomes are direct evidence of market value. Rational people would consider cost and future income when buying or selling property in order to form their opinions of market value. However, in the comparative sales approach, an indicated value is direct evidence of the market's opinion of value, which gives this approach a certain preeminence.

Rule 4 states, in part:

When reliable market data are available with respect to a given real property, the preferred method of valuation is by reference to sales prices.

The comparative sales approach is based upon the principle of substitution and presumes that the market value of a property will approximate the sales prices, listings, offers, and appraisals of competitive substitutes. With a perfect degree of substitution and purely competitive market conditions, properties would have exactly the same value. No two real properties are ever

identical; all differ at least in location. However, reasonable substitutes may exist if relevant economic characteristics are similar. Because bargaining is characteristic of most sales, even perfect economic substitutes frequently sell for different amounts. This is the nature of the real estate market.

The market value of real estate is more realistically described as a band or a range rather than as a point. The appraiser is attempting to make an estimate that lies within that range. It is difficult, if not impossible, to specify the exact limits of any range of market value, especially since the range varies with different types of properties, locations, economic and market conditions, and other factors. The possible range is smaller for a property in a homogeneous residential subdivision than for a property in a heterogeneous commercial district. For example, a residential property may have a market value ranging between \$125,000 and \$130,000; any appraisal that lies within this range may be considered reasonable.

SALES DATA COLLECTION AND ANALYSIS

A sale price represents an agreement between two or more parties at a particular instant of time. As provided by section 110 and rule 2, a sale price of real property (except a possessory interest), as measured in cash or its equivalent, is rebuttably presumed to be the fair market value of the property if the terms were negotiated under conditions reflecting an open market transaction. (Under section 110(c), this rebuttable presumption does not apply where a taxpayer has failed to provide certain information about the conditions of the transaction.) Accordingly, the circumstances of each sale must be investigated before the sale price can be used as a value indicator for the subject property. This applies to sales of both the subject and comparable properties. For the sale to be an open market transaction, the following conditions must be satisfied:

- Exposed for sale in the open market
- Both parties seeking to maximize their gains
- Neither party taking advantage of the exigencies of the other
- Reasonable time allowed to find a buyer
- Reasonable knowledge of the property's uses, present and prospective, by both buyer and seller
- No collusion or "love and affection" between the parties
- Consideration in cash or its equivalent⁷⁸

Sales prices may not be indicative of market value. Consider the following examples: A seller may sell hastily in order to raise money; a purchaser may be forced to buy an adjoining lot to continue present operations; an uninformed buyer may pay a price in excess of the property's market value; a purchaser may give the seller a second deed of trust as partial consideration, and the cash equivalent value of such financing may differ substantially from its nominal value; or,

⁷⁸ Cash equivalence is discussed in a later section.

finally, a property may transfer between relatives, and, due to "love and affection" or other factors, the sale price may not represent market value.

If any of the open market conditions identified in the definition of fair market value is absent, the presumption that the sale price represents fair market value may be rebutted. If it is established that the property would not have sold for that price in an open market transaction, the property should be assessed at its fair market value as estimated by using other value indicators.⁷⁹ Such a sale is also not valid as an indicator of value for other properties, and it should not be used in the comparative sales approach.

In collecting market data, some information may be incorrect or misleading; it is risky to rely on only one or two sales in arriving at a value indicator. This risk can be minimized by acquiring information from more than one principal and asking questions designed to check the consistency of the data. In the selection of comparable sales data, the appraiser should not give preference to the type of buyer or seller involved in a transaction. This applies, in particular, to the type of legal entity involved. Sales involving private individuals, corporations, partnerships, financial institutions, and governmental entities may all be used when estimating market value, *provided that the conditions of a market value transaction are met* and the necessary adjustments (to reflect comparability to the subject property) are made.

The real estate market functions with more regularity than a casual observation of sales might indicate. A compilation of the unadjusted sales prices in a neighborhood may indicate a relatively wide range of values. However, the range narrows considerably after sales are confirmed and adjustments are made for the primary elements of comparison.

Area of Search

In selecting market data for analysis, an appraiser should focus on transactions pertinent to the subject property's specific market. In general, comparable properties are those that compete with the property being appraised or have a demonstrable effect on prices or other relevant components of the market in question. The subject and comparable properties must have the same highest and best use. The type of real estate being valued and the nature of its market will define the geographic boundaries from which to draw comparable sales data. Neighborhood is a very important factor in the single-family residential market, and the area to search for comparable sales is generally limited to the subject's neighborhood and other similar neighborhoods in close proximity. However, certain types of properties have regional, national, and even international markets. The search for market data should include the same area in which potential buyers would search for comparable substitutes.

Time Period for Sales

The desired time period for comparable sales depends on the sales activity in the market place. In a rapidly changing market with frequent sales, the appraiser should look for comparable sales within a few months of the appraisal date. If there is little sales activity and prices are stable, a

⁷⁹ *Dennis v. Santa Clara* 215 Cal.App.3d 1019.

longer time span is appropriate. However, appraisers and assessment appeals boards cannot consider sales of comparable properties more than 90 days after the date for which value is being estimated. This limitation does not apply to sales of the subject property.⁸⁰

Number of Sales

The number of sales needed depends on the comparability of the sales to the subject property. If the subject is a house in a subdivision of similar houses, then three or four sales of closely comparable houses are usually sufficient. If closely comparable sales cannot be found, for example, as with some industrial properties, then additional comparable sales will be needed. In some cases, the appraiser may need to investigate a large number of sales just to find three or four comparables.

Sources of Sales Data

County assessors generally have ample sales data within their offices, including a record of all real property sales within the county. However, the amount of detail on each sale will vary. Other sources are available to provide additional detail or information on transactions in other counties; there are several private companies in California that provide real estate sales data. Multiple-listing services also have comprehensive lists of sales transactions in their region and listings of property currently offered for sale. Real estate brokers, other appraisers, and title companies are other sources of sales data. In the absence of other comparable sales data, the appraiser may consider multiple listings and other public listings of asking prices for properties in establishing a range of value. It is important to note that listings should not be considered as direct evidence of the final value estimate for real property.

Verification of Data

Verification of sales data is an important step in the comparative sales approach. Assessors have an advantage in this area because the law requires property owners to report certain information about real estate transactions to the assessor on forms signed under penalty of perjury. An inspection of the property may be needed to determine physical condition, locational influences, and visual appeal.

SALES DATA ADJUSTMENTS

The appraiser considers all differences between the subject and comparable properties that could affect their respective market values, then adjusts the sales prices of comparable properties for these differences in order to arrive at an indicator of value for the subject. Adjustments are made to the comparable property, not the subject property. The adjustments reflect aspects of the transaction or characteristics of the property that have affected sales prices and are referred to as *elements of comparison*. Sales data adjustments may be made to either the total sale price or to an appropriate *unit of comparison* (discussed below), and adjustments can be made on the basis of either a percentage or a dollar amount. The common elements of comparison are:

⁸⁰ Rule 324(d).

1. An adjustment for rights and interests conveyed
2. An adjustment of all non-cash components of the sale price to cash equivalence
3. An adjustment for the difference in market conditions between the date of the sale and the valuation date of the subject property
4. Adjustments for differences in location and physical and economic characteristics between the subject and comparable properties
5. An adjustment for differences in highest and best use
6. An adjustment for non-real property components of the sale, such as tangible personal property (e.g., equipment and furnishings) and non-taxable intangible assets and rights

The first four of these adjustments are described in rule 4. Although physical comparability is often a primary concern when choosing comparable sales, adjustments for the other elements of comparison are also highly important. Adjustments to the sale price of the comparable property should be made in the same order in which the elements of comparison are listed above.

The degree of comparability between a comparable sale and the subject property determines which adjustments are necessary and the size of the adjustments. Typically, adjustments for each characteristic are made as dollar amounts or as percentages. The appraiser adjusts the sales prices of the comparables upward or downward in order to make them comparable to the subject property. Adjustments may be measured using a variety of quantitative and qualitative techniques.⁸¹

Adjustment for Rights and Interests Conveyed

The property tax appraiser must appraise the rights legally associated with the subject property. Since, for most properties, the full bundle of rights is normal, appraisers assume that no unusual rights or restrictions exist. This facilitates the appraisal process and will normally result in a correct value for the property being appraised. However, where enforceable legal restrictions or other enhancements or encumbrances apply to the subject or comparable properties, care must be taken to identify and adjust for these items. For instance, where the subject property has water rights to an adjacent lake, comparable properties should, where possible, also have similar rights.

In the vast majority of cases, the property tax appraiser must appraise the unencumbered fee simple interest.⁸² To be used as a comparable property, the sale price must either reflect the full fee simple interest or be adjusted to reflect the full fee simple interest. This adjustment is frequently required with income producing properties, which are often sold subject to leases. If a property is encumbered with a long term lease that is either above or below the current market rent, an adjustment for property rights conveyed is required. The appraiser must determine

⁸¹ See Assessors' Handbook Section 502, *Advanced Appraisal*.

⁸² Exceptions to this have been previously noted.

whether the contract rent for the property is different from the current market rent and adjust the selling price if necessary.⁸³

Adjustment for Cash Equivalence

Section 110 defines fair market value in terms of "cash or its equivalent." In using sales prices of the subject or comparable properties for the purpose of valuation, rule 4 provides that the appraiser shall adjust purchase prices to reflect amounts equivalent to cash. A cash equivalent adjustment may be required for sales involving: (1) assumed loans or new loans (i.e., promissory notes) that reflect non-market, or atypical, financing terms; (2) seller-paid loan points paid to a third party (e.g., an institutional lender) as part of the buyer's financing; and (3) any other tangible or intangible property other than cash that the seller accepted as full or partial consideration for the property.

The necessity for a non-market financing adjustment will depend upon the interest rate of the new or assumed promissory note. If the note's stated interest rate is not equal to the market rate of interest for similar notes at the time of the sale (i.e., similar in other terms and risk), an adjustment for financing terms is necessary. If the note's stated interest rate is lower than the market rate at the time of sale, it is presumed that the seller compensated for the lower rate by increasing the sale price of the property, in which case the value of the note should be discounted (i.e., reduced) to its cash equivalent amount in order to estimate the market value of the property. If the note's stated interest rate is higher than the market rate, it is reasonable to assume that the seller compensated by reducing the sale price, in which case the note's value exceeds its nominal, or face, value requiring an upward cash equivalent adjustment in order to estimate the market value of the property.

The interest rate required to attract a knowledgeable third-party lender for a particular property is a rate that reflects the current market interest rate. Normally, capital is furnished at competitive market rates by commercial lending institutions. However, there are situations in which commercial loans are neither in demand nor available. In these circumstances, alternative third-party financing terms should be considered. There are two primary means available to measure the amount of the cash equivalent adjustment: (1) by using direct market evidence, that is, by comparing sales with non-market financing to sales with market financing; and (2) by using mathematical procedures to discount the contractual loan payments at the current market interest rate.⁸⁴

Another required cash equivalent adjustment is the cost a seller may incur to obtain third party financing for the buyer. This cost, referred to in the real estate industry as "seller's points," typically arises because government-supported financing has a limit on the interest rate that may be charged by the lender. When market interest rates at the time of the sale are above those allowed, and funds are provided by a private lender, the seller may pay points to compensate for

⁸³ See rule 4(b)(2) and Chapter 3 under "Importance of the Fee Simple Concept in Property Tax Appraisal."

⁸⁴ The techniques for computing cash equivalent adjustments are varied. Further discussion is not presented here since the subject is covered extensively in Assessors' Handbook Section 503, *Cash Equivalent Analysis*.

this difference.⁸⁵ Points may also arise when the seller "buys down" a loan in order for the buyer to qualify for the loan. In such cases, the seller is actually receiving less than the nominal selling price for the property by the amount of the points, and an adjustment to the sale price in the amount of points paid by the seller is required.

Other non-cash items accepted by the seller as part or all of the consideration for the property must also be converted to cash equivalence. For example, a seller may accept \$10,000 in cash and an automobile for a parcel of real estate. If the appraiser intends to use the selling price as evidence of value, the value of the automobile in terms of money (i.e., its cash equivalence) must be estimated.

All cash equivalent adjustments require adjusting any non-cash tangible or intangible property included in the transaction into the equivalent of cash to the seller. The appraiser is not concerned with the buyer's obligations to outside parties. Thus, if a buyer makes a cash down payment and borrows the balance of the purchase price from a third party, it is still a cash sale from the seller's standpoint, because the seller receives the full purchase price in cash.

There are many other expenses that might be incurred by the seller as part of a transaction. In the case of real property, in addition to the example of seller's points discussed above, these include real estate commissions, escrow fees, and recording fees. However, in terms of cash equivalence, these expenses are not valid adjustments from the total amount the seller receives in exchange for his or her property. They are payments for services rendered, not for the real property transferred. The fact that the seller pays for these services does not make the payments deductible expenses from the sale price of the property. Property will sell for the same general price whether or not these expenses are incurred by the seller.

Selling prices adjusted to cash equivalence are value indicators; they do not necessarily represent fair market value. The reliability of value indicators must be resolved by the appraiser in the reconciliation step of the appraisal process when other value indicators are considered and the final value estimate is made.

Adjustment for Market Conditions

The market conditions adjustment is probably the most complex single sales data adjustment. Comparable sales occurring under different market conditions may require adjustment so that they reflect the same market conditions as the property being appraised.

Market conditions may change rapidly or remain static for long periods of time. Market conditions change due to shifts in demand and supply and/or inflationary or deflationary economic forces. Demand and supply for a particular property, or for all properties of its type, may change over time, and as a consequence, the market value of the property may rise or fall. The purchasing power of the dollar may also fluctuate. During inflationary periods purchasing power decreases, with the result that, other factors remaining constant, additional dollars are required to purchase the same property. The reverse occurs during deflationary periods.

⁸⁵ A point is one percent of the loan amount.

Although the adjustment for market conditions is also referred to as the "time" adjustment, the need for the adjustment is not caused by the simple passage of time. Economic variables affecting demand and supply that have shifted and/or inflationary or deflationary forces in the economy are the causes for this adjustment.

Market condition adjustments can be estimated and measured on the basis of sales data in two primary ways: (1) by measuring the difference in sales prices when the same property sells more than once over a period of time and no significant change in the property has occurred between sales; and (2) by measuring the difference in sales prices for separate but very similar properties that sell at different times. The validity of any adjustment is based primarily on the strength of the supporting data. Because different types of property may be subject to different economic forces, the market conditions adjustment should be measured using sales of the same property type as the property being appraised. Because of the complexity of this adjustment, it should be used with care. As a general rule, it is preferable to use comparable sales occurring near the valuation date of the subject property, thereby avoiding the need for this adjustment.

Adjustments for Location and Physical and Economic Characteristics

If the locational, physical, and economic characteristics of the subject property and the comparable properties differ significantly, each of these characteristics requires comparison and adjustment.

An adjustment for location is required if the locational characteristics of a comparable property are significantly different from those of the property being appraised.⁸⁶ Although individuals may have varying preferences regarding locational differences, the market as a whole often shows consistent patterns. Within a homogeneous neighborhood, locational differences may only be the difference between a typical lot and a lot near the park or on a cul-de-sac. However, as the geographic range of comparable sales broadens, the adjustment usually becomes more significant. Physical characteristics include such attributes as building size, quality, age, and condition; size of the site; and site amenities (e.g., view). Economic characteristics are those attributes of a property that affect its income-producing ability. This element of comparison is usually applied in the appraisal of income-producing properties. Related to economic characteristics, the appraiser should also consider differences in zoning and other enforceable restrictions.

The degree of comparability between a sale and the subject property determines which adjustments are necessary and the size of the adjustments. Typically, adjustments for each characteristic are made as dollar amounts or as percentages. The appraiser adjusts the sales prices of the comparables upward or downward in order to make them comparable to the subject property. Adjustments may be measured using a variety of quantitative and qualitative techniques.⁸⁷

⁸⁶ Locational and physical characteristics of real property were discussed in Chapter 4 under "Nature of Real Estate Productivity."

⁸⁷ See Assessors' Handbook Section 502, *Advanced Appraisal*.

Adjustment for Non-Real Property Components of Value Included in the Purchase

Non-real property components of value include stocks, bonds, tangible personal property, copyrights, patents, trade names, etc. With the exception of tangible personal property, the other items listed are intangible personal property. The sales prices of the subject property and comparable properties must be adjusted to exclude the value of these items. That is, when the purchase price in terms of cash or its equivalent includes non-real property items in addition to the real property purchased, the value of these items (on a cash equivalent basis) must be removed from the sale price in order to arrive at an indicator of real property value. Furniture, fixtures, and equipment included in the purchase of a hotel or restaurant are typical examples of tangible personal property that might be included in a purchase of real property.

UNITS OF COMPARISON

Units of comparison are the components into which a property may be divided in order to make comparisons. They are used to compare the subject and comparable properties. The appraiser computes like units for comparison by stating each sale price in terms of appropriate units of comparison. The appropriate unit depends on the type of property being appraised. For example, apartments are typically compared based on sale price per apartment unit; commercial properties based on sale price per square foot; industrial properties based on sale price per square or cubic foot; hotels and motels based on sale price per guest room; etc. In the case of single-family residences, the unit of comparison is typically the entire property. Units of comparison should be selected based on what is typically used by buyers and sellers in the market for the type of property being appraised. All applicable units of comparison should be considered, and any wide variations in the results should be analyzed.

Sales data adjustments for elements of comparison can be made to either the total sale price or to the appropriate unit(s) of comparison. Typically, adjustments for the rights and interests conveyed, cash equivalence, and market conditions (and perhaps also non-real property items) are made to the total sale price. Units of comparison are then calculated based on the adjusted sale price. The unit of comparison is then adjusted for differences in location and physical and economic characteristics.

CORRELATION WITHIN THE COMPARATIVE SALES APPROACH

Analysis of the comparable sales will result in separate value indicators for the subject property based on the data from each comparable sale. Typically, the indicators will indicate a range of value for the subject property. These estimates should not be averaged to reach a single indicator of value. Rather, the adjustments made to each comparable should be evaluated and the greatest weight given to the sales that are closest in comparability to the subject.

VALUE ALLOCATION

The comparative sales approach produces a total property appraisal of an improved property; that is, the appraisal of the land and improvements as a single unit. Since property tax law requires separate assessments for land and improvements, the appraiser must allocate the total property value between these components. While this allocation could technically be accomplished by

either making the land value or the improvement value residual to the other component, in practice the land value is estimated and subtracted from the total value to derive the value attributable to the improvements. Land is not generally subject to depreciation, and its value may be estimated by direct comparison with sold properties, a technique seldom applicable to improvements alone.

LIMITATIONS OF THE COMPARATIVE SALES APPROACH

The comparative sales approach is very reliable in an active market in which there are numerous recent sales of comparable properties. It is the preferred approach when reliable market data is available.

However, two primary factors limit the usefulness of this approach. First, certain types of property are infrequently sold, with the result that there may be insufficient market evidence to derive a valid indicator by direct comparison. Where few comparable sales exist, or the comparable properties are not close substitutes for the subject, it is difficult to make comparisons. An appraiser using the comparative sales approach under these circumstances is forced to make many subjective adjustments to the market data. Second, the conditions of each comparable sale must be carefully investigated before it can be used as an indicator of value. Many sales do not meet the conditions of an open market transaction and are not good indicators of market value. In spite of these limitations, comparative sales are usually a more accurate index of market value than any other available evidence.

STOCK AND DEBT APPROACH

The stock and debt approach is a variation on the comparative sales approach. It is included in rule 3 as an acceptable approach to value. This approach is based on the fundamental accounting equation stating that the value of a corporation or other business organization's assets equals the value of its liabilities plus its net worth.

The stock and debt approach relies on values for an organization's liabilities and net worth (i.e., the values of its debt and equity interests) as established in the capital markets; it thus relies on the value of fractional interests in the company. To use the approach, the securities of the company whose taxable property is being appraised must be publicly traded. The current market value of the company's stock (equity) is added to the current market value of its liabilities (debt). Using the fundamental accounting equation, the sum of these amounts equals the total value of all corporate assets as valued in the capital market. This approach values all of the assets of the corporation, taxable and nontaxable. Therefore, the appraiser must make adjustments for the value of any nontaxable assets. These adjustments should be based on the value the capital market places on the nontaxable assets.

The stock and debt approach has several limitations:

1. It cannot be applied to companies that have little or no public trading of their securities.
2. The adjustments for nontaxable assets may be difficult to make.

3. Typical stock prices do not effectively measure the advantages of ownership and control that are inseparable in non-corporate or closely-held corporate property. This is often evidenced by the fact that the purchase of enough stock to gain control of the corporation is typically made at a price above the stock's market price.
4. Stock and debt securities are generally highly liquid in contrast to the physical assets against which they represent claims. The aggregate value of the stock and debt securities may include a liquidity premium above the value of the physical assets.

Despite these limitations, the stock and debt approach has some validity because it is based on the valuation of a corporation's assets by market participants.

INCOME APPROACH

INTRODUCTION

The income approach to value includes any method of converting an income stream into a present value estimate (i.e., an indicator of current fair market value). The income approach is also called the capitalization approach because capitalization is the process of converting an expected income into an indicator of value. In addition to the following discussion, see Chapter 4 of Assessors' Handbook Section 504, *Advanced Appraisal*, for information on advanced issues in the income approach.

The methods or techniques used in the income approach may be relatively simple (e.g., income or rent multipliers and direct capitalization), or more complex (e.g., various yield capitalization techniques). All of these methods are referred to as capitalization techniques because they convert an expected future income stream into a present value estimate.

The income approach requires careful application because small variations in its key variables (capitalization rate, duration of income stream, estimated income and expenses, etc.) will be mathematically leveraged into a wide range of estimated value. This is particularly true for the capitalization rate variable. The accuracy of the income approach is no greater than the validity of the assumptions used to estimate the key variables. The mathematical techniques used in the approach, while sometimes complicated, are merely tools for converting these assumptions into an estimate of current market value.

APPLYING THE INCOME APPROACH FOR PROPERTY TAX PURPOSES

Rule 8 prescribes the conditions under which the income approach may be applied. Subdivision (a) specifies that:

The income approach to value is used in conjunction with other approaches when the property under appraisal is typically purchased in anticipation of a money income and either has an established income stream or can be attributed a real or hypothetical income stream by comparison with other properties. It is the preferred approach for the appraisal of land when reliable sales data for

comparable properties are not available. It is the preferred approach for the appraisal of improved real properties and personal properties when reliable sales data are not available and the cost approaches are unreliable because the reproducible property has suffered considerable physical depreciation, functional obsolescence or economic obsolescence, is a substantial over- or underimprovement, is misplaced, or is subject to legal restrictions on income that are unrelated to cost.

Subdivision (b) states that in using the income approach, "an appraiser values an income property by computing the present worth of a future income stream."

Subdivision (c) establishes that the amount to be capitalized is the net return that a reasonably well informed owner and reasonably well informed buyers may anticipate that the taxable property existing on the valuation date will yield, considering prudent management and subject to such legally enforceable restrictions as such persons may foresee as of that date. It states, in part:

Net return, in this context, is the difference between gross return and gross outgo. Gross return means any money or money's worth which the property will yield over and above vacancy and collection losses, including ordinary income, return of capital, and the total proceeds from sales of all or part of the property. Gross outgo means any outlay of money or money's worth, including current expenses and capital expenditures (or annual allowances therefor) required to develop and maintain the estimated income. Gross outgo does not include amortization, depreciation, or depletion charges, debt retirement, interest on funds invested in the property, or rents and royalties payable by the assessee for use of the property. Property taxes, corporation net income taxes, and corporation franchise taxes measured by net income are also excluded from gross outgo.

Subdivision (d) states that 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 and whether the lessor or the lessee has agreed to pay the property tax." Thus, the estimate of economic rent for income-producing property must be made without regard to actual lease arrangements that may exist, including rent levels and property tax payment considerations, since the valuation objective is the market value of the unencumbered and unrestricted fee simple interest.

Subdivision (e) recommends using income from property rental rather than from business operation, since income derived from business operation is more likely to be influenced by managerial skills and may arise in part from nontaxable property or other sources. If income from business operation must be considered, sufficient income must be excluded to provide a return to working capital, any other nontaxable intangible assets and rights, and unpaid or underpaid management.

Subdivision (f) requires the inclusion of a property tax component, where applicable, equal to the estimated future ad valorem portion of the tax rate for the area times the assessment ratio, in the capitalization rate for all property tax appraisals.⁸⁸

Subdivision (g) provides the following two methods of developing a capitalization rate for property tax appraisals: (1) by comparing the net incomes that could reasonably have been anticipated from recently sold comparable properties with their sales prices adjusted, if necessary, to cash equivalents (the market-derived rate); or (2) by deriving a weighted average of the capitalization rates for debt and for equity capital appropriate to the California money markets (the band-of-investment method) and adding increments for expenses that are excluded from outgo because they are based on the value being sought or the income being capitalized. In the former, the appraiser determines the ratio of net income to adjusted selling prices of comparable sales to develop a range of yield or overall rates. Subdivision (g)(1) states that this method is preferred when the required sales prices and incomes are available. In the latter, the appraiser derives a weighted average of current rates for debt and equity capital (subject to the inclusion of a property tax component).

Subdivision (h) provides that income may be capitalized by the use of gross income, gross rent, or gross production multipliers (derived by comparing sales prices of closely comparable properties with their gross income, gross rent, or gross production).

Finally, subdivision (i) excludes open space land defined in section 421 from the provisions of rule 8 and also states that not all provisions of rule 8 apply to taxable possessory interests.

ASSUMPTIONS OF THE INCOME APPROACH

The validity of using the income approach depends upon whether the subject property meets the following three assumptions: (1) value is a function of income (i.e., the property is purchased for the income it will produce); (2) value depends upon the quality and quantity of the income stream (i.e., the investor demands a return of and on his or her investment in the property with consideration of the property's risk); and (3) future income is less valuable than present income (i.e., the value of the property is the sum of the present worth of its anticipated future net benefits). If the circumstances of the subject property do not meet these three assumptions, the income approach should not be given great weight as an indicator of the property's current market value.

Value is a Function of Income

A basic assumption of the income approach is that property is purchased for the income that it will produce. It follows that a property's value depends upon the income that it will produce. This assumption has general acceptability in the appraisal of most commercial, industrial, and multiple-residential properties since the owners of these properties frequently are not the users. It

⁸⁸ Under a triple net lease, the tenant assumes all expenses of operating the property, including property taxes. If the income to be capitalized is income estimated under a triple net lease, it is not necessary to add a property tax component to the capitalization rate.

is plausible, for example, that the owner of a retail property owns it for the rental income received and that a potential purchaser would buy it for the expected future rental income. This is an important assumption, and in cases in which it does not correspond with the facts, the income approach may not apply.

In order to use the income approach, the benefits a property will provide over time must be expressed in terms of money. Benefits expressed in money are most often found in commercial, industrial, and multiple-residential properties, since these are typically developed and purchased for the income they provide and are frequently leased to tenants in competitive markets. Single-family residential properties may also be leased, but they are often developed and purchased to provide their owners with amenity benefits rather than monetary benefits. Consequently, it is often difficult to apply the income approach to single-family residences.

If the income approach is used to value property that provides both monetary and amenity benefits, care should be exercised in converting amenity benefits into value. If the capitalization rate reflects the amenity benefit, a question arises whether the amount of the amenity benefit reflected in the rate equals the amenity benefit in the subject property. For example, a farm may be both a production unit returning monetary benefits and a living unit returning amenity benefits. Because the appraiser is often unable to impute an income to the amenities from the living unit, the capitalization rate is derived from market data that is based only upon the income derived from the farm as a production unit. The capitalization rate will consequently be lower than it would have been had it been possible to impute an income to the amenities and sum the income from both benefits (i.e., monetary and amenity) to obtain a more accurate measure of the true monetary return. Capitalization rates that include both monetary and amenity elements should be used for properties that have amenities similar to those of the properties from which the respective rates were derived.

Rents are, in effect, sales prices for short-term rights to use property. Appraisers apply these short-term sales prices in the income approach to obtain value indicators, which are estimates of the present worth of the sum of all these expected future short-term sales prices. The sum may involve short-term sales prices for a terminating period or in perpetuity.

It is generally preferable that the income to be capitalized be the income from the taxable property to be appraised. For example, a retail store operated by the property owner involves at least two activities. One is the ownership of the real and tangible personal property, and the other is the business of selling merchandise at the property. It is necessary to determine what portion of the operation's expected future earnings is attributable to the ownership of the taxable property. If the earnings of the business (after deductions for operating expenses) are capitalized into an indicator of value, the appraiser should be aware that the indicator may contain the value of nontaxable intangible assets and rights. The value of such assets and rights must not be reflected in the value of the taxable property. However, taxable property may be assessed and valued by

assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial and productive use.⁸⁹

Value is Determined by the Duration of Income and Its Risk

The income approach assumes that the investor in real property will estimate the duration of the income stream and its risk, or likelihood of receipt, when selecting a capitalization rate to value the property.

For land, the estimated duration of the income stream is usually in perpetuity, but improvements have limited lives. The estimate of the remaining economic life of an improvement (that period of time over which the property will earn a net income above the rent imputable to the land alone) is an important consideration in the income approach. Average life tables have been developed as general guides to estimating remaining economic life. However, a careful study of the structural soundness of the improvements, the degree of functional obsolescence, and the economic and social trends in the neighborhood and community should serve as the primary basis for this estimate.

The risk of an income stream refers to its certainty, that is, how likely it is that the investor will receive it. The greater the uncertainty of the income, the higher the capitalization rate at which the income should be capitalized. Not all investments are subject to the same level of risk, with the result that not all income streams should be capitalized at the same rate.

Investors demand both a *return of* their investment (a recapture of the investment) and a *return on* their investment (a yield on the investment). The yield rate contains components for (1) time preference, (2) liquidity preference, (3) risk, and (4) investment management.

1. *Time preference* is the return investors demand for forgoing present consumption. Time preference reflects the pure time value of money. The minimum, or "risk free," rate is the lowest yield rate that would be acceptable if instant cash liquidity were available, there were no risk of loss, and no management effort were required. The risk-free rate is represented by the return on United States government securities, which contain no default risk and little requirement for investment management. Time preference also includes an allowance for anticipated inflation.
2. *Liquidity preference* means that investors would rather have assets that are readily convertible into cash at face value. To give up this feature may mean waiting a significant period to sell an asset, or having to sell it at a discount to realize cash quickly.
3. *Risk* refers to the uncertainty involved with any projection into the future. Investors may commit their capital to relatively secure investments such as United States Treasury securities or passbook savings accounts. When they instead invest in speculative ventures,

⁸⁹ In using the income approach, the appraiser should use the estimated economic, or market, rent attributable to the taxable property, if possible, to estimate the value of the taxable property. Using the estimated economic rent for the taxable property assures that the value, if any, of intangible assets and rights is not reflected in the value of the taxable property.

they demand to be compensated for the element of uncertainty associated with these investments.

4. *Investment Management* is that component of the yield rate that compensates the investor for personal efforts involved in making decisions between alternative investments. It is *not* compensation for the day-to-day management efforts involved in real property.

Future Income is Less Valuable Than Present Income

The third assumption of the income approach is that future income is less valuable than present income. The concept of present value, essential to an understanding of the income approach, provides that the sum of the present worth of the future income payments is *always less* than the undiscounted sum of these future payments.

This concept is one of the most important in valuation. Because investors prefer immediate returns over future returns, they "discount" future returns, or reduce their value, when analyzing investments. Because of the pure time value of money, this is true even if no risk is involved. A rational investor would not pay \$1,000 today for the certain right to receive \$1,000 one year hence, because he or she could earn interest on the \$1,000 during the year, with the result that the total value would accumulate (at the risk-free rate of interest) to an amount greater than \$1,000 at the end of the year. To the rational investor, a certain payment of \$1,000 a year from today is worth something less than \$1,000 today, with the amount of the discount determined by the risk-free rate of interest.

The present value is the amount which, when compounded periodically (usually annually) at a given rate, will accumulate to the future amount. For example, \$1,000 due one year from today has a present value of \$909.09 if the annual interest rate is 10 percent ($\$909.09 \times 1.10 = \$1,000$). A series of payments made at equal intervals is known as an *annuity*. The present value of an annuity is the sum of the separate periodic incomes, discounted to their respective present worths. Factors used to convert annuities into value may be obtained from compound interest tables, personal computers, or financial calculators.⁹⁰ The process of discounting a series of annuity payments, or any future payment or payments, in order to obtain the present value of this income, is the basic theoretical underpinning of income capitalization.

CONVERSION OF INCOME INTO VALUE

The key component variables of income capitalization include: (1) the income to be capitalized; (2) the capitalization rate or factor used to convert the income into a value indicator; and (3) the time period over which the income is to be realized. The capitalization rate or factor must provide for both the *return of* the portion of the investment that declines in value (the investment amortization or recapture) and for the *return on* the investment (the yield). The means of investment recapture selected by the appraiser, as reflected in the capitalization method chosen, should reflect the expectations of buyers and sellers.

⁹⁰ Assessors' Handbook Section 505, *Capitalization Formulas and Tables*, contains annuity factors.

In its simplest form, the capitalization process may be represented by the equation $V = I/R$, where V is the indicated present value of the income stream, I is the income to be capitalized, and R is the capitalization rate. If the time during which the income is to be realized is less than perpetuity, a recapture component must be included in R . If any two elements of this equation are known, the third can be found. For example, $I = RV$ and $R = I/V$. In other words, if the income and the value of a property are known, as is the case with a comparable sale, a capitalization rate can be derived.

When capitalizing equal payment annuities of limited duration or deferred income payments, the appraiser may use annuity tables to process the future income into its present value. The factors in these tables account for the terminating nature of the income stream and hence also for recapture. The factor, F , is a ratio between value and annual net income, $F = V/I$. Since the component for recapture is included in the annuity factor, the rate used in conjunction with the tables need not reflect a recapture component. In this case, the basic capitalization formula becomes $V = IF$ rather than $V = I/R$, and capitalization becomes a matter of multiplication rather than division. The basic formula $V = IF$ also applies when using income multiplier analysis; all income multipliers are also factors.

The proper capitalization formula or method to use is a function of the shape of the income stream and should reflect the perceptions and actions of market participants. The appraiser must know the basic capitalization equations and understand the relationship between the variables in these equations before proceeding to the mechanics of the process. While specific applications may differ because of variations in the nature of the income stream or the composition of the capitalization rate, the basic principles of capitalization remain constant.

Direct capitalization is a method that converts a single year's income estimate into a value indicator in one step, either by dividing the income estimate by a capitalization rate or multiplying it by an income factor. In direct capitalization, no allocation is made between the return on and the return of the investment. This method does not explicitly specify investor assumptions regarding the return of and the return on the investment, the duration or pattern income, or changes in the value of the investment. Rather, these assumptions are implicit in the rates or income factors used, which are derived from sales of properties comparable to the property being valued. The following sections discuss the derivation of an overall capitalization rate from comparable sales and valuing a subject property using direct capitalization with an overall rate.

Income multiplier analysis is closely related to direct capitalization. A single year's gross income may be converted to an indicator of value by multiplying it by an income multiplier derived from the sales of comparable properties. This method is mathematically related to direct capitalization since a capitalization rate is the reciprocal of an income multiplier or factor (although an income multiplier is generally based on a gross level of income, while an overall capitalization rate is based on a net level of income). The following sections contain discussions of deriving a gross

income multiplier from comparable sales and valuing a subject property using a gross income multiplier.⁹¹

Yield capitalization is a method that converts a series of future benefits into an estimate of present value by discounting each future benefit at a selected yield rate. In yield capitalization, the appraiser: (1) estimates a holding period for the investment; (2) forecasts the expected future income during the holding period; (3) selects a yield, or discount, rate; and (4) converts future benefits into an estimate of present value by discounting each periodic income over the holding period.⁹² The periodic income streams may be discounted to present value using annuity tables, which contain annuity factors. *Discounted cash flow (DCF) analysis* is a widely used "modern" form of yield capitalization. Yield capitalization is discussed more thoroughly in Chapter 4 of the Assessors' Handbook Section 502, *Advanced Appraisal*.

Again, the method of capitalization utilized must reflect the assumptions and actions of the investors who make up the market for the property being appraised. The method must fit the size, shape, and duration of the subject property's income stream. These are matters that must be determined from an analysis of the market, comparable properties, and the property being appraised. The crucial difference between the various methods of capitalization is the manner in which the investment is recaptured.

CAPITALIZATION RATES AND MULTIPLIERS

A capitalization rate is any rate used for conversion of income into value. In the appraisal of property for assessment purposes, future income is discounted to present value at a rate that reflects the pure time value of money (including an allowance for anticipated inflation); liquidity preference; risk; investment management; investment recapture; and, if applicable, a component for property taxes. The capitalization rate is based on a hoped for or anticipated rate of return on and of the investment. It is the rate required to attract capital to the investment.

Direct market evidence is the preferred source for obtaining capitalization rates. Actual selling prices (adjusted to cash equivalence) of comparable properties can be related to their anticipated incomes. The income used in rate derivation must be the investor's anticipated income, because the decision to invest in property is directly related to its anticipated return.

As previously stated, one variation of the basic capitalization equation is $R = I/V$. When V (the sale price of the property when deriving a rate) and I (the income attributable to the property) are known, the derivation of R (the capitalization rate) is a simple mathematical computation. The type of rate derived will vary according to the level of income processed. When valuing property

⁹¹ Some appraisers consider income multiplier analysis to be a part of the comparative sales approach rather than the income approach. The significant consideration is whether the method provides a good indicator of market value for the property being appraised, not how the method is categorized.

⁹² Yield capitalization can also be performed by developing an overall capitalization rate which reflects the estimated income pattern, duration, value change in the investment, and yield rate. However, microcomputer applications that allow a period by period approach to income analysis and discounting (i.e., a discounted cash flow approach) have made such techniques less popular.

the rate must be applied to the *same level of income* from which it was derived. (However, this general principle is complicated somewhat by the treatment of property taxes, which is discussed below.)

The income multiplier is another useful tool of the income approach and is simpler to apply than some forms of capitalization. All multipliers are factors and follow the second variation of the basic capitalization formula, $V = IF$. Gross income multipliers are derived by dividing the adjusted sales prices of comparable properties by their anticipated annual gross incomes. The appraiser then multiplies the estimated income by the indicated multiplier to arrive at a value indicator for the subject property, applying the multiplier to the same level of income from which it was derived. The rationale of income multiplier analysis is that both the sale price or value and the gross income of an income property are subject to the same market influences and presumably move in the same direction in response to market forces.

Overall capitalization rates and income multipliers must be derived from sales that are comparable to the subject property. The requirements for comparability include similar types of property (same use, remaining lives, condition, and land-to-improvement ratios), similar income streams, availability of similar new financing for the subject, similar market of potential purchasers, similar terms of sale, and similar market conditions prevailing at time of sale.

CHARACTERISTICS OF THE INCOME STREAM

Components of the Income Stream

When investors purchase property for its future income, they anticipate that the future income from the property will satisfy several different functions. Therefore, the income stream can be separated into several components: (1) a component to provide for all property related expenses, including vacancy and collection losses, maintenance and repair, and utilities; (2) a component to provide for the payment of the property taxes on the property; (3) a component to allow for the *return of* the investment (investment recapture); and (4) a component to allow for a *return on* the investment (investment yield), even if this return on or yield is not realized until the property is resold.

Shape of the Income Stream

An income stream is a flow of income over time. The income stream used to derive income multipliers or capitalization rates, or used to value a property, can be represented by the income from one year or over several years. An income stream can be of one pattern or shape, or a combination of several shapes: It can remain constant (level); it can increase or decrease; it can terminate at a certain point in time; or it can continue into perpetuity. In the derivation of income multipliers and capitalization rates from comparable sales, and in the use of multipliers and rates to value properties, the appraiser should be aware of the pattern or shape of the income stream expected by market participants. There are five primary income patterns to which appraisal models are applied:

1. *Constant Perpetual*. A series of equal, annual incomes that flow into perpetuity. In theory, land is a non-wasting asset and is considered to be capable of producing a constant perpetual income.
2. *Constant Terminal*. A series of equal, annual incomes that terminate at some point in the future. Terminating income streams are normally associated with wasting assets (improvements).
3. *Straight Line Declining Terminal*. A series of annual net incomes that decline in equal amounts over a period of time until the income terminates.
4. *Variable Income*. A series of annual incomes that fluctuate in various amounts from year to year. In some cases the income may be a negative amount.
5. *Single Income Payment (Reversion)*. A lump sum payment that will be received at some point in time in the future.

PROCESSING THE INCOME STREAM

When the income approach is used, the appraiser processes the income to a level from which an income multiplier or capitalization rate can be derived, or to a level from which the income is capitalized into an estimate of value. "Processing" the income means subtracting out amounts of income from the total, or gross income, that a property is expected to produce. The amount of income subtracted depends on whether the appraiser is: (1) deriving a capitalization rate; or (2) capitalizing an income stream into an estimate of value using a capitalization rate. In addition, the type of income for extracting multipliers or rates from a property sale is different from the type of income used to value a property. These differences are addressed in the following sections.

DERIVING INCOME MULTIPLIERS AND OVERALL CAPITALIZATION RATES FROM COMPARABLE SALES

When deriving income multipliers or capitalization rates, the appraiser must use *anticipated income*, that is, income anticipated by the buyer in a particular transaction.⁹³ When deriving a gross income multiplier, the income is processed only to the level of anticipated potential gross income. When deriving an overall capitalization rate, the income is processed to the level of net income before recapture. These levels of income are summarized below:

⁹³ The approaches to value described in this manual are generally appropriate for properties that are operating at stabilized occupancy and operation. Stabilized occupancy occurs when there are no transitory abnormalities of supply and demand and existing market conditions are expected to continue over the economic life of the property (Appraisal Institute, *The Appraisal of Real Estate*, 342). If the property being appraised is not operating at such a level, further refinements may be required. See Assessors' Handbook Section 502, *Advanced Appraisal*.

Anticipated Potential Gross Income (APGI)
(minus) Anticipated Vacancy and Collection Losses
equals Anticipated Effective Gross Income (AEGI)
(minus) Anticipated Operating Expenses
equals Anticipated Net Income Before Recapture and Property Taxes (ANIBR&T)
(minus) Anticipated Property Taxes
equals Anticipated Net Income Before Recapture (ANIBR)

Deriving a Gross Income Multiplier

The investor's anticipated potential gross income (APGI) can be used to derive a gross income multiplier (GIM) by dividing the sale price, adjusted for cash equivalency, by the anticipated potential gross income. The basic formula for a gross income multiplier (GIM) is:

$$\text{GIM} = \frac{\text{SP}}{\text{APGI}}$$

where

GIM = the gross income multiplier, market-derived;
 SP = the cash equivalent selling price of a comparable property; and
 APGI = the anticipated potential gross income of comparable sale property (note: this may differ from its *actual* current income).

When appraising smaller residential properties, appraisers commonly speak of gross rent multipliers. A gross income multiplier is more useful for larger apartment projects and some commercial properties, since these types of properties frequently return income from sources other than basic building rent (e.g., income from parking, laundry facilities, or storage areas).

Deriving Overall Capitalization Rates from Comparable Sales

Subtracting the anticipated expenses, including the anticipated property taxes, from the anticipated effective gross income produces the anticipated net income before recapture (ANIBR). The anticipated net income before recapture divided by the sale price, adjusted for cash equivalency, produces a market-derived overall rate (OAR). The basic formula for deriving an OAR is:

$$\text{OAR} = \frac{\text{ANIBR}}{\text{SP}}$$

where

OAR = the overall capitalization rate, market-derived;

ANIBR = the anticipated net income before recapture of comparable sale property (note: this may differ from its actual current income); and

SP = the cash equivalent selling price of a comparable property.

VALUING PROPERTY USING INCOME MULTIPLIERS AND OVERALL CAPITALIZATION RATES

After the required sales and income data have been collected, analyzed, and processed to derive income multipliers and capitalization rates from comparable properties, the derived multipliers and rates are used with the correct level of income to find an indicator of value of the subject property.

When valuing property, the appraiser does not apply the individual buyer's anticipated income and expenses as were used in deriving rates. Instead, *economic, or "market," estimates of projected income and expenses are used*, that is, a level of income and expenses that would be projected by a typical purchaser of the subject property. The appraiser estimates the economic rent for the subject property using economic rents from comparable properties. Allowable expenses that a typical buyer would project are estimated based on the operating characteristics of the subject property. The reasonableness of the appraiser's projections can be checked using prevailing market rents and expenses for comparable properties under standard terms or conditions.

Ad valorem property taxes (property taxes based on property value) are not deducted as an expense when valuing property since this would presume that the value of property being appraised is already known. Instead, a property tax component is added to the overall capitalization rate. Because of the level of income involved, no adjustment for property taxes is required to the gross income multiplier.

When valuing property using a gross income multiplier, the income stream is processed to the level of economic potential gross income. When valuing property using an overall capitalization rate, the income stream is processed to the level of economic net income before recapture and property taxes. The steps in processing the income stream in order to estimate the value of the property being appraised are as follows:

- Economic Potential Gross Income (EPGI)
- (minus)* Economic Vacancy and Collection Losses
- equals* Economic Effective Gross Income (EEGI)
- (minus)* Economic Operating Expenses
- equals* Economic Net Income Before Recapture and Property Taxes (ENIBR&T)

Valuing Property Using a Gross Income Multiplier

The general formula for valuing property using a gross income multiplier is to multiply the estimated economic potential gross income (EPGI) by a gross income multiplier derived from the sales of comparable properties. Thus:

$$V = GIM \times EPGI$$

where

- V = indicated market value of the subject property;
- GIM = gross income multiplier selected from multipliers derived from comparable properties; and
- EPGI = economic potential gross income of the subject property.

Example: Valuing Property Using A Gross Income Multiplier

Assume the following data:

- GIM The gross income multiplier derived from comparable properties is 6.25;
- EPGI The estimated economic level of potential gross income for the subject property is \$80,000.

The indicated market value is:

$$V = GIM \times EPGI = 6.25 \times \$80,000 = \$500,000.$$

Valuing Property Using an Overall Capitalization Rate

The general formula for valuing property using an overall capitalization rate is to divide the estimated economic, or market, net income before recapture (ENIBR) by an overall rate obtained from the sales of comparable properties. However, since property taxes cannot be deducted as an expense in arriving at the income to be capitalized, the property tax appraiser capitalizes the economic net income before recapture and property taxes (ENIBR&T), using a capitalization rate that is the sum of the overall rate derived from comparable sales and the estimated ad valorem property tax rate. Thus:

$$V = \frac{\text{ENIBR\&T}}{\text{OAR} + \text{ETR}}$$

where

- V = indicated market value of the subject property;
 ENIBR&T = the economic net income before recapture and property taxes of the subject property;
 OAR = the overall capitalization rate; and
 ETR = the estimated ad valorem property tax rate.

Example: Direct Capitalization Using an Overall Rate

Assume the following:

- ENIBR&T the economic net income before recapture and property taxes of the subject property is \$25,000
 OAR the overall capitalization rate selected from OARs derived from comparable sales is 0.095 (or 9.5%)
 ETR the estimated ad valorem property tax rate is 0.011 (or 1.1%)

The indicated market value using direct capitalization by an overall rate is:

$$V = \frac{\text{ENIBR\&T}}{\text{OAR} + \text{ETR}} = \frac{\$25,000}{0.095 + 0.011} = \frac{\$25,000}{0.106} = \$235,849 \text{ round to } \$235,500.$$

RESIDUAL TECHNIQUES: OVERVIEW

Residual techniques of income capitalization allow an appraiser to capitalize the income allocated to an investment component of *unknown* value once all investment components of *known* value have been satisfied. Residual techniques can be applied to the physical components of a property (land and improvements) or to the financial components (debt and equity).

When using residual techniques, the appraiser: (1) applies an appropriate capitalization rate ("appropriate" in terms of the risk and return expectations of market participants) to the value of the known property component to determine the amount of income needed to support the investment in that component; (2) deducts this amount from the total economic, or market, net income before recapture and property taxes (ENIBR&T) of the subject property to derive the *residual income* available to the unknown component; (3) capitalizes the residual income into an estimate of value of the unknown component using an appropriate capitalization rate for that component; and (4) obtains a value indicator for the total property by summing the value of the known component with the estimated value of the unknown component.

Familiarization with the building and land residual techniques discussed briefly below is recommended. These techniques may be used when the required data are available.

Building Residual Technique

The building residual technique is used when the value of the land is known but the value of the improvements is unknown. After processing the estimated economic income of the subject property to the level of ENIBR&T, the income imputable to the land (the land value multiplied by the land capitalization rate) is deducted. The residual income is attributable to the building (or improvements) and may be converted to an estimate of improvement value by capitalizing it using a building capitalization rate.

The capitalization rate for the land, which assumes a constant perpetual income stream, is a combination of a yield rate and an effective tax rate. The capitalization rate for the building (improvement) is a combination of a yield rate, a recapture rate for the return of the investment in the wasting improvement, and the effective property tax rate.

Land Residual Technique

The land residual technique is used when the value of the building (improvements) is known but the value of the land is unknown. The income attributable to the building (the building value multiplied by the building capitalization rate) is deducted from the estimated ENIBR&T of the subject property. The residual income is attributable to the land and may be converted into an estimate of land value using a land capitalization rate.

The land residual technique allows the appraiser to estimate land values when comparable land sales data are not available. The technique can also be used to estimate the highest and best use of both vacant and improved sites by hypothecating potential highest and best uses and comparing the resulting indicators of land values.

LIMITATIONS OF THE INCOME APPROACH

As discussed at the outset, the income approach to value is based on the three premises that: (1) investors purchase property for its anticipated income; (2) investors estimate the duration and quality (i.e., risk) of this income; and (3) future income is less valuable than present income. If the facts regarding the property being appraised do not correspond to these premises, the income approach should not be used. If the property meets the premises of the income approach, and if income and expense forecasts, remaining economic life estimates, and capitalization rates are accurate and supported by market data, the approach produces a supportable indicator of market value.

RECONCILIATION OF VALUE INDICATORS AND THE FINAL VALUE ESTIMATE

In the appraisal process, typically more than one approach to value is applied, leading to separate indicators of value. In addition, several value indicators may also be derived from within a single approach. In the comparative sales approach, for example, each sale produces a separate indicator

of value. Multiple value indicators within a single approach, however, are generally resolved within that approach.

The final analytical step in the appraisal process is to reconcile value indicators from the separate approaches utilized into a final estimate of value. Resolving the differences among the value indicators is called *reconciliation*. The result of reconciliation is the final value estimate.

In the reconciliation process, consideration should be given to factors influencing value that are either not reflected or only partially reflected in the indicators. One should not make a simple arithmetic average of the several indicators. The greatest weight should be given to that approach or combination of approaches that best measures the type of benefits the subject property yields.⁹⁴ The reconciliation step should involve an analysis of: (1) the relative appropriateness of the approaches applied; (2) the accuracy of the data collected and calculations made in each approach; (3) the quantity of data available for each approach; and (4) the consistency in the manner in which the approaches to value were applied.

The cost estimate should be reviewed for the reliability of the depreciation estimate and whether it is supported by market data. If the sales comparison approach was used, a check should be made to determine whether the indicator relies heavily upon only one sale (a situation that is extremely undesirable). In reviewing the income approach, the appraiser should reexamine the estimates of economic rent, economic life, expenses, and capitalization rate, and alternative estimates should be considered. The appraiser should consider whether estimates are consistently optimistic or pessimistic.

Although containing an element of judgment, the analysis of value indicators should be based upon indicators derived from objective data, plus general overall value influences (economic, physical, political, and social factors). If a value indicator were perfect, it would already reflect these value influences. However, in actual practice, a value indicator is usually far from perfect. As indicated above, if the appraiser has adequate and reliable data, the greatest reliance should be placed on that indicator which best measures the type of benefits the subject property is expected to yield. These benefits may be in the form of amenities or money.

Some appraisers hold that the amount produced by the cost approach prior to the consideration of depreciation (i.e. replacement cost new of improvements plus land value) reflects the upper limit of value. Alternatively, other appraisers hold that the income approach consistently yields the lowest indicator. Both of these conclusions are generally the result of conservatism, error, or misapplication of the approaches. There is nothing inherent in any of the three primary approaches that should result in a value consistently lower or higher than those derived by the other approaches.

⁹⁴ In the case of a change in ownership of real property other than a possessory interest, the purchase price of the property is rebuttably presumed to be the fair market value of the property at the time of the change in ownership. This presumption does not apply if the purchase price was not negotiated under the specified open-market conditions. Furthermore, the presumption may be rebutted if a preponderance of evidence, as shown by other indicators of value, demonstrates that the fair market value is significantly more or less than the purchase price.

CHAPTER 7: PERSONAL PROPERTY APPRAISAL PROGRAM

As discussed in Chapter 3, the California Constitution, article XIII, section 2 provides that the taxation of tangible personal property is discretionary with the Legislature.⁹⁵ In the Revenue and Taxation Code, the Legislature has broadly defined personal property in section 106 as follows:

"Personal property" includes all property except real estate.

In many respects, the same basic appraisal principles that apply to real property also apply to personal property. The same definition of market value from section 110 applies to personal property as well as real property. However, unlike real property, personal property is assessed at market value every year; it is not governed by the value limitations under article XIII A of the California Constitution (Proposition 13). Except for manufactured homes and floating homes, there is no base year value for personal property and the appraisal date is always the lien date, January 1.

DIFFERENCES BETWEEN PERSONAL PROPERTY AND REAL PROPERTY

Although taxed at the same maximum percentage of market value as real property, personal property is treated differently in many other respects.

- Special assessments are levied on real property only.
- The Legislature has wide authority pursuant to article XIII, section 2, of the Constitution concerning the taxation and/or exemption of personal property.
- Tangible personal property cannot be assessed to insurance companies, banks, and financial corporations.
- Locally assessed real property is governed by article XIII A, while personal property is appraised at market value annually.
- Unless otherwise provided by the Legislature, the tax on State and national banks shall be according to or measured by the net income and shall be in lieu of all other taxes and license fees upon banks or their shares, except taxes upon real property and vehicle registration and license fees.⁹⁶
- There is no taxable possessory interest in personal property, except as provided for in section 201.5.
- The tax rate on the unsecured roll is the rate of the prior year's secured roll.⁹⁷

⁹⁵ The information covered in this chapter is only a brief summary of the appraisal issues regarding personal property; for a thorough analysis, see Assessors' Handbook Section 504, *Assessment of Personal Property and Fixtures*.

⁹⁶ Section 27 of article XIII of the California Constitution.

⁹⁷ California State Constitution, article XIII, section 12.

SITUS

The determination of the tax situs of property is an essential factor of a valid assessment, especially for personal property. Section 14, article XIII of the California Constitution clearly states:

All property taxed by local government shall be assessed in the county, city, and district in which it is situated.

Normally, the tax situs of personal property is considered to be the location of the property. Situs is not a problem with property that remains in one location, but problems are encountered when determining the situs of transitory or migratory property. Rules 203, 204, and 205 provide direction on the situs of property in transit, movable property (e.g., contractor's equipment, boats, general aircraft, and racehorses), and leased property. Under section 623, if a taxpayer owns leased personal property situated at multiple locations in a county, the assessor may assess the property at either each location or may place a single assessment of all the leased personal property in the county at a single location.

A common situs question concerns leased property. According to rule 204, property leased on a short term basis has situs where the lessor normally keeps the property. If property is leased for a term of more than six months, the situs is determined on the basis of the lessee's use. There are numerous special situations regarding situs that are beyond the scope of this manual. Chapter 3 of the Assessors' Handbook Section 504, *Assessment of Personal Property and Fixtures* contains a comprehensive discussion of situs.

REPORTING REQUIREMENTS

Because historical cost information is a very important tool for mass appraisal, the law requires most owners of business personal property to annually report the historical cost of equipment to the assessor. The property statement is the declaration of assessable property, signed under penalty of perjury, on which business personal property is reported (See Chapter 7, Assessors' Handbook Section 504, *Assessment of Personal Property and Fixtures*). Historical cost is used as a starting point because it normally represents the value of the property when purchased new. Additionally, it is a verifiable figure and lends itself to the mass appraisal process.

In addition to asking for costs of taxable personal property, the property statement requests a variety of other information that is needed by the assessor for making annual reviews of property. For example, although fixtures are classified as real property, they are treated as a separate appraisal unit (i.e., separate from the land and improvements) for the purpose of comparing adjusted base year value to fair market value. Since fixtures usually decline in value at approximately the same rate as personal property, the property statement requests the same information regarding fixtures as for personal property so the assessor can make the appropriate calculations.

The requirements for filing a property statement are set forth in section 441, which states, in part:

Each person owning taxable personal property, other than a mobilehome subject to Part 13 (commencing with section 5800), having an aggregate cost of one hundred thousand dollars (\$100,000) or more for any subsequent assessment year shall file a signed property statement with the assessor. Every person owning personal property that does not require the filing of a property statement or real property shall, upon the request of the assessor, file a signed property statement.

Based on this statute, a person who has taxable personal property (other than a manufactured home) in the county that cost \$100,000 or more is required to file a property statement with the assessor regardless of whether the assessor requests such a filing. Filing is also required if the assessor requests the person to file a property statement. If a person is required to file a property statement (because of either the \$100,000 threshold or the assessor's request) and fails to do so, under section 463 a penalty is applied to all the taxable personal property and fixtures that were subject to the reporting requirement.

The term "property statement" has a special meaning for California property tax assessment. The contents of all property statements are prescribed by the State Board of Equalization. Assessors may make limited rearrangements of the property statement for purposes of their processing needs, but the questions and instructions are uniform statewide. If an assessor needs different kinds of information or additional information than is contained in the property statement, he or she may request the taxpayer to provide such information but generally may not apply a penalty for failure to do so.⁹⁸

Thus, in cases in which a person has less than \$100,000 (at cost) of personal property, the assessor may elect to request the person to file a property statement or may elect to obtain the necessary information by some other means, such as a questionnaire or a physical inspection of the property.

Escapes and double assessments ("errors") commonly occur due to misunderstandings regarding situs, classification of property, reporting categories, etc. Such errors are especially likely to occur when there are substantial changes to a commercial or industrial property such as new construction, new tenants, or a change in ownership. For complex properties, standard property statements (and change in ownership statements) rarely contain sufficient detail to ensure that all taxable property is assessed and that no assets or portions of the property escape assessment. When a change of ownership or other major change to a property occurs, the assessor needs to take extra steps to ensure that the property is assessed correctly. In addition to field inspections, discussions with the taxpayer, and internal coordination between real property appraisers and auditor-appraisers, the assessor may ask the taxpayer to supply additional information to clarify the necessary details. Most taxpayers are likely to cooperate since they want to avoid double assessments and future escape assessments.

⁹⁸ There is one notable exception: Assessors may request an aircraft owner to file a non-prescribed statement giving the make, model, and year of manufacture of the aircraft and will apply a 10 percent penalty for failure to do so. (Sections 5365 and 5367.)

AUTHORIZED SIGNATURES

To ensure correct reporting of information on the property statement, rule 172 provides complete details of who is an authorized signatory for property statements. These include the assessee, a partner, a duly appointed fiduciary, or an agent. If the assessee is a corporation, the property statement must be signed by an officer, an employee, or an agent who has been designated in writing by the board of directors to sign such statements on behalf of the corporation. If the statement is signed by an agent or employee who is a member of the bar, a certified public accountant, a public accountant, an enrolled agent, or duly appointed fiduciary, a written authorization is not necessary.

TRADE LEVEL

As stated earlier, historical costs are normally used as a starting point for the appraisal of personal property and fixtures. However, there are many situations where the owner's book costs do not provide adequate information for making a fair market value appraisal, and, therefore, the trade level principle must be applied.

Consistent with the definition of full cash value, property must be assessed at the proper level of trade based on its location and use on the lien date. An appraiser must recognize that property normally increases in value as it progresses through production and distribution channels, and to the consumer, whether or not the cost or value added is booked.

The trade level concept is applicable when book cost does not provide adequate information for making a fair market value appraisal. It is a cost component, which is most frequently applicable to leased equipment and self-constructed equipment. Rule 10(a), *Trade Level for Tangible Personal Property*, explains the concept of trade level and reads in part:

In appraising tangible personal property, the assessor shall give recognition to the trade level at which the property is situated and to the principle that property normally increases in value as it progresses through production and distribution channels. Such property normally attains its maximum value as it reaches the consumer level. Accordingly, tangible personal property shall be valued by procedures that are consistent with the general policies set forth herein.

Under the provisions of the rule, personal property is assessed on the basis of how it is situated or used on the lien date rather than at the book cost of the owner. In effect, the rule provides for equal value for properties equally situated.

This concept is more easily understood using the following example.

EXAMPLE X
TRADE LEVEL
<p>FACTS:</p> <ul style="list-style-type: none">• ABC Grading Company purchases a bulldozer for \$250,000 and uses it to prepare land for subdivision development.• At the same time, Dozer Sales, a bulldozer dealer, purchases an identical bulldozer for \$200,000 (dealer's cost) and rents it on a one-year lease to JKL Grading Company. JKL uses the bulldozer to prepare land for subdivision development, in competition with ABC.• Concurrently, the bulldozer manufacturer (GHI) provides an identical bulldozer to its subsidiary, RST Grading Company (a competitor of ABC and JKL). The manufacturer's cost is \$150,000. RST uses the bulldozer to prepare land for subdivision development, in competition with ABC and JKL. <p>Logically, the full economic cost for each piece of equipment should be the same. In each situation, the bulldozer is used for the same purpose or at the same trade level. If no trade level adjustments were made and the book costs were used as the sole basis for appraising, the assessments would not be the same; they would be substantially different. The trade level principle, per Rule 10, requires the assessor to estimate fair market value for the three machines and provide uniformity of assessment.</p> <p>Based on the information above, Dozer and GHI's costs would require two different trade level adjustments to arrive at the \$250,000 (consumer level) value. Dozer's cost (\$200,000) is a dealer cost that would not include retail items such as sales tax and the dealer's profit margin. GHI's cost (\$150,000) is the manufacturer's cost which does not yet include retail items missing from the dealer cost, plus items such as profit margin normally added in when the manufacturer sells the product to either the dealer or a retailer. In this case, the dealer cost is adjusted 125% ($\\$250,000 / \\$200,000$) and the manufacturer's cost is adjusted 167% ($\\$250,000 / \\$150,000$) to arrive at the proper trade level.</p>

As illustrated in Example X, the trade level concept requires adjustments based on what a consumer at that level of consumption would pay. If another consumer of like property at that level of trade would be subject to a cost (i.e., sales tax), the full economic cost should include that cost component whether or not the cost was actually incurred. In *Xerox Corporation v. County of Orange*, (1977) 66 Cal.App.3d 746,⁹⁹ the Court indicated that under the market value concept, where price is the basis of value, the sales tax and freight charges are elements of value. Consumer trade level includes sales tax, freight and installation charges and the property is valued in accordance with the comparative sales, cost or income method. The courts have also supported the trade level concept by allowing inclusion of a markup in value for interdivisional transfers of manufactured goods for purposes of delivery or to facilitate marketing.¹⁰⁰

⁹⁹ Decision supported in appeal, *County of San Diego v. Assessment Appeals BD. No. 2* (1983) 140 Cal.App.3d 52.

¹⁰⁰ *Beckman Instruments, Inc. v. County of Orange* (1975) 53 Cal.App.3d 767.

Although rule 10 addresses the trade level principle for personal property specifically, the principle of trade level also applies to fixtures such as machinery and equipment fixtures that are normally assessed as a separate appraisal unit from the structure property. For this reason, the business property statement contains directions on trade level and directs the taxpayer to make trade level adjustments to book costs, when appropriate, for reporting any kind of property.

It is important to note that there are many circumstances where a property's historical cost is not necessarily the proper starting point for a fair market value appraisal. While the trade level issue most commonly arises in the case of personal property and fixtures, the appraiser should be alert for other situations in which valid book costs do not reflect the appropriate level of trade for property tax purposes.

TAXABILITY

Since the Legislature has the authority over the taxation of all tangible personal property, including providing for its special treatment or exemption, this, combined with the exemptions already in the Constitution, has led to special treatment or exemptions for a number of categories of personal property. A few of the major exemptions are discussed below.

HOUSEHOLD FURNISHINGS

Section 224 provides for the exemption of personal effects, household furnishings, and pets owned by any person. Rule 134 provides additional detail on this exemption.

BUSINESS INVENTORIES

Business inventories are exempt pursuant to section 219. Under rule 133(a)(1),

Business inventories... include all tangible personal property, whether raw materials, work in process or finished goods, which will become a part of or are themselves items of personalty held for sale or lease in the ordinary course of business.

PERSONAL PROPERTY OWNED BY BANKS, INSURANCE COMPANIES, AND FINANCIAL CORPORATIONS

The personal property of insurance companies is exempt from property taxation under the California Constitution, article XIII, section 28. Instead, they pay an in lieu "income" tax based on gross premiums. The exemption applies to all personal property owned by an insurance company regardless of how the property is being used.

Banks and financial corporations are also exempt from personal property taxation pursuant to section 23182.¹⁰¹ That tax, at a rate of 2% higher than the ordinary franchise tax applicable to

¹⁰¹ Pursuant to amendments made under Stats. 1999, Ch. 675 (SB 934) beginning in 2000 state-chartered credit unions are exempt from paying the bank and corporate in-lieu franchise tax (section 23701y). State-chartered entities

corporations generally, is "in lieu of all other taxes and licenses, state, county and municipal, upon the said banks and financial corporations except taxes upon their property,..." As such, assessors should independently evaluate and determine, on a case by case basis, whether these entities are shown on the "Confidential List of Banks and Financial Corporations" (in a CAO) and are qualified by the Franchise Tax Board (Corporate Audit Section) as a bank or financial corporation for assessment purposes. The personal property of those qualifying as financial corporations are exempt from property tax. However, when a bank or financial corporation leases property to another party, section 235 provides that, for property tax purposes, the lessee is conclusively presumed to be the owner of the property. Accordingly, such property is taxable to the lessee.

APPRAISAL METHODS FOR PERSONAL PROPERTY

AUDIT-APPRAISAL METHOD

The audit-appraisal method is based largely on data obtained from existing business records. On a yearly basis the assessor obtains, through the property statement, historical cost information (or costs adjusted for trade level, as discussed above) and other relevant data from the property owner. The acquisition (or trade-leveled) costs are used as a starting point for the estimation of market value. All costs necessary to place the equipment into service are to be included. These include the purchase price of the equipment, sales or use tax, freight charges, installation and set-up costs, machinery foundation costs, and trade level adjustments where applicable.¹⁰²

The historical (or trade-leveled) cost is adjusted to an estimate of current reproduction cost new through the use of a price index or to replacement cost new through the use of current prices for comparable equipment. Assessors' Handbook Section 581, *Equipment Index and Percent Good Factors* (AH 581), is published annually and provides a number of equipment index tables for commercial and industrial equipment. Current prices for replacement equipment are sometimes available from commercial publications or from the property owner.

The cost new (reproduction or replacement) is then adjusted for depreciation (depreciation is the loss of value from all causes). This is typically done through the use of percent good tables, which are also contained in the AH 581. The use of tables is intended to estimate the value of property under typical conditions.

It is possible for individual items or groups of items to suffer abnormal depreciation due to excessive wear and tear, extraordinary functional obsolescence, and/or any form of external obsolescence. On the other hand, sometimes equipment suffers less-than-typical depreciation due to better-than-normal maintenance and other factors. Adjustments should be made whenever the

are 1) not subject to the bank and corporations in-lieu tax, 2) subject to real property tax, and 3) not subject to personal property tax. Federally-chartered entities are 1) not subject to the bank and corporation in-lieu tax, 2) subject to real property tax, and 3) subject to personal property tax.

¹⁰² Except personal property leased for a period of six months or less (rule 10(c)) and for certain liquefied petroleum gas tanks as provided by rule 153.

standard depreciation tables do not accurately measure the actual loss of value of the equipment. Using recent sales of comparable equipment, the appraiser may be able to make a direct estimate of total depreciation from all causes.

PHYSICAL APPRAISAL METHOD

The physical appraisal method is used when accounting records are nonexistent or are inadequate for appraisal purposes, or when there are other reasons to believe that an accurate appraisal cannot be made by using the property statement or other available documents. Physical appraisal may be necessary, for example, when a business has changed owners. Since the recorded costs are just an arbitrary allocation of the total purchase price among such classifications as real property, inventory, personal property, and goodwill, the allocated value may have only a minimal relationship to market value.

The physical appraisal method requires viewing, listing, classifying, and describing property. The auditor-appraiser evaluates the condition and quality of the equipment and then estimates the replacement cost new and the depreciation to determine market value. This can be done with the help of cost and value guides for equipment that is frequently bought and sold.

AUDIT PROGRAM

AUDIT OBJECTIVES

The appraisal of most personal property is based on information submitted by the taxpayer on the property statement, as previously noted. In order for these appraisals to be reliable estimates of value, it is vital that the reported information be accurate and complete.

Assessors are required by section 469 to regularly audit the books and records of certain taxpayers. Pertaining to mandatory audits, this section states, in part:

In any case in which locally assessable trade fixtures and business tangible personal property owned, claimed, possessed, or controlled by a taxpayer engaged in a profession, trade, or business has a full value of four hundred thousand dollars (\$400,000) or more, the assessor shall audit the books and records of that profession, trade, or business at least once each four years.

Additionally, the assessor may audit the books and records of businesses below the mandatory audit level.¹⁰³

The purpose of an audit is to determine whether existing assessments (including previous years' assessments within the statute of limitations) are correct or should be changed. A property tax *audit* (per rule 191) is a means of collecting data relevant to the determination of taxability, situs, and value of property. In order to make this determination, the auditor-appraiser collects data relevant to the determination of taxability, situs, classification, and value of property. Generally,

¹⁰³ Revenue and Taxation Code sections 441(d) and 470; rule 192(e).

this involves determining the original acquisition date, historical cost, and location of the property on the lien date. The audit is also an opportunity for the auditor to clarify correct reporting procedures with the taxpayer.¹⁰⁴

STATUTORY PROVISIONS

The Legislature has provided the assessor with the statutory authority to review a taxpayer's records for information required on the property statement in the event a taxpayer is not willing to completely and/or accurately report the required information, or for any related purpose. This authority to allow the assessor to review books and records is stated in section 441(d), as follows:

At any time as required by the assessor for assessment purposes, every person shall make available for examination information or records regarding his or her property or any other personal property located on premises he or she owns or controls.

In regard to business records, section 470(a) similarly provides:

Upon request of an assessor, a person owning, claiming, possessing or controlling property subject to local assessment shall make available at his or her principal place of business, principal location or principal address in California or at a place mutually agreeable to the assessor and the person, a true copy of business records relevant to the amount, cost and value of all property that he or she owns, claims, possesses, or controls within the county.

STATUTORY REQUIREMENT FOR REQUESTING INFORMATION ON UNREPORTED PROPERTY

Under section 501, if the appraiser becomes aware of any unreported personal property, a written notice requesting the information required on the property statement should be sent to the owner/assessee. If no statement is filed by the owner/assessee within a reasonable time, the appraiser shall estimate the value of the property, and on the basis of the estimate, shall promptly assess the property and add a 25 percent penalty to any assessment made under section 502.

STATUTORY REQUIREMENTS FOR NOTIFYING TAXPAYER OF RESULTS

Upon completion of the audit, the assessor has the following obligation under section 469:

Upon completion of an audit of the taxpayer's books and records, the taxpayer shall be given the assessor's findings in writing with respect to data that would alter any previously enrolled assessment.

Rule 191 requires that the taxpayer be given an opportunity to respond orally or in writing to the audit results, and any written comments become part of the audit report. If an audit reveals an overassessment, section 469 provides:

¹⁰⁴ See Chapter 8, Assessors' Handbook Section 504, *Assessment of Personal Property and Fixtures*.

[T]he assessor shall notify the taxpayer of the amount of the excess valuation or misclassification, and the fact that a claim for cancellation or refund may be filed with the county as provided by sections 4986 and 5096.

In all cases, it is the auditor-appraiser's goal to determine the current market value of the taxable property. The use of tables and value guides to estimate fair market value of equipment is designed to expedite the mass appraisal process. However, these tools do not remove the need for appraisal judgment or the requirement that the ultimate assessment reflect the fair market value of the property on the appraisal date.

CHAPTER 8: SPECIAL TOPICS

APPRAISAL OF MANUFACTURED HOMES (MOBILEHOMES)

The taxation of manufactured homes, or mobilehomes, is addressed by Revenue and Taxation Code section 5800 and following. Although manufactured homes are not subject to the provisions of article XIII A of the California Constitution (Proposition 13), these statutes provide for essentially similar treatment for these properties.¹⁰⁵

The Health and Safety Code generally defines a manufactured home as a structure that is transportable, is 8 or more feet in width, 40 or more feet in length, or—if erected on a site—320 or more square feet in area. Additionally, the structure must be built on a permanent chassis and designed to be used as a dwelling unit.

CLASSIFICATION

Since the amendment made to section 5801(b)(2) by Chapter 796, Statutes of 1991, effective January 1, 1992, the classification of manufactured homes is no longer an issue. The statute simply provides that manufactured homes are classified as personal property, stating, in part:

Except as provided in paragraph (1), a manufactured home, otherwise subject to taxation pursuant to this part, shall not be classified as real property for property tax purposes that would be excluded from taxation pursuant to this part.

Only manufactured homes on permanent foundations pursuant to Health and Safety Code section 18551 are considered real property. Such homes are taxed as all other real property is taxed, are not subject to section 5800, and are not classified as manufactured homes. Although classified as personal property, most of the provisions relating to the taxation of personal property are not applicable to the taxation of manufactured homes. The primary differences in the taxation of manufactured homes from other personal property are:

1. *Secured Roll.* The assessment of a manufactured home is entered on the secured roll.¹⁰⁶
2. *Payment of Taxes.* The taxes on manufactured homes may be paid in two installments.¹⁰⁷
3. *Base Year Value.* A base year value is determined for a manufactured home on the date it changes ownership.¹⁰⁸
4. *Declines In Value.* The taxable value of a manufactured home is the lesser of its factored base year value on the lien date, taking into account reductions in value due to any factor causing a decline in value (e.g., depreciation, damage, destruction, obsolescence, etc.).¹⁰⁹

¹⁰⁵ See Assessors' Handbook Section 511, *Assessment of Manufactured Homes and Parks*, for a detailed discussion.

¹⁰⁶ Section 5830.

¹⁰⁷ Section 5830(c).

¹⁰⁸ Section 5802.

¹⁰⁹ Section 5813.

5. *Supplemental Assessments.* Manufactured homes that undergo a change in ownership or new construction are subject to supplemental assessment.¹¹⁰

PERSONAL PROPERTY CHARACTERISTICS

The classification of a manufactured home as personal property rather than real property has several consequences, as outlined below.

- Personal property held for sale or lease in the ordinary course of business is exempt from taxation under the business inventory exemption (sections 129 and 219, and rule 133). Thus, if on the lien date a manufactured home is held for sale or lease (i.e., is vacant and not actually in use) by a person engaged in the business of selling or leasing such properties, the property is exempt until it is sold, at which time a supplemental assessment will be made to the new owner.
- Under the Soldiers and Sailors Civil Relief Act of 1940, military personnel on active duty in California may declare their personal property's legal situs to be outside the state and, therefore, the property is deemed to be tax exempt. The exemption does not apply to military personnel who are legal residents of California.
- The Legislature has not provided for the creation of possessory interests in personal property. Private uses of personal property owned by a governmental agency are not taxable possessory interests except for pollution control equipment financed pursuant to section 201.5.
- Personal property owned by banks, financial corporations, and insurance companies is exempt from the property tax (article XIII, sections 27 and 28 of the California Constitution). However, if a person leases or rents personal property from a bank or financial corporation, for property tax purposes the lessee is "conclusively presumed" to be the owner of that property (section 235).

Classification may also affect the amount of property tax levied since special assessments are not levied on personal property.

TAXABILITY

Section 5801 provides that a manufactured home is taxable on the local property tax roll if:

1. Sold new on or after July 1, 1980; or
2. So requested by the owner.

Owners of other manufactured homes pay license fees to the Department of Housing and Community Development.

¹¹⁰ Section 75.5.

SITE VALUE

It is important to recognize that the full cash value of a manufactured home *does not* include any value attributable to a particular site. Section 5803 provides, in part:

"[F]ull cash value" [of a manufactured home] ... does not include any value attributable to the particular site where the manufactured home is located on rented or leased land which would make the sale price of the manufactured home at that location different from its price at some other location on rented or leased land. In determining the "full cash value" of such a manufactured home on rented or leased land, the assessor shall take into consideration, among other relevant factors, sales prices listed in recognized value guides for manufactured homes, including, but not limited to, the Kelly Blue Book Manufactured Housing and Mobilehome Guide and the National Automobile Dealer Association's Mobilehome Manufactured Housing Appraisal Guide.

The effect of site value on the purchase price of a manufactured home can be either positive or negative. In situations where negative site values exist, it is the land, not the manufactured home, that is entitled to a reduction in value. Such negatively impacted parks may not command the same rent level as comparable parks not facing similar adverse conditions. As a result, the manufactured home owners may pay reduced rents, but the market values of the manufactured homes are not affected since the homes perform as constructed without any decrease in value.

ACCESSORIES

The statutory definition of *manufactured home accessory* includes both portable and permanently installed items. Manufactured home accessories are defined in Health and Safety Code section 18008.5, which provides that accessories include, but are not limited to, awnings, storage cabinets, carports, skirting, heaters, coolers, fences, windbreaks, and porches. Accessories may be real or personal property but, unless they qualify as household furnishings within the context of the law, they are generally subject to local property taxation, whether or not the manufactured home to which they belong is subject to local property taxation. However, pursuant to section 5805, accessories installed on a rented or leased lot with a manufactured home first sold prior to January 1, 1977, are presumed to be subject to the state vehicle license fee. This presumption may be rebutted by evidence that the accessory was not included in the vehicle license fee base for the manufactured home, or was not otherwise subject to the vehicle license fee.

Accessories on licensed manufactured homes sold after January 1, 1977, may be exempted by the county board of supervisors, up to a maximum of \$5,000, pursuant to the provisions of section 155.20.

APPRAISAL OF FLOATING HOMES

While vessels are generally regarded as personal property, "floating homes" have been accorded special treatment by the Legislature and are treated as real property. Section 229 provides that

floating homes shall be assessed and valued in the same manner as real property. A floating home, under section 229(c), is defined as a structure that has all of the following characteristics:

1. It is designed and built to be used, or is modified to be used, as a stationary waterborne residential dwelling.
2. It has no mode of power of its own.
3. It is dependent for utilities upon a continuous utility linkage to a power source originating onshore.
4. It has a permanent continuous hookup to a shoreside sewage system.

The statute prescribes that a floating home is not to be assessed as a vessel, but is valued like other real property under the provisions of article XIII A of the California Constitution (Proposition 13).

APPRAISAL OF CONSTRUCTION IN PROGRESS

When real property, or a portion thereof, is being constructed, the assessor must determine the fair market value of the portion of the property that is under construction at each lien date. When the construction is complete, the assessor determines the fair market value of the newly constructed property. The following is a brief discussion of this complex issue. For an expanded discussion, see Chapter 6 of AH 502, *Advanced Appraisal*.

Construction in progress on the lien date is also subject to assessment and must be appraised. Section 71 states, in part:

New construction in progress on the lien date shall be appraised at its full value on such date and each lien date thereafter until the date of completion, at which time the entire portion of property which is newly constructed shall be reappraised at its full value.

This language is repeated in Property Tax Rule 463(d).

Determining the value of construction in progress sometimes presents a difficult appraisal problem. The same methods and principles that apply when valuing completed improvements are applicable to construction in progress. However, the procedure is usually more difficult due to a lack of market data. The income and sales comparison approaches are of limited use because property under construction is typically not producing any income, and it is difficult to find comparable sales of partially completed projects. For this reason, the cost approach is nearly always used. The cost approach is used to determine the amount of costs in place relative to the partially completed project on the lien date. The total of costs in place on the lien date may be higher or lower than the market value of the new construction in progress on the lien date.

START DATE

The commencement of construction is the date when actual physical activity first occurs on the site. For example, layout of foundations, erection of fencing, site grading, or other physical activity at the site indicate the beginning of construction.

COMPLETION DATE

Since new construction in progress is appraised on each lien date until completed, identifying the date of completion is important. Rule 463.5 defines the date of completion of new construction. In general, the date of completion is the earliest of either the date that an improvement is available for use, the date a certificate of occupancy is issued, or the date that it is occupied.¹¹¹

¹¹¹ Further aspects of the appraisal of construction in progress are addressed in Assessors' Handbook Section 502, *Advanced Appraisal*.

APPENDIX A: ADMINISTRATIVE AND LEGAL ASPECTS OF PROPERTY TAX ASSESSMENT

OVERVIEW

PROPERTY TAX BASE

The property tax is a significant general revenue source for local agencies (i.e., counties, cities, and special districts) and school districts. The tax is imposed on the owners of property and is based on property value.¹¹² Property tax liability is for a fiscal year, or a portion thereof, and property taxes are collected by the county and distributed to local governmental jurisdictions based on a statutory formula.

The property tax is imposed on two major categories of property: real property and tangible personal property. Some of the major types of property that are *not* part of the property tax base are most property owned by government; most private property used for religious, charitable, or educational purposes; household personal property; automobiles and trucks; business inventories; and intangible personal property.¹¹³

ASSESSMENT ROLL

"Assessment" means placing a value on property for the purpose of property taxation. An assessment roll, as defined in section 109, is the entire listing of all taxable property within the county, including that which is state assessed. Among other things it identifies the property, the owner (if known), and the assessed value of the property. Each year the county assessor prepares two separate rolls: the "regular assessment roll" (sometimes referred to as the "601 roll" because it is discussed in section 601)¹¹⁴ and the "supplemental assessment roll."

Under section 109, the "secured roll" is that part of the roll containing state assessed property and property on which the taxes are a lien. The remainder of the roll is the "unsecured roll." The "local roll" lists those parts of the secured and unsecured roll containing all property that it is the assessor's duty to assess. The "board roll" is that part of the secured roll containing state assessed property.

Generally, all real property for which title is held by the owner or possessor is on the secured roll. Personal property may also be on the secured roll if its owner also owns real property in the county that can be used to secure the personal property tax liability. The unsecured roll consists of taxable property owned by taxpayers who do not own real property in the county that can be

¹¹² However, since the 1978 passage of Proposition 13, discussed later, real property has generally been taxed based on its market value at the time of acquisition or completed new construction, with annual increases for inflation limited to a maximum of 2 percent per year, and not based on its current market value as of each tax year.

¹¹³ The question of what property is taxable is addressed in Chapter 3.

¹¹⁴ Unless otherwise indicated, all references to "code" in this appendix refer to the Revenue and Taxation Code; all references to "section" or "sections" refer to sections of the Revenue and Taxation Code; and all references to "rule" or "rules" refer to the Property Tax Rules found in Title 18 of the California Code of Regulations.

used to secure payment of the property tax. Most property on the unsecured roll is tangible personal property used by businesses that lease, rather than own, the real property at which they conduct business. In most cases, possessory interests in real property are placed on the unsecured roll if the holder of the possessory interest does not also own other real property in the county. Taxable airplanes and boats are also on the unsecured roll.

The board roll lists all property assessed by the State Board of Equalization (SBE or Board). This roll is prepared by the Board and delivered to the county auditor, who allocates board assessments within the county according to statute. As mentioned above, the board roll is considered part of the secured roll.

Secured property taxes are payable in two installments, the first no later than December 10 and the second no later than April 10. Unsecured property taxes are payable in one installment due no later than August 31. The county tax collector is responsible for the preparation of tax bills and the collection of taxes due.

The supplemental assessment roll lists all property that has undergone a change in ownership or new construction. It is discussed later in this appendix.

ASSESSMENT ROLL REVISIONS AND ESCAPE ASSESSMENTS

For a wide variety of reasons, the initial assessment roll inevitably contains errors. Common errors include errors in value judgment, "clerical" (calculation) errors, errors caused by the failure of property owners to report correctly (or to report at all), and various misunderstandings. Such errors result in overassessments, underassessments, misclassifications, assessments to the wrong assessee, assessments assigned to the wrong tax-rate jurisdictions, and numerous other problems that result in incorrect assessments.

In general, California law provides, within specified time limitations, that an erroneous assessment is to be corrected, regardless of the cause of the error and regardless of whether the error resulted in an overassessment or an underassessment. Both the limitation on time (statute of limitations) and the procedure for making a correction vary greatly according to the nature and cause of the error.

Any error that results in an underassessment (or no assessment where there should have been one), regardless of the reason, is an "escape." The first sentence of section 531 makes it clear what is required when an escape has occurred: "If any property belonging on the local roll has escaped assessment, the assessor shall assess the property on discovery at its value on the lien date for the year for which it escaped assessment." Section 861 establishes the same requirement for escaped property subject to assessment by the Board. As stated previously, there are time limitations and procedural differences for various types of escapes, but sections 531 and 861 make it clear that any escape is to be enrolled *unless* the applicable statute of limitations or other specific provision of law prohibits or modifies the assessor's ability to do so.

Errors that result in overassessments must also be corrected. Some of the statutes governing corrections use the word "may" rather than "shall" (e.g., see sections 4831(a) and 4831.5), but others provide that errors resulting in lower values or taxes "shall" be corrected (e.g., sections 51.5, 4831(b), 4985, and 5096). Although legally "shall" is mandatory and "may" is permissive (see section 16), certainly the assessor's obligation to make corrections that result in lower assessments or taxes is equal to the obligation to enroll escapes.

One important difference between escape assessments and corrections that reduce the assessment or tax is that the assessor enrolls escape assessments unilaterally. In most cases, a correction that reduces the assessed value or tax bill requires the concurrence of one or more other county officers, because the taxpayer may be entitled to claim a refund. In the case of a refund of taxes paid, the taxpayer must file a claim for the refund within four years after making the payment or within one year after the mailing of a tax collector's notice of overpayment, whichever is later.

As stated above, the process of correcting an erroneous assessment, whether an escape, a lower assessment, or some other correction, varies greatly according to the circumstances of the change. Assessors' Handbook Section 201, *Assessment Roll Procedures*, contains helpful discussions regarding several types of escape and correction actions. Also see "Taxpayer Reporting of Information" later in this appendix.

PROPERTY TAX RATE

The property tax rate is composed of two parts: (1) the basic, or general, rate; and (2) additional rate(s) levied to retire voter-approved debt.

The basic rate is limited to a maximum of 1 percent. The tax proceeds resulting from the basic rate are general revenues that are apportioned among local jurisdictions (e.g., counties, cities, special districts, and school districts) according to a statutory formula. Local governmental agencies within the counties are permitted to levy additional rates to retire voter-approved debt. The tax proceeds from each additional debt rate are allocated to the local agency that incurred the debt and are earmarked for the payment of principal and interest to retire the debt.

Depending on the number and size of approved debt issues, tax rates may vary from area to area within a county. The SBE maintains a tax-rate area mapping program that assigns a unique tax-rate area number (TRA) to each geographical area in the state with a different distribution of revenues among local taxing jurisdictions. County auditors use TRAs to allocate property tax revenues to the appropriate taxing jurisdictions, and the SBE also uses TRAs to allocate state assessments among the counties.

The tax rate, as described above, applies to locally assessed real property and state assessed property. The California Constitution, article XIII, section 12, provides that the tax rate applicable to the unsecured roll is the prior year's secured roll tax rate.

To determine the amount of tax due, the tax rate is applied to the taxable value of the property (defined as the "assessed value" or "full cash value" per section 51). For example, property with a

taxable value of \$200,000 in an area where the total tax rate is 1.1 percent would have a property tax liability of \$2,200, computed as follows:

$$\text{\$200,000 assessed value} \times 0.011 \text{ tax rate (1.1\%)} = \text{\$2,200 property tax due}$$

In most cases, the owner of the property is assessed for the property tax. As provided in section 405, the county assessor may assess the owner or the lessee, or may make a joint assessment to both the owner and lessee.

STATE VERSUS LOCAL ASSESSMENT

The assessment function is the joint responsibility of the state's 58 county assessors and the SBE. All taxable property is either locally assessed by county assessors or state assessed by the SBE. County assessors are locally elected officials. Assessors' duties and practices are prescribed by the State Constitution, statutes passed by the Legislature (primarily in the Revenue and Taxation Code or the Government Code), and property tax rules adopted by the State Board of Equalization.

The SBE was established in 1879 by constitutional amendment. Its original purpose was to regulate county assessment practices in order to insure uniform and equitable assessments and to assess the property of railroads. Currently, in addition to its property tax responsibilities, the Board administers a variety of state and local business tax programs. The Board consists of five elected members, four of whom are elected from legislatively defined districts. The fifth member, the State Controller, is elected at large and serves in an *ex officio* capacity.

Role of County Assessors

County assessors are responsible for the assessment of all taxable property within their local jurisdictions, except state assessed property. The assessor's responsibility involves three main objectives: (1) discovering and taking inventory of all taxable property within the county; (2) determining the taxability of each item of property; and (3) valuing and assessing each item of taxable property in accordance with property tax law. Discovering and taking inventory of property and determining its taxability, although difficult processes, are reasonably precise and objective. The third objective, property valuation and assessment, involves detailed analyses and requires the application of considerable knowledge and skill.

Role of the State Board of Equalization

State Assessments and Appeals

Under article XIII, section 19 of the California Constitution, the SBE is responsible for the assessment of property owned or used by specified public utilities (generally regulated telephone, telegraph, electric, and gas companies), the property of railroads, and all intercounty pipelines, canals, flumes, ditches, and aqueducts.¹¹⁵ The procedures governing such valuation and

¹¹⁵ See the *State Assessment Manual* for a detailed discussion on state assessment.

assessments are set forth in sections 721 through 868. The values for these state-assessed properties are entered on the Board roll and allocated to the counties on a proportional basis.¹¹⁶

The Board also hears appeals of certain property tax matters, including petitions for reassessment of public utilities and railroads (state assessees), appeals on assessments of taxable property owned by local governments outside their boundaries,¹¹⁷ and appeals by claimants whose property has been denied the welfare exemption by the Board's staff.¹¹⁸

Oversight of Local Assessment Practices

In addition to the assessment of state-assessed property, the Board has several duties relating to the local assessment function. As provided in Government Code section 15606, the Board prescribes rules governing all local boards of equalization and assessment appeals, provides training in assessment practices for assessors and their staff, prescribes and enforces the use of assessment forms, and initiates an action in court, if necessary, to compel an assessor to comply with any rule adopted by the Board. These duties, which are aimed at promoting equitable and uniform assessment throughout the state, are carried out through a variety of activities, including the following:

- Property Tax Rules
- Letters To Assessors
- Assessment Practices Surveys
- Assessors' Handbook
- Program Assistance
- Appraiser Training and Certification

Property Tax Rules. The Board prescribes rules and regulations to govern assessors and local boards of equalization (appeals boards). These rules are adopted to interpret and clarify statutes relating to assessment principles and procedures and have the force and effect of law.

Letters To Assessors. The Board issues advisory Letters To Assessors. These letters, which are distributed to all county assessors and to interested parties by subscription, provide uniform information and instruction about particular applications of property tax law and assessment matters.

¹¹⁶ The Board performs the entire assessment function—appraisal, assessment, and tax collection—for privately owned railroad cars and harvested timber. The taxes collected from timber owners are redistributed to the counties on a proportional basis; the tax on private railroad cars is the only property tax that is retained by the state.

¹¹⁷ While the California Constitution provides generally that property owned by government entities is exempt from property taxation, real property owned by local governments outside their boundaries is locally assessable if the property was taxable at the time of acquisition. (Article XIII, section 11.)

¹¹⁸ In order to qualify for the welfare exemption, the claim must be approved by both the Board and the county assessor.

Assessment Practices Surveys. Under state law, the Board is required to periodically "survey" the assessment practices of each county assessor's office. The purpose of the survey is to (1) determine the adequacy of the procedures and practices the county assessor uses in valuing property, and (2) evaluate the assessor's performance of mandated duties. The Board also conducts "special topic surveys" on assessment practices statewide. These surveys focus on specific subject areas (e.g., "change in ownership" or "assessment appeal procedures") that have a significant impact on local property taxation. They are conducted on an as needed basis.

Assessors' Handbook. The Board publishes the *Assessors' Handbook*, a collection of separately bound manuals on various appraisal and assessment topics for the guidance of assessors and their staffs. The manuals—formally individual "sections" of the *Handbook*—are periodically updated to reflect legislative changes and revisions in recommended appraisal and assessment procedures. This manual, for example, is a particular section of the *Assessors' Handbook*.

Program Assistance. The Board conducts several programs that assist county assessors in the local assessment function. The Board reviews property tax exemptions granted at the county level, and it has a direct role in administering the welfare exemption, which cannot be granted without Board approval. The Board prevents multiple claims for the homeowners' exemption by acting as a statewide clearinghouse for claims, and it performs a similar function for other property tax relief programs. The Legal Entity Ownership Program discovers changes in control or changes in ownership of legal entities, which may require reassessment of property owned by the entities. This information is difficult to acquire at the local level. Finally, the Board prescribes many types of forms used by assessors, including business property statements, exemption claim forms, and change in ownership forms.

Appraiser Training and Certification. Appraisers working for county assessors' offices or the Property Taxes Department of the State Board of Equalization must hold a valid appraiser's certificate issued by the Board. In order to obtain and retain the certificate, appraisers must meet minimum qualifications, pass an examination, and complete a specified number of hours of training per year. The Board conducts training classes and workshops at various sites statewide and monitors appraisers' progress toward fulfilling annual training requirements.

Property tax appraisers meeting the minimum qualifications are issued a temporary certificate, which is valid for no more than one year. Within that time, the appraiser must pass the certification exam given by the Board. Certified property tax appraisers must annually complete 24 hours of training conducted or approved by the Board. After holding a valid appraiser's certificate for at least three years, an appraiser may obtain an advanced appraiser's certificate by meeting specified educational requirements or passing an advanced certification examination. A holder of this certificate is required to complete at least 12 hours of training each year.¹¹⁹

¹¹⁹ Refer to sections 671 through 673 and rules 281 through 283 for certification and training requirements.

LIEN DATE

All taxable property (both state and locally assessed) is assessed annually for property tax purposes as of 12:01 a.m. on January 1, which is called the *lien date*.¹²⁰ It is referred to as the lien date because on this date the taxes become a lien against all real property assessed on the secured roll.

TAXPAYER REPORTING OF INFORMATION

The statutes require that any person who acquires real property, a manufactured home, or a controlling interest (more than 50 percent) in a legal entity, or any "original co-owner" who cumulatively transfers more than 50 percent of the legal entity interests, must file a change in ownership statement *within 45 days* of the date of the transfer. (Sections 480 through 480.4.) In most cases, this requirement is satisfied by filing a preliminary change in ownership report (PCOR) *concurrently with the recordation* of the deed. Both the change in ownership statement and the PCOR inform the assessor of the property, date, and persons involved in a change in ownership and whether or not the property is subject to reappraisal. Similar provisions in sections 480.7 and 487 require that a life insurance company that has established a separate account in connection with a pension plans must file a change in ownership statement showing transfers of real property to or from that account. Penalties are applicable for failure to report any transfers resulting in a change in ownership. (Sections 480.7 and 482.)

With respect to reporting personal property, section 441 requires that each person/legal entity owning taxable personal property costing \$100,000 or more shall file with the assessor a signed *property statement* between the lien date and 5 p.m. on April 1. Persons or entities that do not meet the \$100,000 threshold are nevertheless required to file upon request of the assessor. A penalty of 10 percent of the assessed value of the unreported property may be imposed for failure to file timely. If, after written request any person fails to provide the information required, the assessor shall estimate the value of the property and "promptly" assess the property.

TAXPAYER APPEALS OF PROPERTY VALUATION

Property owners may appeal assessments¹²¹ appearing on the regular assessment roll by filing an application for change in assessment with the county appeals board (either the board of supervisors sitting as a county board of equalization or an assessment appeals board appointed by the board of supervisors to replace the county board of equalization) *between July 2 and September 15*.¹²² Assessments made outside the regular assessment period (e.g., supplemental assessments and escape assessments) may also be appealed according to statutory provisions found in section 1603 and following. (For appeals of base year values, also see section 80.)

¹²⁰ Section 2192 of the Revenue and Taxation Code.

¹²¹ See the *Assessment Appeals Manual* for detailed discussion of assessment appeals.

¹²² If September 15 falls on Saturday, Sunday, or a legal holiday, an application that is mailed and postmarked on the next business day shall be deemed to have been filed within "the time period between July 2 and September 15." Additionally, effective January 1, 2002, the deadline is extended from September 15 to November 30 for property on the secured roll if the assessee did not receive notice prior to August 1 of the same year.

When the taxpayer challenges an assessment, there is frequently some discussion informally with the assessor's office as to how the assessment was determined. The assessor and the taxpayer may exchange information about the value or characteristics of the property. Occasionally, in becoming aware of new facts affecting the value of the property, the assessor and the taxpayer may agree to the same amount and file a written stipulation with the board. (Section 1603(c).)¹²³

The first formal level of appeal is to the board of supervisors sitting as a county board of equalization or to an assessment appeals board if the county has created one or more of these boards. Counties may also use hearing officers for some types of appeals. The hearing is administrative in nature, so the taxpayer's use of legal counsel is optional.

Generally, the property owner has the burden of proving that the assessor has improperly valued the property. However, the burden of proof falls on the assessor in the case of an appeal concerning an owner-occupied single-family dwelling or any appeal of an escape assessment. In a case where real property transferred ownership, section 110 and rule 2 provide that the purchase price is rebuttably presumed to be the correct value as of the date of the transfer. The burden of proof falls on the party seeking to overcome that presumption.¹²⁴

If the appeal is denied, the taxpayer has recourse to the courts, but only under certain circumstances. These include arbitrariness, lack of due process, abuse of discretion, failure to follow standards prescribed by law (e.g., using an erroneous method of valuation), or other questions of law. The assessor may appeal to court for the same reasons as the taxpayer. In either case, the court will not receive new evidence of value and will only review the record of the hearing before the county board.

In the case of state-assessed properties, assessee appeal to the State Board of Equalization. If the appeal is denied, the assessee is entitled to *trial de novo* in the superior court. (In a *trial de novo*, new evidence may be heard, and the court hears the case based on all available information, not just that contained in the prior administrative record.)

PROPERTY TAX EXEMPTIONS

The State Constitution provides for a variety of exemptions from the property tax. Some of the exemptions are required by the Constitution. Others are not specifically required but the Constitution provides that the Legislature may, by statute, provide for the exemption. Some exemptions include the entire property; others provide for partial relief. In total, there are over 100 exemptions from property tax. About 30 of them require claims to be filed or the exemption is waived.

¹²³ Appeals boards are not required to accept stipulations, so a stipulation must contain adequate reasons for an agreed-upon value.

¹²⁴ This presumption does not apply to a sale of a possessory interest. In the case of an appeal of a cable television possessory interest where the assessor values the possessory interest based on something other than a portion of the franchise fee, neither side has a presumption of correctness.

The Legislature has authority to exempt any kind of personal property as prescribed by statute, but it cannot exempt real property without specific Constitutional authority. Exemptions are not a creation of article XIII A (Proposition 13) but are provided under article XIII of the Constitution.

In regard to real property, article XIII, section 3 lists the various types of exempt property. Section 4 describes the type of property that the Legislature may exempt from property taxation in whole or in part and includes the welfare exemption, and section 6 provides that the failure to claim an exemption in the manner prescribed by law is deemed a waiver of the exemption. Article XIII, section 7, allows the Legislature, with a two-thirds vote, to authorize county boards of supervisors to exempt real property having a full value so low that, if not exempt, the total taxes and applicable subventions on the property would amount to less than the cost of assessing and collecting them.¹²⁵

The "assessment process" describes the functions required in property assessment. Although the following is primarily directed at local assessment, much of it applies to state assessment as well. A review of the assessment process presents a good overview of the assessment activities within an assessor's office. The assessment process comprises the following functions:

- Property Discovery
- Property Identification and Situs
- Property Classification
- Data Collection and Analysis
- Property Valuation
- Preparation and Certification of the Assessment Roll
- Notification of Assessment
- Appeals Management

Property Discovery. This function involves finding all taxable property in the jurisdiction. For land, buildings, and other things attached to land (real property), this requires a mapping system and, generally, on-site verification of location. The discovery of movable items (personal property) is accomplished by a system of taxpayer self-reporting as described above and is supported by an audit program. The discovery phase also includes obtaining an accurate description of the taxable property.

Property Identification and Situs. Real property items are identified by a parcel identification system keyed to assessor's maps. Personal property is identified by some type of account identification system. Situs refers to physical location in the case of real property and taxable location in the case of personal property.

¹²⁵ The subject of exemptions is briefly discussed in Chapter 3.

Property Classification. The assessed property must be classified according to type. Common categories include land, improvements, fixtures, personal property, and exempt property. This list is not all-inclusive. The property classification may have a bearing on the manner in which property is assessed or taxed.

Data Collection and Analysis. This phase involves the collection and analysis of the economic data required to value the property. General, comparative, and specific data are collected.

Property Valuation. In this phase, generally accepted methods of valuation are used in conjunction with the data obtained to estimate the taxable value of the property. The valuation becomes the basis for the assessment.

Preparation and Certification of the Assessment Roll. As previously discussed, the assessment roll lists the taxable value of all taxable property in a county. The specific content of the roll is prescribed by statute and Board regulation. The assessor is required to complete and deliver the local roll to the county auditor on or before July 1 of each year.

Notification. On or prior to the completion of the assessment roll, the assessor must provide notification to property owners of their assessments in a manner prescribed by law. The assessor is always required to notify owners whose real property value has increased for reasons other than an increase caused by the annual inflation factor. Generally, the law permits but does not require assessors to notify owners if there has been a decrease in the assessment or no change to the assessment.

Appeals Management. As previously discussed, property owners have the right to appeal their assessments before a local appeals or equalization board. An important part of the assessor's office workload following enrollment of the assessment is the management of the appeals function.

FOUNDATION OF PROPERTY TAX LAW

The foundation of property tax law is found in the California Constitution, state statutes, property tax rules, judicial decisions, and other sources. These are discussed below.

CALIFORNIA CONSTITUTION

The basis for assessment of all real and personal property in California is the California Constitution. Specifically, all property tax assessments are established by the provisions of either article XIII or article XIII A (the constitutional article adopted following the passage of Proposition 13). In one form or another, article XIII, section 1, authorizing the assessment of property "in proportion to its full value unless otherwise provided by this constitution or the laws of the United States," has been in existence for more than 100 years. Article XIII A (Proposition 13), adopted in 1978, overlays an additional system of assessment, and to that extent, it has overridden article XIII, section 1. However, personal property continues to be governed by article XIII, section 1. Not subject to the California Constitution are federal lands and all property

owned by the United States, including certain Indian lands and personal property, which are immune from taxation by states and counties unless authorized by Congress.

STATUTES

The vast majority of the Legislature's enactments with respect to ad valorem assessment are found in the Revenue and Taxation Code. Where there is an apparent inconsistency or contradiction between a statute enacted by the Legislature and a provision of the Constitution, the SBE and the county assessor have no authority to refuse to apply or enforce the statute. Under article III, section 3.5 of the Constitution, an administrative agency created by the California Constitution or by an initiative has no power to declare a statute unconstitutional or refuse to enforce it *unless* an appellate court has made a determination that such statute is unconstitutional. Although a county assessor is also considered an "administrative agency," section 538 grants special authority to assessors to bring suit if the assessor believes a statute or a rule to be unconstitutional or invalid.

PROPERTY TAX RULES

Title 18 of the California Code of Regulations embodies the Property Tax Rules, which are formally promulgated by the SBE for the purpose of interpreting and implementing the statutes. Numerous appellate courts have held that these rules are more than mere "guidelines" and have the force of law on all parties, both taxpayers and assessors.

JUDICIAL DECISIONS

Judicial precedents under both article XIII and article XIII A have shaped the course of California's property tax system. For example, in *DeLuz Homes, Inc. v. County of San Diego* (1955) 45 Cal.2d 546, the court upheld both the concept and the valuation of possessory interests, stating that possessory interests in tax exempt land or improvements are taxable real property and must be assessed at full cash value. In the case of *Amador Valley Joint Union High School Dist. v. State Board of Equalization* (1978) 22 Cal.3d 208, the court determined that Proposition 13 was constitutional and not a violation of equal protection. As another example, in *Title Insurance & Trust Co. v. County of Riverside* (1989) 48 Cal.3d 84, the court held that if in a corporate merger or reorganization one entity *indirectly* obtains control over another (through the purchase or transfer of stock), there is a change in ownership as to the real property owned by the corporation which obtained indirect control.

In some instances, the Legislature has responded to appellate or Supreme Court decisions by amending property tax statutes in major respects, such as excluding from change in ownership the dissolution of a partnership by means of a buy-out by the majority partner under section 64(a), reversing the consequences of *Zapara v. County of Orange* (1994) 26 Cal.App.4th 464.

OTHER

While several Board-generated documents and publications provide advice regarding the application of property tax law and assessment (the *Assessors' Handbook*, *Letters To Assessors*, and *Assessment Practices Surveys* described previously), none actually have the authority of law.

They are distributed to all county assessors and other interested parties in order to provide guidance about particular aspects of property tax assessment and to promote uniform assessment practices consistent with property tax law. While courts have assigned varying degrees of importance to such documents ("entitled to great weight" as opposed to "not persuasive"), they are strictly advisory and are not binding on taxpayers or assessors.

ASSESSMENT PRE- AND POST-PROPOSITION 13

In June 1978, when California voters approved Proposition 13 (placed into law by article XIII A amending the California Constitution and subsequent implementing statutes and rules), California property taxation was revolutionized by: (1) limiting the property tax rate to 1 percent plus additional rates necessary to retire voter-approved bonded indebtedness; (2) placing explicit limitations on the power of government to impose additional property taxes; and (3) significantly changing the method of property assessment.

Prior to Proposition 13, annual assessments for both real property and personal property were based on current market value. As a practical matter, fiscal and staffing constraints prevented assessors from physically revaluing each item of property in their respective counties every single year, with the result that reappraisals were usually conducted on a cyclical basis. Typically, these cycles ranged in duration from three to seven years. Between physical reappraisals, assessors would often apply interim value increases based on trending factors. This system of assessment ensured that all property—subject to the limitations of cyclical appraisal programs—was assessed based on its current market value.

Under the law implementing Proposition 13, most locally-assessed real property is now subject to a set of assessment rules based on its *market value at the date of acquisition*. Several important components of this system are described below:

- Proposition 13 first required property assessments to be "rolled back" to the 1975-76 level for the 1978-79 fiscal year. Properties that have not sold or undergone new construction since February 1975 are said to have a 1975 *base year value*. The base year value is the current market value (or "full cash value") of real property in 1975-76, or in any subsequent year based upon a change in ownership or new construction. (Sections 50 through 51.5, and 110.1.)
- Each property's base year value must be adjusted each year to reflect inflation as measured by the California Consumer Price Index, but an upward adjustment cannot exceed 2 percent. This process continues until the property changes ownership or undergoes new construction. The value that reflects the annual inflation indexing is known as the *adjusted, or factored, base year value*. (Section 51.) Each year, the adjusted base year value is the maximum assessable amount for the property for that year.
- When a change in ownership occurs, real property is assessed to its current market value as of the date of the change in ownership. (Sections 60-61.) Newly constructed property is also assessed at its current market value as of its date of completion. (Unfinished new

construction is assessed based on its market value on the January 1st date.) (Sections 70-71.) *Acquisition value assessment* refers to the process of basing the assessment on the value of the property at change in ownership or completed new construction. The assessment at the time of change in ownership or new construction becomes the property's new base year value, which is subject to the annual inflation adjustment described above.

- If a fractional change in ownership occurs, the portion that changes ownership is given a new base year value based upon its current market value as of the date of the change in ownership and the portion that did not change ownership retains its existing adjusted base year value. Analogously, if new construction occurs on only a portion of a property (e.g., the addition of a bedroom), the newly constructed portion is given its own base year value based upon its current market value, and the pre-existing portion retains the old adjusted base year value. Thus, a property assessment can contain multiple base year values, based upon prior fractional ownership changes or partial new construction, until such time as the entire property interest changes ownership.
- Property assessments are reviewed each year for a decline in value. If the current market value of a property is below its adjusted base year value, the property is temporarily reassessed to reflect the lower value, that is, current market value. (Section 51(a).) This type of reduction is frequently referred to by the original proposition number approved by the voters, or a "Proposition 8" (or Prop 8) adjustment. At some future year, when the property's current market value exceeds its adjusted base year value, the adjusted base year value is restored to the assessment roll.

Not all property is subject to article XIII A (Proposition 13). Locally assessed personal property and state assessed property are not subject to Proposition 13 (article XIII A).¹²⁶ These two categories of property are assessed at current market value each year, as of the lien date, by county assessors and the SBE, respectively.

Thus, the only category of property generally subject to the provisions of article XIII A, although it includes the major portion of the total assessed value in the state, is locally assessed real property (including fixtures). Within this category there are several classes of property not subject to article XIII A provisions. These include "restricted value" properties and taxable government lands.¹²⁷

SOME IMPORTANT ASSESSMENT PROVISIONS

The following sections, building on the framework outlined above, discuss several significant assessment provisions under article XIII A.

¹²⁶ The appraisal and assessment of personal property is addressed in Chapter 7.

¹²⁷ Restricted value properties and taxable government owned lands are discussed in Chapter 3.

EXCLUSIONS FROM REASSESSMENT UPON CHANGE IN OWNERSHIP OR NEW CONSTRUCTION

Constitutional amendments to Proposition 13 and various statutory interpretations have permitted several exclusions from the provisions requiring the reassessment of locally assessed real property to current market value upon a change in ownership or new construction. Some significant exclusions are:

Interspousal Exclusion. According to section 63, any transfer between spouses during marriage or transfers between former spouses after marriage in connection with a property settlement agreement or dissolution are excluded from change in ownership provisions. No claim form is required.

Parent/Child and Grandparent/Grandchild Exclusion. Under section 63.1, transfers from parents of their principle residence and up to \$1 million (taxable value) of other property to their children (and vice versa) may be excluded from change in ownership reassessment, providing a claim is filed and certain requirements are met. In 1996, a similar exclusion was enacted for transfers of property occurring on or after March 27, 1996, from a grandparent to a grandchild under certain limiting conditions. If a claim is not timely filed, the exclusion is available prospectively only when the claim is filed.

Trust Exclusion. Under section 62 (d), transfers of real property or interests in legal entities into a revocable trust or into an irrevocable trust in which the grantor/transferor is the present beneficiary are excluded from change in ownership. It is necessary to look through the trust to determine the beneficial owners of the property or legal entity transferred.

Replacement Property for That Taken by Eminent Domain. Excluded from change in ownership and reappraisal is the acquisition of comparable replacement property made necessary due to a taking by eminent domain, public entity acquisition, or judgment of inverse condemnation. A claim must be timely filed. (Section 68.)

Replacement Residences for Senior Citizens or Disabled Persons. Under section 69.5, senior citizens may transfer the adjusted base year value of an original principal residence to a replacement principal residence if the replacement is of equal or lesser current market value and is located in the same county, or between counties if the county where the replacement home is located has adopted an ordinance permitting the transfer. Severely and permanently disabled persons meeting specified requirements may also transfer the base year value of an original principal residence to a replacement dwelling of equal or lesser current market value under the same provisions. A claim form is required and the claim must be timely filed.

Property Acquired or Constructed to Replace Property Destroyed in a Disaster. Owners of property that is substantially damaged or destroyed by a disaster, as declared by the Governor, may transfer the base year value of such property to comparable property within the same county under conditions specified in section 69. Alternatively, under the conditions prescribed in section 69.3, an intercounty transfer of the base year value is allowed if the county where the

replacement home is located has adopted an ordinance permitting the transfer. A claim form must be timely filed.

Proportional Interest Transfers. Under section 62(a)(2), any transfer between an individual and a legal entity or between legal entities that results solely in a change in the method of holding title to the real property, and in which the proportional ownership interests of the transferors and transferees remain exactly the same, is excluded from change in ownership and reappraisal. It is necessary to look through the legal entity to determine the proportionality of ownership interests and whether the exclusion applies; a change in ownership statement is required.

Legal Entity Interest Transfers. Under section 64(a), the purchase or transfer of ownership interests in legal entities, such as corporate stock, partnership or LLC interests, does not constitute a transfer of the real property owned by the legal entity, unless there is a change in control under section 64(c) or a change in ownership under section 64(d).

Other. Exclusions from market value assessment as a result of new construction include the following: (1) additions of fire sprinkler systems (section 74); (2) modifications to make an existing residence or structure more accessible to a severely and permanently disabled person (sections 74.3 and 74.6); and (3) specified seismic retrofitting and earthquake hazard mitigation features applied to existing buildings (section 74).

DECLINE IN VALUE APPRAISALS

Proposition 8, passed in November 1978, amended article XIII A to provide for declines in value. As a result, section 51 requires the assessor to annually enroll either: (1) a property's base year value factored for inflation; or (2) its market value as of the lien date (taking into account any factors causing a decline in value), whichever is lower.

When a property is assessed at its current market value due to a decline in value, the resulting assessment is commonly referred to as a "Prop 8" value or assessment. Prop 8 reductions in value are *temporary* reductions recognizing that the current market value of a property has fallen below its factored base year value. Once a Prop 8 value has been enrolled, a property's value must be reviewed each following lien date to determine whether its then current market value is less than its factored base year value. When and if the market value of the Prop 8 property increases above its factored base year value on a subsequent lien date, the assessor must again enroll its factored base year value.

Unlike adjusted base year values, which may increase no more than 2 percent in any year, Prop 8 values can vary widely from year to year as the market fluctuates. However, in no case may a Prop 8 value higher than a property's factored base year value be enrolled.

Some declines in value are treated differently than under Prop 8. If a property is damaged or destroyed by a *misfortune or calamity* and the county in which it is located has adopted a disaster ordinance pursuant to section 170, the owner may qualify for a reduction in the assessment that differs significantly from a Prop 8 reduction. First, such a reduction is effective immediately as of the date a calamity occurs, instead of on the following lien date as in a Prop 8 reduction. Second,

calamity reductions result in a lower assessment only during the time period between the date of damage and completion of repair. When the repair is complete, the property's factored base year value is restored to the assessment roll (however, items added during repair and not a part of the original property may qualify as new construction and result in additional assessments).

If a property was being assessed under Prop 8 when it suffered damage and was then granted additional calamity relief under section 170, the assessor must carefully review the value of the property at the completion of repair to determine whether its factored base year value or Prop 8 market value should be enrolled.

SUPPLEMENTAL ASSESSMENT ROLL

During the first five years after the implementation of Proposition 13, some property owners were able to delay the added property tax liability arising from a change in ownership or new construction. This occurred because of the continuation of pre-Proposition 13 rules establishing tax liability for the fiscal year (July 1 to June 30) based on the taxable value of the property as of the preceding March 1 lien date. (Effective for the 1997 assessment year, the lien date was changed from March 1 to January 1.)

Prior to July 1, 1983, the law provided that when property was assessed due to change in ownership or new construction, the additional value was not subject to tax until the next fiscal year beginning *after* the next March 1. Under this system, new value could escape taxation for a period of from 4 to 15 months. For example:

- An ownership change in February 1980 was not reflected in higher taxes until the 1980-81 fiscal year, beginning July 1, 1980, 4 months later.
- An ownership change on March 2, 1980, was not reflected in higher taxes until the 1981-82 fiscal year, beginning July 1, 1981, 15 months later.
- An ownership change in October 1980 was not reflected in higher taxes until the 1981-82 fiscal year, beginning July 1, 1981, 8 months later.

With the Legislature's enactment, effective July 1, 1983, of supplemental assessment provisions, property reassessed due to a change in ownership or new construction is now subject to tax immediately (as of the date of change in ownership or completion of new construction) by placing the new taxable value on the supplemental assessment roll. (Sections 75 and others.) The supplemental roll applies only to locally assessed real property and manufactured homes.

Under the supplemental roll system, the increase or the decrease in assessed value resulting from a change in ownership or new construction is reflected in a prorated assessment (the *supplemental assessment*) that covers the portion of the fiscal year remaining after the date of the change in ownership or completed new construction. The supplemental assessment statutes apply to any property subject to article XIII A that has undergone a change in ownership or completed new construction since July 1, 1983.

For changes in ownership or completed new construction occurring between January 1 and May 31, two supplemental assessments are issued. The first covers the portion of the current fiscal year remaining after the assessable event; the second covers the ensuing fiscal year in its entirety.

Supplemental assessments do not affect exemptions for which the assessee is otherwise eligible. If granted, the exemption is applied to the amount of the supplemental assessment.

- Effective January 1, 2001, section 75.11(d) requires assessors to enroll all supplemental assessments: 1) on or before the fourth July 1 following the July 1 of the assessment year in which either a change in ownership statement under sections 480 - 480.2 was filed or preliminary change in ownership report under section 480.3 was filed or new construction was completed, 2) on or before the sixth July 1 following the July 1 of the assessment year in which either a change in ownership statement under sections 480 - 480.2 was filed or a preliminary change in ownership report was filed, or new construction was completed if the section 504 penalty was added, or 3) on or before the eighth July 1 following the July 1 of the assessment year in which the event occurred if the change in ownership or change in control was unrecorded and a change in ownership statement required by section 480 or preliminary change in ownership report, as required by section 480.3, was not timely filed. Effective January 1, 2002, the time limit for change in ownership statement or completion of new construction to which the penalty in section 504 was added is changed from six years to eight years. However, there is no limitations period on enrolling supplemental assessments if the penalty under section 503 is added.

APPENDIX B: COMMON MEASUREMENTS USED IN APPRAISAL

Land Measurements-Linear

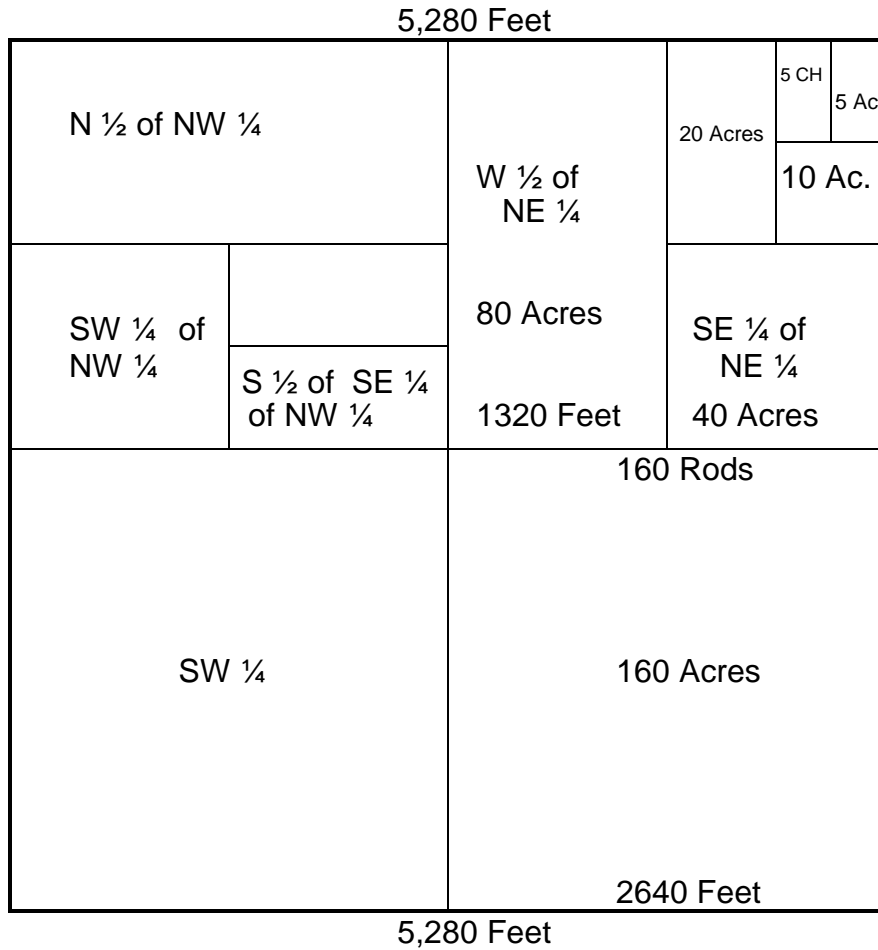
1 foot	=	12 inches
1 yard	=	3 feet
1 mile	=	1,760 yards
1 mile	=	5,280 feet
1 link	=	7.92 inches
1 rod	=	25 links
1 rod	=	16.5 feet
1 chain	=	4 rods
1 chain	=	100 links
1 chain	=	66 feet
1 furlong	=	10 chains
1 furlong	=	660 feet
1 furlong	=	1/8 mile
1 mile	=	80 chains
1 mile	=	320 rods
1 league	=	3 miles
1 league (Spanish)	=	2.6 miles
1 vara	=	33 inches
1 vara	=	2.75 feet

Land Measurements-Area

1 square foot	=	144 square inches
1 square yard	=	9 square feet
1 acre	=	43,560 square feet
1 acre	=	4,840 square yards
1 acre	=	160 square rods
1 acre	=	10 square chains
1 square mile	=	640 acres
1 square mile	=	1 section
36 sections	=	1 township

Depiction of a Section

1 section = 1 square mile



GLOSSARY OF TERMS

Term	Definition
Annuity	A periodic series of obligatory payments; an annuity can be level, increasing, decreasing, or a combination thereof.
Annuity Factor	In yield capitalization, the number, usually obtained from financial tables, that is multiplied by an income amount to produce an estimate of present value.
Appraisal Unit	The unit that people in the market typically buy and sell.
Appreciation	The increase in property value resulting from an excess of demand for a property relative to its supply.
Assemblage	The combining of two or more parcels, usually but not necessarily contiguous, into one ownership or use.
Assessed Value	The taxable value of a property against which the tax rate is applied.
Assessment Roll	A listing of all taxable property within a county. It identifies, at a minimum: (1) the property (usually by assessor's parcel number); (2) the tax-rate area where the property is located; (3) the name (if known) and mailing address of the assessee; (4) the assessed value of the property, including separate assessed values for land, improvements, and personal property; (5) penalties (if any); and (6) the amount (if any) of specified exemptions (e.g., Homeowners', Church, Welfare, etc.). Distinct assessment rolls include the locally-assessed secured and unsecured regular assessment rolls, the locally-assessed supplemental assessment roll, and the state-assessed roll (which is added to the locally-assessed secured roll).
Band of Investment	A technique in which the capitalization rates attributable to the components of a capital investment are weighted and combined to derive a weighted-average rate attributable to the total investment.
Base Year Value	In accordance with section 110.1, a property's base year value is its fair market value as of either the 1975 lien date or the date the property was last purchased, newly constructed, or underwent a change in ownership after the 1975 lien date.
Capitalization	Any method of converting expected future benefits into an indicator of present value; the discounting of projected income to a present value.
Capitalization Rate	Any rate used to convert income into an indicator of value; a ratio that expresses a relationship between income and value.
Change in Ownership	A transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest.

Term	Definition
Comparative Sales Approach	An approach to value by reference to sale prices of the subject property or comparable properties; under rule 4, the preferred approach when reliable market data are available.
Compound Interest	Interest on the sum of principal and the accrued interest, combined at regular intervals; interest on interest.
Contract Rent	The actual amount of rent a property is earning as specified in a lease; the existing rent on property as distinguished from rent that could be expected if the property were available for rent on the open market.
Cost	The expenditure required to develop and construct an improvement or acquire personal property.
Cost Approach	A value approach using the following procedures to derive a value indicator: (1) estimate the current cost to reproduce or replace an existing structure without untimely delays; (2) deduct for all accrued depreciation; and (3) add the estimated land value and an amount to compensate for entrepreneurial profit (if present).
Cost-Estimating Methods	<p>The estimation of replacement or reproduction cost. Four methods are described below:</p> <p>(1) <i>Quantity Survey Method.</i> Under this method, all costs of each piece of material and all labor are estimated and summed; this method accounts for the quantity and quality of all the agents of production necessary to develop and construct an improvement.</p> <p>(2) <i>Square Foot Method.</i> This method uses the known costs of similar buildings, adjusted for physical differences and market conditions. The costs are estimated in terms of dollars per unit, such as \$100 per square foot; costs per unit for properties of equal utility are often obtained from data compiled and published by cost-estimating firms. Also known as the Comparative Unit method. The Assessors' Standard Classification System is used in conjunction with square foot cost tables to produce a cost estimate using the square foot method.</p> <p>(3) <i>Unit-In-Place Method.</i> This method adds together the unit cost of each component of an improvement, such as the cost of a foundation, a wall, or a roof; costs for walls and foundations are usually estimated per linear foot and are often obtained from data compiled and published by cost-estimating firms.</p> <p>(4) <i>Trended Historical Cost.</i> Under this method, an improvement's historical cost is adjusted (factored forward) to the current price level using trending tables.</p>

Term	Definition
Depreciation	<p>A decrease in utility resulting in a loss in property value; the difference between estimated replacement or reproduction cost new as of a given date and market value as of the same date. There are three principal categories of depreciation, described below:</p> <p>(1) <i>Physical Deterioration</i>. The loss in utility and value due to some physical deterioration in the property; considered curable if the cost to cure it is equal to or less than the value added by curing it.</p> <p>(2) <i>Functional Obsolescence</i>. The loss in utility and value due to changes in the desirability of the property; attributable to changes in tastes and style or the result of a poor original design. Functional obsolescence is curable if the cost to cure it is equal to or less than the value added by curing it.</p> <p>(3) <i>External (or Economic) Obsolescence</i>. The loss in utility and value due to an incurable defect caused by external negative influences outside the property itself; results from the immobility of real property.</p>
Direct Capitalization	A capitalization method used to convert a single year's income expectancy into an indicator of value, either by dividing the income estimate by an appropriate rate or by multiplying the income estimate by an appropriate factor.
Direct Costs	Expenditures required for the labor and materials necessary to develop and construct an improvement; sometimes referred to as "hard costs."
Discounted Cash Flow (DCF) Method	A capitalization method in which a discount rate is applied to a series of projected income payments, including the reversion, in order to arrive at an estimate of present value (i.e., current market value). The DCF method can be applied with any yield capitalization technique.
Discount Rate	A selected yield rate used to convert expected future payments into an estimate of present value.
Economic Life	The period of time over which improvements to real property contribute to property value.
Economic Rent	The amount of rental income that could be expected from a property if available for rent on the open market, as indicated by the prevailing rental rates for comparable properties under similar terms and conditions; economic rent is distinguished from contract rent, which is the actual rental income for the subject property as specified in a lease; economic rent is also referred to as market rent.
Effective Age	The age indicated by the condition and utility of the property.
Effective Gross Income	The estimated potential gross income less allowances for vacancy and collection losses.

Term	Definition
Equity Dividend	A single year's cash flow after debt service but before income taxes (i.e., a single year's net income before recapture (NIBR) less debt service).
Equity Capitalization Rate	A rate that reflects the relationship between the equity dividend and the equity investment (i.e., a single year's net income before recapture less debt service divided by the equity investment); a rate used to convert the equity dividend into an indicator of equity value; also known as the equity dividend rate, the cash on cash rate or the cash flow rate.
Expense Ratio	The ratio of total expenses, excluding debt service, to either potential or effective gross income
Factor	One of two or more numbers that when multiplied together produce a third number; a multiplier. A capitalization factor is the reciprocal of a capitalization rate.
Fee Simple Estate	Absolute ownership unencumbered by any other interest or estate, subject only to the limitations of eminent domain, escheat, police power, and taxation.
Fixture	An item of tangible property, the nature of which was originally personal property, but which is classified as real property for property tax purposes because it is physically or constructively annexed to real property with the intent that it remain annexed indefinitely.
Going Concern Value	Generally, the total value of an operating business enterprise. It includes the value of the real property, tangible personal property (e.g., machinery and equipment), labor, the marketing operation, and intangible assets and rights. It includes the incremental value of the business concern, which is distinct from the value of the real property (See also footnote in Chapter 1, "Other Types of Value," under the definition there.) This subject is addressed in depth in Assessors' Handbook Section 502, <i>Advanced Appraisal</i> .
Gross Income Multiplier	The relationship between sale price (or value) and gross income, expressed as a factor; used to estimate value as a multiple of income. Gross income is usually (though not always) expressed in annual terms, and includes income to the property from all sources; in an apartment property, for example, the gross income could be the sum of living unit rent, parking space rent, vending machine income, and laundry facility income.

Term	Definition
Gross Rent Multiplier	The relationship between sale price (or value) and gross rent, expressed as a factor; used to estimate value as a multiple of income. Gross rent is usually (though not always) expressed in annual terms, and includes the income to the property derived from the principal improvements only. The gross rent for an apartment property, for example, is from living units only and excludes income from parking space rent, vending machine income and laundry facility income.
Highest and Best Use	The most profitable use of a property at the time of the appraisal; that available use and program of future utilization that produces the highest present land value; must be legal, physically possible, financially feasible, and maximally profitable; see text for the distinction between highest and best use as though vacant and highest and best use as improved.
Historical Cost Improvements	The total cost of a property when it was originally constructed. All buildings, structures, fixtures, and fences erected on or affixed to the land; all fruit, nut bearing, ornamental trees and vines, not of natural growth, and not exempt from taxation, except date palms under eight years of age; see text for statutory definition.
Income Approach	Any method of converting an income stream or a series of future income payments into an indicator of present value.
Income Rate (R_o, or R_E)	A rate that expresses the relationship between one year's income and the corresponding total value of a property; or, in the case of R_E , with the value of only the equity interest.
Indirect Costs	The outlay for items, other than labor and materials, required to develop and construct an improvement; includes such costs as legal fees, property taxes, construction financing, administrative expenses, appraisal fees, and lease-up expenses; sometimes referred to as "soft costs."
Interest Rate	The rate of return on debt capital; the price paid for borrowing money.
Investment Value	The specific value of property to a particular investor, based upon individual investment requirements, as distinguished from the concept of market value.
Leaseback	A transaction in which an investor purchases property and leases it back to the seller, generally under lease terms and conditions that were negotiated at the time of the sale.
Leased Fee Interest or Estate	The lessor's interest in property; an ownership interest held by a landlord with the right of use and occupancy conveyed by lease to others; the right to receive rent stipulated in the lease and to receive the property (the reversionary right) at the end of the lease term.

Term	Definition
Leasehold	The lessee's interest in property; the right to use and occupy real property during the term of a lease, subject to any contractual restrictions.
Lessee	One who has the right to use or occupy property under a lease agreement; a tenant.
Lessor	One who conveys the right to use and occupy property under a lease agreement; a landlord.
Lien date	All taxable property (both state and locally assessed) is assessed annually for property tax purposes as of 12:01 a.m. on January 1, which is called the lien date. It is referred to as the lien date because on this date the taxes become a lien against all real property assessed on the secured roll.
Loan-to-Value Ratio	The ratio between the mortgage amount and the value of the property pledged as security for the debt; usually expressed as a percentage.
Market Rent	The amount of rental income that could be expected from a property if available for rent on the open market, indicated by the prevailing rental rates for comparable properties under similar terms and conditions; distinguished from contract rent, which is the actual rental for the subject property as specified in a lease; also referred to as economic rent.
Mortgage Constant	The capitalization rate for debt; the ratio of the annual debt service to the principal amount of the mortgage loan; the total annual amount required to pay off an amortizing loan with level monthly payments, expressed as a percentage of the original loan amount.
Net Income Before Recapture and Taxes (NIBR&T)	The annual net income remaining after deducting all operating expenses but before deducting other charges such as recapture, debt service, and property taxes. For property tax appraisal purposes, NIBR&T is capitalized into an indicator of value using various income capitalization techniques.
Net Lease	A lease where the lessee pays not only for the use of the property, but also for stipulated additional charges such as property taxes, insurance, and maintenance.
New Construction	Any addition to real property, whether land or improvements (including fixtures) since the last lien date; any alteration of land or improvements (including fixtures) since the last lien date that constitutes a major rehabilitation thereof or which converts the property to a different use.
Operating Expenses	The periodic expenditures necessary to maintain the real property and continue production of the effective gross income, assuming prudent and competent management; sometimes referred to as "allowable expenses."

Term	Definition
Overall Rate (R_o)	The relationship between the anticipated net income before deducting for recapture (NIBR) and the sale price; the rate implies the investor's perception of both return on and recapture of the investment.
Percent Good	The complement of depreciation; if a property is 20 percent depreciated, its percent good is 80 percent; percent good refers to the portion of benefits remaining in an asset compared to the total benefits when new.
Personal Property	Personal property includes all property except real property.
Plottage	An increment of value that results when two or more sites are assembled under single ownership, producing greater utility.
Potential Gross Income	The total income of a property before deducting vacancy and collection losses or operating expenses.
Principal	A capital sum; a payment for reduction of the capital borrowed as distinguished from the payment of interest.
Projection Period	The holding period; a period of time over which net income is projected for valuation purposes; a presumed period of investment in property.
Property	Property includes all matters and things—real, personal, and mixed—that are capable of private ownership.
Real Property	The possession of, claim to, ownership of, or right to the possession of land; all mines, minerals, and quarries in the land; all standing timber whether or not belonging to the owner of the land, and all rights and privileges appertaining thereto; and improvements; in California property tax law, the term is synonymous with "real estate."
Recapture	The return of invested capital; in real estate investments, capital may be returned gradually as part of the annual income; it may be recaptured all or in part through resale of the property, or through a combination of both. The variety of the methods of recapture require the various capitalization techniques.
Remaining Economic Life	The estimated period during which the improvements will continue to contribute to a property's value.
Replacement Cost	The cost required to replace an existing property with a property that has equivalent utility.
Reproduction Cost	The cost required to reproduce an exact replica of an existing property.
Residual Techniques	Capitalization techniques (within the income approach) in which an income amount is allocated to a property component of unknown value after subtracting the income return required by the property component of known value. This income amount is then capitalized into an estimate of

Term	Definition
	value of the unknown component.
Reversion	A lump-sum benefit in property that an investor receives or expects to receive at the termination of an investment.
Reversionary Rights	The rights of the lessor at the expiration of a lease; the estate returned or due to be returned.
Risk	Uncertainty about the outcome of future events; uncertainty about the future profitability of investments or projects; the possibility of not receiving the projected income.
Risk Rate	The annual rate of return on capital that is commensurate with the risk or uncertainty assumed by the investor; the rate of return or yield required to attract capital to the level of risk or uncertainty of that investment.
Safe Rate	The minimum rate of return on invested capital. Theoretically, the difference between the total rate of return and the safe rate is considered a premium to compensate the investor for risk, the burden of management, and the illiquidity of the capital invested; also known as the <i>risk-free</i> rate.
Sale Price	The amount of money a buyer agrees to pay and a seller agrees to accept in an exchange of property rights; sale price is based on a particular transaction, not necessarily on what the typical buyer would pay or the typical seller would accept.
Sale Price Adjustments	A procedure for deriving a value indicator by comparing the property being appraised to similar properties recently sold, by adjusting the sale prices of the comparables using elements of comparison.
Salvage Value	The value of property at the end of its economic life in its present use; the estimated market value for an entire property (e.g., a house) or for a part (or parts) of a property (e.g., the plumbing fixtures or doors of a house) that is removed from the premises for use elsewhere.
Scarcity	The present or anticipated under-supply of an item relative to the demand for it.
Taxable Value	For real property subject to article XIII A of the California Constitution, the base year full value adjusted for any given lien date as required by law or the full cash value for the same date, whichever is less, as set forth in section 51(a). For personal property, the full cash value (market value) on the lien date each year.
Unit of Comparison	The components into which a property may be divided in order to make comparisons, e.g., an apartment might be compared by price per apartment unit, price per room, price per gross square footage, or price per leasable square footage.

Term	Definition
Utility	The capacity of goods to evoke a desire for possession; wantedness; want-satisfying power.
Value	The power of one commodity to command other commodities in exchange; a ratio of exchange; present worth of future net benefits.
Weighted Average	An average that is calculated by weighting each component by a factor that represents its relative importance to the whole, multiplying each component by its assigned weight, and adding the products; used in the band of investment method.
Yield	The return on investment.
Yield Capitalization	A capitalization method used to convert future benefits to present value by discounting each future benefit at an appropriate yield rate or by developing an overall rate that reflects the investment's income pattern, value change, and yield rate.
Yield Rate	A measure of investment return (usually annualized) that is applied to a series of incomes to obtain the present value of each; examples are the interest rate, the discount rate, the internal rate of return, and the equity yield rate.

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