NEW CONSTRUCTION AND PROPERTY TAXES

What Effect Does New Construction, Altering an Existing Building or Changing the Use of a Property Have on Property Taxes?

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"New construction" is one of the most common reasons a property is reassessed and the assessed value increased beyond the Proposition 13 protected 2% annual increase. It is important to understand that an appraisal is an estimate of market value. An assessment is the value placed on a tax roll.

Normally "new construction" is thought of as building a new structure, or adding on to an existing structure. Under California property tax law, "new construction" can also mean renovating a structure to change its use, rehabilitating a structure to a "like new" condition, or even removing a structure. However, not every building permit for new construction results in a reassessment of the property. In general, the Assessor's office processes thousands of building permits annually, yet typically less than half result in new, higher assessments.

This brochure is designed to help property owners and taxpayers understand when new construction results in a reassessment.

Generally, value is added for new construction under the following circumstances:

1. New building(s) constructed on vacant land.
2. Additional square footage added to an existing building.
3. Additional buildings or improvements to property. For example, a garage, swimming pool or bathroom.
4. Physical alteration (rehabilitation) converting a building or any portion thereof, to the substantial equivalent of a new structure, <u>or</u> changing the manner in which a building is used.

How and when will "new construction" be assessed?

In estimating new construction, only the value of the improvement being added is considered. That is, if a new building is constructed on vacant land, the land will retain its existing indexed, base year assessed value.[1] If an addition to a structure changes its size, for example, increasing the size of a single family residence from 1,200 square feet to 2,000 square feet, only the market value of the additional 800 square feet is added to the assessed value. A new base year value is determined for the addition only. The indexed base year assessed value of the land and existing structure(s) remain unchanged.

The assessed value is determined as of the **date of completion** of construction. If the construction is ongoing as of the lien date (January 1), an estimate of the value of the partially complete construction is made and entered on the next assessment roll.[2] When construction is complete, the base year assessed value is determined and a supplemental assessment is issued for the difference between the value as of the date construction is completed, and the value that existed on the assessment roll. The new construction is based upon market value. The Assessor may use the Sales Comparison Approach, the Cost Approach, and in case of income producing properties, the Income Approach to value the new construction.[3]

Will the contractor's costs, or in the case of owner-built new construction, the owner's actual cost, be considered in the assessment?

While these costs are considered, the Assessor is obligated by California State Constitution to add the market value of the new construction. When the Sales Comparison Approach is employed, an appraisal of the land and the improvements is done as of the date of completion to determine the value of the new construction.

The Cost Approach is often employed by the Assessor to appraise new construction. It is important to note that proper application of the cost approach considers all the costs incurred in the course of construction. These "Full Economic Costs" include labor and materials, permit fees and contractor's overhead and profit. In addition, there are indirect costs such as developer's administration expense, professional fees, construction financing, insurance, and entrepreneurial incentive or profit.

Entrepreneurial incentive is defined as the amount that a developer expects to receive before a project is initiated. Entrepreneurial profit is the amount that a developer actually receives after a project is completed. A prudent developer who undertakes to construct and market a property anticipates receipt of a (entrepreneurial) profit in addition to the return of the equity investment.

New Construction associated with income producing properties may be assessed using the Income Approach. Here the methodology is similar to the Sales Comparison Approach because the market value of the total property is determined based on the income which the subject property could generate. The market value of the land is then deducted to leave a residual market value of the improvements.

In general, the difference in the amount of money the property would have sold for if offered for sale as it existed immediately prior to the new construction, and the amount it would sell for on the open market, immediately after the completion of construction, is the best indicator of market value.

If I add square footage to my home, will it cause a reassessment of the entire property, including the land?

Under Proposition 13, the entire property, land and improvements, will only be completely reassessed when the real estate transfers ownership. If new construction occurs on only a portion of a property (for example, the addition of a bedroom), the newly constructed portion is re-assessed and assigned its own base year value. The remainder of the property which did not undergo new construction (including the land) retains its existing base year value. In some cases, the scope of work being done constitutes equivalent to new construction and the entire house will be reassessed but the land will retain its existing base year value.

What if I am just repairing my property?

Normal maintenance and repair is the action of continuing, preserving or retaining property in proper condition. Maintenance performed on real property is normal when it is regular, standard and typical. The installation of new items that replace old items but provide a similar function is not typically considered re-assessable new construction. Routine repairs necessitated by normal wear and tear, such as replacing a water heater, carpet or roofing are not considered new construction, and are not subject to re- assessment.

What if I purchase a property in poor condition? Will the repairs be assessable?

Purchasing a property in poor condition and then replacing multiple items in a short period of time is not standard and typical normal maintenance. Timing and scope of work must be considered to determine when maintenance and repair becomes rehabilitation and renovation that brings an improvement to a state that is substantially equivalent of new. Rehabilitation is defined as the restoration of a property to satisfactory condition without changing the plan, form or style of the property, and involves curing physical deterioration. If rehabilitation makes the structure substantially equivalent to new, it qualifies as re-appraisable new construction.

1 A base year value is established each time there is a change in ownership or completion of construction, which, in subsequent years is modified only by applying the mandated inflation factor, not to exceed 2%. A property with multiple completion of construction dates, or multiple partial interest transfers, will have a separate indexed base year value for each component. The total assessment is the sum of the components and is the basis for calculation of the taxes.

2 The lien date is the time when taxes for any fiscal year become a lien on property; and the time as of which property is valued for tax purposes. The lien date for California property is 12:01 a.m. on January 1 (effective January 1, 1997) preceding the fiscal year for which the taxes are collected. The lien date for prior years was March 1.

3 There are three universally accepted valuation/appraisal techniques to determine fair market value: (1) Sales Comparison Approach, (2) Income Approach (usually appropriate for income producing properties) and (3) Cost Approach. While the Cost Approach is a valid and useful technique for determining value of some properties, the final determination of assessed value will be based on the amount the general public would pay for the work, including a market based profit. The application of the cost approach to determine assessed value is the least preferred method of valuation and is only appropriate for special use properties, or when available market information is insufficient to render an accurate application of the previous two approaches to value. For more information on these three approaches to value, please see the references enclosed.

What is "Substantially Equivalent to New"?

New construction is assessable when that new construction has converted an improvement (or a portion of the improvement) to a state that is substantially equivalent to new. For example, if a house is stripped and taken down to the studs, and the restoration is such that the house has been converted to a state comparable to a new house, the value added by such a conversion would be re-assessable as new construction. The Assessor will look at the project and determine whether structural components such as roof structure, exterior walls, floor structure, foundations, substantial portions of the plumbing, electrical and/or HVAC (heating, ventilating or air conditioner) systems are being replaced.

In the course of a major renovation or extensive rehabilitation, property owners may convert their properties to the substantial equivalent of new by significantly altering the existing improvements. In some situations, property owners use both additions and alterations to convert improvements into the substantial equivalent of new. Whether or not new construction transforms an improvement (or a portion thereof) into a state that is substantially equivalent of new is a factual determination that must be made by the appraiser on a case-by-case basis.

What if I am repairing major damage suffered in a calamity?

A property owner who has suffered a loss due to a misfortune or calamity, such as fire, flood or earthquake, may be entitled to property tax relief. The damage must be sudden, caused by a misfortune or calamity, not a gradual deterioration over a long period of time. In general, the reconstruction of property that has been damaged or destroyed by misfortune or calamity is not re-assessable new construction if the following requirements are met: 1) the property is reconstructed in a timely fashion; and 2) the property after reconstruction is substantially equivalent to the property prior to the damage or destruction. For more information on eligibility requirements for disaster relief, go to **www.sccassessor.org** or call (408) 299-5300.

What if I am just remodeling?

Remodeling is changing the plan, form, or style of a structure. Remodeling that does not involve adding to the size of the structure or to the amenities provided within the structure is generally not considered new construction and is not subject to reassessment. The exception is those situations where the remodeling is so extensive as to constitute the "substantial equivalent" of a new structure. If a remodeling project is extensive, the property owner is encouraged to contact the Assessor's staff at (408) 299-5300, in advance, to obtain a better idea of how the project will be treated for assessment purposes.

I am installing solar energy improvements to my home. Will these improvements be assessed?

An active solar energy system is defined as a system that uses solar devices which are thermally isolated from the living space or any other area where the energy is used, to provide for the collection, storage or distribution of solar energy. Revenue & Taxation Code Section 73 provides that the construction or addition of any active solar energy system is excluded from the definition of assessable new construction. An active solar energy system does not include solar pool heaters or hot tub heaters. For more information on solar energy exclusion, go to **www.sccassessor.org** or call (408) 299-5300.

Are seismic safety improvements assessable?

Section 74.5 provides an exclusion for the addition of any seismic retrofitting components to existing buildings and structures. There are specific filing requirements to get the seismic safety exclusion. For more information on the seismic safety exclusion, go to **www.sccassessor.org** or call (408) 299-5300.

How does the Assessor know that new construction has occurred?

By state law, Santa Clara County and all the cities within the county are required to provide the Assessor with copies of building permits. The Assessor is required by law to assess all new construction, whether or not a building permit has been issued. Discovery of new construction occurs in a variety of ways such as information volunteered by the public, personal observation of Assessor staff performing routine field checks, or reported at the time a property transfers ownership. Upon discovery, the Assessor is required to determine or estimate the date of completion of construction, and the value as of the completion date, and to correct the assessment roll for up to four years from the date of discovery.

What if I plan to live in the house I am building?

A homeowner's exemption is available for property owned and occupied by the owner as the principal place of residence. Information about this exemption is automatically mailed to new property owners in the months following the acquisition. For additional information, go to **www.sccassessor.org** or call (408) 299-6460.

What if I don't agree with the assessed value placed on the new construction?

After receipt of the notice of assessment, you may request an informal review of the assessment from the Assessor's Office. If you believe the review does not result in a satisfactory conclusion, you may pursue an assessment appeal. Any assessment appeal must be filed within the time specified on the notice.

The assessment appeal process is available for disagreements regarding the enrolled value of the property. An independent Assessment Appeals Board, appointed by the Board of Supervisors, hears all appeals and renders a decision. Information concerning the assessment appeals process and deadlines in which an appeal must be filed, are included with the value notification(s) sent to the property owner. Information regarding assessment appeals is available from the Clerk of the Board at (408) 299-5088 or at **www.sccgov.org/portal/site/cob.**

References

California Constitution Article 13A SEC. 2. (a)

The "full cash value" means the county assessor's valuation of real property as shown on the 1975-76 tax bill under "full cash value" or, thereafter, the appraised value of real property when purchased, newly constructed, or a change in ownership has occurred after the 1975 assessment.

Property Tax Rule: 463 (b)3

Any physical alteration of any improvement which converts the improvement or any portion thereof to the substantial equivalent of a new structure or portion thereof or changes the way in which the portion of the structure that had been altered is used, e.g., physical alterations to an old structure to make it the substantial equivalent of a new building without any change in the way it is used or alterations to a warehouse that makes it usable as a retail store or a restaurant. Only, the value, not necessarily the cost, of the alteration shall be added to the appropriately indexed base year value of the pre-existing structure.

California Revenue and Taxation Code Sections: 70, 71, 72, 73, 74.5, 110.

Available at

www.boe.ca.gov/lawguides/property/current/ptlg/rt/revenue-and-taxation-code-property-taxation.html

Property Tax Rules: 2, 4, 463 (d)

Available at

www.boe.ca.gov/proptaxes/prop-tax-rules.htm

Assessor's Handbook 410, Assessment of Newly Constructed Property

Mission Statement

The mission of the Santa Clara County Assessor's Office is to produce an annual assessment roll including all assessable property in accordance with legal mandates in a timely, accurate, and efficient manner; and provide current assessment-related information to the public and governmental agencies in a timely and responsive way.

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