Property Assessment:
What's business property really worth?

Synopsis

The Santa Cruz County Grand Jury reviewed the process used by the Santa Cruz County Assessor's Office to establish value and determine the reduced assessment on a business property.

The Grand Jury used information from a previously decided case of a large commercial entity that involved a collection of businesses, parcels and associated improvements. One of the key elements of this case was the use of an assessment methodology known as the "income method" for, at least in part, determining the fair market value of a business property.

The Grand Jury's objective was not to validate or "second guess" the assessor's actual determination of the full cash value in the case reviewed but to understand the process employed in making that determination and to evaluate whether that process would deliver a fair and reasonable property valuation. No attempt was made to review all of the assessor's processes.

Definitions

Assessment
An estimate of the "full cash value" of a parcel and improvements for the purpose of determining the property tax.

Capitalization
Converting regular income over a period of time to an equivalent monetary value.

Comparables
Like properties, equipment and improvements having known market values that can be used to estimate the value of targeted properties, equipment and improvements.

Consolidated Financial Reports
A combined financial statement for a corporate entity which includes all of the profit centers in one combined financial statement.

EBITDA
Earnings Before Interest, Taxes, Depreciation, and Amortization — a measure of business income.

Income Method
A property assessment methodology used to establish the value of business property in which capitalization of a net income stream is used as one approximation. That is to say, we estimate the capital investment that would be required to produce the net revenue stream. We must assume a reasonable rate of return commensurate with the risk. The

resultant capital investment would include land and improvements. To arrive at a calculated land value, the value of the improvements would be subtracted.

Parcel
Basic unit of real property subject to an assessment.

Proposition 13
An amendment to the California Constitution passed by the voters in June 1978, governing the taxation of real property. Proposition 13 prescribed an assessment structure for establishing the base full cash value of a property and imposed limits on increases in the assessment above the base.

Proposition 8
An amendment to the California Constitution that amended portions of Proposition 13 (see below) passed by the voters in November 1978. Proposition 8 permits property tax payers to request a reassessment of their property when they believe that their property has been reduced in value due to damage or other economic conditions. As Proposition 13 did not provide a mechanism for reducing the assessment, Proposition 8 was passed a short time later to incorporate a reduction mechanism.

Background

Assessor's Office Responsibilities

Property taxes are based on the assessed value of a property. It is the responsibility of the assessor to establish the full cash value of the property upon which the amount of property tax is calculated. The assessor does not collect taxes nor set the rules for how a property is assessed. In order to meet the responsibilities of the office, the assessor must:

- Locate and identify the ownership of all taxable property in the county.
- Establish a value for each property subject to property taxation.
- List the value of each property on the assessment roll.
- Apply any applicable legal exemptions and exclusions.

Assessed Valuations

The assessed value of real property is determined by law which includes the effects of Proposition 13. Proposition 13, passed in June of 1978, requires that the assessed value of real property be set at the 1975-76 full cash value (base year value). Real property is then reappraised only when a change in ownership occurs, or after new construction is completed. Generally, a change in ownership is a sale or transfer of property; new construction is an addition or improvement to a property. Except for these two instances, property assessments can be increased annually by the percentage increase in the consumer price index but by not more than 2%.

However, business personal property (non-land/improvements such as equipment) and certain restricted properties are reappraised annually. The owners of all businesses must file a property statement each year detailing costs of all supplies, equipment and fixtures at each location. This annual statement is required unless the property qualifies for direct assessment (appraised by assessor). Business inventory is exempt from taxation.

Proposition 8, passed in November of 1978, amended Proposition 13 providing clarifications and a mechanism allowing an assessor to reduce an assessment when a property has been substantially damaged or its value has been reduced by “other factors” such as economic conditions. A reduction to the base-year value under the auspices of Proposition 8 is not permanent. Assessors are required to track every reduction until the base year value is restored.

A number of factors are used in assessing or reassessing the value of business property:

- Market price of comparable land, considered at the most likely highest value usage.
- Construction costs.
- Equipment and improvements costs.
- Business income, commonly EBITDA – earnings before interest, taxes, depreciation, and amortization.

Disputed Assessments

It is the assessor’s responsibility to establish a value for each property subject to property taxation. Property owners who disagree with the assessor’s appraisal can present their case to the assessor and provide evidence supporting a claim for a lower assessment.

In the event that the property owner fails to convince the assessor, the property owner has the right to appeal to the Assessment Appeals Board, a three-person board of citizens appointed by the Santa Cruz County Board of Supervisors.

Finally, property owners who are not satisfied with a determination by the Assessment Appeals Board can take their case to Superior Court.

Scope

The scope of this Grand Jury investigation was limited to a review of the assessor’s process used to reassess a unique commercial property owned by a privately held company. No attempt was made by the Grand Jury to validate or “second guess” the assessed value determined by the assessor.

Findings

1. The case studied involved one company having a large number of parcels and multiple businesses. It was necessary for the assessor, with the property owner’s eventual concurrence, to segregate the parcels and associated improvements and other assets in order to determine which parcels, improvements and other assets were related to the requested assessment reduction.

2. The business associated with the requested assessment reduction in this particular case is relatively unique making the use of "comparables" difficult. The Assessor's Office, therefore, relied on the Income Method for determining the value of the property.
3. The initial assessment was established using base-year values adjusted per the requirements of Proposition 13 and augmented by annual valuations of equipment. Reductions under the auspices of Proposition 8 were based on multiple factors including the capitalization of the business' five-year average income stream.
4. A one-year study of the business was conducted by the assessor. Industry experts were consulted to assure the assessor's understanding of the business and the reasonableness of various valuations.
5. Externally audited consolidated financial reports were used as a starting point for the income analysis. Secondary financial reports, isolating the business associated with the requested assessment reduction from the consolidated financials, were prepared by the property owner.
6. The property owner's accounting processes, audited consolidated financial reports and breakouts were tested by the assessor's staff working both at the property owner's site and in the Assessor's Office.
7. An agreement stipulating the value of the property in question for tax purposes (Settlement Agreement and Mutual Release) was approved by the Assessment Appeals Board and executed by the property owner and the county.
8. Annual reviews by the assessor of the reduced assessment are being conducted as required.

Conclusions

1. Based only on the case described in this report, the Grand Jury found the assessor's process for handling the request for a reduced assessment of business property owned by a privately held company to be reasonable, thorough and professionally conducted.
2. A company's stated income can be suppressed by paying excessive salaries or other benefits to owners, employees or vendors. This can affect the company's Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA), which can then artificially lower its assessment.
3. A higher level of confidence in the financial statements provided by business property owners would be realized by having an external auditing firm review and certify the statements. The certification should apply to that portion of the business which is being used for property evaluation purposes.
4. The current Assessor's Office web site does a reasonably good job of describing the assessor's functions for the majority of the county's properties. However, many citizens are concerned about how the larger county taxpayers are assessed

and whether their size and influence leads to preferential treatment.

5. A more effective public outreach could reduce the concerns about possible preferential treatment for some large high profile land parcels.

Recommendations

1. Expand the Assessor's Office web site to include a discussion of how business assessments are conducted. Without disclosing confidential financial information, the methodology used by the Assessor's Office should be explained for different categories of properties so that the appraisal approach is more transparent. This would enhance the public's understanding and perception of the fairness of the assessment process.
2. When the income method is used, thoroughly investigate the ownership structure of a business to assure that the Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) is not being reduced through expenses that principally benefit the owners or owner-related parties (e.g., excessive salaries, "consultancies," travel and entertainment, gifts). If such expenses are found to have reduced the income of the business being evaluated, they should be added back into the stated EBITDA.
3. When using a business property owner's financial statements to determine the income stream to be used in the assessment of business property, require that those statements be audited and certified by an independent external auditing firm for the applicable portion of the business.

Responses Required

Entity	Findings	Recommendations	Respond Within
Santa Cruz County Assessor		1-3	60 Days September 1, 2007

Appendix – Sources

Documents

Property owner's financial reports — audited consolidated financial reports, breakout of financials describing the business associated with requested assessment reduction.

Assessor's working documents — spreadsheets used in validating property owner's breakout.

Settlement Agreement and Mutual Release ("Stipulation Agreement").

Other legal documents — Assessor's Office.

Web Sites

Proposition 8 (1978) — http://traynor.uchastings.edu/cgi-bin/starfinder/18364/calprop.txt

Proposition 13 (1978) — http://www.leginfo.ca.gov/.const/.article_13A

Santa Cruz County Assessor — http://www.co.santa-cruz.ca.us/asr/index.htm