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 change its use, or 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, or 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 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 reassessed 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 maintaining 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- assessable 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 year taxes 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.

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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 conversion 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.

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?

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/leito/ob.

References

California Constitution Article 13A (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 Rules 464 (b)
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 suitable 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.boc.ca.gov/landlords/property/current/prop/property-revenue-and-taxation-code-property-taxation.html

Property Tax Rules 2.4, 463 (d)
Available at www.boc.ca.gov/prop/prop-tax-rules.htm

Amato'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 to governmental agencies in a timely and responsive way.