PTA PROPERTY TAX UPDATE

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What is External Obsolescence and what does it have to do with Property Taxes?

J.P. Patel Senior Tax Consultant

The American Society of Appraisers defines External Obsolescence as, "…the loss in value of a property caused by factors external to the property."

Specific examples may help you evaluate whether the equipment value in your facility may be affected by External Obsolescence.

A medical device company product was selling very well but it did not have an adequate facility. This company built a new facility. As soon as the facility came on line, the Food and Drug Administration (FDA) determined that the product made by this company needed further testing. The equipment was new and capable of doing what it was were intended for, but due to the FDA decision, the value of this equipment was affected.

A food processing facility was built for bulk package retailers and warehouse clubs. Consumer preference changes over time and they started demanding individual convenience packs, single serving items such as do-it-yourself bowls and grab and go meals. This company's sales declined for their bulk products and sales increased for individual packs. The value of the equipment that made bulk product is affected due to factors unrelated to the functionality of the equipment.

California banned use of single serve plastic bags in grocery stores. The value of the equipment used to manufacture these bags is affected irrespective of equipment capability.

Some industries are in decline due to external factors in general such as construction, mining, etc. Some industries are being transformed due to the internet, such as printing, pre-press, fax machine, CD/DVD manufacturing, camera, post-production video, etc. The value of this manufacturing equipment is affected due to factors beyond the control of the individual equipment owner.

I hope the above examples give you something to think about if your plant equipment is affected by changes in the industry, legislation, consumer preferences, reduction in demand, etc. Sometimes our clients think we ask too many questions that may seem unrelated to property taxes. Our reasoning is, we want to understand your business as much as possible. Knowing your business helps us minimize your property taxes. Working with different clients in various industries, helps gain knowledge that could pertain to your equipment valuation.

How to Avoid Double Taxation on Tenant Improvements

Vanita Bansal, Tax Consultant

Commercial offices are renovated by, moving partitions, painting, plumbing, HVAC, re-carpeting and relocating electrical, telephone jacks and lines etc. to suit a new tenant.

The amount paid by tenant / lessee for tenant improvements (TI) or leasehold improvements (LHI) is recorded in lessee's books as fixed assets, and the lessee for property tax purposes reports them to County along with other fixed assets on the 'Property Tax Statement' known as Form 571-L.

Most Assessor's offices assess TI's as reported on 571-Ls, typically under the Structure category. However, in most situations, TI's are not fully taxable to a lessee.

Renovation of an office property, generally, costs between $2 million to $5 million, depending on the size of the office and cost per square foot. Based on our experience, 50% to 80% of the new costs should not be assessed to either the building owner or the tenant.

Tenant improvements, as mentioned above, which are installed by a lessee are considered part of the building. When a building is appraised by the Real Estate Division, a branch of the Property Tax office, these improvements are generally included in the assessment of the building and taxed to the owner of a building. When a lessee does replacements or makes improvements and pays for it, he/she reports them on a 571-L. It is the responsibility of an assessor to inquire with the Real Estate Division whether or not these improvements are already included in the building. If it is included in the building then it should not be assessed to the lessee.

Section 51 states, "In general, improvements related to business property (i.e., landlord improvements, leasehold/ tenant improvements, structure items, and fixtures) are valued, as is other real property". However, due to lack of coordination in the Assessor's office between the Real Estate Division (secured property) and the Business Division (unsecured property), tenant improvements maybe assessed to both lessor and lessee resulting in double assessment. Further, Rule 463 explains, "The installation of new items that replace old items but provide a similar function is not typically considered re-assessable or new construction".

Due to a lack of deep knowledge in the subject matter, the taxpayer/lessee often does not demand an assessor to coordinate between the Real Estate and the Business Divisions. Consequently, TI's are typically being double taxed.

If your office has been renovated in the last ten years and you are paying property tax on the improvements, you may be a victim of TI-double taxation.

Flag Day

An American tourist in the Netherlands was chatting with a friend and asked about the meaning of the red, white, and blue stripes in the Dutch flag.

“Our flag symbolizes our taxes,” the friend joked. “We get red when we talk about them, white when we get our tax bill, and blue after we pay them.”

“That’s the same with us,” the American said. “Only we see stars, too.”

TaxTidbits

May 7th - 10% Penalty Date - Last day to file a business personal property statement (571L) without incurring a
penalty.

California ranks 22 in the nation for property taxes. That is still high after Prop 13. Many California property owners are required to pay **parcel taxes.** These are annual property taxes not based upon the value of the property. This is one way to get around Prop 13.

Nationally only seven states have a higher top corporate tax rate than California's flat tax rate of 8.84 percent.

California levies a 7.5 percent general sales and use tax on consumers, which is the highest statewide rate in the nation. This is before additional taxes from the counties.

Information from CalTax.org

Property Tax Update

Tooting Our Horn

Although this is an informational newsletter, we would like to take the opportunity to brag about a sampling of our successes, from various industries, in the last quarter. These are a few **examples of the refunds** that our clients have received from the county, due to our work.

Business Personal Property

Commercial Printers	$82,749.57
Computers & Office Equip. Wholesale	$30,727.16
Crop Production	$60,584.97
Data Center	$114,905.79
Fruit & Vegetable Processing	$367,559.71
Graphic Design	$36,936.86
Machine Tool Manufacturing	$303,862.19
Management Services	$41,004.90
Plastic & Rubber Manufacturing	$73,540.39
Semiconductor Equipment Mfg.	$57,862.51
Warehousing & Storage	$51,957.84

PTA Real Estate Tax Division
Real Property 12/01/16 to 03/10/17

Real Property

California

Office Property - LAC County	**$26,079**
Office Property - SB County	**$16,324**

Hawaii

Commercial Property - Maui County $163,695

The Income Approach - Vacancy and Collection Loss

Christopher Larsen, Tax Consultant

The Income Approach is one of the most widely used methods for valuing real property. In fact, it is often considered to be the primary approach to value for commercial and multi-family residential property types. These types of properties are regularly purchased by investors, who are not particularly interested in the real estate but the income stream the real estate can generate.

In this series of articles, we've looked at some tips for estimating market rent and accounting for rent concessions while deriving an Income Approach. This time I'd like to discuss adjusting for vacancy and collection loss as part of the Income Approach.

When conducting an Income Approach, the first expense that any appraiser or investor should consider is vacancy and collection loss (V&C). Most properties experience some level of regular vacancies over the long term. And even if a property has a tenant committed to a long-term stable lease, there is still the risk that a tenant goes bankrupt or is unable to pay its rental obligations for whatever reason. Thus, even in the most stable situations, any Income Approach should include some allowance for vacancy and collection loss.

Now that we understand a little better what the V&C expense is and why we need to account for it, next we need to try to quantify the proper allowance for the property being analyzed. Vacancies can vary drastically from property to property based on property type, regional demand, location, the competence of management, and a myriad of other factors. Perhaps the best place to start is with the occupancy history of the subject property itself. Let's look at some common scenarios:

Single-tenant properties, like a single family home or a large industrial distribution facility, may be fully leased for years at a time, experiencing no vacancy at all during this period. However, it may take many months to find a new tenant when the old one leaves. For example, consider a single-tenant industrial building that is leased for 36 months. After the lease expires and the tenant leaves, assume it takes four months to clean the property, market it, and get a new tenant in place. In this example, the property was vacant for four months over a 40-month stretch or 10% of the time on average. Single-tenant properties often experience vacancies in bursts like this.

On the other hand, multi-tenant properties, like apartment complexes or retail centers, often experience individual tenant turnover on a regular basis. As tenants come and go, it is not uncommon to have a few units or suites vacant nearly all the time. For example, consider a 20-unit apartment complex. As renters come and go, the building is usually mostly occupied; however, if 4 of the 20 units are vacant at any given time on average, then the long-term vacancy rate for this property is probably around 20%.

Another good source of vacancy information can be market surveys from commercial real estate brokerage. These surveys will often list average vacancy or occupancy rates organized by region and property type. For example, a typical market survey may show averaged vacancy rates for retail, office, industrial, and apartment sectors, in a specific region during a specific period.

Similar to the information provided by commercial brokerage surveys, reports are available via online real estate databases, such as CoStar Property. These websites often have tools which you can use to generate vacancy reports using customizable parameters you select. You can narrow a search based on property type, location, size, and many other factors.

These are the most common sources of vacancy information. A prudent appraiser or investor will use as much data as possible to estimate a reasonable long term vacancy allowance for a subject property.

Quotes

It's not about money. It's about the people you have, and how you're led.
—Steve Jobs

Remember, even if we can't see them, those we love are always with us.
—Lucinda Riley

Precaution is better than cure.
—Edward Coke

We must take care of our families wherever we find them.
—Elizabeth Gilbert

The person who can bring the spirit of laughter into a room is indeed blessed.
—Bennett Cerf

Death, taxes, and childbirth! There's never any convenient time for any of them.
—Margaret Mitchell

Every child is an artist; the problem is staying an artist when you grow up.
—Pablo Picasso

At the end of the day, a loving family should find everything forgivable.
—Mark V. Olsen

Laughter is the only free emotion—the only one that can't be compelled.
—Gloria Steinem

There's nothing that makes you more insane than family. Or more happy. Or more exasperated. Or more secure.
—Jim Butcher

Vessel Exemption- Article XIII, Section 3(l) of the California Constitution

Albert Zammaripa, VP Northern CA

Pursuant to the California Constitution, certain vessels which meet the requisite activity and size may qualify for an exemption from property tax. Section 3(l) includes the following as being exempt:

> **"Vessels of more than 50 tons burden in this State and engaged in the transportation of freight or passengers"**

In order to qualify for the exemption, the vessel has to first meet the weight requirement, which is 50 tons burden. What is meant by 50 tons burden refers to "net tons", as registered in the United States Customs Office. The net tons criteria was resolved in *Kiessig v. San Diego County, 51 Cal.App.2d 47*.

When section 3(l) of the Constitution was enacted by the people in 1934, the primary purpose was to gain and retain large fleets and marine related business in this state. Various other states had already passed similar laws, when California opted to incorporate a benefit to fleet operators.

For the purposes of Article XIII, Section 3(l), "freight" generally denotes property transported by a carrier from consignor to consignee. Such a relationship requires that the transportation of freight or passengers be "for hire". The "exemption" was not intended to exempt all vessels of a specified tonnage, but only those engaged in actual transportation of property or persons for hire.

From my involvement in cases involving exempt vessels, there has been much controversy with the County Assessor regarding what constitutes transportation for hire. There are a couple of appellate cases worth noting to determine what may constitute "transportation for hire". The two I felt most clearly distinguished the activity are *Dragich v. Los Angeles County, 30 Cal.App.2d 397 and Alalunga Sport Fishers, Inc. v. San Diego County, 247 Cal.App.2d 663.*

The finding by the Court in *Dragich v. Los Angeles County* was that boats used solely in catching fish and bringing them into market are not entitled to an exemption, since such boats are not engaged in the transportation of property or persons for hire. In *Dragich*, the court did not allow the exemption since the vessels were not necessarily hired by any one person, instead a group of fisherman went out for fishing activities and returned with their catch.

In *Alalunga Sports Fishers, Inc. v. County of San Diego (1967) 247 Cal.App.2d 663*, the tax exemption was held to apply to certain sport fishing vessels of the required tonnage that carried passengers from a particular dock in the San Diego harbor to various fishing grounds. The court exempted the vessel since it was carrying passengers "for hire" to the fishing grounds and returned to their homeport with their catch.

There is a clear distinction between *Dragish* and *Alalunga*, since the key component was that the vessel employed had to be "for hire". The courts have contemplated the question of the legislative intent of Section 3(l) and it was determined that "transportation" in its common form must include a "for hire" component.

PTA

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