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Summary of Canyon Villas v. State, Tax Comm'n, 124 Nev. Adv. Op. No. 7

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Canyon Villas v. State, Tax Comm'n, 124 Nev. Adv. Op. No. 72 (Sep. 25, 2008)[1]

ADMINISTRATIVE LAW – PROPERTY TAX VALUATION

Summary

Appeal from a district court order denying judicial review of property tax valuation.

Disposition/Outcome

After a hearing en banc the Nevada Supreme Court affirmed the district court's denial of appellant's petition for judicial review.

Factual and Procedural History

Prior to the Clark County Assessor performing assessments on Olen Residential's (hereinafter "Olen") apartment complexes, Olen notified the Assessor that the complexes had significant construction defects. Based on these defects, Olen requested that the Assessor reduce the taxable value of the property. Instead, the Assessor assessed the properties in accordance with NRS 361.227 without accounting for construction defects.

Olen appealed the assessment to the Clark County Board of Equalization. The County Board raised the capitalization rate on 7 of the properties for reasons unrelated to any alleged construction defects. Olen then appealed the County Board's decision to the State Board of Equalization. Relying in part on evidence of a $112 million construction defect judgment in an action relating to some of the apartment complexes, the State Board raised the capitalization rate on all sixteen apartment complexes by 2.25 percent to account for decreases in value related to construction defects.

Olen petitioned the district court for judicial review. Olen argued that the proper method for accounting for construction defects was to simply deduct the amount of the defects from the value of the apartment complexes. The district court disagreed, and denied the petition. This appeal followed.

Discussion

To overcome the Court's presumption that the State Board's decision is valid,[2] a taxpayer must demonstrate by clear and convincing evidence that the decision is unjust and inequitable.[3] To meet this requirement, the taxpayer must demonstrate the State Board applied a fundamentally wrong principle, refused to exercise its best judgment, or levied an assessment so

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[2] NEV. REV. STAT. § 361.430 (2007) (in reviewing, the court presumes that the decision was valid.

[3] Imperial Palace v. State, Dep't of Taxation, 108 Nev. 1060, 1066, 843 P.2d 813, 817 (1992).

high that fraud and bad faith are a necessary implication. [4]

Olen's chief contention on appeal was that the Assessor did not properly account for construction defects in valuing its properties. Thus, the case turns on whether the income capitalization method properly accounts for construction defects in valuing income-generating properties. The court addresses this question with a three-part analysis. First, the court briefly discusses Nevada's statutory tax assessment scheme. Next, the court determines that the income capitalization method is sufficient to assess Olen's properties. Finally, the court determines that the State Board properly applied that method in this case.

Nevada's Property Tax Assessment Scheme

Pursuant to Article 10, Section 1 of the Nevada Constitution, the Legislature enacted 361.227 providing for the assessment of real property and assigning county assessors to determine the values of property located within their county. [5] Under the statute, the assessor must first determine the taxable value of the land. The assessor must then ensure that the taxable value is not greater than the "full cash value" of the property.[6]

Under NRS 361.227(1) the assessor appraises property based on the value of the land and any improvements. In valuing the improvements, the statute requires the assessor to use a cost approach. [7] In applying this approach, the assessor must subtract any applicable obsolescence, "impairment to property"[8], and other depreciation from the cost of replacing the improvements.

Once the assessor has determined the taxable value of the property, NRS 361.227(5) provides three methods an assessor may use to determine the property's full cash value. [9] If, after applying one of the three methods, the property's taxable value exceeds the full cash value the assessor must reduce the taxable value accordingly.

Construction Defects and Taxable Value

Olen argued that the assessor should account for construction defects by treating them as obsolescence and reducing the taxable value by the amount of the construction defect. The court rejected this argument with respect to income-producing properties because the income they generate has a direct impact on their value. Instead, the court held that Olen was required to show some connection between the construction defects and reduced income potential for the affected properties.

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[4] State, Bd. of Equalization v. Bakst, 122 Nev. 1403, 1409, 148 P.3d 717, 721 (2006).

[5] *See* Nev. Rev. Stat. § 361.260 (2007); Bakst, 122 Nev. at 1410, 148 P.3d at 722.

[6] *See* Nev. Rev. Stat. § 361.025 (2007) (defining "full cash value" as "the most probable price which property would bring in a competitive and open market under all conditions requisite to a fair sale);

[7] Nev. Rev. Stat. 361.227(1)(b) (2007).

[8] Nev. Admin. Code 361.116 (2008).

[9] These methods include: (1) a comparable sales analysis; (2) a summation of the values of the land and any improvements; and (3) "capitalization of the fair economic income expectancy or fair economic rent, or an analysis of the discounted cash flow." This third method is also referred to as the income-capitalization method.

In the case of commercial properties, a taxpayer must demonstrate that a defective condition affects the income-producing ability of the property.[10] Although a construction defect could constitute obsolescence, there must be some demonstrated loss in value related to the defects. If after applying the income capitalization method the assessor determines that the full cash value of a property is less than the taxable value, the assessor should make a reduction for obsolescence.

The Income-Capitalization Method

The assessor utilized the appropriate method in determining the full cash value of Olen's properties using the income capitalization method. Olen's argued that none of the methods set forth in NRS 361.227(5) adequately account for construction defects. The court rejected this argument, and for the first time expressly indicated that the "income-capitalization method is usually the best method" to determine the value of income-producing properties. [11] Because the properties in this case are income-producing, the assessor was correct in applying this method.

The income-capitalization method adequately accounts for construction defects in two ways. First, the method considers the current income producing ability of the property or the net operating income. To the extent that construction defects affect the ability of the property to generate income, they reduce the value of the property. Second, the assessor must determine the properties capitalization rate. Because the capitalization rate is based on a buyers expected rate of return, numerous factors can affect it. Among these factors is the condition of the property, including any construction defects. Thus, the income capitalization method is the best method for valuing income-producing properties, including those with construction defects.

Application of the Income-Capitalization Method

The assessor properly applied the income-capitalization method to Olen's properties. Although the assessor admitted that he did not account for construction defects in determining the capitalization rates for Olen's properties, the court excused that failure because the construction defect litigation was ongoing and any adjustment would have been speculative. The court held that by increasing of the capitalization rate by 2.25 percent to account for the construction defects once the litigation was complete the State Board sufficiently accounted for the defects.

Conclusion

Olen failed to meet its burden of providing clear and satisfactory evidence that the State Board valuation was unjust and inequitable. In valuing income-producing properties with construction defects, assessors should normally apply the income-capitalization method. Use of this method properly accounts for decreases in the value of a property arising from construction defects in two ways. First, construction defects will likely have a negative impact on a property's

[10] *See* NEV. REV. STAT. § 361.227(5)(2007); Hometowne Associates, L.P. v. Maley, 839 N.E.2d 269, 274 (Ind. Tax Ct. 2005).

[11] Canyon Villas v. State, Tax Comm'n, 124 Nev. Adv. Op. No. 72 (Sep. 25, 2008).

net operating income, thus reducing the present value of the property. Because the State Board properly valued the properties using this method, and exercised its best judgment in determining the correct capitalization rate, the district court's order is affirmed.