



# Valuation Without Reliance on Market Value: The Nevada Experiment In Valuation Through Methodology

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Nevada has always marched to its own tune. From legalized gambling and prostitution to quickie divorces, Nevada has never been reluctant to take the road less traveled. Nevada's property tax system is one more example of its departure from what other states consider the norm.

Many states have followed the principle that market value is the benchmark for property taxation. Nevada has taken a different tact. The Nevada Supreme Court has noted,

"[v]aluation of property is an illusory matter upon which experts hold differences of opinion... ..There exists no mathematical formula to establish market value."<sup>1</sup>

Consequently, instead of establishing market value as a benchmark for property taxation, Nevada has found solace in methodology. In Nevada, it is rigid adherence to methodology that ensures uniform and equitable taxation.

The ascendancy of methodology over a traditional market value system began in 1981 with the Legislature's abandonment of the tie between market value and taxable value. The gulf between market value and taxable value has gradually widened, and the focus of property taxation has shifted to questions concerning methodology instead of value. This shift is evident in the Nevada Supreme Court decisions in *Imperial Palace, Inc. v State Department of Taxation*,<sup>2</sup> *State, Board of Equalization v. Bakst* and, most recently, *State, Board of Equalization v. Barta*.<sup>3</sup> This article examines the legislation which severed the tie between market value and

taxable value and the three decisions of the Nevada Supreme Court.

### The Tax Shift Legislation of 1981

In 1981, the Nevada Legislature revised the state's tax structure.<sup>4</sup> The legislation is commonly referred to as the "tax-shift legislation," because it replaced the state's reliance on property tax with an increased sales tax. However, the property tax remained the primary source of revenue for local government.

The tax-shift legislation was also intended to provide property tax relief to homeowners. The legislature sought to accomplish this, in part, by revising the statutory method for valuation of property. Prior to this legislation, land and improvements were taxed based on full cash value determined using standard appraisal approaches to valuation.<sup>5</sup> Taxable value was the same as full cash or market value.<sup>6</sup> The Legislature replaced this with a system that, for improved properties, severed the tie between taxable value and full cash value.

The system ushered in by the tax-shift legislation requires that the land and improvement components of an improved parcel be valued separately. The land component must be valued "consistently with the uses to which the improvements are being put."<sup>7</sup> In many instances, a taxable value based on value in use will be the same as full cash value based on highest and best use. But this equivalency will not occur in all instances.

The tax-shift legislation requires that improvements be valued at replacement cost, less depreciation. The determination of replacement cost is made using the cost manuals published by Marshall & Swift.<sup>8</sup> And, instead of a market-derived depreciation, the legislation requires that improvements be depreciated at the rate of 1.5% per year for fifty years.<sup>9</sup> The determination of replacement cost, less depreciation, determined in this manner, may be greater than or less than the full cash value of the improvements. Only by happenstance would replacement cost, less depreciation, equal the market value of the improvement.

4 The primary components of the legislation were contained in Assembly Bill 369, Chapter 149, 1981 Statutes of Nevada 285; Senate Bill 69, Chapter 427, 1981 Statutes of Nevada 786, and Senate Bill 411, Chapter 150, 1981 Statutes of Nevada 305.

5 See, 1977 Nev. Stat. 1318.

6 The term "full cash value" means "the most probable price which property would bring in a competitive and open market under all conditions requisite to a fair sale." Nev. Rev. Stat. 361.025. In this paper, the terms "full cash value" and "market value" are used interchangeably.

7 Nev. Rev. Stat. 361.227 1(a)(2).

8 Nev. Admin. Code 361.128.

9 Nev. Rev. Stat. 361.227 1(b).

1 *State, Board of Equalization v. Bakst*, 122 Nev. 1403, \_\_\_, 148 P. 3d 717, 723 (2006) (citing *Nevada Tax Commission v. Southwest Gas Corp.*, 88 Nev. 309, 497 P. 2d 308 (1972)).

2 108 Nev. 1060, 843 P. 2d 813 (1992).

3 124 Nev. Adv. Op. No. 58 (2008).

... continued on page 4

## Valuation Without Reliance on Market Value: The Nevada Experiment In Valuation Through Methodology

...continued from page 3

The tax-shift legislation moved Nevada away from full cash value as the benchmark for property taxation. Taxable value was no longer the same as full cash value.<sup>10</sup> Instead, full cash value became a ceiling that taxable value could not exceed.<sup>11</sup>

### The Valuation of Improvements: *Imperial Palace, Inc. v. State, Dept. of Taxation*

The Imperial Palace Hotel & Casino is located on South Las Vegas Boulevard, in the area commonly referred to as the Las Vegas Strip. In 1990, the property included a casino, a warehouse, a clubhouse, a motel, five hotel towers and a parking structure. The assessor valued these improvements based on their replacement cost new, less depreciation. However, the Imperial Palace had recently completed construction of several of these improvements and the actual construction costs were significantly less than the assessor's estimated replacement cost new, less depreciation. Consequently, the owner challenged the valuation of its improvements.

On appeal, the Imperial Palace did not challenge the valuation of the land or argue that the combined value of the land and improvements exceeded full cash value. Instead, the appeal only questioned the methodology used to determine the replacement cost of improvements. Imperial Palace argued that the actual cost of constructing the improvements should be used to determine replacement cost because it was more accurate and reliable than the estimated replacement cost developed by the assessor.

This dispute gave the Nevada Supreme Court an opportunity to address the relationship between taxable value and market value created by the tax-shift legislation. First, from a procedural perspective, the State argued that a taxpayer could not challenge taxable value unless it exceeded full cash value. Cases decided prior to the tax-shift legislation supported this argument.<sup>12</sup> Logically, if full cash value was the benchmark for property taxation, a court would not need to address a case unless the benchmark was exceeded. But, after the tax-shift legislation the same logic did not prevail, because full cash value was not the benchmark for determining the value of improvements. Consequently, the Court held a taxpayer could challenge a valuation which was incorrectly calculated, regardless of whether the erroneously calculated

value exceeds the full cash value. Resolution of the procedural issue cleared the way for the Court to address the substantive issue raised by the taxpayer: was it erroneous to use the Marshall & Swift cost manuals when the actual cost of construction was available?

The statute required that the improvements be valued at replacement cost, less depreciation. The assessor estimated the replacement cost using the cost manuals published by Marshall & Swift. The Court noted these manuals were based "on average construction costs of the typical buildings within the applicable classification." There was no assertion that the resulting value approximated Imperial Palace's "replacement cost," as that term is used in the appraisal community.<sup>13</sup>

The taxpayer argued that the most accurate information available should be used to determine the replacement cost. Here, the actual costs of construction were available. Consequently, Imperial Palace argued that the actual cost should trump the estimated replacement cost determined by the assessor using the Marshall & Swift cost manuals.

The Court was not persuaded by the taxpayer's argument. The Court noted that "an assessor's use of actual cost of replacement would cause unequal taxation."<sup>14</sup> The Legislature had delegated to the Nevada Tax Commission the responsibility of determining the standard to be used by the assessors to determine the replacement cost of the improvements. By regulation, the Tax Commission directed the assessors to use "the standards in the cost manuals, including modifiers of local costs, published through or furnished by the Marshall and Swift Publication Company."<sup>15</sup> The regulation only allowed assessors to deviate from the Marshall & Swift standards in very limited situations and the case before the Court was not one of them. The Court found the Tax Commission's interpretation of the statute reasonable and the Legislature's acquiescence a confirmation that the interpretation was consistent with legislative intent.

In reaching its decision in this case, the Court did not look at either *actual* replacement cost or market value methodology as a tool to reach a benchmark to uniform and equal treatment. Instead, the decision was premised on the primacy of methodology. Only the "Marshall and Swift calculator method ensures the uniform and equitable application of Nevada's taxing statutes."<sup>16</sup>

As a result of the tax-shift legislation and the *Imperial Palace* decision, challenges to the valuation of improvements focus

10 Compare Nev. Rev. Stat. 361.025 with Nev. Rev. Stat. 361.043.

11 Nev. Rev. Stat. 361.227 5.

12 See e.g., *State of Nevada v. Central Pacific Railroad Co.*, 7 Nev. 99 (1871) ("The first question necessary to be determined here is, whether there is a direct allegation that the property was assessed beyond its real and just value [...] for if there is no such allegation, it must be admitted at once there is no showing of injury[...]").

13 "Replacement cost is the estimated cost, as of the effective appraisal date, of a building with utility equivalent to the building being appraised, using contemporary materials, standards, design and layout." *The Appraisal of Real Estate*, p. 357 (12th ed. 2001).

14 108 Nev. at 1067, 843 P.2d at 818 (emphasis added).

15 Nev. Admin. Code 361.128.

16 108 Nev. at 1067, 843 P.2d 818.

on the Marshall & Swift cost manuals. The occupancy classification of a building or the subjective determination of whether it is low-cost, good, average or excellent, may now have more impact on its property tax than its actual cost of construction or its market value. Equalization is achieved, not by reference to *actual* replacement cost or full cash value, but by ensuring that the cost manuals of Marshall & Swift are applied in a uniform and consistent manner.

### **The Valuation of Land: *State, Board of Equalization v. Bakst***

Lake Tahoe is the largest alpine lake in the United States. It is located in the Sierra Nevada Mountains, on the border between Nevada and California. Lake Tahoe is home to some of the most expensive single family residences in Nevada. The valuation of those residences for property tax is the subject of *State, Board of Equalization v. Bakst*.

The plaintiffs in *Bakst* were homeowners at Lake Tahoe who challenged the methodologies used to value their properties for tax year 2003-04. Their "tax revolt" did not end with tax year 2003-04. Many of the same individuals were plaintiffs in *State, Board of Equalization v. Barta*. The *Barta* decision addresses the valuation of many of the same parcels for tax year 2004-05.

In Washoe County parcels are appraised once every five years. In the intervening years, a factor is applied to the prior year's taxable value in an attempt to reflect the general changes in the market. Tax year 2003-04 was a reappraisal year for those in Washoe County at Lake Tahoe.

To determine the land values at Lake Tahoe, the assessor's office used a sales comparison approach to valuation. However, the assessor's method of implementing this approach was later challenged by the taxpayers. The taxpayers' challenge focused on four "disputed methodologies."

First, there were a limited number of vacant lots that had sold. Contractors were buying older homes and removing the improvements to create home sites for new, larger homes. The assessor decided to use sales of these "teardowns" as comparable properties for the valuation of home sites.

Second, in analyzing the comparable properties, the assessor found that home sites with a view of Lake Tahoe sold at higher prices than home sites which did not have a view of the lake. The assessor, therefore, adjusted values to reflect the quality of the view from the parcels.

Third, in analyzing the comparable properties, the assessor found that home sites with frontage on Lake Tahoe sold at higher prices than parcels which did not have frontage on the lake. However, the amount of the premium that these home sites warranted varied depending on whether the lake frontage was a sandy beach or a rocky embankment. The assessor, therefore, adjusted values to reflect the differences in the lake frontage.

Fourth, in analyzing the comparable properties, the assessor found that prices had appreciated over time. He did a paired sales analysis to determine the amount of appreciation that had occurred. Based on this analysis, he adjusted values to reflect the appreciation that had occurred between the date the comparable property sold and the valuation date.

The taxpayers argued that the disputed methodologies were not authorized by statute or regulation. The statute requires that vacant land be assessed at full cash value and that improved land be assessed at full cash value "consistently with the uses to which the improvements are being put."<sup>17</sup> The Tax Commission, by regulation, directed that this be done using the sales comparison approach.<sup>18</sup> The regulation did not, however, specify the types of sales that should be used as comparable properties, the elements of comparison that should be considered in the sales comparison analysis or the manner of determining an appropriate adjustment. The taxpayers argued that, in the absence of statutory or regulatory guidance on these issues, the assessor was not authorized to fill the void by using the four disputed methodologies.

The assessor, on the other hand, relied on the regulation which authorized the use of the sales comparison approach. In implementing this approach, the assessor argued that he was justified in using "teardowns" as comparable sales because there were not sufficient sales of vacant land. Furthermore, he argued that the sales comparison approach anticipates that adjustments will be made for those elements of comparison that help explain the differences in the prices paid for the properties. At Lake Tahoe, the price paid for a property is influenced by view, lake frontage and the point in time that the purchase was made. Adjusting for these factors is a standard, generally accepted appraisal practice. The assessor argued that the use of the four disputed methodologies in implementing the sales comparison approach was an appropriate exercise of professional judgment and did not require, nor was it susceptible to, codification in a regulation.

The arguments framed the issue: in implementing a sales comparison approach, can an assessor use his professional judgment and follow generally accepted appraisal practices or does the assessor's use of those appraisal practices need to be authorized by a statute or regulation?

The analysis of the Nevada Supreme Court starts with the Nevada Constitution. Article 10, Section 1 states:

[T]he Legislature shall provide by law for a uniform and equal rate of assessment and taxation, and shall prescribe such regulations as shall secure a just valuation for taxation of all property, real, personal and possessory [...].

<sup>17</sup> Nev. Rev. Stat. 361.227 1.

<sup>18</sup> Nev. Admin. Code 361.118.

... continued on page 6

# Valuation Without Reliance on Market Value: The Nevada Experiment In Valuation Through Methodology

...continued from page 5

Similar language in the constitutions of other states has been interpreted as requiring that the taxpayer's property wealth, measured by a common standard such as market value, bear its proportionate share of the overall property tax burden.<sup>19</sup> In those states, uniform and equal treatment is achieved by adherence to a common standard, such as market value or full cash value; but a variety of methods could be used as tools to arrive at a value consistent with that standard.<sup>20</sup> Early decisions of the Nevada Supreme Court seemed to follow a similar rationale.<sup>21</sup> But, after the tax-shift legislation, it is not surprising that the Nevada Supreme Court found that this clause of "the Constitution clearly and unambiguously requires that the *methods* used for assessing taxes throughout the state must be 'uniform.'"<sup>22</sup>

The Nevada Supreme Court noted that the Tax Commission is the agency charged by the Legislature with the duty of establishing uniform regulations governing the assessment of property, but that the Tax Commission had failed to provide guidance on the disputed methodologies. In the absence of regulatory guidance, the county assessors were not justified in relying on generally accepted appraisal practices because there could be no guarantee that all assessors would apply the same appraisal practices. Consequently, the Court concluded that "the methodologies the assessor used are invalid and violated the Nevada Constitution because they were not consistent with the methods used throughout Washoe County [...] they were not the same as the methods used by assessors in other counties."<sup>23</sup>

The decision in *Bakst*, like the decision in *Imperial Palace*, is not premised on a discussion of value; but on methodology. Only by following the same methodology can the uniform and equal application of the tax laws be ensured.

It is unclear where the *Bakst* decision will lead. The disputed methodologies in this case are, to a large extent, accepted appraisal practices. For example, a market conditions adjustment to reflect appreciation or depreciation that has occurred since the date of sale is the type of adjustment one

would expect an appraiser to make.<sup>24</sup> However, this adjustment cannot be implemented by the assessors unless and until it is incorporated into a regulation. Can this requirement be satisfied by a regulation that simply lists "market conditions" as an element of comparison that an assessor can make an adjustment for? Or, does the regulation need to identify the types of changes in the market (i.e., appreciation) that can be considered when making an adjustment for market conditions? Furthermore, if an adjustment is warranted, the rationale of *Bakst* would suggest that the assessors should calculate the adjustment in a uniform and consistent manner. Consequently, there will probably need to be a regulation identifying the techniques that can be used to quantify the adjustment to be made and explaining how to use the techniques.

In *Bakst*, the assessor complained that "the type of mechanized, mathematical approach to appraisal demanded by the taxpayers was unheard of."<sup>25</sup> But, it appears that is what Nevada is moving toward: a more mechanical, mathematical approach to determining the taxable value of land.

## Full Cash Value Versus Methodology: *State, Board of Equalization*

The *Barta* case concerns many of the same taxpayers and same properties that were involved in the *Bakst* case. The only difference is that one year had passed.

The assessor had not reappraised the properties. Instead, the assessor had developed a factor based on an analysis of general market trends. This factor was applied to the previous year's values to calculate taxable values for the current tax year. But here, the previous year's values were found to be unconstitutional in *Bakst*. Simply applying a factor to adjust a value which was not constitutional did not cure the underlying problem. However, that did not end the case.

In *Barta* the State and County appellants raised an issue that was not addressed in *Bakst*. They argued that the assessment should not be vacated unless it exceeded full cash value. This argument was based on old case law which supported the proposition that a taxpayer is only harmed, and therefore entitled to appeal, if the taxable value assigned to his property is higher than full cash value.<sup>26</sup> This proposition has merit as long as full cash value is the standard used to judge whether a property has been over valued.

This argument was raised in *Imperial Palace*, but did not prevail. In that case, the valuation of improvements was at issue. Under the tax-shift legislation, the standard for valuing improvements is replacement cost, not full cash value. Con-

19 See e.g., *Boehm v. Town of St. John*, 1996 WL 732284 (Ind. 1996).  
20 *Id.*

21 See, e.g., *Goldfield Consolidated Co. v. State*, 35 Nev. 178, 127 p. 77 (1912) ("a basic principle of property taxation is that it should be uniform and equal, regardless of the method adopted to arrive at the result"); *Sawyer v. Dooley*, 21 Nev. 390, 32 P. 437 (1893) ("all that is required is a uniformity of taxes, and not a uniformity in the manner of assessing or collecting them").

22 122 Nev. at \_\_\_, 148 P. 3d at 724 (emphasis added).

23 122 Nev. at \_\_\_, 148 P. 3d at 726.

24 *The Appraisal of Real Estate*, p. 434 (12th ed. 2001).

25 122 Nev. 1403 at \_\_\_, 148 P. 3d at 720.

26 See, *State v. Wells Fargo & Co.*, 38 Nev. 505, 150 P. 836 (1915); *State of Nevada v. Central Pacific Railroad Co.*, 10 Nev. 47 (1875); *State of Nevada v. Central Pacific Railroad Co.*, 7 Nev. 99 (1871).

sequently, the logic of limiting appeals to situations where the taxable value exceeded full cash value did not apply.

The standard for valuing home sites at Lake Tahoe is full cash value.<sup>27</sup> The plaintiffs in *Barta* admitted that the taxable value of their properties did not exceed their full cash value. Consequently, it would seem that the logic of the old cases would apply in this situation. The Nevada Supreme Court, however, did not agree.

In *Bakst*, the court had held that the Constitution "clearly and unambiguously requires that the *methods* used for assessing taxes throughout the state must be 'uniform.'"<sup>28</sup> This rule requires assessors "to apply only those valuation methodologies set forth in regulations adopted by the tax commission for use throughout the state."<sup>29</sup> Application of the approved methodology is not a determination of the property's actual full cash value, just as the application of the Marshall & Swift cost manuals is not producing an *actual* replacement cost. Deviation from the approved methodologies deprives taxpayers of their right to a uniform and equal rate of assessment and taxation.

At one time, the boards of equalization were required to equalize property values based at full cash value,<sup>30</sup> but with the tax-shift legislation, the standard for equalization changed from full cash value to taxable value.<sup>31</sup> Taxable value is determined using the approved methodologies. Now, a deviation from the approved methodologies is just as egregious as a value in excess of full cash value was prior to 1981. This is particularly true when "the nonuniform methods cause the unequal taxation of an entire assessment group."<sup>32</sup> Consequently, the Court reversed the prior cases to the extent they suggest a taxpayer cannot contest an inequity in valuation arising from the use of an unauthorized methodology when the value of the property is less than full cash value.

The decision in *Barta*, like the decisions in *Imperial Palace* and *Bakst*, is a testament to the ascendancy of methodology. By reversing the prior precedent, the Court clearly provided taxpayers a remedy to challenge the methodology employed to determine value, regardless of whether that value is greater than or less than full cash value. A taxpayer does not need to present evidence of a value; the taxpayer need only show that there is an error in methodology.

27 Nev. Rev. Stat. 361.227 establishes two standards for the valuation of land. Vacant land is to be valued at full cash value based on its highest and best use. Improved land is to be valued at full cash value considering the use to which it is put. In the *Barta* case, a home site's value in use is probably the same as its full cash value.

28 122 Nev. at \_\_\_, 148 P. 3d 724 (emphasis added).

29 124 Nev. Adv. Op. No. 58, at \_\_\_.

30 Atty. Gen Op. 80-34 (Oct. 10, 1980).

31 Compare 361.345 and 361.395 before and after 1981.

32 124 Nev. Adv. Op. No. 58 at \_\_\_.

## Conclusion

In 1988 the Nevada Legislature commissioned a study of the fiscal affairs of its state and local governments. This included an examination of the property tax system. In the study, the failure to tie taxable value to market value was cited as a major feature that the Legislature should examine for possible change. The study noted,

When the common tie between market value and assessed value is abandoned, the property tax essentially abandons its underlying theory. The tax ceases to be a tax on some objective measure of value (of accumulated wealth) and becomes, instead, a somewhat arbitrary collection of exactions based on age and the like.<sup>33</sup>

The Legislature did not take action on the recommendation. Instead, Nevada has moved further toward a property tax system based on "a somewhat arbitrary collection of exactions."

Nonetheless, the property tax system can be navigated by the taxpayer and the "somewhat arbitrary nature of the exactions" actually increases the opportunities for tax relief. The mechanical calculation of replacement cost improvements can be examined and challenged, regardless of the improvements' actual replacement cost. Similarly, the methodology used to determine the taxable value of land can be examined and challenged, regardless of the land's actual full cash value. And, failing the use of these approaches, a taxpayer can always challenge the valuation of his property if it exceeds full cash value.

33 A Fiscal Agenda For Nevada, Robert D. Ebel, ed. (Univ. of Nevada Press 1990).