

Memorandum

To: Honorable Jerome E. Horton, Chairman
Honorable Michelle Steel, Vice Chair
Honorable Betty T. Yee, First District
Senator George Runner, Second District
Honorable John Chiang, State Controller

Date: April 9, 2013

From: Randy Ferris 
Chief Counsel

Subject: **Other Chief Counsel Matters – April 24-25, 2013**
Item Number ___ - Request for Authorization to File *Amicus Curiae* Brief

EHP Glendale, LLC, and Eagle Hospitality Properties Trust, Inc. v. County of Los Angeles
Court of Appeal, Second Appellate District, Div. Eight, Case No. B 244494
(Los Angeles County Superior Court Case No. BC 385925)

BOARD APPROVAL REQUESTED TO FILE AMICUS BRIEF

The purpose of this memorandum is to request Board authorization for the Legal Department to file a neutral *amicus curiae* brief in the above appeal involving the local property tax valuation of a hotel property in Los Angeles County in order to explain and clarify the Board's interpretation of Property Tax Rule 8, *The Income Approach to Value*, as discussed in Assessors' Handbook 502, *Advanced Appraisal* (AH 502). Currently, based on the parties' briefing schedule, all amicus briefs in this case must be filed no later than April 22, 2013. The Board has requested an extension of the filing deadline to May 15, 2013, which is under review and consideration by the court.

In their challenge to the Los Angeles County Assessor's valuation of the hotel property using the income method, one issue raised by the taxpayers is how certain intangible assets and rights should be removed from the appraisal unit. The taxpayers appealed the trial court judgment in favor of Los Angeles County, arguing that the assessor's valuation approach improperly included intangible assets in direct violation of the Board's guidance as provided in AH 502.

In this action the parties, in their respective appellate briefs, have addressed the treatment of intangible assets and rights in the income valuation methodology as discussed in AH 502. (See attached: Appellants' Opening Brief, pp. 39-42; Respondent's Brief, pp. 23-28.) Specifically, in support of their positions, the taxpayers quote and discuss this language found on page 162 of AH 502:

The value of intangible assets and rights cannot be removed by merely deducting the related expenses from the income stream to be capitalized. Allowing a deduction for the associated expense does not allow for a return on the capital expenditure. For example, allowing the deduction of wages paid to a skilled work force does not remove the value of the work force in place from the income indicator, because the amount of the wages paid does not necessarily represent a return of and on the work force in place, and further bears no relationship to the costs associated with locating, interviewing, training and otherwise acquiring the work force. Similarly, the deduction of a management fee from the income stream of a hotel does not recognize or remove the value attributable to the business enterprise that operates the hotel.

We note that Los Angeles County contends that AH 502 contains a "*flawed assumption*" and that "[t]he problem with the SBE's guidance in this regard is that it is *entirely arbitrary and unsupported*." (Respondent's Brief, pp. 25, 27 [italics added].) It is this language that the Legal Department believes merits a Board response and explanation so as to explain and clarify the complained-of guidance for the Court of Appeal.

If approval is granted to file an amicus brief, the Legal Department will explain to the court that the quoted AH 502 language, in context, is consistent with the governing statutes, regulations, and case law. Specifically, it is Property Tax Rule 8, subdivision (e), which most directly provides the needed background and context for the provision in question:

Recently derived income and recently negotiated rents or royalties (plus any taxes paid on the property by the lessee) of the subject property and comparable properties should be used in estimating the future income if, in the opinion of the appraiser, they are reasonably indicative of the income the property will produce in its highest and best use under prudent management. Income derived from rental of properties is preferred to income derived from their operation since income derived from operation is the more likely to be influenced by managerial skills and may arise in part from nontaxable property or other sources. *When income from operating a property is used, sufficient income shall be excluded to provide a return on working capital and other nontaxable operating assets and to compensate unpaid or underpaid management.* (Italics added.)

Property Tax Rule 21, subdivision (e)(3)(C), while pertaining only to possessory interests, nevertheless is consistent with Rule 8, providing, in relevant part, that:

When valuing a taxable possessory interest using operating income, allowed expenses include the following: cost of goods sold (if applicable), typical operating expenses, typical management expense, an allowance for a return on working capital, and *an allowance for a return on the value of any nontaxable property that contributes to the gross operating income.* (Italics added.)

The amicus brief also will advise the Court of Appeal as to the legal significance of Board property tax valuation advice contained in an administratively approved handbook. While the advice contained in such a Board publication is not binding on the courts, and does not have the force and effect of law, such advice nevertheless is entitled to due deference by the courts as a legal interpretation by the agency charged with administration and enforcement responsibilities with respect to the tax statutes in question. (See *Yamaha Corp. v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 10-13 [an agency's interpretation of statute is granted some judicial deference, but carries less weight than quasi-legislative rules].)

Nevertheless, it is also true that such administrative advice is subject to statutes and Board regulations, and should be interpreted in a manner consistent with them. The explanations provided in this amicus brief will be in harmony with the relevant statutes, regulations and case law. The explanations will also be consistent with the positions advanced by the Legal Department on the Board's behalf in legal briefs filed in judicial actions.

For example, at pages 23-24 of its answering brief in the California Supreme Court in *Elk Hills Power, LLC v. Board of Equalization*, the Board's attorneys discussed the distinction between, on the one hand, government permits which authorize the construction and operation of real property, and on the other, so-called business or enterprise values that may contribute to the income stream, such as superior management skills and valuable trade names:

For example, Elk Hills mistakenly relies on *Shubat v. Sutter County Assessment Appeals Board* (1993) 13 Cal.App.4th 794. *Shubat* distinguished between intangibles such as zoning, which are related to property, and business "enterprise value," which results from such things as a valuable trade name or the superior business skills of the owner and is not related to the right to use the property at highest and best value. . . . Unlike "enterprise value," intangibles that have been held not to relate to taxable property, such as exceptional management skills, superior work force or a franchise "right to do business," the deployed ERCs are a requisite part of the authorization for the construction and operation of the tangible power plant itself.

Thus, with respect to operating properties, while there is no requirement under Rule 8 to make a deduction from the income stream on account of "management" that is merely prudent, and not "unpaid or underpaid," the rule is clear that if such a deduction is necessary, then it must include an allowance for a return on the value of the nontaxable asset that has so contributed to the gross operating income to be capitalized. (Property Tax Rule 8, subd. (e).)

Finally, the positions expressed by the Board in the amicus brief will not be intended to expressly or directly support either the taxpayers or the County of Los Angeles in the appeal, but instead will be offered only for the purpose of clarifying the meaning and context of the above-quoted handbook statements in light of the governing statutes, regulations and case law.

For the above reasons, the Legal Department requests that the Board approve the Legal Department's request to file a neutral amicus brief in this local property tax judicial appeal for the dual purposes of informing the court of the significance of Board's handbooks and explaining the meaning and context of the language criticized by the county defendant and respondent in the Court of Appeal.

Should you require additional information or have any questions, please contact Assistant Chief Counsel Robert Lambert at (916) 324-6593 or Tax Counsel IV Richard Moon at (949) 440-3486.

Approved:


Cynthia Bridges
Executive Director

RF:bk

Attachments: Attachment 1 Respondent's Brief, pages 23-28
Attachment 2 Appellants' Opening Brief, pages 39-42

cc:	Ms. Cynthia Bridges	MIC: 73
	Mr. David Gau	MIC: 63
	Mr. Dean Kinnee	MIC: 64
	Mr. Robert Lambert	MIC: 82
	Mr. Robert Tucker	MIC: 82
	Mr. Richard Moon	MIC: 82
	Mr. Daniel Paul	MIC: 82

Attachment 1

Respondent's Brief, pages 23-28

former management and franchise with Red Lion. (AR [vol. X], 1802; cf. *Cal. Portland Cement Co. v. SBE* (1967) 67 Cal.2d 578, 584-585)

iii. The Excerpt of AH 502 that Appellants would Embrace is Unjustified and Should be Given Little or No Weight.

Respondent County recognizes and considers the weight of Assessors' Handbooks published by the California State Board of Equalization in discharging its duties, but ultimately must square its assessments with the requirements of law. Assessors' Handbooks are not law. The SBE itself describes the role of its handbooks this way:

Informal Guidance

Assessors' Handbook and Other Board-Approved Publications

The Assessors' Handbook is a collection of manuals or sections adopted and published by the Board of Equalization. The manuals address property tax appraisal and assessment practices. Other publications address assessment appeals boards and other matters. Prior to adoption, each manual undergoes a process whereby interested parties participate in drafting the language, and interested parties are afforded an opportunity to submit written comments or to address the Board during a public hearing regarding the final language.

The Assessors' Handbook and other Board-approved publications do not have the force of law. Instead, they provide advisory notice to county assessors and appeals boards of the Board's interpretation, analyses, conclusions, and recommendations concerning problems of general concern, and often document court decisions, legislative enactments, or other legal and policy information. While Board-adopted publications are advisory only, courts have held that they may be properly considered as evidence in the adjudicatory process. [Fn., citing *Coca-Cola Co. v. State Board of Equalization* (1945) 25 Cal.2d 918; *Prudential Ins. Co. v. City and County of San Francisco* (1987) 191 Cal.App.3d 1142; *Hunt-Wesson Foods, Inc. v. County of Alameda* (1974) 41 Cal.App.3d 163.]

([SBE's] Letter to Assessor 2003/039, dated May 29, 2003, "Hierarchy of Property Tax Authorities," pp. 4-5, available at: <http://www.boe.ca.gov/proptaxes/pdf/lta03039.pdf>.)

The County in the first round of appellate briefing at AOB, pp. 45-48, previously addressed the so-called SBE Guidelines relied on by Appellants. Appellants in their latest brief again quote approvingly from Assessors' Handbook 502, Advanced Appraisal, p. 162:

The value of intangible assets and rights cannot be removed by merely deducting the related expenses from the income stream to be capitalized. Allowing a deduction for the associated expense does not allow for a return on the capital expenditure. For example, allowing the deduction of wages paid to a skilled work force does not remove the value of the work force in place from the income indicator, because the amount of the wages paid does not necessarily represent a return of and on the work force in place, and further bears no relationship to the costs associated with locating, interviewing, training and otherwise acquiring the work force. Similarly, the deduction of a management fee from the income stream of a hotel does not recognize or remove the value attributable to the business enterprise that operates the hotel."

(AOB, p. 40.)

A flawed assumption implicit in the above quote from the SBE is that a management expense (or any expense) results invariably in a positive "return on" the expense that should be recognized in addition to the amount of the expense itself and allocated as a charge against revenue. Competent management is a necessary prerequisite to tangible property being put to a

beneficial use, and the ordinary and non-controversial expenses routinely charged against a property's revenue such as the expense of gardening, janitorial and plumbing services aren't provided yet an additional "premium" on their claim against the revenue of the property being appraised. These services are properly accounted for by their market price and are ordinary and necessary expenses incurred to put the property to beneficial and productive use. (See Rev. & Tax. Section 110(e).) Where management is simply competent management, the appropriate additional "return on" the intangible of management services should be zero. In fact, in the case of bad management, the management agreement – despite the expense incurred for such management services – could actually result in the hotel losing money. Therefore, the amount to account for the "return on" management may actually be a negative amount. In the case of a negative return on an expense the Assessor may actually be required to disallow some of the claimed expense as overstated or to impute added income to arrive at a market value that would reflect a competently managed hotel. (Cf. *Dennis v. Santa Clara County* (1989) 215 Cal.App.3d 1019, 1029-1030 [below market contract rents that are not reflective of economic rent are not to be used to value property.])

The County further incorporates verbatim its previous briefing on this issue, from its AOB in B217036, pp. 47-48:

"The problem with the SBE's guidance in this regard is that it is entirely arbitrary and unsupported. Appraisal principles provide that if an investor purchases a capital asset with a limited life, then the return that the asset produces is attributable to both a return on the investment, and a return of investment. This is because the asset is deemed to wear out over time, and therefore must provide as part of its total return, a return of the investment to recapture the asset value lost because of depreciation. (6 AA 1547-1548 [tab 57]; 7 AA 1750 [tab 68].) Therefore, the discount rate for such an asset has embedded within it components for both "return on" and "return of" investment. (6 AA 1541:17-1548; see also Bogdanski, Federal Tax Valuation (Warren, Gorham & Lamont), § 3.05[5][c], pp. 3-76 – 77.)

"Regarding the value of an assembled workforce, once the workforce is initially assembled, it is maintained over time as employees come and go through the hiring efforts of the organization's human resources department. This staffing cost of an organization is reflected and accounted for in its income statement.

"The last sentence of the foregoing quoted text from the Assessors' Handbook is equally unsatisfying. Management companies earn fees that represent the cost of their services to manage an asset. The SBE appears to

say that deducting the fee required for the management of a hotel from an income statement does not adequately recognize or remove the value attributable to this management service? Why not? This is exactly how an intangible service, such as property management, is priced in the marketplace and is taken into account by prospective purchasers and appraisers. (CCA, ex. 3, 15 ["base management fee"]; ex. 7, 52 ["base management fee", "incentive management fee".])

"Moreover, Plaintiff EHP Trust is required by law to receive its earnings in the form of passive income substantially derived from real estate [1960-2 C.B. 819, 820 ("... This bill restricts the "pass through" of income for tax purposes to what is clearly passive income from real estate investments, as contrasted to income from the active operation of businesses involving real estate."); 26 CFR 1.856-4(a).] In what sense can the fee that it agrees to pay for the management of its property not reflect the market value of those services?!

3. Appellants' Attempt to Reargue Whether the Assessor Applied a Valid Appraisal Method is Barred by Law of the Case

Plaintiffs' opening brief seeks to reargue whether the income approach applied by the Assessor was a valid appraisal method. This Court decided the question in its 2011 opinion, and the issue is now settled.

Attachment 2

Appellants' Opening Brief, pages 39-42

The mere fact that an assessor makes an assertion or expresses an opinion is not “substantial evidence.” If this were so, then the assessor’s opinion that he had accounted for enforceable restrictions in *Dominguez, supra*, would have sustained that assessment, even though the deduction amounted to only pennies on the dollar and delaying recognition of the mandated site-clean up costs defied common sense and was based solely on the assessor’s bare assertion. If an assessor’s bare assertion was sufficient to support an assessment appeals decision, then the San Francisco assessor’s contention that he had accounted for depreciation on the subject property as in *Bret Harte, supra*, would have supported the assessment even though the assessor there used the arbitrary assumption that all buildings in San Francisco were half depreciated and so gave the subject a 50% depreciation adjustment so there was no need to actually ascertain a property’s true depreciation. If an assessor could just state that he had removed the value of intangible assets by using the income approach as did the appraiser in *GTE Sprint*, then there would have been no basis to invalidate that method. Accepting bare contention in disregard of the plain facts eliminates fact-based taxation.

c. The Assessor’s technique or method violated SBE Guidelines.

The SBE developed and published guidelines for the segregation of assessable property from non-assessable intangible assets in its AH-502, “Advanced Appraisal” (December 1998) Chapter 6, pages 150 to 165.⁶⁷ AH-502 was noted by this Court at *EHP Glendale, supra*, 193 Cal.App.4th at 268, fn. 4.

⁶⁷ This portion of AH-502 was marked as Exhibit “J” to EHP’s appendix of exhibits supporting its motion for summary judgment. (II-PAA-336-353.)

The SBE *expressly* disapproved of the method Mr. House used to supposedly remove the value of intangible assets. The SBE advises in pertinent part that:

The value of intangible assets and rights cannot be removed by merely deducting the related expenses from the income stream to be capitalized. Allowing a deduction for the associated expense does not allow for a return on the capital expenditure. For example, allowing the deduction of wages paid to a skilled work force does not remove the value of the work force in place from the income indicator, because the amount of the wages paid does not necessarily represent a return of and on the work force in place, and further bears no relationship to the costs associated with locating, interviewing, training and otherwise acquiring the work force. Similarly, the deduction of a management fee from the income stream of a hotel does not recognize or remove the value attributable to the business enterprise that operates the hotel.

(AH-502 at p. 162.) The *Assessors' Handbook* recommends that the intangible assets be separately identified and valued and then deducted from the business enterprise value to establish the value of the taxable assets. (*Id.* at pp. 156, 158.)

The SBE adopted AH-502 (including its guidance on the treatment of intangibles for property tax purposes) pursuant to the authority granted the SBE to prescribe rules, regulations and instructions promoting uniform assessment practices. (Gov. Code, § 15606(c)-(g).) The SBE's Handbooks have been relied upon by the courts in interpreting valuation questions and have been accorded great weight in that regard. (*Watson Cogeneration Co. v. County of Los Angeles* (2002) 98 Cal.App.4th 1066, 1070-1071 (relying upon portion of AH-502 dealing with intangibles); *Exxon Mobil Corp. v.*

County of Santa Barbara (2001) 92 Cal.App.4th 1347, 1353, 1356 (Court of Appeal relied upon *Assessors' Handbook* Section 502); *Hunt-Wesson Foods, Inc. v. Alameda County* (1974) 41 Cal.App.3d 163, 180 (proper for trial court to consider *Assessors' Handbook* when method of valuation is at issue.)

The trial court rejected consideration of the *Assessors' Handbook* because it “is a guide and is not binding on the assessor or local assessors’ appeals boards.”⁶⁸ The trial court’s dismissal of the *Handbook* was incorrect in two respects. First, the *Handbook* summarizes the law. The requirement to separately identify, value and remove the intangible assets, as distinct from merely enrolling the income indicator without further adjustment, derives directly from case law. “[T]he Board’s appraisers are required by law to identify and value intangible assets, if any, and exclude these values from the appraisal of the taxpayer’s property [W]here the types of intangible assets identified by Sprint may reasonably be said to exist, the Board must exclude their values when assessing the tangible property for taxation.” (*GTE Sprint, supra*, 26 Cal.App.4th at 999-1000, 1003, 1007.) The mere fact that the SBE includes material derived from case law in its *Handbook* does not render the underlying law a mere “guide,” nor does the trial court thereby gain the discretion to ignore the underlying law. The trial court does not find the *Handbook* to wrongly state the law or to be otherwise unreliable. The trial court offers no rationale for ignoring the *Handbook* at all. The trial court’s decision boils down to “I can ignore it and so I will,” without explanation.

The second reason the trial court erred by ignoring the *Handbook* is that its guidance made sense under a reasonable consideration of the record.

⁶⁸ V-AA-1258:6 [Judgment].

The Assessor's employee testified that the income approach he used to account for intangible assets, a method that violated case authority and the *Handbook*, developed a value conclusion that equaled the purchase price that included intangible assets. This absurd testimony demonstrates that the so-called "Rushmore Method" does not work. It does not segregate intangible assets.

Thus, the record demonstrates that *Mr. House's testimony unintentionally corroborated the validity of the Handbook* (i.e., just removing expenses does not account for or remove the value of intangible assets from assessment). The trial court does not identify any reason or fact which supports disregarding the SBE's authoritative guidance.

C. **The Board's Decision Was Incomplete as a Matter of Law.**

In *Farr v. County of Nevada*, the Supreme Court held that for an assessment appeals board's findings to be sufficient:

"[T]he record must show the Assessor's explanation for making or not making such adjustments so that the Board may have an evidentiary basis for its consideration.) [Citations.]

Second, the Board's written findings of fact (Rev. & Tax.Code, § 1611.5) should include all legally relevant subconclusions supportive of its ultimate decision so that a reviewing court is able to trace and adequately examine the Board's mode of analysis. [Citations.] While it is not necessary for the findings to cover every evidentiary matter, the Board should address specifically its reasoning for accepting or rejecting each issue raised by the parties. [Citation.]

(*Farr v. County of Nevada* (2010) 187 Cal.App.4th 669, 686.)