MARKS PANETH REAL ESTATE ADVISOR JUNE 2015:

COMMERCIAL PROPERTY TAX ASSESSMENTS

Court of Appeals Weighs In

Property taxes often represent a significant chunk of an owner's annual expenses. Yet many taxpayers simply accept the billed amounts calculated by their assessors. But that might not be wise, as a recent case in California illustrates. In *SHC Half Moon Bay, Inc. v. County of San Mateo,* the California Court of Appeals, applying property tax laws similar to those in some other jurisdictions, found that a county's assessment improperly inflated a hotel's value — in turn improperly increasing the hotel's property taxes.

Hotel Owner Challenges Property Tax

In 2004, SHC Half Moon Bay ("SHC") purchased the Ritz-Carlton Half Moon Bay Hotel for about $124 million. The purchase price included real and personal property (furniture, fixtures and equipment), as well as intangible assets and rights. As part of its income valuation approach, the San Mateo County assessor assessed the hotel at its purchase price and deducted the value of personal property. It ultimately reached a total value of about $117 million for the property.

SHC challenged the property tax assessment, asserting that it erroneously included over $16 million in nontaxable intangible assets — specifically, the hotel's assembled workforce, its leasehold interest in the employee parking lot, agreement with the golf course operator and goodwill. It argued that simply deducting the hotel's management and franchise fee of $1.6 million wasn't in accordance with state law. Instead, SHC contended, the assessor was required to identify, value and exclude the value of the intangible assets from the assessment calculation.

The county Assessment Appeals Board upheld the assessment. SHC then sued for a property tax refund, but the trial court also sided with the county. SHC appealed.

Court Sides with Owner

The Court of Appeals began its review by noting that California law mandates that the quantifiable fair market value of intangible assets that directly enhance a property's income stream — such as goodwill, customer base and favorable franchise terms or operation contracts — be deducted from an income stream analysis prior to taxation. (Many county laws similarly provide that property tax valuations should be based on the value of the real estate only.)

The court concluded that the assessor's deduction of the management and franchise fee from the hotel's projected revenue stream didn't account for and exclude intangible assets. The court pointed out that the assessor's own expert had conceded to the Assessment Appeals Board that the assessor's methodology didn't exclude all intangible assets and rights.

The expert's report stated that only "the majority of the property's business value" was removed by deduction of the franchise and management fees. The report also acknowledged that the capitalized value of necessary preopening expenses (for example, the cost of assembling and training a workforce,

preopening marketing expenses and working capital) is frequently deducted as an intangible asset of a hotel.

According to the court, the expert's report and testimony demonstrated that the assessor's methodology failed to attribute a portion of the hotel's income stream to the enterprise activity that was directly attributable to the value of the intangible assets and deduct that value prior to assessment. Therefore, the methodology was "legally incorrect."

The Appeals Court did, however, uphold the Assessment Appeals Board's finding that the fee largely captured the goodwill. Although there may be situations where a taxpayer can establish that the deduction of a management and franchise fee doesn't capture goodwill, it said, SHC failed to do so here.

Appeal Leads to Savings

As a result of the appellate court's ruling, the assessor was required to recalculate the value of the property, applying the income method consistently with the court's findings. In other words, it will have to exclude the value of the hotel's assembled workforce, leasehold interest in the employee parking lot and agreement with the golf course operator. This change in assessment should produce substantial tax savings.

SHOULD YOU CHALLENGE YOUR PROPERTY TAXES?

Unlike the property taxes at issue in *SHC Half Moon Bay* (see main article), which were the result of an individually tailored assessment, property taxes are often based on estimates derived from mass appraisal techniques. These techniques might prove accurate overall, but the individual estimates don't necessarily reflect specific properties' characteristics.

So don't just blindly pay your tax bill. Take a close look at the factors that were applied to your property and determine whether they actually do apply. For example, you might find errors in the property description, such as square footage, age, condition and construction materials. To contest an assessment, you can present testimony from a professional appraisal, financial data for the property (such as income and cash flow statements), current leases and assessments for similar properties.

If you decide to appeal your assessment, pay attention to the relevant jurisdiction's deadlines. While some jurisdictions have a "rolling" appeals process, many observe strict deadlines.

TAX COURT DISALLOWS PROPERTY OWNER'S BAD DEBT DEDUCTION

A long-time real estate investor who also made occasional loans has learned the hard way about what does — and doesn't — qualify as deductible business bad debt. In ruling that the taxpayer couldn't deduct about $153,000 in uncollected debt, the U.S. Tax Court in *Langert v. Commissioner* clearly explained the requirements that must be satisfied before a taxpayer can claim a bad debt deduction.

Property Loan Goes Bad

The taxpayer had been involved for about 30 years in one or more activities involving real property, including buying, selling and renting real property and providing management services. During that period, the taxpayer made six loans, but he never advertised himself as a moneylender or kept a separate office or separate books and records relating to any of the loans.

In 2003, the taxpayer/lender transferred about $157,000 to an individual to help finance the purchase of some property. The individual and his mother signed a document titled "Unsecured Note." They weren't required to provide collateral. The taxpayer never checked the debtor's credit ratings and didn't require any financial statements or other pertinent financial information.

After making 28 monthly payments, the debtor defaulted on the loan. The taxpayer/lender asked him orally, not in writing, to pay the outstanding debt. He didn't ask the debtor's mother to pay the debt, nor did he pursue any legal remedy for the default. When the debtor filed for bankruptcy, the taxpayer didn't file a claim for the debt with the court. He also didn't contact the foreclosure trustee or file a claim when the property went into a foreclosure auction.

The taxpayer claimed a deduction for his loss on Schedule C ("Profit or Loss From Business") of his 2009 tax return. The IRS subsequently issued the taxpayer a notice of deficiency that disallowed the deduction.

Court Nixes Deduction

In Tax Court, the taxpayer claimed he was entitled to a deduction for a "business bad debt" because he had made the loan for the sole purpose of obtaining interest income. As the court noted, for all or a portion of a debt to be deductible as a bad debt, the debt must, among other things, constitute 1) a debt created or acquired in connection with a trade or business or 2) a debt from which the loss is incurred in the taxpayer's trade or business.

The mere fact that a taxpayer makes a loan solely to obtain interest income, the court said, doesn't on its own lead to a finding that the loan is deductible. Moreover, for a taxpayer to be entitled to a bad debt deduction in connection with the trade or business of lending money, the debt must have been sustained in the course of loan-making activity that was so "extensive and continuous as to elevate that activity to the status of a separate business."

The court found that making six loans over 30 years, during which the taxpayer conducted real property activities, didn't elevate the loan activity to the status of a separate business. In support, it cited a previous case where the court found that making eight or nine loans over four years didn't elevate the activity to separate business status.

The Tax Implications

As the court pointed out in its ruling, under typical circumstances the taxpayer would be able to treat the bad debt as a capital loss. In such situations, the deduction is subject to the strict annual limit of $3,000 in net capital losses.

HOW CAN YOU BENEFIT FROM CARBON CREDITS

As more building owners have begun to explore the advantages of pursuing energy-efficient or "green" initiatives in their properties, some might wonder how carbon credits come into play. Although these credits have received a lot of attention over the past decade or so, many business owners don't understand how they work and how they can benefit owners.

How the Credit Works

Carbon credits are generally earned by offsetting carbon dioxide (CO_2) emissions through conservation, alternative energy and other technologies. A single carbon credit represents a metric ton of CO_2 or CO_2-equivalent gases removed or reduced from the atmosphere.

The credits represent transferable rights to emit greenhouse gases and can be traded (or sold) on voluntary and “compliance” carbon markets. Compliance markets include legally binding mandatory emission-trading mechanisms established under, for example, the Kyoto Protocol. Regional compliance markets can also be found in areas of the United States and Australia.

Businesses purchase the credits to offset their own emissions, whether to meet their corporate social responsibility goals or external carbon reduction goals. Increasing numbers of companies are experiencing stakeholder pressure to improve their emissions.

To earn credits, a property owner would first need to set verifiable audit baselines through an investment-grade audit (a type of audit used to justify investment in a capital-intensive energy-efficient initiative). The audit would identify opportunities to improve energy efficiency and generate credits that can be traded on a market. Such opportunities can range from behavioral changes, such as powering down computers overnight, to capital projects, such as installation of solar panels. Credits generated in the United States typically can be traded domestically or abroad.

Benefits of Carbon Credits

Carbon credits produce favorable financial results on several fronts. A building with energy-efficient features will obviously reap savings on energy costs and could trigger tax breaks. That, in turn, would reduce operating expenses while increasing net operating income and internal rates of return. Increasingly, such buildings come with a competitive edge, as growing numbers of potential tenants consider sustainability when selecting their spaces. Moreover, trading or selling credits on a voluntary or compliance market provides an owner with additional revenues.

Win-win?

Carbon markets aren’t yet commonplace, and an eventual mandatory cap-and-trade system in the United States isn’t a given. But the bottom-line benefits of energy-efficient efforts have been clear for some time now, and the potential of carbon credits to build revenues can be a bonus.

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