Real Property Law REPORTER

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Kenneth Baar

Approximately 100 jurisdictions in the state have mobilehome park space rent control ordinances. It is unquestioned that under these ordinances park owners have a constitutional right to a fair return. However, guiding judicial precedent as to what constitutes a fair return is often contradictory and/or so theoretical as to provide no real guidance. The author describes the basic judicial doctrines in this area and explains why one particular type of approach is workable while the other common approaches are conceptually flawed and unworkable. This approach, maintenance of net operating income (MNOI), defines fair return as the pre-rent control net operating income adjusted by the CPI.

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CONTINUING EDUCATION OF THE BAR ▪ CALIFORNIA

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The government argued that Kenney's $83,413 should be taken from the total net proceeds, leaving a balance to divide between Kenney and Donna, of which Donna's half ($111,915.50) would be available to satisfy the liens. The government contended that because equitable subrogation only allowed Kenney to stand in the shoes of the lenders, he should be paid from the net proceeds as a lender, before his and Donna's shares were divided.

The government's method would have forced Kenney to take his subrogation award from proceeds in which he had a half interest, effectively forcing him to pay for half of the amount to which he was entitled. Several California cases established that Kenney should be credited from the total net proceeds for all the principal and interest payments that he made ($166,826) before the balance was equally divided.

The district court reached the correct result in its calculation, but it erred in giving the government all of the escrow interest on Donna's share of the net proceeds. Kenney's award of $83,413 was 54 percent of the $153,622 in controversy, so he should have received 54 percent of the escrow interest on the $153,622.

The district court did not abuse its discretion in denying interest on the payments Kenney made for Donna. It was free to consider that Kenney's payments on Donna's behalf enabled him to protect his own half interest in property, and that the property had appreciated.

THE EDITOR'S TAKE: Kenney had three theories to support his claim that his payment of Donna's share of the mortgage should give him priority over the tax liens held by the government, but only the weakest one worked.

The best theory (*i.e.,* best for him) was "diminishing interest"—that half of every payment he made on their joint mortgage worked a partial, proportional transfer of Donna's equity in the security. (He might have made that theory even more lucrative by claiming only half the payments on the first mortgage, but 100 percent of his payments on the second mortgage, because those funds went entirely to Donna, but perhaps he was concerned about looking too greedy.) This theory lost only on a statute of frauds ground, which means that it can be much bolstered in future cases: If you fear that your client's spouse's creditors may come after the shared assets, have the parties execute a joint agreement that any excess payments by your client are partial purchases rather than loans. (I proposed a variation of that arrangement some years ago for spouses to execute mutual deeds of trust to protect recovery for excess contributions from creditors in Bernhardt, *Secretly Severing Joint Tenancies*, 19 CEB RPLR 125 (May 1996); either one should work.) This gets more complicated when title is held as community property rather than in joint tenancy, since some creditors of either spouse can then reach the entire asset and not just the share of one of them.

The next best theory was to credit Kenney both for what he paid and also for interest on those payments. (That would have been a handsome amount, being calculated from the date each payment was made.) The court rejected that theory on the ground that the interest wasn't equitably, and I think it was probably also not economically, required: A junior creditor should be subordinate to the same existing senior liens whether they were still held by the original lenders or paid off by Kenney. (It also looks like Kenney got credit for the full amount of each mortgage payment, not just for how much it reduced principal, which may or may not be a windfall, since the liens themselves accrued additional interest each month when not paid.) Unlike the first theory, this one is unlikely to be made any stronger because of an agreement between the spouses concerning it: The United States would have to sign the agreement, too.

Finally, the theory accepted by the court was that Kenney should have subrogation rights for the payments he made on the senior liens against the property that Donna and he owned that was subject to levy by the government for her debts. That was obviously fair, since his paying off those mortgages increased Donna's equity, and therefore the amount the government could reach. (And, of course, fairness would have it come off the top rather that out of Kenney's own share, as the government contended.) But, with regard to that theory, Kenney was lucky in two respects: First, that he had paid off the mortgages in full, since subrogation does not work for only partial payments. This rule does not seem particularly just, since partial reductions of principal on senior liens still benefit junior creditors, but any other rule has too many complications. (That consideration makes Kenney's first theory—of diminishing interest—much more attractive, and essential, since the mortgage has been only partially paid.) Second, Kenney apparently was not aware of the government's tax liens when he paid the mortgages, since knowledge can kill the right to subrogation. While this rule seems based more on a confusion between torts and property principles rather than on economic logic, it is the rule and can cause real harm to those who too readily agree to pay other's debts. See Bernhardt, *Paying the Wrong Debt*, 19 CEB RPLR 212 (Oct. 1996). If your client does know of tax liens against his spouse, don't make those mortgage payments too readily.—*Roger Bernhardt*

Taxation

Taxes and Assessments

Improvements to real property subject to less than 35-year lease are not "owned" by lessee, and therefore are properly included in lessor's property subject to assessment exclusion.

Auerbach v Assessment Appeals Bd. No. 1 (2006) 39 C4th 153, 45 CR3d 774

The Anderson grandchildren were the beneficiaries of two trusts that held an interest in property in Beverly Hills. Northern Trust (Trustee) was the cotrustee of the trusts. In 1996, the trusts leased the property to Hilfiger for 10 years with two 5-year options to extend the term; at that time, the property was improved with a retail building. The lease required Hilfiger either to renovate the existing retail building on the property or to demolish it and

build a new one; Hilfiger would own the improvements during the term of the lease. Hilfiger built a new building.

When the grandfather died in 1999, transferring ownership of the trusts' interests in the property to the grandchildren, the Trustee applied for the $1 million grandparent-grandchild reassessment exclusion under Rev & T C §63.1. Taking the position that the trusts owned the building and the land for property tax purposes, the county assessor (Assessor) granted the exclusion but applied it to both the building and the land on a prorata basis. The Trustee contested the allocation before the Assessment Appeals Board (Board). The Board ruled in the grandchildren's favor, directing the Assessor to apply the exclusion solely to the land.

The Assessor unsuccessfully petitioned for writ of mandate. The court of appeal reversed (reported in 28 CEB RPLR 116 (July 2005)). The supreme court granted review and affirmed.

Proposition 13 limits the amount that the assessed value of real property may be increased to reflect increases in the property's actual market value. When ownership changes, however, the property may be reassessed at its current market value. The issue of change of ownership is governed by statute: Rev & T C §60, which contains the basic change-in-ownership test; Rev & T C §61, which contains examples of what is a change in ownership; and Rev & T C §62, which contains examples of what is not a change in ownership. Section 60 is intended to be the overarching definition of a change in ownership for reassessment purposes, with which the examples in §§61 & 62 must be consistent. Section 60 provides:

> A "change in ownership" means a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest.

The parties agreed that the trusts owned the land and thus have a present interest in it. Before entering into the lease with Hilfiger, the trusts clearly owned the then existing building as well as the land. The purpose of §60 is to ensure that it is the fee interest, or its equivalent value, that is subject to property taxation, and that tax reassessment follows the fee interest or its equivalent through various changes in ownership. For purposes of a §60 change in ownership, Hilfiger had a leasehold interest in the building or, at most, a possessory interest in an estate for years, not ownership of the fee interest. The lease provision stating that Hilfiger owned the building during the term of the lease was not dispositive for purposes of §60's change-of-ownership test.

The beneficial use of the building also transferred. The owner of legal title to property is presumed to be the owner of the full beneficial title. Receiving rent is not the only way a lessor may have the beneficial use of property. The lease provisions that required Hilfiger to pay millions of dollars to construct a building subject to the lessor's right of sale or eviction, which would belong to lessor at the end of the lease, and to surrender the building in good condition, and that specified that all of Hilfiger's monetary obligations under the lease constituted rent, all gave the trusts the beneficial use of the property.

As to the third prong of §60, a leasehold interest, particularly a lengthy one, has a substantial value that can approach the value of the fee interest. Under §§61 and 62, a leasehold interest of 35 years or more has a value substantially equal to the value of a fee interest; a shorter leasehold interest does not have that value. The instant lease, including renewal options, was for less than 35 years; it did not transfer the fee interest in the building or its equivalent from the trusts to Hilfiger.

Thus, the trusts owned the building for purposes of determining whether change of ownership occurred under §60. The change in ownership of the trusts' interest in the property included the building as well as the land.

COMMENT: *Since property tax issues are not my strongest field, I turned to Bill Ahern, of Allen Matkins Leck Gamble Mallory & Natsis (Orange County), for help. I had earlier read a helpful article by him on "Property Tax Reassessments" in the Los Angeles Lawyer; this case seemed to fall right within his bailiwick. Here is our dialogue.—RB*

Q: Bill, do you think that this case would have been litigated if the lessors were not trying to claim the grandparent-grandchild exclusion?

A: Probably not, Roger, since the economic effect to the taxpayers would not have been as severe. In this case, it appears that two trusts owned the property as tenants-in-common. The trusts were established by the taxpayers' grandparents. Via the trusts, the property was transferred from the grandparents to their grandchildren (*i.e.,* the taxpayers). Absent an exclusion, this transfer constitutes a reassessment event for property tax purposes. I believe that this transfer occurred around 1999. However, the Revenue and Taxation Code provides that when grandparents transfer ownership interests in real property that is not their principal residence to grandchildren, the first $1 million of its value is excluded from reassessment if the grandchildren's parents are deceased. Since the taxpayers' father was deceased at the time of the transfer, they were able to claim the grandparent-grandchild exclusion.

This is where the case gets interesting. The taxpayers were arguing that they did not own the improvements for property tax purposes so that the entire $1 million exclusion could all be allocated to the land, which was likely owned by the grandparents for some time and had a low base year value assigned to it for property tax purposes. Newly constructed improvements on real property are generally reassessed upon completion. Since the improvements on the property were completed in 1997, the value assigned to the improvements for property tax purposes was probably fairly close to their fair market value at the time of the taxpayer's acquisition of the property. If the taxpayers were allowed to apply the entire grandparent-grandchild exclusion to the land, $1 million of the land would not be reassessed and would retain its prior

property tax value. However, when making the allocation, the assessor allocated 92 percent of the exclusion to the building and 8 percent to the land. This basically resulted in all of the land being reassessed to its current fair market value (which was probably a big increase) and a portion of the improvements being reassessed to its then current fair market value (which was not probably that big of an increase, since the improvements had a 1997 base year). As a result, the taxpayers argued that they did not own the building for property tax purposes so that the entire exclusion could have been allocated to the land. If the exclusion was not applicable, it probably would not have made much difference if the improvements were reassessed, since their base year value was probably fairly close to their value at the time of the taxpayers' acquisition of the property. It seems to me that the taxpayers were really trying to protect the exclusion and avoid having to allocate it to the improvements.

Q: The Hilfiger lease was originally for a term of 10 years with two 5-year options. Would it have made any difference if the lease was originally for a term of 40 years?

A: Interesting question, and it depends. The Revenue and Taxation Code generally provides that the creation, assignment, or sublease of a leasehold interest (including renewal options) with an original term of 35 years or more is a change in ownership of the real property subject to the lease. In the case of these long-term leases, the lessee is basically deemed to be the owner of the property for property tax purposes.

So, if the remaining term of the Hilfiger lease was equal to 40 years at the time of the transfer, there would not have been a change of ownership of the property, since the lessee (*i.e.*, Hilfiger) would be deemed to be the owner of the property for property tax purposes at that time. However, please note that when the property reverted back to the lessor upon the termination of the lease, that would be a reassessment event, since the initial term of the lease was in excess of 35 years and the termination of leasehold interests that have an original term of 35 years or more constitutes a reassessment event.

Q: What if the term of the Hilfiger lease was originally 40 years and had a remaining term of 20 years at the time of transfer? Would that have made a difference?

A: As the term of a lease that has an initial term of 35 years or more decreases to less than 35 years, the lessor is once again deemed to be the owner of the property for property tax purposes, and the transfer of the lessor's ownership interest in the real property would be a reassessment event. So, if the Hilfiger lease had an original term of 40 years but only had a remaining term of 20 years at the time of the transfer, I believe that this would have been a change of ownership that would cause the property to be reassessed at such time.

Q: In the case of these long term leases of 35 years or more, what happens if the tenant sells its interest in the property?

A: As we were discussing, for property tax purposes, if a lease has a term in excess of 35 years it is considered to be akin to a fee ownership interest in the land and the lessee is considered to be the owner for property tax purposes. Accordingly, if the Hilfiger lease had a remaining term in excess of 35 years and Hilfiger sold its ownership interest in the ground lease to a third party, that would constitute a change of ownership for property tax purposes and result in a reassessment of the property. Alternatively, if a lessee transfers its interest in a ground lease that has a remaining term of less than 35 years, that would not constitute a change of ownership and therefore not constitute a reassessment event.

Q: Do you think this case would have had a different outcome if the lease said that Hilfiger owned the improvements?

A: Actually, the lease did say that Hilfiger owned the improvements. This is pretty common in ground leases where the tenant constructs the improvements. This allows the lessee to depreciate the improvements for income tax purposes. The court even stated that "Whatever this might mean for other purposes, this statement is not dispositive for purposes of section 60's change-of-ownership test...." 39 C4th at 162. As a result, the income tax and property tax provisions that relate to leases are inconsistent. So, to answer your question, the property tax reassessment consequences would not have been altered whether the lease stated that the lessor or lessee owned the improvements.

Q: Finally, do you think that there will be another reassessment when the Hilfiger lease terminates?

A: I do not believe that there will be another reassessment. The Hilfiger lease originally had a term of less than 35 years. As we were discussing, the termination of a lease that had an original term of less than 35 years generally does not constitute a reassessment event.

Business tenant holding month-to-month tenancy on city property was properly assessed "possessory interest tax" based on value of years-long anticipated terms of possession.

Silveira v County of Alameda (2006) 139 CA4th 989, 43 CR3d 501

Silveira had been in possession of a marina owned by the City of Oakland (City) since 1967. His one-year license and concession agreement with the City ended in September 1990 and continued thereafter under a month-to-month holdover provision in the agreement. Silveira, who was subject to a "possessory interest tax" based on a percentage of the lease's fair market value, sought reassessments and refunds from the Alameda County Assessment Appeals Board (AAB) for the 1998, 2001, and 2002 tax years on the ground that improper market values had been placed on his possessory interest based on anticipated eight-year terms of possession, later reduced to five, five, and three years, respectively. Silveira argued for a market value based on a one-month term of possession. When the AAB accepted the assessor's recommended values, Silveira sued the County. The trial court granted the County summary judgment.

The court of appeal affirmed. The rule applicable to the assessments (former 18 Cal Code Regs §23) (Rule 23) provided:

> (a) When a written instrument creating a possessory interest specifies a period of occupancy which is to exist,