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Alert | Litigation/Property Tax

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California Court of Appeal Landmark Opinion Expands Intangible Asset Exemption from Property Tax Assessment

On April 7, 2023, the Second District of the California Court of Appeal published a landmark opinion on California property tax law that expands the tax-exempt status of intangible assets, holding that transient occupancy tax reimbursements and key money payments are intangible assets and that the "Rushmore Method" of removing intangibles from assessment is legally invalid. See *Olympic and Georgia Partners, LLC v. County of Los Angeles*.[1]

In a 2-1 decision, the Court held that the County of Los Angeles erred by including the value of three intangible assets in the property tax assessment of the Los Angeles Ritz-Carlton and JW Marriott Hotels, owned by Appellant Olympic and Georgia Partners, LLC (Olympic), a subsidiary of Anschutz Entertainment Group. The County had included three intangible assets in the base year value of the hotels:

- The $80 million value of transient occupancy taxes that the City of Los Angeles agreed to reimburse to Olympic over a 25-year period in order to subsidize the development of the hotels;

[1] Greenberg Traurig, LLP attorneys Colin W. Fraser, Cris K. O'Neall, and DeAndré R. Morrow served as counsel to Plaintiff and Appellant Olympic and Georgia Partners, LLC.

- The $36 million value of a one-time "key money" payment management companies made to Olympic in order to obtain the rights to manage the hotels; and
- The $34 million value attributable to the hotels' flag and franchise, assembled workforce, and food and beverage operations, which the County claimed had been completely removed by simply deducting the expenses associated with each asset using the so-called "Rushmore Method."

Procedural Background

Olympic initiated the dispute at the administrative level before the Los Angeles Assessment Appeals Board in 2017, claiming that all three revenue streams were intangible assets that were exempt from taxation under California law. After the Board rejected these arguments, Olympic appealed to the Superior Court of Los Angeles, which affirmed the Board's decision that the transient occupancy tax reimbursements and key money payment were taxable but rejected the Board's holding that the "Rushmore Method" effectively removed from assessment the full value of the hotels' flag and franchise, assembled workforce, and food and beverage operations. Olympic and the County then filed cross-appeals to challenge the superior court's ruling.

The Court's Analysis and Holdings

The majority of the California Court of Appeal held in favor of Olympic on all three issues, removing a total of $150 million from the hotels' assessed base year value each year from 2008 forward.

The Opinion includes a historical review of the California Supreme Court's treatment of intangible assets, noting that modern California property taxation law began when Justice Roger Traynor wrote the opinion in *Roehm v. Orange County* in 1948 and that the most recent step in the development of the governing law was the 2013 decision in *Elk Hills Power, LLC v. Board of Equalization*. The Court concluded its historical review by recognizing that "where the taxpayer can fairly value the intangible, assessors must deduct that amount from the final assessment."

The Court first held that the transient occupancy tax revenue that is reimbursed to Olympic as part of a strategy to incentivize development of the hotel is not subject to property tax because it "was intangible and capable of valuation." The Court characterized the reimbursement as a "subsidy" by the City of Los Angeles to Olympic to incentivize the development of a hotel that was otherwise uneconomic to develop. The Court summarized its holding as follows:

> For the $80 million subsidy, *Elk Hills* required the assessor to subtract this sum from the hotel's valuation. This asset was intangible and capable of valuation. It directly contributed to the hotel's income stream: the City pays monies to Olympic based on hotel usage. It was necessary because without it the hotel would not have been built. The law thus required the assessor to deduct the $80 million.

The Court held that the key money payment made by the hotel management company to Olympic as a condition to getting a management contract is not subject to property taxes because it is more accurately characterized as a "discount" on the value of the management contract, which itself is a tax-exempt intangible asset under well-established California law. The Court summarized its holding as follows:

> The discount was not income *to* the hotel; it was a price break the managers gave the hotel on payments *from* the hotel. When I get a dealer discount for buying a car, the discount is not

> income to me. My payment is income to the dealer, not the other way around. The assessor's logic was flawed because discounts are not income.

The Court also held that the Rushmore Method, which assessors commonly use in assessing hotels, is *not* a legally valid method for removing tax-exempt intangibles from assessments because it fails to account for both a return "on" investment and return "of" investment. The Rushmore Method claims to remove the value of intangible assets from assessment by deducting the expenses associated with those assets (e.g., the management fees paid to a manager). Assessors have been using this "method" to appraise hotels because it relieves them of their duty to identify, value, and remove intangibles from assessment. The Court held that Rushmore is invalid because it assesses the return "on" investment that any hotel owner would expect to receive in exchange for hiring a management company (or investing in other intangible assets). The Court rejected the Rushmore Method as follows:

> [T]he County argues its assessment "identified and completely removed" the value of Olympic's interest in the managers' franchises and workforces because "the deduction of the hotel owner's payment of a franchise fee to an operator like [Ritz-Carlton and] Marriott completely accounts for the value of the franchise affiliation and the associated workforce.
>
> This argument is incorrect. If a franchise fee were so high as to account completely for all intangible benefits to a hotel owner, the owner would have no reason to agree to the franchise deal. The County put an article by Stephen Rushmore in the record, but this article contains no empirical support for the illogical premise that every franchise fee wipes out all intangible benefits a franchise agreement might offer a hotel owner. (Cf. *SHC Half Moon Bay, LLC v. County of San Mateo* (2014) 226 Cal.App.4th 471, 492 [disagreeing with a county's claim that all intangible value was removed by deducting the management and franchise fee].)

Key Takeaways

This opinion has significant implications for the assessment of hotels and other California properties that involve the use of intangible assets and rights to operate a business enterprise.

California courts have never before addressed whether transient occupancy tax reimbursements or key money payments are subject to, or exempt from, property taxes. Property owners that receive a subsidy from a government entity to incentivize construction projects (whether subsidized using transient occupancy taxes or some other revenue source) can rely on this opinion to exclude the value of those subsidies from assessment. As can hotel owners who receive key money payments from hoteliers as a condition to entering a management contract.

California courts have previously held that the Rushmore Method of excluding intangible assets from assessment is invalid in two published Court of Appeal opinions. (See *GTE Sprint Communications Corp. v. County of Alameda* (1994) 26 Cal.App.4th 992; *SHC Half Moon Bay, LLC v. County of San Mateo* (2014) 226 Cal.App.4th 471.) But taxing authorities have been ignoring these rulings and using the Rushmore Method anyway by attempting to distinguish the prior rulings on their facts. The Court's decision in *Olympic and Georgia Partners* should put this dispute to rest.

GT GreenbergTraurig

Authors

This GT Alert was prepared by:

- Colin W. Fraser | +1 949.732.6663 | frasercw@gtlaw.com
- Ruben Sislyan | +1 310.586.7765 | sislyanr@gtlaw.com
- James T. Smith | +1 415.590.5104 | James.Smith@gtlaw.com

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