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Colin Fraser: For people in the hotel industry and people, other businesses that are getting subsidies from the government to develop businesses. This piece creates exposure and you're going to have to rethink your contracts.

Nikki Dobay: [00:00:30] Hello and welcome to GeTtin' SALTy, a state and local tax policy podcast hosted by Greenberg Traurig. My name is Nikki Dobay, shareholder in the Sacramento, California and Portland, Oregon offices. Super pleased to have one of my colleagues back on the podcast, shareholder Colin Fraser, out of one of our Southern California offices. He'll tell us which one. But Colin, you were here [00:01:00] a few months ago talking about a case, Olympic & Georgia partners that you had recently had oral arguments on at the time we spoke last. And you informed me that California does keep things moving so you got a decision in this case. So first, thank you for coming back to the podcast, and second, what the heck happened in this decision? Catch us up on this case.

Colin Fraser: Well, thanks for having me back on. I'm from the Orange County office of G and T [00:01:30] although I do work up and down the state. Yeah, we got a decision a couple weeks ago in the Olympic & Georgia Partners case from the California Supreme Court. Last time I was on the show, I explained that there were three completely separate issues in the case. They all did concern intangible assets, which is a tricky subject in property taxation, but each of them were different. The three issues were, and I'll summarize, [00:02:00] one was a revenue stream worth $80 million that was created by a payment from the city of Los Angeles to the developer of this hotel. This is the JW Marriott and Ritz-Carlton Hotel in downtown LA. And this payment stream was made to incentivize the developer to build a convention center hotel in downtown Los Angeles to support the city's convention center and help revitalize [00:02:30] downtown. So that was the first issue in the case.

Second one was a payment that's called key money. This is a payment upfront that a management company pays to a hotel owner to secure a management agreement for the long-term, and that one was worth $36 million. And then the third issue in the case was a collection of enterprise assets associated with the hotel. And really the issue was the methodology to [00:03:00] remove from assessments the full value of all of those enterprise assets, which are intangible assets. And the methodology at issue was called the Rushmore method or the Rushmore approach. And so the court has issued a decision. Backing up real quick, you might remember that the California Court of Appeal had issued an earlier decision a couple years back, and it held in favor of the taxpayer on all three issues. We won, I like to call it a hat trick [00:03:30] at the Court of Appeal. The court held that the transient occupancy tax was an intangible asset and that it was not assessable because it was a subsidy. It essentially attempted to make up for the value that the property did not have. And that was the reason why the developers weren't interested in developing this hotel unless somebody subsidized it. And then the court looked at the key money payment and said, I think quite pragmatically, this is the Court of Appeal, that it was a discount [00:04:00] on the value of a management agreement.

Management agreements are intangible assets. Discounts can't be assessed, so it can't be assessed. And the Court of Appeal also held that the Rushmore method doesn't do the job of removing the full value of intangible assets from assessment. So now the Supreme Court has looked at those, and on the Rushmore method, it affirmed the Court of Appeal and held in favor of the taxpayer finding that if you use the Rushmore method, which [00:04:30] is a method that just deducts expenses associated with any given intangible asset, and the court held that if you just do that, you have not proven that you have removed the full value of that intangible asset because any investment, whether it's an intangible or any other property right, you expect both a return of your investment, the money you put in, and you expect a return on your investment, a profit. And by deducting the expenses, [00:05:00] you do not account for the profit. And so that is being assessed, it's an intangible, it can't be assessed, the methodology doesn't work.

And then on the other two assets at issue here, the California Supreme Court reversed the Court of Appeal and held that both the transient occupancy tax reimbursement, which they call the cost reimbursement, and we can call it here, it's less of a mouthful and the key money [00:05:30] were assessable. And one of the things that's very interesting about this case is the court agreed that both of those are intangible- [inaudible 00:05:43]

Nikki Dobay: Intangibles. Okay.

Colin Fraser: And yet it held, they could be assessed anyway.

Nikki Dobay: Under the property tax, which is a tax on real property.

Colin Fraser: That's right.

Nikki Dobay: Just want to put a point on that.

Colin Fraser: Yeah. And I think it'd be interesting to kind of walk [00:06:00] through for the listeners how the California Supreme Court got there.

Nikki Dobay: Well, and before they do that, I would just want to come back to Rushmore and kind of put that to bed real quick. So the Court of Appeals said Rushmore didn't do the job. The Supreme Court agreed with that. Does that mean the Rushmore test is dead?

Colin Fraser: I don't think so.

Nikki Dobay: Okay.

Colin Fraser: The Supreme Court left open a [00:06:30] possibility that you could use the Rushmore method if it were shown that there is no return on investment.

Nikki Dobay: Okay.

Colin Fraser: That the management agreement doesn't produce a profit.

Nikki Dobay: Okay.

Colin Fraser: Now, does that still count as the Rushmore method? Maybe not. Maybe we're being in semantics, but the whole point of the Rushmore method was that it just assumed without proving its math that [00:07:00] deducting the expenses from the income stream that you capitalize in an income approach automatically removes the full value. And so if now in the future when assessors and taxing authorities are applying the decision in Olympic & Georgia Partners and many other California Court of Appeal decisions that reject Rushmore, if those taxing authorities go the extra step and prove, "Hey, there is no profit to be expected here." They're not really [00:07:30] using the Rushmore method anymore, are they? That's the whole problem with the Rushmore is it's based on just an assumption.

Nikki Dobay: Okay. So the court's saying this is a proof issue, you don't get to just assume these things.

Colin Fraser: That's right. It is a burden of proof issue.

Nikki Dobay: Okay. All right. Just wanted to put that to bed. Now, what was the court's underlying basis for saying, "We're going to tax intangibles under the real property tax."? Which is supposed to be a tax on real property, which is different than intangible. [00:08:00] So enlighten me, how do we get there?

Colin Fraser: It all begins with a case called Elk Hills, which was another California Supreme Court decision. Everyone refers to it as a seminal decision, a very significant decision. And in our briefing to the California Supreme Court in this case, we relied a lot on the Elk Hills decision. In Elk Hills, the Supreme Court of California held that an intangible asset that has a [00:08:30] revenue stream associated with it cannot be assessed. The value of it cannot be assessed for property tax purposes, but you can assume its existence when valuing the property. And what the court meant by that is let's say you have a license to operate a power plant, which was at issue in that case, you can assume it exists so that the plant can be operating rather than treating the power plant as scrap, [00:09:00] as if it can't run at all. That's what it means to assume the existence of an intangible. But you can't assess the value of the intangible asset itself where it has a discrete revenue stream associated with it. And that was Elk Hills.

Nikki Dobay: Okay. So just so I got my head around this. So there's certain intangibles that have to be in place so that the property can function in the way that it is meant to. [00:09:30] But then we've got intangibles that create revenue streams, which are a totally different thing. And so Elk Hills kind of separated those things?

Colin Fraser: Yes. And what our understanding was at the time was that Elk Hills created a categorical rule. If you have an intangible asset that's capable of valuation, you need to remove it from assessments.

Nikki Dobay: That tracks.

Colin Fraser: And what the California Supreme Court said in this case [00:10:00] was, and this is a quote, "Elk Hills does not establish a broad categorical rule compelling the assessor to exclude revenue that derives from any type of intangible asset that is capable of valuation." So we have a change now. And what the court said the key inquiry is, because there has to be a test, the key inquiry according to the Olympic & Georgia Partners case, is whether [00:10:30] the intangible derives from income that's primarily attributable to an enterprise activity, an intangible asset, or alternatively, whether it's deriving its value from the real property itself. That's the test. And so in this case, just to make that abstract concept a little bit more concrete, the transient [00:11:00] occupancy tax payment, this is a tax imposed on every guest at the hotel anytime they stay at the hotel. And the court said that that extra revenue, it's derived from the real property, not a business. Because every time a guest stays at your hotel, you get a certain percentage more money as the owner of this hotel than you would otherwise. [00:11:30] And that's why they said that the value of this revenue stream could be assessed.

Nikki Dobay: And I have a feeling we're going to get there, so hopefully this isn't a spoiler alert, but figuring out where the line exists between something that is derived from the real property versus something that is not derived from the real property is going to be a nightmare.

Colin Fraser: A nightmare. And even in this case, I don't think it's that clear cut. The court tried to make it as [00:12:00] if it were black and white, that this percentage of extra revenue you get from the city every time a hotel room is rented out, that that has nothing to do with business. But let's just look at the hotel, there's 1,001 rooms in this hotel. If you have a great hotel operator and they're capable of renting out all 1,001 rooms every night, they're just the best, then you are going to get more transient occupancy tax revenue. And if you [00:12:30] have a poor operator who only is capable of renting out 200 rooms a night, you will get far less transient occupancy tax payments. So it's not purely just the rooms, the real estate. There certainly is a component here attributable to the savviness of your operator. And so we don't even have a clear line in this case.

Nikki Dobay: But again, this goes back to this idea that this was [00:13:00] an incentive that was provided by the city to get this project to even come to fruition. Is it because it's a hotel or is it any incentive related to any property?

Colin Fraser: That's a great question. So the court, when it started making the rules in this case to analyze the transient occupancy tax payments and the key money, it was very clear that [00:13:30] its ruling is limited to the facts of this case and the agreements at issue in this case. So the funding agreement between the hotel owner and the city of Los Angeles, and then the management agreement between the hotel owner and Marriott and Ritz-Carlton. So it limited its decision very explicitly to those agreements. And it actually said that this case does not effectuate any sea change [00:14:00] at all. So it tried to limit it to the facts of the case. And it said, because during oral argument, and in our briefing we pointed out that this is a subsidy, it is trying to make up for money or value that otherwise isn't there. The real estate wasn't worth it, so the city came in and provided extra money. And we argued to the California Supreme Court, "Look, there are many subsidies very similar to this that exist in our state [00:14:30] we subsidize wind-

Nikki Dobay: And there has to be some property link for the subsidy to exist.

Colin Fraser: We pointed out, "Look, if you look at the subsidies that are paid to wind farms and solar generators or the subsidies that exist for low-income housing that allow the construction of low-income housing with subsidies to make that pencil out..." We said to the court, "Look, if you say the transient occupancy tax [00:15:00] is accessible, this is a subsidy, then all of those subsidies are now at risk." And so what the court did is say, "Nope, none of those are at risk. We are treating the transient occupancy tax as one thing and every other subsidy as another." And we will see how that plays out in the future. Because the whole purpose of precedent in case law is to create [00:15:30] guidance because the next time around you might have something similar that you can apply an analogy to, and you can look to the case as a basis to learn how to treat a new asset, a new right, and figure out how to treat it. And so it's hard to believe that this decision won't be used to figure out ways to tax other intangible assets and rights.

Nikki Dobay: Well, and also you said that there's the second piece to this, which is [00:16:00] the key money piece. Correct?

Colin Fraser: This one is even stranger.

Nikki Dobay: Oh, great. Lay it on me.

Colin Fraser: Okay. This one's even stranger. So the argument made by the county of Los Angeles could be summed up pretty quickly with the key money. They said the key money is like a lease. They're paying this 36 million payment, in exchange they get to run a business at the hotel. That's a lease. We should assess it.

Nikki Dobay: Okay. Okay.

Colin Fraser: [00:16:30] Okay?

Nikki Dobay: I'm tracking so far.

Colin Fraser: And the court agreed. What's strange here is that it's not like a lease because when you lease property, the key element of a lease is that you get the property to the exclusion of all others, including the owner. The owner's not allowed to come, and just the most simple example, if you rent an apartment, the owner can't stroll in any day on the grounds [00:17:00] that, "Oh, I own the building, so I'm coming in." That's not how it works. They have given up the possession in exchange for the money.

Nikki Dobay: Yep.

Colin Fraser: So that's one thing. Marriott can't exclude the owner of the property from the property. The second difference is they're only in there for the benefit of the owner. They're there to run a business for the owner's benefit. And so that's a second big difference between them. And [00:17:30] the third difference is this money was paid to secure a long-term management agreement. And what the court did was it tried to disconnect those two things. The key money on the one hand, the management agreement on the other, because all the parties agreed management agreements are intangible assets. No one argued that you could assess the value of an intangible asset in this case. And so what the court did is [00:18:00] it said, "Well, yes, the management agreement is an intangible asset, but this key money payment is something else entirely. What it is is a payment to secure the management agreement, and that is a lease. And so we can assess it."

I don't understand the line drawing here, just like I don't understand the line drawing with the transient occupancy tax. It just doesn't seem to make sense that you can make that [00:18:30] distinction rather than the analogy that the Court of Appeal made, which is, "Look, it's a discount. Take the total amount of money that the manager will make over the course of this 50 year management agreement and deduct from that number 36 million, the payment that went to the owner to get that revenue stream. And then you have really the net value of the management agreements, which is less."

Nikki Dobay: Now I know there were two [00:19:00] dissents in this case, correct?

Colin Fraser: There were, yes.

Nikki Dobay: So this case, it isn't as if this was like everybody was having a kumbaya moment and all on board. Do you feel like the majority was doing some mental gymnastics to get to a result, or is this really where the majority or the folks that joined onto the majority are at on these issues?

Colin Fraser: Yeah, I'm not comfortable criticizing [00:19:30] the justices of the Supreme Court to say they were trying to reach some result and they were willing to take any path to get there.

Nikki Dobay: Fair, fair.

Colin Fraser: They wrote a 60-page decision.

Nikki Dobay: All right, so if it wasn't mental gymnastics-

Colin Fraser: They analyzed it.

Nikki Dobay: ... it was really, really sophisticated.

Colin Fraser: I disagree with them. I don't think that this is applying the Elk Hills decision as I understand that decision. I think that we're left with a major question mark when reading this case, which is, what is the test? [00:20:00] What is the test that we can use here? And there is no test.

Nikki Dobay: Yeah. So what are the takeaways from this? Because you talked about why do we have cases and precedent and it's usually to help folks in the future try to arrange their affairs so that they are legal in accordance with the result that they're trying to achieve. But if there's no test, where are we at? What does this all mean?

Colin Fraser: So what it means [00:20:30] is this, taxpayers who are in the hotel industry and who are receiving key money payments or making key money payments, they're managers, and then also developers who are getting incentives that are in any way similar to a transient occupancy tax, they need to consider this case really carefully and find ways to draft their contracts in ways that are very different from the contracts in this case. That's how you take advantage [00:21:00] of the statements by the Supreme Court in our case, saying, "Hey, we're limited to the facts. This is not a sea change. We're just talking about this contract-

Nikki Dobay: These facts.

Colin Fraser: ... with these two entities. And we have already figured out a few ways, and we pointed them out to the court when we were arguing this case, and the court then addressed them in its decision about, "Hey, if you just structure this..." Let's just take the transient occupancy tax, if you structure it differently, it's not assessable. It's [00:21:30] very easy to structure it in a way that avoids the implications of the Supreme Court's decision. Generally speaking, what I'm suggesting here is don't do a contract for missing money in a development for a subsidy that takes revenue generated from taxes at your property and just [00:22:00] spins it back to the developer. It has to be more separated from the property itself. Because that was the linchpin that the court looked at. They looked at the property, they said, "You are getting taxed this transient occupancy tax on, the guests have to pay it, it goes to the city, and then it goes right back to the owner." And what the court said is, "Look, it's just the same as if it went from the guest directly to the owner." And we disagree, we said, "No, this is a tax."

And [00:22:30] one of, I think the key... Now this was a failed argument, this didn't work, but look, what you do in property tax when you're trying to develop an income approach based on lease rates is you look at the market, you don't use actuals, you look at the market and you make sure what is the market rate? And we're going to assess the property as if it was rented out at that rate, not an above market rate, not in a below market rate. In this case, it's different because when the transient occupancy tax payment was agreed to, [00:23:00] it was the only one of its kind in LA. I think there was only one other in the state of California. It does not reflect the market. That's a standard that is, I would say, fundamental to property taxation and it just kind of got thrown out the window.

Nikki Dobay: Well, there's so many things that are disturbing about this, I will say, but I'll try to be brief because I worry about this case. So as we talked about in the last podcast in Oregon for centrally assessed properties, statutorily [00:23:30] intangibles are in, and we also just had the Oregon Supreme Court in a combined decision for two taxpayers, Delta Air Lines and Pacific Corps, an electric utility company, reverse at least one of those taxpayers tax court's decision that that was unconstitutional under the state's uniformity clause and the equal protection clause. So now the Supreme Court of Oregon has said, "Not unconstitutional." We'll see if a petition [00:24:00] is filed with the US Supreme Court in those cases. But Oregon does it statutorily. California, there's nothing in the statute that talks about intangibles.

Colin Fraser: Well, I'll correct you, there is. In California, we have two statutes in the revenue and taxation code, section 110 and section 212 that both state the value of intangible assets is not subject to property taxation.

Nikki Dobay: So you have a good statute [00:24:30] in theory.

Colin Fraser: Yes, we have two good statutes.

Nikki Dobay: In theory. But with this case, we're now seeing the court, I guess they're finding a way to say this is intangible, but it's still subject to property tax.

Colin Fraser: You know what they're doing? It's so interesting, because you're right, they are saying it's intangible, but subject to property tax and the way they are is, if you look at the statute, it says the value of intangible assets cannot be assessed. They're going after that word, value.

Nikki Dobay: [00:25:00] Value.

Colin Fraser: It's not the value of the intangible asset they're saying. It's the value of the real property.

Nikki Dobay: That they can consider the intangible as part of the value of the real property.

Colin Fraser: They're assessing the value of the real property, so they say.

Nikki Dobay: Yes.

Colin Fraser: And that's how they're creating this exception to the exception. All property is assessable, intangible assets are an exception, excluded from all property being assessable. And then, well, if your intangible [00:25:30] asset derives its value from the real estate, it becomes assessable again.

Nikki Dobay: So this is what I think we can call a slippery slope.

Colin Fraser: Yes.

Nikki Dobay: Okay. All right. Classic slippery slope.

Colin Fraser: This is a very slippery slope, and this idea that you can stake it up on the hill by this statement in the decision that we're, "Nothing to see here, nothing to see."

Nikki Dobay: No change.

Colin Fraser: "This has no extra effects." That's not well-planted.

Nikki Dobay: All right, so [00:26:00] this concerns me because as is often the case, California's what? The fourth-largest economy in the world. We have a lot of other states in this crazy country of ours that look to California and what you all are doing. And I worry that other states are going to see this decision and say, "Hey, this seems like a great idea." Again, we've been battling this in Oregon, because got it right in our statutes that says you can do it for certain taxpayers [00:26:30] in real property tax. And so that's a legislative fight that we need to take on. But this is all those other states that have those statutes that say the value of intangibles, can't be taxed under the real property tax...

Colin Fraser: I am [inaudible 00:26:49] this case will be cited in other states around the country. California's statutes exempting intangible assets from assessment or the value of the intangibles, [00:27:00] they're not unique.

Nikki Dobay: Unusual.

Colin Fraser: They exist in many other states. And while those states might not have the exact same language, the effect is the same. They're materially similarly worded. And I would imagine taxing authorities around the country are seeing this decision and thinking that this is a way for them to assess these assets and not just these assets.

Nikki Dobay: Yeah. Yeah.

Colin Fraser: [00:27:30] These transient occupancy tax reimbursement deals, they're pretty rare. The key money is more popular for sure, but I don't think that the taxing authorities are going to stop with just those two asset classes. I think that anything that's similar... And they're creative, taxing authority, I thought these arguments were creative in this case, I thought this was a long shot. And so yes, this will be used. You're going to see this cited around the country, [00:28:00] just like I did a case a few years back to challenge the theory of the dark store theory- [inaudible 00:28:08]

Nikki Dobay: Yeah, yeah.

Colin Fraser: And when I was arguing that case at the California Court of Appeal, I was using cases from Wisconsin and Florida and Michigan that had already addressed it and had come out in our favor. So yeah, this is probably going to be cited across the country.

Nikki Dobay: All right. Well Colin, thank you so [00:28:30] much for this follow-up conversation. I know this has been a case you've been dealing with for a long time, and I'm sure this was-

Colin Fraser: Since 2016. Since I joined the firm. I took it-

Nikki Dobay: Wow, almost 10 years.

Colin Fraser: Me and Chris O'Neill took this case at the Los Angeles administrative level and ran it all the way up to the California Supreme Court. One thing I would say before we close out is-

Nikki Dobay: Yeah, yeah.

Colin Fraser: A little plug for GT on this. I think-

Nikki Dobay: Please.

Colin Fraser: ... for people in the hotel industry and people, [00:29:00] other businesses that are getting subsidies from the government to develop businesses, this case creates exposure and you're going to have to rethink your contracts. And it's in this long decision, there's some guidance in there about how to do that to avoid the implications here so that the next time there's a transient occupancy tax deal or a management deal with key money, it might not be assessed. And I think we can really help with that.

Nikki Dobay: Awesome. Well, [00:29:30] I'm sure you can. And I'm sure you're going to keep on fighting other property tax issues all across California and maybe all across the country when this one blows up. So we got to find some juicy ones up here in Oregon and we'll take them on.

Colin Fraser: Invite me up.

Nikki Dobay: All right. All right, so before we go, I have to do a surprise non-tax question. And I came into this podcast today, a few minutes late, and Colin was chatting with our wonderful producer and I learned something about Colin, [00:30:00] which it made me pick the surprise non-tax question. So Colin, based on that conversation, I think you're a little bit of a risk-taker. So I learned coming into this that Colin likes ride motorcycles. So my question today, just follow me for a minute because I've got to give you some background. So my question is, have you ever heard of something called the Red Bull Rampage? That's the first question. So have you heard of that?

Colin Fraser: I think I have. Is it a [00:30:30] motorcycle race of some kind?

Nikki Dobay: It's a mountain bike race. So let me tell you about this. And then my second question is, would you ever contemplate doing this, probably if you had lived a real risk-taker life? So this is a race in Utah, it's coming up in October, I think it happens in October of every year. These crazy extreme mountain bikers go to Utah, they build trails in all these crazy mountains, [00:31:00] and then they have this big race at the end of this two week period and it's just downhill and they've got to get down the downhill trail in three minutes or less.

Colin Fraser: I've seen it. I've seen it.

Nikki Dobay: You have.

Colin Fraser: It's like people going down a roller coaster track except they're on a bicycle and they're jumping over cliffs.

Nikki Dobay: Yes.

Colin Fraser: Yeah, I wouldn't do that. My other hobby other than motorcycle riding is surfing. And one of the best parts about surfing is when you land, you land on the water and it doesn't break [00:31:30] all your bones. I've seen the Red Bull Rampage and when they fall, I don't know how those guys stand up again.

Nikki Dobay: I agree. So last year we watched it for the first time. You can watch it on YouTube. It's incredible to watch. Once you get into it, you can't stop watching it. But last year was the first year women raced. I'm not going to say they weren't allowed before, but it was crazy. And there was eight women. [00:32:00] I can only think, I have a really strange fear about losing my two front teeth, so I could never do it. There's many things I can't do because I'm like-

Colin Fraser: I think that would be the lightest injury you could get. Your two front teeth? It's your femur breaking is the problem.

Nikki Dobay: But yeah, it's insane. If you're listening to this, you have to go out and watch the Red Bull Rampage. I'm so glad you've seen it because I didn't know where that question was going to go, but I was like, "If anyone knows [00:32:30] about this, I think it might be Colin." Colin, thank you so much for the conversation today and for talking about rampaging. We talk it all the time in our house by the way, that's... One of our dogs is really into rampaging. And thank you to the listeners for tuning in. Colin and I's information will be in the show notes. We will also link a recent alert that Colin put together on this case. And as additional developments happen, we will let you know. So thank [00:33:00] you for listening and I will be with you again on the next GeTtin' SALTy.