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Avoiding Surprise Tax Implications for Private Leasehold Interests

Investors or developers who are considering projects on publicly owned land should take heed of the lessons learned in a pivotal case involving Time Warner and Los Angeles County.

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For any investor or developer considering an investment in a project on publicly owned land, the recent case of *Time Warner Cable, Inc. v. County of Los Angeles* (2018) 25 Cal. App. 5th 457 is a valuable reminder of unique risks of unexpected tax burdens on private leasehold interests in publicly owned real property (or a "possessory interest" in tax-exempt property). While *Time Warner* involved a dispute over a county assessor's valuation of a cable television operator in rights-of-way over public land, the issues before the court are relevant to possessory interests generally and worth considering in any potential investment in a project on public land.

California, like many other states, taxes private property interests in tax-exempt properties. The taxable value of a possessory interest is the cash amount that a hypothetical purchaser would pay for that interest in an open and competitive market. An assessor can use comparable sales, replacement cost or capitalize the anticipated net earnings of the hypothetical purchaser in calculating that value, but in using the anticipated earnings approach some or all of the value of the lessee's intangible right to do business at the property must be excluded.

In *Time Warner,* the value of the possessory interest included a percentage of the operator's gross revenues from incidental broadband and telephone services, in

addition to its net earnings from its cable television service franchise fee. Upholding the assessor's inclusion of such revenues from the operator's incidental business operations in the taxable value of the possessory interest, the court did not consider whether the right to provide such incidental services was an intangible asset, but found that such incidental services provided "added value" to the taxable possessory interest which was not "beyond the reach" of the county assessor.

THE PERCENTAGE RENT PROBLEM

The erroneous inclusion of the going concern value of intangible assets in the assessed value of possessory interests can often be blamed on a common practice of the tax-exempt landowner to require that a percentage of all revenues from the lessee's business operations at the property be payable as additional rent, including revenues from intangible assets (such as trained workforce in place, rights to the project name, its vendor relationships and other items of goodwill). Percentage rent provisions create an appearance of such revenues being derived from the possessory interest, leading to their improper assessment in the value of the possessory interest—an "added value" that is beyond the reach of the county assessor.

Even though the court in *Time Warner* found the going concern value of revenues from intangible rights of its business operations could be used in valuing the possessory interest, it further found that the county assessor's failure to provide substantial evidence in support of its valuation of 5 percent of those revenues in the value of the possessory interest was an error (as was the assessor's failure to allocate any portion of those revenues to the lessee's cable system located on the possessory interest). Those findings may be helpful to prospective lessees of tax-exempt properties in support of percentage rent provisions drafted to expressly avoid their inclusion in the possesssory interest valuation, even though they are subject to percentage rent; and by including a rent adjustment contingency to provide the lessee with rent relief to offset the misallocation of the lessee's intangibles to the possessory interest value.

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