TAX

RECENT KENTUCKY CASES HOLD THAT EXEMPT OWNER DOES NOT MEAN PROPERTY TAXES PRECLUDED, AND LEASED REAL PROPERTY VALUE MAY INCLUDE "INTANGIBLE VALUES"

by Mark D. Lansing

Kentucky cases recently held that property is not exempt from taxation merely because the owner may be constitutionally exempt. Also, the valuation of leased property is rental income less expenses. However, if sales of similar property suggest "an intangible value" that must be included to reach fair cash value.

In addressing the taxpayer's challenge, each case stated that one aggrieved by a tax assessment may appeal to the Kentucky Board of Tax Appeals ("KBTA"). See KRS 131.340(1) ("The Kentucky Board of Tax Appeals is hereby vested with exclusive jurisdiction to hear and determine appeals from final rulings, orders, and determinations of any agency of state or county government affecting revenue and taxation."). The KBTA's "function is not simply to review the action but to try anew the issues as presented." *Jefferson Cnty. Prop. Val. Adm'r v. Oxford Prop., Inc.*, 726 S.W.2d 317, 319 (Ky.App. 1987) (citing KRS 131.340(1)).

In *Grand Lodge of Kentucky Free and Accepted Masons, et al. v. City of Taylor Mill et al.*, No. 2015-CA-001617-MR (Ky. App. Feb. 10, 2017), the Kentucky Court of Appeals rejected the argument that residences could not be taxed, solely on the basis that the underlying real property owner was exempt from taxation under Section 170 of the Kentucky Constitution ("issue is not whether the ownership rights of the Grand Lodge and MRV can be assessed, but rather, whether the lesser interests of the residents can be taxed"). The Court of Appeals found that the residents had exclusive rights under Residential Agreements in the property in exchange for valuable consideration. The Court found the possessory interest was enough to subject the residents to property tax under Section 170 and KRS 132.195. To determine the appropriate valuation to compute such tax, the Court of Appeals held that the individual units were leaseholds and, thereby, "[t]he law is well-settled that a leasehold's fair market value for taxation purposes is obtained by subtracting the fair market value of the real property with the leasehold from the fair market value of the real property without the leasehold." In reaching this decision, the Court of Appeals observed, "[t]herefore, if their interests are tax exempt, 48 households, which certainly could not be considered low income housing, . . ., are receiving governmental services, but are paying no tax to support such services." Similarly, in *Miriam Osborn Mem. Home Assn. v Assessor of City of Rye*, 14 Misc 3d 1209(A), aff'd, 275 A.D.2d 714 (2nd Dep't 2010), a taxpayer's claim for exemption was rejected; even though, it was a not for profit corporation that owned the land and leased the premises to residents. The residents were wealthy and, thus, no "charitable" purpose existed.

In addressing the valuation of a leasehold in CPT *Louisville I LLC v. Jefferson County PVA*, Order No. K-24995, File No. K14-S-85, K15-S-278 (Ky. Bd. Tax App. Jan. 8, 2016), the Court did not solely rely on an income approach. Instead, the Court rejected the taxpayer's restriction of value and deduction of intangibles from the "business enterprise value", noting:

> [e]ven if the appraiser is correct in his assumption that there is an intangible component in this difference between his appraisal and the sales price, in accordance with this Board's final order in Walgreen Co. and Wilgreen LLC v. Fayette County Property Valuation Administrator, Order No. K-24624, March 26, 2014 (decision upheld by the Fayette Circuit Court and on appeal before the Court of Appeals, 2015-CA-000407), this Board concludes that this intangible component should be included in the fair cash value assessment of the property. In a transfer of an established, well-located, well-occupied, premiere, upscale shopping center, or more specifically, a "lifestyle center," such as the Paddock Shoppes, there would necessarily be a transferable intangible value "inextricably intertwined" with the buildings and land. As this Board stated in Walgreen, this intangible value enhances the value of the mere buildings and the land, and "this enhancement cannot be disregarded in a fair cash value determination." Walgreen at page 9. In this case, any added intangible value would be and is reflected in the 2013 sales price between a willing buyer and a willing seller.

Also, CPT *Louisville I LLC v. Jefferson County PVA*, supra, addressed whether an appraiser was required to analyze a known purchase price that was substantially greater than his conclusion of value. Often times, an appraiser testifies that they are doing an "independent appraisal", and thereby, they must put on blinders to other valuations. In this case, the taxpayer appraiser ignored a recent prior purchase price of the real property. By doing so, the Court found the appraiser lacked credibility, noting:

> However, when the Board pressed Mr. Chapman, several times throughout his testimony, to specifically explain the $20 million difference between the sales price and his appraisal valuation, he could not point to any specific items that had been included in the sales price that should have been removed in order to explain the significant difference between that price and his valuation. (TR 11:04, 11:06, 11:07, 11:08, 11:25, 11:29, 11:30) While he was fully aware of the 2013 sales price for the property, and the fact that his valuation was $20 million less than the recent sales price, he had not reviewed any of the sales documents nor conducted any analysis of the difference in those values in order to explain or understand that difference.

Administrative tribunals routinely reject an appraiser's failure to address known or knowable facts that are contrary to their conclusion of value, and thereby, are not simply accepting the appraiser's "independent" appraisal. Thus, and in particular, the taxpayer appraiser cannot opine value in a vacuum, but should consider and explain differences in valuations that exist at the time their appraisal is made. This is particularly true for known valuations, as they are likely to be placed in evidence.

In *Walgreen Co. and Wilgreen, LLC v. Fayette County Property Valuation Administrator*, File No. K12-S-21; K13-S-38, Order No. K-24624 (KBTA Mar. 26, 2014), aff'd, No. 14-CI-01566 (Fayette Cir. Ct. Feb. 18, 2015), aff'd, No. 2015-CA-000407 (Ky. App. Sept. 23, 2016), discretionary review denied, 2016-SC-000590 (Mar. 15, 2017), the Court rejected the taxpayer's argument that its build to lease rental income had to be ignored. The Court noted that such argument had been rejected by a number of states, stating:

> In *Helman v. Kentucky Bd. of Tax Appeals*, 554 S.W.2d 889, 891 (Ky. App. 1977), we explained how the PVA should consider rental income in relation to fair cash value. We held as follows:
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> > The true income approach to fix fair cash value is a valid one and income from or rental value of real property is a proper factor to be considered in fixing its valuation for tax purposes. However, the courts throughout the United States are in complete agreement that income or earnings are neither the only element nor the controlling element to be considered in determining the valuation of realty for tax purposes. See Commonwealth, et al. v. J. B. Clay & Company, 215 Ky. 125, 284 S.W. 428 (1926). A number of other elements necessarily enter into the value, such as original cost, location, cost and character of improvements, rental history, location as to future growth of the adjacent area, sales of adjacent property, sales of comparable property, type of building or property, etc.
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> > Where the income approach is used, all jurisdictions, including Kentucky, require that net income and not gross income be the factor. Other considerations are the terms of the lease, such as requirements for maintenance, alterations or improvements, fixed rent or percentage of sales; prospective earnings as well as past earnings; length or duration of the lease; options at increased or decreased rentals; and, of considerable importance, the type of tenant and his financial stability.
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> > Id. at 891(emphasis added).

The Court also rejected the suggestion of the taxpayer's appraiser that intangible value was included in a straight application of the income approach (i.e., a business enterprise value) in valuing the leased property, stating:

> Additionally, we cannot agree that the law in our Commonwealth's supports Walgreens' position that the bundle of rights associated is intangible personal property. The lease attaches to the real estate. "A lease is but a conveyance of an estate in realty. It divests the owner, for a given time, of a certain estate in the realty, leaving in him the reversion." Mattingly's Ex'r v. Brents, 159 S.W. 1157, 1160 (Ky. 1913). "[T]he proper criterion of fair cash value for any property, including a leasehold, is the price a seller willing but not forced to sell would take and a buyer willing but not forced to buy would give for it. And that figure may or may not approximate the value of the lessee-added improvements, depending on the circumstances." Kentucky Tax Comm'n v. Jefferson Motel, Inc., 387 S.W.2d 293, 296 (Ky. 1965). "When the lessor is not tax-exempt he bears the incidence of ad valorem taxes on the entire value of the property as a whole, and he passes it on to the tenant through the rental rate agreed upon between them." Id. The point being, the tax authority still collects a tax on the full value of the property. Id.

As buyers may purchase property at prices that exceed the valuation indicated by the income approach, the appraiser should identify and value any non-tangible property that might have been included in the purchase price, and explain the reason(s) for the difference between the purchase price and her conclusion of value (not simply ignore them).

Finally, in *Buffalo School Apartments, LLLP v. LaRue County Board of Assessment Appeals*, et al., K16-S-30; K16-S-77 (KCC July 7, 2017), the Court rejected the PVA's contention that tax credits for low income housing ("LIH") property was required to be included in that property's valuation (i.e., as a value enhancer). Instead, the Court found that such credits are alienable and distinct from the real property. Accordingly, the LIH property value had to be based on the lower rental income it received. Here, not all states have similarly found.

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[1] In *GenOn Mid-Atlantic, LLC v. State Department of Assessments and Taxation*, Case Nos. 14-MF-00-093 (2015), although the appraiser testified that he was doing an independent appraisal (and therefore, could not review other known and relied upon valuations of the same property by the taxpayer), the Maryland Tax Court negatively noted the failure of the taxpayer's appraiser to analyze its conclusion of value and the differences (it concluded a lower value) with other valuations conducted for the taxpayer on impairment. This failure was found to negatively impact the appraiser's credibility.

FOR MORE INFORMATION CONTACT:

Mark D. Lansing is a Member in Dickinson Wright's Washington, D.C. office. He can be reached at 202.466.5964 or mlansing@dickinsonwright.com.