CALIFORNIA REAL PROPERTY TAXATION OF TIMESHARE INTERESTS

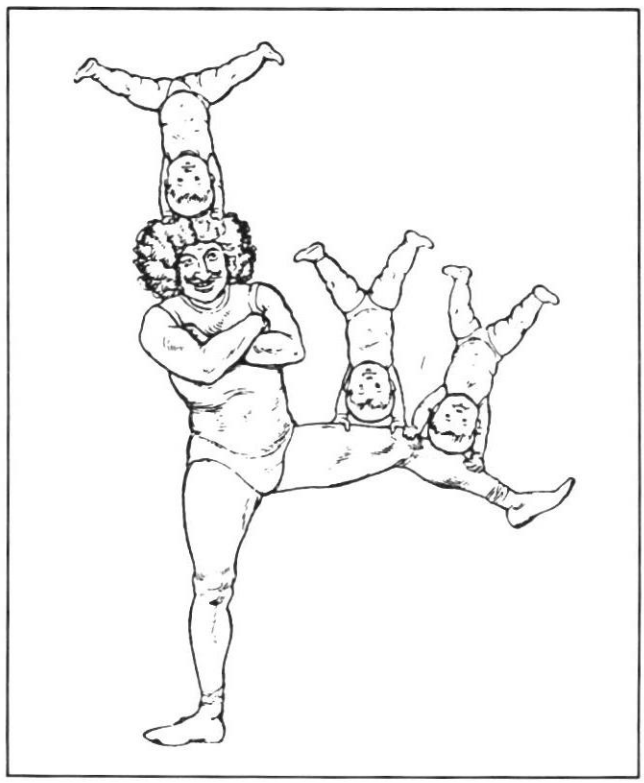
by Karl O. Tuschka

From a national perspective, California is often viewed as developing distinct approaches to new problems in addition to being the harbinger of things yet to come in the rest of the country. Though it may be early to suggest a national trend, this article presents an interesting and worthwhile review of California's taxation for timeshare interests.

California's Real Property Tax System

The California approach to real property taxation differs from the national norm in several ways. Its system is a creature of the state's constitution rather than being a mere statutory enactment. This limits the legislature's power to substantially modify the basis of real property taxation. However, the constitution does not exclusively control this taxation; it is supplemented by the Revenue and Taxation Code enacted by the legislature. Among its many other functions, the state's Board of Equalization insures the property tax is levied on an equalized basis; it drafts regulations which become codified and issues letters of instruction to the county assessors.

California voters through referendums have had a significant and revolutionary effect on the state's real property tax system. In 1978, California voters amended their state constitution with the passage of Proposition 13. Put very simply, prior to the enactment of Proposition 13, valuation of real property in California was the duty of the county assessor in each of the 58 counties. All property was assessed on an annual basis at a specified percentage of value. The Board of Supervisors, in each of the counties, determined what percentage of the total real property valuation within the county was sufficient to generate funds for the county's annual budget, and that percentage was the tax rate for the ensuing fiscal year.



The revolution wrought by the passage of Proposition 13 can best be seen with a quick overview of the changes it created. Rather than undertaking an automatic valuation of all real property on an annual basis, the county assessors are now permitted to reassess only in the following instances: a change of ownership; new construction; or substantial rehabilitation resulting in a new use or

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constituting the equivalent of new construction. Thus property held by one owner, absent of any new construction or substantial repairs, would never be subject to reassessment. This situation could continue indefinitely until the occurrence of an event to trigger a change. Year after year the assessment would remain static with only a slight addition of up to two percent annually as an inflation factor.

As a result of Proposition 13, the tax rate was fixed statewide at one percent of assessed value. This fixed rate no longer bears any relationship to the fiscal year budget of the counties. The rate no longer merely tracks the budget, but rather the budget must now reflect available revenue in a controlled system.

Taxation Of Timeshare Interests

The absence of legislation and court cases, coupled with the hunger of local governmental entities for additional revenue sources, has resulted in undue confusion and inequity with respect to the initial real property taxation of timeshare interests. At first the tax system did not contemplate the new timeshare product. The timeshare interest was not defined by statute and there were no rules on valuation of timeshare.

The unfortunate by-product of this confusion is that California's timeshare projects have initially borne the brunt of the local governmental entities hunger for additional revenues. Because timeshares at first had no tax status, statutory definition or precise rules for valuation, local county assessors proclaimed open season with a view to maximizing local governmental revenues from this new target. The attack has resulted in multiple increases in valuation over prior assessments without any substantial change in the existing physical plant or the value of the underlying real estate. This has been the case not only with recently constructed projects, but also with conversions of older hotels, condominiums or apartment houses.

Such an approach only could have a very significant adverse impact on the timeshare industry. The problem not only was the impact of the tax levy, but also the chaos resulting from trying to implement future projects without any set of clear rules.

In response to the resulting furor and under strong pressure from the timeshare industry, the state legislature enacted new statutes specifying the manner in which assessments are made; and the state's Board of Equalization followed with an assessment regulation directed to the county assessors. The timeshare concept now has been defined by statute. However, given the impact of Proposition 13's passage and the confusion and complexity of the resulting statutory law and regulations, certain fundamental problems and anomalies remain. Indeed, it may be said the recent legislation and regulations only gloss over the existing confusion.

Powell Place And Casitas Del Monte

In order to evaluate the initial situation in California, here are two specific timeshare projects. Both examples are somewhat dated because the contested assessments occurred before the enactment of Section 998 and the Board of Equalizations issuance of Rule 472. However, the examples illustrate the magnitude of the assessment increases and certain unsolved problems.

Powell Place for many years had been a residential hotel and apartment house located on San Francisco's Nob Hill, a center for tourists and business travelers to the Stanford Court, Fairmont and Mark Hopkins Hotels. Also it is near the financial district, the center of the city's business activity and immediately adjacent to the intersection of the two historic cable car lines. In its urban center location, the Powell Place timeshare project was envisioned for use both by visiting tourists and by business travelers.

The other example is Casitas Del Monte, a low-rise resort complex situated in the Palm Springs area of Riverside County in Southern California. Unlike Powell Place, Casitas Del Monte is a destination resort with swimming pools, tennis courts and other sports and recreational amenities.

Both case examples provide hotel-like services including maintenance, reception, reservations, kitchens and linen service. Purchasers at both projects are provided exchange privileges with other projects.

Initial Reassessment Method And Results

The county assessors of San Francisco and Riverside Counties determined that valuation for real property tax purposes would be made based upon the full price paid for each timeshare interval. For each project, this amount was determined by adding up interval purchase prices as indicated by the value of the transfer tax stamps placed on each of the conveyancing deeds. As a result of this assessment technique, the assessed value of Powell Place changed from fiscal year 1981-82 at $1,120,723 to the fiscal year 1983-84 at $9,802,668. In the case of Casitas Del Monte, the developer's purchase price and rehabilitation costs totaled $2,725,000 in 1981. For the 1982-83 fiscal year the new timeshare project was assessed at $6,038,422. Indeed, the reassessment for Casitas Del Monte actually exceeded the total of all timeshare purchase prices paid. In that case, the assessor took the position that because all timeshares are fundable, he was not restricted to the actual price paid, but rather was free to assess across the board on the basis of the highest price paid for any one unit.

Both case examples involved existing structures, and although certain rehabilitation efforts had been undertaken, no significant physical plant improvements had occurred in the interim between assessments. The change to timeshare use alone was the basis for these drastic increases in assessment. The county assessors saw an opportunity to target a new and as yet undefined product, and they took advantage of that opportunity with gusto.

By simply cumulating the various purchase prices, the county assessors included not only the underlying land

and physical improvements, but also all the tangible personal property items such as furnishings, sports equipment and office equipment since under California's real property tax system, personal items are not part of a real property tax assessment; all the intangible personal property items such as the value of management, maintenance, maid services, accounting, recreational services and reservations together with all of the other incidental services provided by a hotel-like timeshare project; and rights to participate in exchanges with other projects at different locations at different times. Additionally, no offset was allowed for marketing costs or special financing.

By using the purchase price as a criterion of value, a whole range of tangible and intangible personal property, together with the developer's entrepreneurial efforts, were incorrectly included in the assessments of value. The result was an increase in valuation and a corresponding increase in the tax levy from more than 200 percent for Casitas Del Monte to almost 900 percent for Powell Place.

Unsegregated Tax Billing

In addition to utilizing this questionable purchase price approach to valuation, tax collectors for San Francisco and Riverside Counties sent tax bills not to the individual unit owners, but rather to the timeshare owner's association for payment. By this process, the counties sought to shift the burden of tax collection costs from the government to the privately organized owners' associations. A segregation of the tax bill and collection procedures needed to be devised in a fashion similar to the system employed with multi-owner condominium projects. Now this has been partly accomplished by recent statutory additions.

Use And Valuation

The manner in which these initial assessments were made and the process by which the tax bills were transmitted raised a wide range of questions with respect to real property taxation of timeshare interests in California. California law requires that real property be assessed at its full value and at its highest and best use. Is the mere multiplication of the number of timeshare interests sold by the various purchase prices a reflection of full value? If highest and best use is the ultimate criteria, are condominiums, hotels and apartment houses not susceptible to timeshare usage; and shouldn't these properties be valued on an identical basis? Is the tax lien, as security for payment of the tax bill, to be imposed on the single defaulting timeshare interval or upon the timeshare project as a whole? The last question is further complicated by the fact that tax bills were not being transmitted to individual owners but rather to the association which, in turn, has no direct liability for payment of the tax. What approach can be taken to remove both tangible and intangible personal property items not otherwise susceptible to real property tax from the overall assessment? Is there a rational formula to determine the value of the exchange rights or must such rights be valued and subtracted from the real property tax assessment only on a case-by-case basis?

Theories Of Valuation

There are three generally accepted theories to measure the value of real property for tax purposes: the current replacement cost of improvements together with the cost of the land; sales data for comparable properties and the capitalization of income approach. These methods of valuation are the basic and universally accepted approaches to real property evaluation. The mere multiplication of purchase prices by the number of intervals sold does not fit any of the accepted criteria for appraisal. Timeshare conveyances all contain stringent restrictions for the use of the property by each timeshare owner; owner's rights are always restricted to time and usually limited to a particular unit or available model type. Ordinarily the timeshare owner does not have the ability to make changes in physical improvements such as altering the room configurations or redecorating. These limitations have a negative impact on the value of the timeshare owner's real property interest in the project. Furthermore, the purchase price of an interval in a timeshare project includes the right to use specified personal property items such as furniture, decor, sports equipment, etc., together with the use of certain intangible personal property rights, including the right to receive hotel-like services and to exchange for other intervals or locations at the same or different times.

The purchase price multiplication approach is not the equivalent of full value, but is a highly inaccurate and irrational overstatement of valuation. The whole value of the timeshare project does not equal the sum of its gross parts as reflected in the purchase price for each timeshare interval. Such an approach to valuation gives no offsetting credit for the higher than usual marketing costs required to merchandise the timeshare product and provides no discount for special financing.

The general criteria of value for real property tax assessment purposes is market value. To determine market value, one must contemplate a hypothetical purchase and sale transaction between an informed seller having no compulsion to sell and an informed buyer having no compulsion to buy. The actual selling price of the specific unit being assessed is not controlling in a determination of market value. The best indication would come from comparable units conveyed in a resale market. In that situation, the necessity of the developer to sell would be absent as would the pressure of the marketing campaign. Unfortunately, there is no substantial resale market from which to obtain the necessary comparability data.

By oversimplification, the equating of purchase prices with market value has caused assessors' offices to leap to the conclusion that an aggregation of all purchase prices is equivalent to the overall value of the property as a whole. However, that approach is an erroneous leap in logic which disregards both the inherent restrictions that go along with timeshare ownerships and the

simultaneous conveyance of both tangible and intangible personal property rights. The mere multiplication of the purchase prices bears no rational relationship to actual full market value of the real property interest to be taxed and very greatly overstates the actual taxable values.

The New Legislation And Regulations

The addition of Section 998 to California's Revenue and Taxation Code is a mammoth step in the right direction. No longer will the assessors be permitted (as in the cases of Powell Place and Casitas Del Monte) to include not only the kitchen sink, but also the cutlery, maid services, reception staffing and timeshare exchange rights.

However, the section falls woefully short of a panacea, and many of the problems faced by the timeshare industry remain unsolved in California. By a quick reading of the new section, one would infer the legislature had adopted a comparable sales approach to valuation. The section states the assessment is to be made "by reference to resort properties, condominiums, cooperatives or other properties which are similar in size, type and location to the property."

However clear that direction may appear on its face, the statute is rendered vague because it requires that any determination of such comparability be added to "an amount necessary to reflect an increase or decrease to the market value attributable to the fact that the property is marketed in increments of time." Even if we are to accept arguendo that the fact of timesharing alone has an effect on the value of the underlying real property improvements, the statute provides no direction whatsoever on how such an effect on value is to be determined or quantified. What this means is that once the assessor makes a comparability value determination using like properties not in timeshare use, he may then do whatever he wants to add in or subtract out value for the timeshare quality of the project.

The statute goes on to provide that any alternate method may be utilized. Given the drafting, one must suppose these alternates would include a cost analysis or capitalization of income. These are the other principally accepted theories. The result is an emasculated statute which does not do what its timeshare industry proponents anticipated. Rather than linking timeshare projects directly to physically similar condominiums or resort properties, the statute leaves wide open the methodology for valuing the timeshare quality of the project. This will undoubtedly lead to yet further inequity.

To analyze the problem in yet another way, look again at one of the two case examples. In the case of Powell Place, an existing 60-year old apartment hotel had an assessed valuation on the 1981-82 secured role of $1,120,723. To derive that value figure, the San Francisco County Assessor's Office used comparable sales data or had capitalized the existing income stream. To that assessment roll value the new statute would now have the assessor add something to reflect the fact that the property has been converted to a timeshare project. What is the increment of value (whether up or down) that this conversion to timeshare has spawned? How does the statute assist the assessors and the timeshare project developer in determining full value? Is there any assurance this additional increment of value will be equalized throughout the state as to like projects?

The answer is simply no. The assessors are left to speculate as to what methodology should be employed; and in the absence of any firm rule or applicable formula, the timeshare project developer, the owner's association and the interval owners have no tools to use in planning for the future.

As an outgrowth of the statutory changes discussed, the Board of Equalization has drafted a new regulation. This regulation is provisionally designated Rule 472, and is entitled, "Valuation of Real Property Interests and Timeshare Estates and Timeshare Uses." Rule 472 correctly addresses some of the basic problems. It insures that certain of the tangible and intangible personal property items ought to be excluded. These are the items which had caused the greatest difficulty with the reassessments in our two case examples. In addition, the regulation allows for a seasonal adjustment of value, where appropriate, for seasonal resort projects.

The troublesome parts of this regulation are found in certain sections. The new regulation contains the same vice as referenced in the basic text of its authorizing statute, Section 998. Again it fails to provide sufficient guidance on the specific methodology to be employed in determining the influence of the timeshare use on value. It is simply not sufficient to state that the assessors are to "add an amount necessary to reflect any increase or decrease in such value attributable to the fact that the subject property is marketed in increments of time." All this says is that the assessors may take into consideration the property being marketed on a timeshare basis rather than otherwise.

Subsection (i) of the rule appears to empower the assessors to utilize any of the generally recognized alternative methods of evaluation whether it be cost of replacement, comparable sales or capitalization of income. Yet it gives no guidance for utilizing these tools in the timeshare context. The result is enough to be constitutionally suspect.

Unfortunately, while Section 998 and Rule 472 may help to avoid some of the dire problems faced in the initial reassessments of the two case examples, neither the statute nor the rule provide any specific guidance on how the timeshare quality of the property is to be valued separately. Presumably different timeshares and locales will have different bases of value. It does not appear there is any universal formula applicable to timeshare as a whole. But perhaps a generalized methodology can be developed which can be applied to take into account particular variations.

A discussion of Revenue and Taxation Code Sections 2188.8 and 2188.9 could well be the subject of an entirely separate discussion since the sections raise a

number of very interesting public policy issues. The following is a brief review of the leaseholds the statute provides: upon written request, the assessor will prepare separate assessments for the timeshare interests in a timeshare project; once a request is made, all subsequent timeshare owners are bound; the separate assessments are cumulated for purposes of preparing the secured tax role; the cumulated assessment shall be a lien on the entire timeshare project; a single tax bill containing an itemized breakdown applicable to each separate assessment will be prepared and transmitted to the timeshare project organization or owner's association; the county in which the timeshare project is located may charge an initiation fee for the first time cost of separately assessing and for the ongoing implementation not to exceed the actual cost; and this amount is to be included in the tax bill transmitted to the timeshare project organization. The section dealing with fee interests differs in that the lien too is segregated. This is consistent with lien rules in the real property tax system.

In the case of leasehold, while separate assessments are prepared if requested, the bill is sent to the timeshare owner's organization and a lien is imposed on the project as a whole. Yet the obligation to pay ostensibly lies with the timeshare interval owner. The section also imposes a significant burden on the timeshare organization to provide detailed information with its segregation request and annual updated information. With other types of property, the assessor's office would garner such information through a review of the county recorder's office of public records. The general public, not the property owner, ordinarily bears the administrative cost of the tax system. It is not so with timeshares.

One effect of imposing the costs of administration on the timeshare owner's association is that the burden may fall very unevenly among the various California counties. Counties where destination resort locations are concentrated may be able to computerize collection efforts; and by streamlining the methodology, the per unit costs will be substantially reduced. In other counties where only a few timeshare projects exist, the costs of collection using less streamline methodology will be substantially greater on a per unit basis. Once again the possibility of significant inequities exist.

The California Leasehold Anomaly

One of the stranger progeny of the post Proposition 13 flurry of statutory enactments has been the definition of change in ownership. Section 61 (c) (1) of the Revenue and Taxation Code provides a change in ownership will occur and thus trigger a reassessment upon the creation of a leasehold interest in taxable real property if the term is 35 years or more including written renewal options. The creation of a leasehold for less than 35 years, including written renewal options, does not constitute a change in ownership. Thus, where a timeshare use is created by a leasehold of less than 35 years, no change in ownership has occurred and there will be no reassessment for real property tax purposes even though the entire property is devoted to such timeshare usage.

As a result of this definitional anomaly, a strange situation has developed in California. Some of the less than 35-year timeshare uses, based on a leasehold interest, are not subject to reevaluation for real property tax purposes while the identical interval (in terms of time, space and amenities) will be subject to reassessment if it is a fee or a leasehold exceeding 35 years. This concept is based on the rationale that a lease of 35 years or more is the substantial equivalent of a fee interest, and thus triggers reappraisal for real property tax purposes as a change in ownership. The same rules apply in the nontimeshare context. The problem is only magnified with timeshares because of the very significant increases in assessed value found by the county assessors with respect to properties converted to timeshare usage. This strange circumstance provides a window of relief to potential future timeshare project developers. By selling timeshare intervals with terms of less than 35 years, neither the timeshare interest nor the project as a whole will be subject to reassessment for real property tax purposes. The taxable unit remains the underlying undivided fee interest. Only on a conveyance of the fee does a change of ownership occur triggering a reassessment. The disadvantage is it is more difficult to market a short-term leasehold than a fee interest or a long-term lease.