by Benjamin A. Blair, JD

# Recent Court Decisions on Real Estate and Valuation

## Market rent paid to shareholders in a rural town not excessive

Plentywood is a town of about 1,700 people in northeast Montana. Plentywood Drug, Inc. (PDI) is a Montana corporation that operates the only pharmacy in Plentywood. Founded in 1910, PDI is now owned by Robert and Marilyn Mann and Kathryn and Marvin Eberling. The pharmacy rents space in a building on Plentywood's Main Street, owned in equal shares by the Manns and Eberlings. The building contains 8,125 square feet of retail space and 5,250 square feet of basement support area.

PDI pays rent to the four owners of the building. The rent is set by oral agreement at the beginning of each year and is not reduced to a formal written lease. PDI paid rent of $83,584 in 2011 and $192,000 in 2012 and 2013. Because the couples each owned half the building, they each reported half the rent on their income tax returns; PDI deducted the rent from its corporate income each year.

The Commissioner of the Internal Revenue Service (Commissioner) audited PDI for tax years 2011–2013, then expanded the audit to the Manns and Eberlings, issuing notices of deficiency to them and to PDI. All proposed adjustments were resolved except those related to the rent paid to the couples as lessors and deduced by PDI as lessee. On that issue, the Commissioner contended that PDI had paid its shareholders too high a rent, which would in effect make some of that rent a nondeductible dividend. PDI and the couples (collectively, Taxpayers) timely appealed to the US Tax Court to decide what fair market rent for the building would be.

The Internal Revenue Code (Code) allows a taxpayer to deduct ordinary and necessary expenses it pays in carrying on business, including the rent paid by the business. But for an expense to be ordinary and necessary, it must also be reasonable in amount. The Commissioner does not often question the reasonableness of rent agreed to by parties at arm's length, but when there is a close relationship between the lessor and lessee, an inquiry into what constitutes reasonable rent is necessary to determine whether the sum paid is in excess of what would have been required in a lease with a stranger.

The parties "quickly realized that finding comparable properties in a town of 1,700 people in frontier Montana" would be difficult. Montana is a nondisclosure state, so real estate data such as sale price is legally confidential and unavailable. And the issue is magnified in a town the size of Plentywood, which has a limited number of potentially comparable buildings.

The Taxpayers produced a rent-survey report from an appraiser based in Williston, North Dakota, a larger town an hour away from Plentywood. He surveyed rent comparables in Plentywood and in Williston. He first considered a lease for the US Post Office in Plentywood, which signed a ten-year lease for $18 per square foot that was renewed in 2008 for $15.90. He also found leases in Williston for office buildings and a pharmacy, but he noted that rents were increasing in Williston during the years at issue because of its location in the middle of the North Dakota oil boom. He concluded to rent for PDI of $25 per square foot of the main floor, plus $8 per square foot for the basement, based on finished basement rents in Williston. He described this conclusion as a rent survey, not an appraisal.

The Commissioner offered the testimony of an IRS staff appraiser. He used data from only properties located in Plentywood but found only four comparables: two government-subsidized apartment buildings, the post office, and a 625-square-foot donut shop. He adjusted the rents for various factors, including for the different types of construction; he observed that retail properties generally have lower construction costs than apartments. He developed rent only for PDI's main level; he concluded that the basement space had no value in itself, but rather contributed to the value of the main floor space. His market rent conclusions were below $60,000 each year.

The tax court began by addressing the Commissioner's argument that the Taxpayers' appraiser should have, but failed to, comply with USPAP because his assignment was an appraisal. The tax court agreed that under Uniform Standards of Professional Appraisal Practice (USPAP) a market rent opinion is an appraisal assignment, but the tax court's rules allow it to consider expert valuation opinions that do not comport with USPAP, though the weight assigned to that evidence may be diminished.

The tax court then considered each party's comparables. The court found that the differences between Plentywood and Williston were too substantial to rely on Williston leases. Williston's population was eight times that of Plentywood, and it had a much stronger economy, generating higher rents. But the Commissioner's comparables were just as problematic: "when a town is so small that an appraiser looking for comparables for retail space ends up looking at apartment buildings, perhaps it might be wiser to go to the next town over."

The parties' appraisers did share one comparable, the post office building. The tax court found many of the Commissioner's adjustments to that lease to be excessive, but the court observed one factor he did not consider: the creditworthiness of the government and the long-term nature of the lease. That factor offset the downward adjustments, so the court concluded that the $15.90 post office rent could be applied. The tax court also rejected the Commissioner's appraiser's conclusion that the basement had no value; it adopted the Taxpayers' appraiser's conclusion for the basement space, even though it was based on rents in Williston.

Accordingly, the tax court concluded to fair market rent for PDI of $171,187.50 per year. Although PDI paid slightly higher rent in 2012 and 2013, the court noted "just how difficult it was for the parties' professional appraisers to calculate a fair rent themselves." Accordingly, the tax court concluded that there was no underpayment of tax, and thus no penalties were applied.

*Plentywood Drug, Inc. v. Commissioner*
US Tax Court
April 26, 2021
T.C. Memo. 2021-045

## Build-to-suit leases do not reflect market rent and are not definitionally part of *real property*

In 2005, Bass Pro Shops (Bass Pro) negotiated a twenty-year, build-to-suit lease agreement with the owners of a property in Johnson County, Kansas (County). Under the lease, the landlord was responsible for various expenses, including property taxes. The lease required Bass Pro to pay annual rent of $600,000, but it gave Bass Pro the option of buying the property for $10 at the end of the lease term. Bass Pro ultimately built a 130,998-square-foot building on the property and has occupied it since construction.

In 2008, Arciterra BP Olathe KS LLC (Arciterra) purchased the property for $1.9 million, subject to the 2005 lease. The lease produced a positive cash flow until 2016, when the County doubled the property's tax assessment. Arciterra appealed to the Board of Tax Appeals (Board), which conducted an evidentiary hearing.

Both parties' appraisers agreed that the income approach was the most relevant indicator of the property's value. The County's appraiser considered a mix of lease types, including build-to-suit leases. He explained that it was acceptable to consider build-to-suit leases to determine market rent if the necessary adjustments were made, though he did not say what adjustments he made to account for that factor. He ultimately concluded to rent of $10 per square foot and arrived at a value of $14.4 million, which he said was for the fee simple estate as required by Kansas law, though he denied that such a standard required the property to be valued as though it was vacant on the date of value.

Arciterra's appraiser prepared two valuations: one of the fee simple interest and one of the "hypothetical leased fee" estate, in which he assumed that the property would be encumbered by a short-term lease to a moderate-credit tenant. He explained that he performed this second analysis because he was unsure what Kansas law required in valuing a fee simple interest when a property is occupied. He excluded first-generation build-to-suit leases, observing that such rents were not representative of market because they were typically negotiated before improvements were made to the property. He concluded to rent of $7 per square foot, arriving at a fee simple value of $7.5 million and a "hypothetical leased fee" value of $9 million.

The Board concluded that build-to-suit leases do not reflect market rent and should not be used to determine market rent unless an appraiser makes the necessary adjustments. Accordingly, the Board rejected the County's appraisal. Instead, the Board adopted Arciterra's hypothetical leased fee valuation. The County appealed.

In an earlier Kansas case, *In re Prieb*, the court concluded that Kansas law required that property tax valuations be based on the fee simple interest, not the leased fee estate. The court here observed that "underlying most of the County's arguments on appeal is its unwillingness to follow *Prieb*." First, the County argued that *Prieb*'s definition of fee simple interest should be rejected in favor of the definition from *Black's Law Dictionary*. But the court of appeals found it "unnecessary to parse any linguistic differences between the two" because the County never explained why the original definition was wrong or how use of *Black's* definition would make a difference. The court also reiterated that, while Kansas tax statutes do not use the term "fee simple," it is clear that the legislative intent underlying the statutory scheme of property taxation has always been to appraise the property as if in fee simple.

The County also disagreed with *Prieb*'s finding that build-to-suit leases are essentially financing agreements, instead asserting that such leases are nothing more than operating leases to occupy real property. The court likewise rejected this argument, finding that second-generation as-is leases are most indicative of market rent, as the cost of owner-occupied renovations are amortized over the term of the lease. Market rent is not necessarily accurately reflected in a particular lease that encumbered a property, particularly when the lease is a build-to-suit lease or is otherwise unique. Here, not only was the lease build-to-suit, but it also included the unusual provision giving the tenant the option of buying the property for $10 at the end of the 20-year lease term.

Finally, the County argued that the statutory definition of *real property* for tax purposes supported the conclusion that the value of the leasehold must be included in the valuation. That definition states that *real property* includes "not only the land itself, but all buildings, fixtures, improvements, [and] rights and privileges appertaining thereto." The court found no authority, though, that a lease is a "right relating to real property" such that the lease is definitionally part of the real property. "This argument is merely another way of asserting that fee simple is not required," and the court rejected it.

Ultimately, the Board heard two days of testimony, and while "there may be legitimate questions about some of the assumptions that underlie" the hypothetical leased fee value prepared by Arciterra's expert and concluded to by the Board, those questions were not appealed. The County failed to show that the Board erred in rejecting its appraisal, and the court affirmed the Board's determination.

*In re Arciterra BP Olathe KS, LLC*
Kansas Court of Appeals
April 2, 2021
484 P.3d 261

## Inconvenience from city's development regulation does not constitute a taking

In May 2012, Benedict Mohit purchased a twenty-acre property located in Haines City, Florida, and "immediately began growing a commercial hay crop." His intent was to farm and use the profits to build and maintain a family home on the property. Two months after he bought the property, Haines City adopted a land development regulation that prohibited using his land for keeping farm animals or for other agricultural purposes absent a permit. After being told by city officials that he needed a permit to carry out his farming plans, Mohit filed suit in state court, alleging that Haines City was unlawfully prohibiting his proposed livestock grazing on his farm.

The state trial court concluded that Mohit should submit a new application for a conditional use permit to pursue livestock farming. Mohit did so, though he wrote on the top of his application that he viewed the permit requirement as unlawful. Three months later, Haines City granted him the permit, allowing him to have up to twenty goats, twenty cattle, and five horses—exactly what Mohit asked for in his application.

Mohit continued to pursue his legal claims, however. He amended his complaint to allege that the regulation and the permit requirement were contrary to state law, violated the Due Process Clause of the US Constitution, and effected a regulatory taking without just compensation. Haines City was granted summary judgment on most issues, but the federal claims were dismissed without prejudice, so Mohit filed in federal court, alleging violations of the Takings Clause, among others. The federal district court denied all of Mohit's claims, and he appealed.

The Fifth Amendment to the US Constitution provides that private property shall not be taken for public use without just compensation. The US Supreme Court has noted two scenarios where a government regulation is so onerous that it constitutes a taking. The first is when, with certain qualifications, a regulation denies all economically beneficial or productive use of land. The second is when the regulation is found to be a taking based on a complex of factors including the economic impact of the regulation on the claimant and the extent to which the regulation has interfered with distinct investment-backed expectations.

On the first scenario—the only avenue expressly mentioned by Mohit in his claims—the court of appeals observed that Mohit cannot plausibly argue that he was deprived of all economically beneficial or productive use of the property. After all, he was permitted to engage in some agricultural activities, even if those activities were less extensive than he would have liked. That is not a denial of "all" productive uses of the property.

On the second scenario, involving the complex of factors, Mohit limited his briefing to arguments about state law instead of engaging in the analysis of the various factors. The court concluded that Mohit did not adequately connect his argument to the only inquiry that matters: whether the regulation constituted a taking. The court concluded that "it may well be that the land development regulation and the permit caused deep inconvenience and frustration for Mohit." But because inconvenience is not sufficient to show a compensable taking, and because Mohit failed to substantiate his arguments, the court affirmed the decision of the district court.

*Mohit v. City of Haines City*
US Court of Appeals, Eleventh Circuit
January 26, 2021
2021 WL 244583

## Recitation of a preexisting interest in a recorded title transaction preserves the interest

Ohio's Marketable Title Act (Act) provides that an unbroken chain of title to land for a period of forty years establishes a marketable record title to the land, which generally extinguishes property interests that predate the landowner's root of title. However, the Act provides that marketable record title is subject to "all interests and defects" inherent in the chain of title with a key exception: a "general reference" to easements, restrictions, or other interests created prior to the root of title is not sufficient to preserve that interest unless the general reference also includes "specific identification" of the recorded title transaction that created the interest.

In February 1926, James and Rose Logan conveyed the surface rights to 139 acres of land in Guernsey County, Ohio, to Edward Riggs, but the Logans retained the mineral rights by adding the following language to the deed: "excepting and reserving therefrom all coal, gas, and oil with the right of said first parties, their heirs and assigns, at any time to drill and operate for oil and gas and to mine all coal." The Logans ultimately sold their mineral rights through execution of a deed specifically referring to the 1926 transaction, with Randall and Kathleen Erickson as the current heirs.

Between 1926 and 2017, the surface rights to the land transferred several times through recorded instruments, with each instrument reciting the same "excepting and reserving" language from the 1926 deed. By 2017, the ownership of the land had transferred to the trusts of Paul and Vesta Morrison.

In August 2017, the Ericksons filed an action to quiet title and for declaratory judgment that they own the mineral rights to the land by virtue of the reservation. The Morrisons counterclaimed for a declaration that the reservation of the mineral rights had been extinguished under the Act. The trial court ruled in favor of the Ericksons, and the Morrisons appealed. They argued that the trial court erred by holding that the severed mineral interest at issue was preserved from extinguishment. The court of appeals agreed, explaining that the reservation does not state by whom the interest was originally reserved, nor to whom the interest was granted. Thus, the reservation was general, not specific. The Ericksons appealed to the state supreme court.

On appeal, the Ericksons maintained that the Act does not require a reservation to include the name of the owner of a mineral interest in order for it to be preserved, and that even in the absence of a specific name in the reservation, a title search would reveal the owner of the reservation by a review of the chain of title, reading the 1926 deed and searching forward in time. Because the owner of the reservation can be determined through the chain of title, the Ericksons contended that it is a specific reference, not a general reference. The Morrisons argued that under the Act, a title examiner should need to review only the language in the root of title and the instruments recorded during the 40 years prior in order to locate any specific references to an interest predating the root of title. Here, because the prior interest cannot be located without a more extensive search and none of the recorded title transactions within the prior forty years mentioned the Ericksons, they contended the reservation is not a specific reference.

The state supreme court reframed the question as whether a reference to a reservation of mineral rights in a surface landowner's root of title is a general reference that is insufficient to preserve the reservation if it does not name the owner of the reserved rights.

The Act was created in 1961 to extinguish stale interests and claims in land that existed prior to the root of title, with the goal of simplifying and facilitating land title transactions by allowing persons to rely on a record chain of title. The court quoted a commentator who observed that the specific identification provision in the Act was directed at the common conveyancing practice of including in the deed description language like "subject to easements and use restrictions of record." This type of general provision is probably adequate to protect the grantor from liability on covenants for title in a warranty deed, but such a general reference leaves it unclear whether a prior interest in fact exists.

The Act creates a three-step inquiry: (1) Is there an interest described within the chain of title? (2) If so, is the reference to that interest a general reference? (3) If so, does the general reference contain a specific identification of a recorded title transaction? Here, the answer to the first question is yes, because the documents in the chain of title state that surface rights in the land are subject to a reservation of mineral rights. At issue is whether that reference to the reservation was a general reference.

In an earlier case, the Ohio court declined to establish a bright-line rule that an interest is preserved only if the reference to it includes either the volume and page where the interest was created or the date it was recorded, because the Act sets forth no such rule. Likewise, there is no rule that requires the reference to identify the type of interest or its owner. A recitation of a preexisting interest is not a general reference simply because it does not name the owner.

Here, the transfer of the surface rights does not contain vague, boilerplate language excepting any reservations that may or may not exist. Rather, the root of title was made subject to a specific, identifiable reservation of mineral rights recited though the chain of title using the same language as the recorded title transaction that recorded it. Accordingly, that reference is sufficient to preserve the reserved rights from being extinguished under the Act. The trial court's judgment for the Ericksons was reinstated.

*Erickson v. Morrison*
Supreme Court of Ohio
March 16, 2021
2021 WL 966949

## Adjusting sale for conversion costs makes sale less comparable to subject facility

Detroit Diesel Corporation (Diesel) owns a single-user manufacturing facility located primarily in Redford Township, Michigan (the Township). As of December 31, 2016, Diesel used the property to manufacture powertrains, diesel engines, and axles for heavy and medium trucks. The facility spanned three million square feet; the first million was constructed before World War II, with the remainder expanded piecemeal over time. Despite the facility's age, Diesel was using it to conduct modern manufacturing activities, having made improvements to the real estate. Nevertheless, large portions of the facility were not up to modern standards.

For the 2017 tax year, the Township determined the true cash value of the property to be

$41 million. Diesel challenged that value as excessive, filing an appeal with the Michigan Tax Tribunal.

At trial, Diesel offered the testimony of an appraiser who explained that very few users were in the market for a three-million-square-foot complex. Many automakers had shut down their plants in Michigan, and while there was demand for this type of building from warehouse and distribution companies, a plant like the subject property would most likely be purchased for industrial redevelopment or conversion to a multitenant space. Accordingly, Diesel's appraiser concluded that the highest and best use of the property was for "industrial development."

Based on that determination, the appraiser identified and adjusted four sales of manufacturing plants with over one million square feet and located in the Midwest. All four sales were of former automotive plants, and the appraiser adjusted for differences in market conditions, size, location, ceiling height, and age, among other factors. He also considered seven supplemental sales. He concluded to a value of $9.41 million for the subject property.

The Township's appraiser argued that high demand existed for industrial space, driven by the auto industry as well as ecommerce and tech companies. He concluded that the property's highest and best use was a continuation of single-user manufacturing, opining that conversion of the property was not feasible. He identified four sales, only one of which was over one million square feet. Further, three of the properties were multitenant properties, two of the sales were leased fee transfers, and another was purchased by a long-term tenant. He also considered four supplemental sales, but he arrived at an opinion of value of $50 million.

At the close of evidence, Diesel argued that the Township's highest and best use conclusion was not supported by its own appraiser's comparables, because the majority of them were not sales for single-user manufacturing. The Township argued that Diesel's appraiser's conclusion was generic industrial use, rather than specific.

The Tribunal noted that it was generally unsatisfied and unpersuaded by the appraisers' sale comparables. But taking a global view of the testimony, the Tribunal found that multitenant use is the most frequent use for large manufacturing facilities, given that nine of eleven of Diesel's comparable sales were converted to multitenant use after sale and that five of eight of the Township's sales were already multitenant at the time of sale. But because the cost of converting a three-million-square-foot, single-user building would be substantial, the Tribunal found that the highest and best use of the property was "industrial use," not solely single-use manufacturing as the Township had advocated.

For various reasons, the Tribunal rejected most of the parties' comparable sales, but concluded that Diesel's first sale comparable was a good indicator of the subject's value. After adjusting that sale, the Tribunal concluded that Diesel's property had a total value of $18 million. The Township appealed.

On appeal, the Township argued that the Tribunal erred in finding that industrial use—encompassing both single-use and multi-use—was the highest and best use of the property. According to the Township, that conclusion was legally erroneous and not supported by substantial evidence. The court of appeals was not persuaded.

The Township first argued that it was inconsistent for the Tribunal to adopt industrial use as the highest and best use because the Tribunal rejected single-user manufacturing—a subcategory of industrial use—as the highest and best use. The court found this argument misplaced, as it was clear the Tribunal was rejecting single-user manufacturing as the one and only highest and best use, but not rejecting a highest and best use conclusion that encompassed single-user manufacturing. Moreover, the focus of the highest and best use analysis is the identification of the most profitable use of the property going forward so long as there is market demand for that use. This does not necessarily mean, however, that the identified use will always produce the same sale price in every circumstance.

The Township also argued that no evidence supported the conclusion that multitenant use was financially feasible. Diesel's appraiser did not account for those costs in his appraisal, and, according to the Township, without discussion of specific conversion costs for the infinite combinations of potential conversions, there is no substantial evidence to support a conclusion that conversion is financially feasible.

The court rejected this argument, noting that the Township "wrongly assumes" that a robust discussion of conversion costs was necessary. Diesel showed that conversion was financially feasible through its comparable sales analysis, which specifically identified multiple older, large single-user manufacturing facilities sold for conversion to multitenant industrial use. Furthermore, conversion costs would not be a relevant adjustment to calculating the property's value, since the comparable relied on by the Tribunal was a price *before* conversion to multitenant use. The subject has not been converted to multitenant use. Adjusting that sale for conversion costs would make it less comparable, not more comparable, to the subject.

In sum, the court found that material and substantial evidence supported the Tribunal's findings and conclusions. Therefore, its decision was affirmed.

*Detroit Diesel Corp. v. Redford Township*
Michigan Court of Appeals
January 21, 2021
2021 WL 218311

## Equitable partition of co-owned land can be divided collectively among groups of owners

Leonard and Linda Smith (the Smiths) and their four children—Lynden, Jaclyn, Sarah, and Lucas—are co-owners of 4,972 acres of land in Sheridan County, Nebraska, which they inherited from Linda's parents. The shared land is made up of three noncontiguous parcels. Two parcels are 46% owned by Linda, with each child owning 13.5%. The third parcel, consisting largely of pastureland, is 32.5% owned by the Smiths in common, with the remainder divided equally among Linda and the four children.

In 2017, three of the Smiths' children, Appellants Lynden, Jaclyn, and Sarah, filed a shared complaint for partition of the co-owned land, seeking that the property be partitioned and divided among its owners in kind and if it cannot be partitioned in kind, then that it be sold, with the net proceeds divided accordingly. The Smiths and son Lucas (Appellees) filed a shared answer, conceding that partition of the co-owned land was necessary and appropriate and requesting that a referee be appointed. The trial court appointed a referee to recommend whether the property could be partitioned in kind without great prejudice to the owners or whether the property should be sold and the proceeds divided.

The referee inspected the property and opined that partition in kind could not be made without great prejudice to the owners. Appellees filed an objection to the referee's report, alleging that the sale of the property would work a serious and unique hardship on the Appellees given their investment in the property and its location adjacent to other property owned by the Smiths.

The purpose of partition is to provide owners with separate and exclusive possession of their portion of co-owned land. Partition in kind physically divides the property, whereas partition by sale involves the division of sale proceeds. There is a strong presumption in favor of partition in kind if feasible and equitable.

During trial, most of the family testified. Appellants and Appellees both called an expert witness to testify regarding the feasibility of partitioning the co-owned land in kind. Leonard proposed a division that would give Appellants 1,880 acres of the total acreage; while that was not equal to the Appellants' collective 40.5% interest by acreage, it would provide them with their collective share of the value of the co-owned land. The Appellees also called an appraiser who calculated the value of each of the three parcels and opined that the land could be fairly partitioned between Appellees collectively and Appellants collectively.

For the Appellants, Jaclyn testified that she did not want a collective share of the land, because then another partition action would have to be initiated, and she did not want to be legally bound to the other family members. The Appellants also called their own appraiser who valued each parcel, but applying the Appellees' division using his values would yield only 35.75% of the total value, versus their 40.5% interest in the land. That would be an inequitable result.

The court entered an order sustaining the Appellees' objection to the referee's report and ordering an in-kind division of the property such that Appellants collectively received 41.17% of the total value of the property. While partition in kind may be difficult in this case, the court concluded that an equitable division was not impossible, and a forced sale would not advance the interests of most of the family. The Appellants appealed.

The Appellants challenged the trial court's authority to order partition in kind such that co-owned land is divided collectively between two groups of owners. They argued that partition in kind can only be achieved by awarding each owner his or her individual share of the land. The court of appeals agreed that such a remedy should be rarely used and only when it is equitably necessary, but that under a court's equitable powers, a court can divide property between two groups of owners. It said that this case was "one of the rare situations which warrants a partition in kind" collectively between the Appellants and Appellees.

First, the Appellants clearly aligned their interests, acting as a unit through the proceedings and, at least implicitly, indicating a collective desire to partition by sale. Additionally, partition by sale would create a significant hardship for Appellees, especially because Leonard and Linda own land which borders the co-owned property and because their ranching and farming operations have been in place on the property for decades. By dividing the land in kind collectively between the two groups, the trial court awarded Appellees sufficient land to keep their operation running, while giving Appellants more than their fair share of the value of the land to sell. The appraisers concluded the land was very marketable, and the Appellants could sell the land awarded them and obtain more than their 13.5% individual share of the total value of the land. This was precisely what they sought in their partition action and at trial.

Because collective division between groups of co-owners is within the powers of the trial court, and here such an approach resulted in an equitable outcome, the court of appeals affirmed the trial court's decision to partition the land in kind rather than to order the sale of all of the land.

*Smith v. Smith*
Nebraska Court of Appeals
March 16, 2021
957 N.W.2d 511

## Foreclosure sale is not an open market transaction for establishing full cash value

In May 2000, an individual (Previous Owner) purchased real property in Humboldt County, California, for $125,000. The property consisted of two wooded 80-acre parcels. The Previous Owner added a 1,500-square-foot manufactured home on a permanent foundation at a cost of $85,000. The Previous Owner then tried to sell the property various times without success. Eventually, in 2012, the mortgage holder foreclosed; the unpaid debt was $245,179. In June 2013, Tim Phillis purchased the property at a public trustee sale for $153,806. At the time of the trustee sale, the manufactured home was in poor condition and lacked a functional water or electrical source.

Under California's Proposition 13, property is to be assessed at its full cash value, which is defined as the appraised value of the property at the time of purchase. Where full cash value is established upon purchase and sale of the property, the term *full cash value* means fair market value. The California tax code further provides that for purposes of determining full cash value of real property being appraised upon purchase, full cash value is the purchase price paid in the transaction unless it is established that the property would not have transferred for that price in an open market transaction. The tax code further provides a rebuttable presumption that the purchase price is the full cash value if the terms of the transaction were negotiated at arm's length and neither party could take advantage of the exigencies of the other.

In November 2013, the property was assessed for tax purposes at a value of $469,976. Phillis submitted an application for a changed assessment for 2013 and 2014. In his application, Phillis argued that his property should be assessed at the price he paid for the property in the trustee's sale.

The County Assessor took the position that a foreclosure sale is not an open market transaction. For support, the Assessor pointed to the State Board of Equalization's annotation to the property tax law stating that the presumptions of full cash value under the tax code do not apply to execution or foreclosure sales, since those are forced sales and thus considered non-market transactions. Moreover, the trustee's sale here was limited by the requirements that a deposit of $2,500 be submitted before the auction and a winning bid must be paid within three days, making traditional financing unavailable.

The county Assessment Appeals Board rejected Phillis's argument that the sale price should be the assessed value. It concluded that foreclosure sales are not fair market sales, but also rejected components of the Assessor's valuation. The Board also found that even if foreclosure sales could be considered in some circumstances, this sale did not meet the parameters of an open market sale because of the inability of a buyer to obtain traditional financing, the seller was forced to sell, and the buyer was in "at least the potential position" of being able to take advantage of the owner's necessity to sell. The superior court agreed.

On appeal, Phillis made the same argument: that the Assessor had the burden of proving that the foreclosure sale in which he purchased the property was not an open market transaction, and that the Assessor had failed to meet the burden. According to the court, Phillis's position assumed that the rebuttal purchase price presumption applies in every case and controls absent evidence the particular purchase was not an arm's-length, open-market transaction. But the court disagreed with that assumption.

The court noted that "it is common knowledge that at forced sales such as a trustee's sale, the full potential value of the property being sold is rarely realized." Property that must be sold within the strictures of the time and manner of a state-prescribed foreclosure "is simply worth less."

Here, Phillis argued that the sale was not "forced" because the trustee was a willing party and the auction was noticed for seven months. But these arguments were not persuasive because all foreclosure sales must be conducted in accordance with statutory requirements regarding notice, timing, and bids. Moreover, the trustee is not attempting to maximize gain, as would be expected of a seller in an open market transaction. Rather, the trustee is attempting to recoup the amount of the defaulted loan, regardless of the actual value of the security property. In short, a foreclosure sale is by nature not an open market transaction supporting application of the purchase price presumption. The Board's judgment was affirmed.

*Phillis v. County of Humboldt*
California Court of Appeal, First District
December 31, 2020
59 Cal.App.5th 432

## Charter school had equitable title entitling it to tax exemption

The International American Education Federation, Inc. (IAEF) operates charter schools in Dallas County, Texas. In 2016, IAEF leased real property from a private landowner to operate IAEF's schools. The following year, IAEF requested that the Dallas Central Appraisal District (DCAD) designate the property as exempt from ad valorem taxes. DCAD denied IAEF's exemption request, as did the reviewing administrative agencies.

IAEF filed its petition for review in the Dallas County District Court, arguing that it was entitled to a property tax exemption on the properties it leased for educational purposes. The trial court agreed, ordering DCAD to take all steps necessary to notify the county Tax Assessor-Collector that the property "was and is exempt" and ensure that all taxes, penalties, and fees be disallowed and refunded to IAEF. DCAD appealed.

The Texas tax code provides that property owned by the state or a political subdivision of the state is exempt from taxation if the property is used for public purposes. Thus, in order to qualify for this exemption, IAEF was required to establish that the property is both owned by the state and used for a public purpose.

Prior case law had determined that open enrollment charter schools are part of the public school system in Texas, and thus are deemed agencies of government, at least for purposes of the Texas Tort Claims Act. Accordingly, DCAD did not dispute that IAEF's property was used for the public purpose of operating schools. Instead, the parties dispute whether the property is owned by the state or a political subdivision thereof.

Texas courts generally have defined "ownership" for taxation purposes in terms of the person or entity holding legal or equitable title. Equitable title for these purposes includes the "present right to compel legal title." For example, in an earlier case, the state possessed property and would acquire full legal title upon payment of all lease payments; the earlier court concluded that the property was owned by the state "no differently from that of any private owner who holds property against which there is an outstanding lien."

Here, IAEF argued that it has equitable title to the property because a purchase option within the lease agreement gave it the unqualified, unilateral right to assume fee title to the property, at least if the option was exercised within the first five years of the lease term. Notwithstanding the limited time in which IAEF could exercise its option, the court of appeals agreed that the lease provision provided IAEF with the power to compel transfer of legal title. Indeed, in 2018, IAEF took full legal title through a special warranty deed, which DCAD conceded during the oral argument.

Under the facts of this case, the court held, "there was no room for reasonable disagreement about whether IAEF could have compelled issuance of the title." By granting IAEF the immediate right to compel the transfer of fee title by unilateral exercise of its own will, the lease was sufficient to grant IAEF equitable title to the property, entitling it to an exemption from property taxation under the Texas tax code.

*Dallas Central Appraisal District v. International American Education Federation, Inc.*
Texas Court of Appeals
December 29, 2020
618 S.W.3d 375

## Loss of business's on-street parking is not a compensable taking

Turano Baking Company (Turano) owned a long, narrow facility in Berwyn, Illinois (City). Although its property was geographically constrained, an alley ran behind the length of the facility, with single-family homes on the opposite side. Two north-south streets ran perpendicular to the alley, and thus Turano's facility.

Desiring to expand its premises to allow for more in-site parking, Turano acquired several residential lots just south of the alley. It planned to create one row of perpendicular parking spots on the former residential lots, reconfiguring the alley into a driveway. In 2014, the City granted a zoning variance to Turano allowing Turano to cut off access to the parking lot from the perpendicular streets by ending them in cul-de-sacs.

This plan had the effect of depriving RDB Properties LLC (RDB), whose property lay near the end of one of the newly blocked roads, of parking spaces on the city streets. The loss of street parking, according to RDB, diminished the value of its property, and without street parking, RDB had lost spots suitable for handicapped parking. After unsuccessfully requesting that the City compensate it for these harms, RDB sued the City under the Fifth Amendment for taking its property without just compensation.

RDB claimed that the City facilitated Turano's actions by granting a zoning variance to the company, by transferring public land to the company, and by approving the cul-de-sac construction. Nevertheless, none of RDB's allegations was severe enough for a constitutional taking, and RDB failed to allege its injuries denied it all or an essential use of its property.

The City moved to dismiss the complaint, arguing it had no role in the alleged taking because the actions at issue were those of Turano, a private entity. The district court granted the City's motion to dismiss, though on different grounds. RDB appealed.

A wide range of government actions may require just compensation under the Fifth Amendment, including permanent physical invasions, deprivation of a property's entire value, exactions, and regulations that unduly interfere with property rights. Compensable takings generally fall into one of two categories: per se takings, which occur when the government physically seizes private property, and regulatory takings, which occur when government regulation of private property becomes sufficiently onerous.

RDB contended that it suffered a per se, physical taking, characterizing the City's cul-de-sac allowance as a physical encroachment on its nearby street parking. But the court of appeals found that RDB's argument missed one crucial point: RDB does not, and never has, owned any street parking places. It is impossible to suffer a taking of property that one does not have. By neglecting to identify any physical intrusion on its own property, RDB failed to allege any kind of direct physical seizure.

Alternatively, RDB maintained that it adequately alleged a regulatory taking in the form of a decline in property value due to the loss of street parking. But the court opined that even if it took RDB's statements as true, the complaint still failed to allege a regulatory taking. First, not every regulation that decreases property value qualifies for compensation. And the fact that street parking might be desirable or valuable does not show that the City's decision to eliminate a few parking spaces amounts to a taking, either from the standpoint of economic impact or interference with investment-backed expectations. Nor did RDB plausibly allege a deprivation of property rights, as opposed to an incidental decrease in property value.

In total, then, the court concluded that nothing in RDB's fact pattern "even remotely approximates the type of government action" considered a taking. The City's decision about how to use the public roads did not deprive RDB of any stick in the bundle of property rights. Accordingly, the district court properly dismissed RDB's case.

*RDB Properties LLC v. City of Berwyn*
US Court of Appeals, Seventh Circuit
February 1, 2021
2021 WL 318235

## Town's reservation of specific use of beach does not confer broader power to issue use permits

The Town of East Hampton, New York, is located at the eastern tip of Long Island and includes miles of oceanfront beaches. A collection of homeowners associations, including Seaview at Amagansett Ltd. (Seaview, and collectively with the others, the Associations), claim to own property that includes a portion of the beach lying landward of the mean high-water mark of the Atlantic Ocean.

Since 1991, the Town has issued permits authorizing their holders to operate and park vehicles on the *beach*, a term codified as including "all land lying between a body of fresh- or salt water and the base of a bluff or dune" or all land lying between the body of water and the naturally occurring beach grass or upland vegetation. This definition of *beach* includes both the upland title claimed by the Associations, which extends to the mean high-water mark, as well as the underwater land between the high and low water marks.

The Associations filed suit to quiet title to the beachfront portions of their respective properties and a judgment declaring that they owned title to the disputed area in fee simple. They likewise sought a judgment declaring that a reservation in their deeds, dated to March 1882, had been terminated or could not be construed as authorizing the Town to issue permits to operate and park vehicles on the Associations' properties.

At trial, the Associations produced a land title expert who testified to each respective property's chain of title. The expert testified, based on documentary evidence, that the Associations owned fee simple title to their properties extending to the mean high-water mark. The Associations also produced all of the deeds in those respective chains of title, beginning with the March 1882 deed, which was common to all of the Associations' chains of title.

After a trial, the trial court dismissed the complaint, and the Associations appealed.

The NY Supreme Court, Appellate Division began by explaining the history of the properties. In 1882, the Town and its trustees were empowered to validly convey to the Associations' predecessor-in-interest the title to the disputed portion of the beach, and they did so. The March 1882 deed, however, contained a reservation, specifically reserving to the inhabitants of the Town "the right to land fish boats and [nets] and spread the [nets] on the adjacent sands and care for the fish" on the south shore of the Town lying west of the conveyed premises.

None of the deeds in the chains of title were invalid, and the fact that certain of the conveyances in those chains of title were made through quitclaim deeds did not, in itself, undermine the Associations' title claims. But the Town asserted that even if the Associations established their respective title claims, the Town nevertheless retains the right to allow the public to operate and park vehicles along the entire beach, including the portion owned by the Associations, based on the reservation in the March 1882 deed.

While the trial court agreed with the Town that the March 1882 deed should be construed broadly, the Appellate Division did not. To the Appellate Division, the reservation is in the nature of an easement allowing the public to use the Associations' portion of the beach only for fishing and fishing-related purposes. The reservation does not, however, confer upon the Town lawful governmental or regulatory power to issue permits allowing the public to operate or park vehicles on any portion of the beach owned by the Associations.

Accordingly, the court modified the judgment of the trial court and remitted the case for the entry of an appropriate judgment.

Seavi*ew at Amagansett Ltd. v.*
*Town of East Hampton*
NY Supreme Court, Appellate Division
February 3, 2021
191 A.D.3d 717

**About the Author**

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