

Property Tax Relief for Tenants of California Public Retirement Systems

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The California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) provide retirement and other benefits to the [*vast majority of public employees*](#) in California. In order to meet their obligations to retirees, CalPERS and CalSTRS invest in a variety of assets, including substantial real property holdings.¹ Some real property holdings involve commercial buildings with private tenants.

Those private tenants should be aware of an important case of first impression regarding the appropriate value of their leasehold interests for property tax purposes. In [*California State Teachers' Retirement System v. County of Los Angeles*](#),² the Court of Appeals for the Second Appellate Division determined that a private tenant of a CalSTRS-owned building paid significantly more property tax than legally allowed. The case suggests that all private tenants of CalPERS- or CalSTRS-owned buildings have been paying too much in property taxes with respect to their leasehold possessory interests. In addition, the case may create unintended economic incentives for California's two public retirement systems when they lease their commercial property to private tenants.

A Bundle of Rights

In general, property owned by the state – including CalPERS and CalSTRS – is not subject to property taxation.³ However, state-owned real property leased to a private tenant is assessed on a leasehold, or possessory, interest, and the assessed property tax is normally passed along to the private tenant as an additional expense associated with the lease.

¹ CalPERS [currently invests \\$21.1 billion](#) (or 8% of its total investments) in real property. CalSTRS [currently invests \\$22.3 billion](#) (or 13.4% of its total investments) in real property.

² 216 Cal. App. 4th 41 (Cal. App. 2d Dist. 2013). (Referenced hereafter as *CalSTRS v. LA*)

³ Cal. Const., Art. XIII § 3.

[Government Code Section 7510\(b\)\(1\)](#)⁴ provides a special set of property tax assessment rules for private possessory interests of property owned by the state public retirement systems (CalPERS and CalSTRS). The possessory interest upon which property tax is assessed equals to the greater of:

- 1) the full cash value of the possessory interest, or
- 2) if the lessee has leased less than all of the property, the lessee's allocable share of the full cash value of the property that would have been assessed if the property had been subject to property tax upon acquisition by the state public retirement system.

At issue in *CalSTRS v. LA* was the constitutionality of the second prong of this test. Namely, does property tax based on the lessee's "allocable share of the full cash value" of the real property comport with the requirement of the California Constitution?

Factual Background

CalSTRS v. LA involved a CalSTRS-owned office building in Los Angeles. Dong Il Kim and Chang Nim Kim, who operated a Mail Boxes, Etc. franchise, leased retail space in the building from CalSTRS for a five year term. The lease provided that the Kims would pay the property taxes allocable to their leasehold.

In 2006, Los Angeles County assessed the value of the building as \$42,362,834, of which \$12,618,715 was allocable to retail space in the building. The County determined that the Kims occupied 3.317437% of the total retail rentable space in the building. Therefore, based on the Section 7510(b)(1), the County assessed the value of the Kim's leasehold interest at \$418,618 (3.317437% x \$12,618,715) and levied a property tax in the amount of \$4,983.34

CalSTRS paid the property tax bill on behalf of Kims and then argued that imposition of property tax on the Kims and, indirectly on CalSTRS, was unconstitutional. Since the Kims only had a *possessory interest* in the office building for five years, the calculation of their property tax did not accurately reflect the fair market value of their property interest in the building.

Under Section 7510(b)(1), Los Angeles County imposed property tax at the *full cash value* of the Kims' proportionate share of the entire possessory estate, as if the Kims' held a fee simple interest in the property. However, general valuation rules prescribe that the value of a limited possessory interest normally declines with each passing year.⁵ The defect in Section 7510(b)(1) is that it provides for no discount to reflect the fair market value of a tenant's (limited) possessory interest. As a consequence, the statute effectively taxes the public retirement agency on a portion of its reversionary interest.

The Second Appellate District for the California Court of Appeal agreed with CalSTRS, finding that Section 7510(b)(1) is constitutionally flawed on two bases. First, the statute violates the prohibition against assessing property taxes on publicly owned property.⁶ Second, the statute violates the prohibition on assessing property in excess of its fair market value.⁷

⁴ All other references to "Section" are to sections of the California Government Code.

⁵ See, e.g., *L. W. Blinn Lumber Co. v. County of Los Angeles*, 216 Cal. 474 (Cal. 1932).

⁶ Cal. Const., art. XIII, §3(a).

⁷ Cal. Const., art. XIII, § 1.

The Value of a Possessory Interest

The appellate court reviewed general principles of the taxation of possessory interests, including the comparative sales approach, the income approach, and the cost approach. Quoting the State Board of Equalization's (SBE) own [Handbook](#),⁸ the court acknowledged that these methodologies must be modified to accommodate the finite duration of certain taxable possessory interests. In the case of a CalPERS- or CalSTRS-owned building, the value of the private tenant's possessory rights must be reduced because a public owner retains the fee simple interest in those rights (the reversionary interest) which is nontaxable.⁹

Section 7510(b)(1) fails to properly account for the reversionary interest held by a public retirement system. It taxes tenants on the "full cash value" of their allocable share of the property, instead of the "fair market value" of their possessory interest (with a discount of the partial possessory interest). In effect, the \$4,983.34 property tax bill that Los Angeles County assessed against the Kims included in its calculation tax on portion of CalSTRS' (tax-free) reversionary interest in the property. The fact that Section 7510(b)(1) shifts the excess tax onto the Kims, rather than CalSTRS, does not make the statute constitutional.¹⁰

Apart from assessing tax on the public retirement system's ownership interest in the property, Section 7501(b)(1) also "requires the lessees to be taxed on a value in excess of the fair market value of the lessees' possessory interest."¹¹ Since the Kims' \$4,983.34 property tax bill was too large (because it included an assessment on the reversionary interest), the property tax bill also amounted to a levy in excess of fair market value. According to the court, this taxing scheme created a second constitutional defect.

Conclusion

CalSTRS v. LA is an important case. It is likely that countless lessees similar to the Kims have been subject to excessive property tax. Depending on who paid the real property taxes, such tenants, or the retirement system which paid the taxes, should seek refunds.

In addition, it is likely that the case may create unintended economic incentives for CalPERS and CalSTRS. The holding of *CalSTRS v. LA* is that counties must discount the property tax bills assessed against leasehold tenants of the public retirement systems. However, for *private* building owners, the property tax bill will contain no discount for the tax-free reversionary interest.

This could lead to a perverse result where the property tax bill (and related rent) for comparable leased space would differ depending on whether the building is owned privately or by a public retirement system. The property tax bill for a leasehold in a CalSTRS- or CalPERS-owned building will presumably be less than a comparable privately-held building. As a consequence, the public retirement systems appear incentivized to charge higher rents for comparable space. Such a result seems counterintuitive and potentially inequitable for private landlords.

Of course, California's response to [unconstitutional statutes](#) is sometimes unexpected and the state may often limit taxpayers' [remedies](#). Nevertheless, until the SBE responds with contrary guidance, taxpayers who share facts with the Kims in *CalSTRS v. LA* should seek refunds. Additionally, the public retirement systems should analyze the potential economic advantages of their tax-free reversionary interest.

8 Assessor's Handbook Section 510, Assessment of Taxable Possessory Interests.

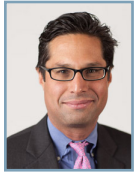
9 *Id.* at 23.

10 216 Cal. App. 4th at 61.

11 216 Cal. App. 4th at 65.

Taxpayers with questions about California property tax issues or other federal or state tax provisions are encouraged to contact the Hanson Bridgett Tax Practice Group.

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