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PARK WATCH

LEGAL DEVELOPMENTS NEWSLETTER

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Oceanside Hearing Officer Rejects City Expert James Gibson and Rent-Setting Based on "Depreciated Net Book Assets"

–First Administrative Decision to Squelch Gibson, First Step in Reversing Case Precedents Validating Gibson's Approach

By Terry R. Dowdall, Esq.

● *UPSHOT*

Oceanside enforces one of the most hostile rent laws in California.

Fritz Neumann, managed by Nap Sellers, applied for a rent increase. The Mobilehome "Fair Practices Commission" awarded the Park Owner nothing, finding the rent was already $85 per space too high, relying on the evidence (testimony and reports) of City expert James Gibson, Phd., an economist.

Gibson advocates use of his "depreciated net book assets" process of determining a rent increase. His process has been used by many rent-controlled jurisdictions, and worse, allowed by published case law dealing with challenges to rent board decisions, including Oceanside.

Given that Oceanside is Gibson's ideological "backyard," Neumann's task was herculean. On appeal, Neumann offered further evidence that the Gibson approach is fundamentally flawed, including a damning letter from a former City attorney who actually directed Gibson to stop work on a pending application.

After hearing the evidence on appeal, the City hearing officer overturned the Commission decision and rejected the evidence offered by the City expert. He also awarded $30,000 in attorney's and expert fees.

This heartening news brings hope to all park owners bogged down in rent-controlled jurisdictions that continue to rely on the flawed mathematics using "depreciated net book assets."

Nap Sellers** assembled a team for the presentation of the increase, including me, **Terry R. Dowdall, Esq.**, and **Dr. Michael

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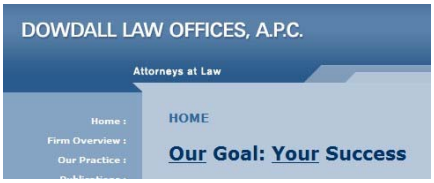

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In this Issue:

St. John, *representing the park owners,* ***Fritz and Betty Neumann****.*

In sum, this decision is the first concrete step in overturning incorrectly decided case law which has unwittingly accepted the value-based "depreciated net book assets" math for rent adjustments.

● *FACTS*

Oceanside's rent controls seem designed to inflict the most effort, inconvenience, cost and delay possible to dissuade and punish owners seeking a fair return. Who else, for example, demands forensic accountant verification of the rent application?

Yet, despite more than a year of delay, staff demands for re-filings, more information, redundant information, and a lengthy application (standing on end it is almost 4 feet tall), the owners persevered to hearing. Fritz and Betty Neumann do not shy away from a challenge.

> The funding for the challenge on the Gibson process of determining rent increases came from Park Owner Fritz Neumann, who personally paid for the work necessary to challenge the Gibson's process of setting rents.

The Owners

Fritz and Betty Neumann faced a daunting challenge back in 1991. *Should they venture their hard-earned savings and invest in a mobilehome park in Oceanside?* Not just any park, but one under rent controls, rife with tenant misconduct, a property tantamount to a public nuisance (according to the Los Angeles Times[1])?

They took on the challenge and morphed "El Camino 76 Estates" from an embarrassment to a benefit enjoyed by the residents.

After years of hard work and persistence, the property evolved to a tranquil residence for all its tenants. The tenants provided the highest compliments of all.[2]

Three Rent Adjustment Applications

During the course of ownership, Neumann applied for <u>three</u> rent increases under the Oceanside rent control law.

The first application was brought in 1995; the second in 2000, and the last in 2014 and recently concluded.

<u>A Common Thread:</u> Each time, the City engaged the services of a Phd., James Gibson, who advocates that the rate of return on a mobilehome park should be based on the "depreciated net book assets" of the enterprise, multiplied by a reasonable percentage rate of return. Gibson relies on "values" of park assets. And as time passes, the asset base diminishes for purposes of "paper" tax deductions. A new park buyer receives the maximum increase because no tax deductions for depreciation have been taken. Here, return on net book assets is basically the same as a "cap rate." The courts reject use of "cap rates" due to the "circularity" problems with it ("income" defines "value," and "value" defines "income"). But because the fictional diminishment of asset values are used for calculations, the longer a property is held, the lower the return.

<u>Long Term Owners Increasingly Punished</u>: It is unavoidable that the long time owner is punished, and the longer the property is held, the greater the harm. The taxable assets eventually become zero. Or as in the instant case, an opinion that the rents are $85 too high, when in earlier years, a $50+ increase was deemed proper. Of course, this approach contravenes every precept of valid rent methodology opined by the courts.

<u>Example:</u> New buyers have taken no depreciation and assets are at their highest. E.g., 5% on 1 million dollars-or $50,000 revenue. So-- *<u>$1,000,000 asset, at $50,000 income, is a 5% rate of return on assets</u>.*

But in year 20 after depreciation reduces taxable asset value to say

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[1] *Residents in this warring corner of a mobile home park in Oceanside talk of bullet holes, broken windows, bashed cars, rampant spray painting, chronic rock attacks, verbal threats, indecent exposure, retribution and vicious rumors. Somebody even reportedly vomited on garments hanging out on a clothesline.*

"We live in terror," said Jim Hewitt, a 15-year park resident. "It's gotten so far out of hand, it's absolutely unreal," said Bob George a spokesman for the Oceanside Police Department. "It's a regular Hatfield and McCoy -type situation out there." Longtime park residents say there have been problems for years, . . .

Los Angeles Times, 1991, Section B-1

[2] *Mr. Neumann has nurtured our park into a place where residents feel comfortable, safe, and secure. He supplied our park with a manager that everyone truly cared for and respected. . . .*

REMEMBER: When we would try to get the old Managers to keep the swimming pool and common areas functional. . . for our use. When we had problems with uninvited guest sleeping in our dirty clubhouse, near our laundry room with the broken windows and doors and on some occasions in our own back yards.

REMEMBER: When we had all the potholes and cracks in our streets that the owner just couldn't repair . . . When we had to set-up our own park security. . . When we patrolled our park at all hours of the night . . When we put up with the Hatfields & McCoys feuding, fussing, and fighting.

We have been fortunate indeed to have an owner that has dumped a pile of money in our park, had the vision and listened to the concerned residents as to what the park needed to come together as a community and live in peace and harmony,. . .

$100,000, using the same $50,000 rent means the rate of return is now 50% (50,000/100,000). Excessive! No increase is allowed.

This calculation makes it *appear* that the owner already receives an *excessive* rent. In fact, in this hypothetical, the park owner froze rents for 20 years. As viewed from a simple example, the "depreciated net book assets" approach is indisputably and palpably ridiculous.

Labeled the "depreciated net book asset" theory, Gibson relies first on a percentage of return suitable to a mobilehome park, which is then multiplied by the value of the depreciable assets of the park. The value of the depreciable assets (*e.g.*, buildings, fixtures, roads but excluding for example, the land) are discounted by the amount of tax depreciation taken since ownership of the park. In other words, the longer a property is held, the less the value of the asset on which return is multiplied by rate. When depreciation has been fully taken, the zeroed out value of the assets is negated, eliminating a basis for any rent increase.

The First Application - 1995

The first time Neumann sought a rent increase, the City retained James Gibson, Phd. Neumann had taken *insignificant* depreciation at this stage of ownership.

Gibson proposed a *$54 rent increase,* not long after the Neumanns became owners. And then, City attorney Dan Hentschke became aware of the proposal.

We *believed* that Hentschke had written to Gibson to have him stop work. But could find no evidence of it. Efforts to have the City provide a copy were fruitless. Gibson did not remember it when questioned.[3] Gibson did not remember being terminated at all.[4] *But Fritz Neumann remembered it. And then the bombshell. Buried deep in dead files for decades*, the letter was discovered. Hentschke *had* written to Gibson[5] directing him to stop work based on defects in Gibson's math.

He said:

* * *

Dear Mr. Gibson,
. . . I am particularly concerned that your analysis seems to assume that the park owner is entitled to an approximately 9% profit in the first several years of ownership, which appears to be contrary to the common understanding that real estate investment, particularly at a 8.12 percent CAP rate, generally have a negative cash flow up front. There is also an apparent omission of an analysis of whether a maintenance of the NOI over the projected term of the investment will result in a unconstitutional denial of a fair rate of return.

I also note that if depreciation is not subtracted from both the numerator and denominator, resulting rate of return very closely approximates the CAP rate.

Finally, using the approach set forth in your letter, it would appear not only that a new park owner would always be permitted to a rent increase after a purchase, despite the apparent fact that the rent control regulations produced a net operating income that supported the purchase price using a capitalization of income approach, and that annual rent stream after the purchase appears to continue to support the properly value.

The analysis also appears to discount the regulatory environment which provides the owner with an opportunity to adjust NOI, within limits, if necessary to prevent an unconstitutional denial of a fair return. Your report appears to contain an underlying assumption that maintenance of the NOI will not produce a fair return over the long run, but there is no analysis to support this apparent assumption.

At this point, please hold off any further work on the draft report and await further instructions. The rent review hearing previously scheduled for September 5, 1996 has been rescheduled.

* * *

The City Staff also turned over nothing in reply from Dr. Gibson, and no further correspondence from City attorney Hentschke. *The letter covers the very same points the owners have made about the "depreciated net book assets" process.* It shed new light on and fully corroborated the arguments of the park owner.

The Second Application – 2000

In the year 2000, a new application was made. City attorney Hentshke had moved on (he was City attorney to 1998). Once again, Gibson was brought back and retained <u>again.</u> The fundamental defects which exist in the net book assets approach were apparently ignored or dismissed without further investigation or analysis.

Gibson recommended $28.56 per month, per space.

The Third Application – 2014

Now a long-tenured owner, Neumann applies again for a rent increase. Once again, Oceanside retains Gibson. The assets of the park have been subject to paper deductions since acquisition in the early 1990's. More than 20 years later, the assets are significantly reduced.

Gibson now reports that the rents are $85.00 per month too high. He opined that the existing rate of return was excessive

[3] RT "Dr. Gibson: At no time, since we've been working for the city, essentially since the beginning of these applications, have we ever been relieved from the city, as Mr. Dowdall suggested".

[4] RT: "CHAIRMAN McNEIL: Was there a letter from the city attorney which terminated your service? DR. GIBSON: I don't recall that."

[5] A copy of this letter is photo-reduced at the end of this article. In a public records request, the City staff did not include a copy of this letter in the documents which were produced. Nor is there any written reply to the letter from Dr. Gibson, nor further written instructions from the City attorney Hentschke.

given the low value of the assets as depreciated.

The Arguments (Based on Empirical Results)

Despite case law on Gibson's side however, the hearing officer, retired Justice Herbert Hoffman, on appeal from a denial of rent increase in the Neumann's case, rejected Gibson's report, testimony and opinions. Siding with the park owner and its experts, Hoffman's spurning of the City Expert was a condemnation *en toto* of the "depreciated net book asset" mathematics for setting rents.

> . . . net book assets mathematics rely on accountancy entries (tax deductions), to mechanically cram down asset values . . .

In the years before the latest rent application, a family of residents brought a costly housing rights lawsuit in the 9th circuit. It failed in both the trial and appellate court.[6] The defense costs (attorney's fees, experts and consultants) had been high. The Neumanns sought a reasonable rent adjustment to compensate for these costs, offset by other income gains since the last previous rent increase hearing, plus capital improvements.

The Oceanside law states that the *net income* in the year of rent control adoption, is to be sustained with adjustments for *increasing expenses* plus 40% of *inflation*. For the Neumanns, the allowable NOI would justify increases requested, of $91.12 for 5 years; $25.89 for 5 more years; and thereafter a permanent $23.65, plus attorney's fees.

Per the ordinance, if a park owner:

> *". . . believes he would not receive a just and reasonable return on his investment in the park after receiving the maximum permissive adjustment ..., a park owner may file an application with the Manufactured Homes Fair Practices Commission for an alternative adjustment of the space rent ceiling based upon the park's net operating income (NOI)."*

Gibson Mathematics Part of Regulatory Scheme of Ordinance: If the park owner believes that the NOIM adjustment will not allow the park owner to earn a "just and reasonable return," the Ordinance authorizes the submission of a *"special adjustment"* application. The Ordinance does not set forth a specific formula or methodology for a mobilehome park owner seeking a *"special adjustment."* Rather, the Ordinance contains a non-exclusive list of factors which are to be considered by the Commission. Still, the regulations underlying the ordinance specify that the formula to be used is the *"depreciated cash investment."*

> *"Unlike the permissive and NOI adjustment, there is no set formula to be used to determine the fair return issue. However, the primary consideration in determining whether the park owner received a fair return on investment is the park owner's depreciated cash investment in the park as compared with the park owner's net income from the park. Several California appellate courts have refused to require consideration of fair market value in determining fair return. This is because fair market is often determined by capitalizing rents. Using capitalization of rents as a basis for determining fair rent has been determined to be inappropriately circular. Nevertheless, the Commission may consider fair market value if under the particular circumstances indicated in the special adjustment application it deems such a consideration warranted."*
> *Section 7.01 (e).*

The phrase "depreciated cash investment" is virtually synonymous with depreciated net book assets. It is no surprise the City retained Gibson to provide expert evidence and analysis of the Neumann's application. The Neumanns asserted the right to the recovery of expenses at fully-indexed inflation, plus capital expenses, plus including the defense of the housing lawsuit as corrected for inflation.

The Neumann's strenuously objected to Gibson's evidence. Dr. Michael St. John, Phd. (former a member of the Berkeley Rent Control Board) argued that Gibson's net book assets mathematics relies on accountancy entries (tax deductions), to mechanically cram down asset values on which a return is calculated. Paper deductions are not tied to any real world economics purposed toward rate setting. As an accounting "manipulation" it produces worthless results antithetical to the norms of accepted rent setting.

Three years in the making, the hearing finally took place in July of 2014. In short, the Rent Commission *adopted* the report of Dr. Gibson which stated that the rents were $85 per space too high, and denied any increase.

Neumann appealed for a new hearing. The City hearing officer, Retired Judge Herbert Hoffman, agreed with Neumann and rejected Gibson's evidence.[7] In so many words, the hearing officer implicitly sustained Neumann's fully brief objections.

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[6] *"The evidence also supports the district court's finding that trampolines are dangerous to young children, making it unreasonable to require Neumann to permit the Ramoses to install one. . . While the Ramoses' personal experience may indicate that the trampoline was helpful to K.R., that is not sufficient to carry their burden. . ."*

[7] *¶"The hearing officer can understand why the Commission staff has relied upon Dr. Gibson and his report in their recommendation to the Commission. Dr. Gibson presents as a convincing expert and his report is well organized and documented."*

The City Hearing Examiner Rejects the Depreciated Net Book Assets Theory of Rate of Return.

The hearing officer first re-stated the essential objection:

> *El Camino recognizes that the methodology of Dr. Gibson has received a form of appellate court approval. Nevertheless, it maintains that Dr. Gibson's analysis is a value-based formula and is flawed for several reasons, but primarily because Dr. Gibson uses depreciating assets which, over time continually diminishes the denominator of his investment return formula.*

He further recognized that the "depreciated net book assets" approach had been accepted, at least discussed, in published authorities in California.

> *The hearing officer is also mindful that the court, in T.G. Oceanside, discussed Dr. Gibson's analysis in the owner's cross-appeal where the hearing officer adopted Dr. Gibson's recommendation based on gross income from revenue generated by all spaces in the park; use of an ROI calculation based upon book assets; use of the almanac benchmark of 9-percent before deduction of income and taxes (higher than 7 .5 percent). (T.G. Oceanside, supra, 156 Cal.App.4th at pp 1382-1385.) While the court used an abuse of discretion standard of review of the hearing officer's determination the holding and discussion therein creates obstacles that El Camino must overcome.*

And overcome we did. The inherent defects of the "depreciated net book assets" approach were recognized through the obfuscation of meaningless expert-speak which caused the judge to reject the Gibson reports and testimony.

The hearing officer said:

> *The hearing officer does recognize that El Camino's experts raise reasonable objections to Dr. Gibson's return on book asset analysis regarding depreciation on of the asset over time which could punish long term ownership. El Camino argues that Dr. Gibson's approach produces inconsistent results in that he prepared three reports for El Camino. In 1995, he recommended a rent increase of $50.66, $28.56 in 2001, and a rent decrease of $85.13 in 2013 (with no major changes in income or expenses).*

The bottom line is that Gibson, despite slick packaging and presentation, was rejected based on Neumann's "reasonable" objections. Despite the case law accepting the Gibson analysis, the hearing officer rejected Gibson.

> What the city staff did not realize is that [they]. . . had been morphed into a petri dish for Neumann's empirically-demonstrated confiscatory result, which proves that "depreciated net book assets" is a void process for rent setting.

The courts have not, apparently, dealt with the factors and arguments which were brought to the fore in this application for El Camino case. Since it is doubtful the City will appeal, this victory is not likely to become a binding precedent. Cities often cover up their defeats and do not appeal to avoid a bad precedent. As it is, Oceanside lives to try to use Gibson another day. And owners are free to introduce the El Camino 76 records to prove the reports must be disregarded and excluded. The courts will then one day have a chance to reconsider and condemn "depreciated net book assets" for what it is: a substantively void rate setting method, invalid on its face.

Empirical Analysis Makes All The Difference

The law is crystal that no particular rent formula is required for rate-setting. So long as the result is not confiscatory any method will do. If one used a "Ouija" board or "tea leaves" to decide rent adjustments, if the result was not confiscatory, there is no argument.

Only those processes or methods which result in unconstitutionally confiscatory results are condemned. Neumann argued that depreciated assets is unavoidably confiscatory. The hypotheticals which Neumann presented were not refuted. But the Commission of lay persons was not impressed and could not turn down a proposed increase fast enough. Oceanside cases are decided on appeal. The Commission is just a mechanical turnstile to the appeal– a staff rubberstamp. Really nothing new or different compared to other agencies composed of lay people. Appeals are different.

That Gibson was retained by the City on three different occasions allowed the comparative analysis to the net book assets process over time, where nothing but tax depreciation has changed. *Empirical verification* became possible to validate the argument that depreciated asset values will demonstrably discriminate against long term property owners. *How?* By diminishing the asset base on which to multiply a reasonable rate of return. The rate of return invariably increases by reason of tax deductions. This therefore undermines a fundamental precept of acceptable rent control jurisprudence: that rent controls should attract capital and avoid the flight of capital. Punishing long term owners plainly accelerates flight.

Dr. St. John reviewed three reports for El Camino – one in 1995, one in 2001, and one in 2013 – and allowed unprecedented insight into the method used to suppress fair rent adjustments by Dr. Gibson. Dr. St John set forth the results of the Gibson process in 3 different periods of ownership of the same property. The result is irrefutable.

What the city staff did not realize is that by continuing to retain Gibson despite City attorney Hentschke's warning—the 1996 letter which had excoriated Gibson for a $50 rent increase to a new owner—City Staff had become a guinea pig: a test case for actual effects of empirical evidence and experience. And for which the City had no answer except legal precedents challenged as incorrect by the Neumann.

The case against "net book assets" is no longer just observational, theoretical or hypothetical. And with Dan Hentschke leaving office in 1998 and out of the way, City Staff could ignore him and go back and hire Gibson *again.* In the case of Neumann, Gibson was retained twice more. *That myopic blunder has now resulted in the embarrassment by rejection of the expert and his theory embraced in the City regulations*.

City staff so much as invited the building of an empirical case of irrefutable proof that "net book assets" confiscates property by exaggerating the return based on a shrinking asset base. A venomous staff has poisoned itself. Columns B, C, and D on this table set out Gibson's conclusions in 1995, 2000, 2011. He recommended space rent increases of:

	A	B	C	D	E
1	GIBSON ANALYSIS OF EL CAMINO 76 MOBILE ESTATES				
2					
3		GIBSON REPORTS			
4		1995	2000	2011	
5					
6	Net Income	128,033	159,894	176,354	
7					
8	Net Book Assets	1,909,467	1,930,912	1,225,643	
9					
10	Return On Book Assets (ROBA)	6.71%	8.28%	14.39%	
11					
12	"Benchmark" ROBA	9.40%	9.70%	7.75%	
13					
14	Addional Justified ROBA	2.69%	1.42%	-6.64%	
15					
16	Additional Justified Income	51,457	27,419	-81,367	
17					
18	Justified Rent Increase				
19	per Space per Month	54.28	28.92	-85.83	
20					
21	Recommended Increase	50.66	28.56	0	
22					
23	Gibson Report Date	8/9/1996	12/14/2001	6/25/2013	

Dr. St. John's Empirical Data: ***Indisputable Evidence***

$54.28 in 1995 (which the City attorney squelched),

$28.92 in 2001

(-)$85.83 in 2013 (rent decrease).

This result eventually takes property completely when all the depreciation is gone. Gibson admitted to this result under cross-examination:

> *Q "How does a fully depreciated asset figure into your methodology, or is it no longer in the equation?"*
> *A. "Assets in the methodology can come and go, and certainly assets are depreciated to zero, ..."and no assets are brought back into the equation if the park recapitalizes under good management of normal operational maintenance."*

R.T. 72-73

Gibson needs new assets added in to make his approach even plausible. Gibson's method says that rents should have increased in previous years but should now decrease by $85.83 a month – a 30% rent decrease.

Neumann submitted, to further show the anomalous result of the Gibson calculation, that a hypothetical explained in a spreadsheet following a park purchased in 1991 for $1,950,000, just like El Camino 76.

- Income is assumed to increase at the rate allowed by the Ordinance (75% of the Consumer Price Index – the CPI).
- Expenses are assumed to increase at the CPI.
- Capital replacements are assumed at $20,000 per year.
- Depreciation is computed for purposes of the calculations over 30 years.

The hypothetical sequence predicted that, consistent with Gibson's computation method, the ROA will rise year by year in theory, just as it rises under Gibson's computations. *The ROA, as computed by Gibson, doubles in twenty years, basically.*

Dr. St. John thusly proved that Gibson's method is inevitably biased against parks long-held in one ownership. When any park has been held in one ownership for many years, Gibson's theory will inevitably find that the rate of return has increased and that for this reason no space rent increase is warranted.

Is it even a "method" or just a mathematical exercise without tangible relation to allowable evenhanded rate setting precepts?

St. John argues that Gibson's method is not really a "method."

> *It is an elaborate set of fundamentally meaningless accounting calculations that result in irrational outcomes. The results of using the Gibson method are all over the map. The method cannot reasonably be considered a "fair return method".*

Neumann also argues that before any alternate approach to determining a rate of return can be applied, Gibson must show that the presumptive method, NOIM, would not provide a fair return. Hentschke had made the same observation in 1995 (*see* Dan Hentschke's letter[8]). Gibson made no effort to show the result of the NOIM formula (showing that the NOI ordinance

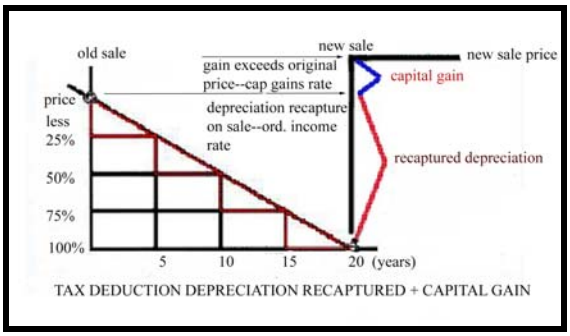
[8] "There is also an apparent omission of an analysis of whether a maintenance of the NOI over the projected term of the investment will result in a unconstitutional denial of a fair rate of return."

would not provide a fair return). If the city presumption applied, there is no need for any other calculation.

There was no effort by Gibson to show that the basic presumption of fair return would have provided a fair return under the ordinance. His report is not even relevant if the City NOIM formula provided a fair return.

● "Net Book Asset" Approach Facially Void, Hence Inadmissible, Because, Inter Alia, It Fails to Consider Recapture

For the benefit of any owner faced with the *"net book assets"* approach to rent-setting, the fundamental defects which manifest why the evidence thereof is inadmissible, as "junk science," flows from the unavoidable **result** of its application to any owner.



An expert should be presented to offer the empirical analysis in the El Camino case and move to exclude Gibson and his evidence. This step would protect the record in the event that a mandamus proceeding would follow.

For edification of rent-controlled owners, there are at least a dozen fundamental defects in the "depreciation on net book assets" approach. One key issue to address is the insufficient foundation for admission of Gibson's reports. The lack of foundation is also based on many elements.

Use of "depreciated net book assets," as the assets diminish for purposes of tax and accounting reporting, suffers from the same defect as other "value-based" criteria rejected by the courts. Use of a "cap rate" is essentially fair market value, determined most reliably by the price paid. This is a function of income. The value of the park is determined by an agreement of the parties, presumably a reflection of fair market value. *This was one of Hentschke's objections.* The Gibson approach fails at the inception of ownership. Hence, Gibson refuses to work as an expert for new *private* owners[9].

A fair rate of return on the assets at inception of ownership is the same as a return based on fair market value. This is how Neumann became entitled to a $54 increase near inception of the ownership, and resulted in City Attorney Hentschke directing Gibson to stop work.

As a "value-based" criteria, the threshold problem with "depreciated net book assets" value, is that the book value is the product of consensual agreement to fair market value, the manipulation of price. The determination of "book assets" is exactly what the courts abhor–use of *value* to determine return.

In summary the problem is that this *"half loaf"* ignores *recapture* value of the depreciation. The mathematics are hence meaningless. A portion of the park value, still taxable, *is relevant only to the IRS.*

What is Recapture?

Since Congress well knows that depreciation is a paper loss or tax fiction, it has enacted *recapture laws*. *Recapture* is the return of depreciation to the property to be taxed. *See the graph*. Depreciation causes taxable values to drop to zero in 20 years, and if then sold, the value zooms up because the depreciation is recaptured. Depreciation has nothing to do with actual condition or value of property in the marketplace.

Everyone knows the assets are not depreciated in fact, only for taxes.

The agency that uses tax depreciation to determine values makes two errors. The mathematics is applied to value-based criteria, disallowed by the courts. Second, the measurement is irrelevant to the purposes for which rent controls are enforced, because it punishes long term ownership on its face.

When a property sells, all the depreciation is added back for taxation purposes. Plus any gain over original price is taxed as a capital gain. *See the graph.* The added-back depreciation is taxed at an "aggressive"– ordinary income rate. Once all the depreciation taken has been taxed at an aggressive rate, the balance of the gain receives capital gains tax treatment.

The purpose of depreciation deductions is to allocate the cost of an asset to the various periods and locations which are benefitted by that asset. Since property values usually increase over time, depreciation has often been called a "phantom" expense. Congress even recognized this fact and instituted changes to the US tax code that introduced what is known as "depreciation recapture." Depreciation recapture was introduced in the Federal Internal Revenue Code by the

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[9] RT: "MR. DOWDALL: . . . If I represent a park owner in the very first year of ownership, I'd love Dr. Gibson. I want to do everything I can to retain him. I've called him before. He won't work for me. Now, why is that? Because in the beginning there is no depreciation. . ."
Mr. Gibson disagrees, testifying that he rejects private jobs in order to independent:
RT: "DR. GIBSON: I've never represented a park owner. I think that Mr. Dowdall has said he's called me up. I've had many attorneys like Mr. Dowdall call up and say, Will you work for me?" And the answer is no, because I can not be independent . . ."

enactment of various sections considered by the Treasury Department to be a loophole.

The *loophole* arose from Federal income tax situations where

(1) the value of the asset had not dropped,
(2) depreciation deductions had offset ordinary income and
(3) gain from the later sale of the asset was taxed at capital gain rates.

New law dealing with personal and real property closed the loophole by "recapturing" and treating the gain attributable to past depreciation deductions as *ordinary income* rather than as *capital gain*.

So, determining rents based on the impact of accrued "paper" depreciation tells half the story—there is no foundation for any opinion based on asset values, unless the recapture liability is also accounted for.

Can "appreciation" justify a reduced cash return? If so, how is it measured in order to justify rent reductions? It Wasn't.

Gibson embraces the notion that "appreciation" may be deemed a component of the return on value. However, he makes no effort to quantify it ("we looked at appreciation of the property" RT p. 52, l. 17).[10]

The Failure to Consider Recapture Is Inadequate Foundation for Determining a Return on Property.

Because the IRS allows a taxpayer to deduct the depreciation of an asset from the taxpayer's ordinary income, the taxpayer has to report any gain from the disposal of the asset (up to the recomputed basis) as ordinary income, not as a capital gain. Any gain over the recomputed basis will be taxed as a capital gain. Gibson's approach simply ignores these components.

When a taxpayer sells an asset for a gain after taking deductions for depreciation, depreciation recapture is used to tax the gain. Because the taxpayer received a deduction from ordinary income for the depreciation of the asset, any gain the taxpayer receives, up to the depreciation amount, must be included as ordinary income to offset the earlier deduction.
Gibson cannot determine asset base without considering amount of recapture on sale.

Since the income for El Camino 76 is ***higher now then when the park was first acquired***, it would sell for a profit. There would be ***gain***. ***Hence, Neumanns' depreciation would be fully recaptured.*** The recapture liability, taxed at ordinary income rates---is the missing link that must be known to determine rate of return on investment using assets as the base. Else, the analysis is based on **half the loaf**.

● Conclusion

The hearing officer's decision rejecting the City expert ("net book assets") is not just based on theory. It was based on empirical evidence gathered over the course of 20 years, reflecting the "results" of the application of "depreciated net book assets." The evidence shows that "net book assets" is an unconstitutionally confiscatory process for setting rents and is inadmissible in any rate-setting proceeding.

The El Camino case proves that the "depreciated net book assets" approach should not be admissible: it lacks foundation, acceptance in the scientific community, and operates in a way opposite to that required of constitutional precepts. It is extremely prejudicial, and evokes passions and prejudice, not analytical thought. We proved that over nearly 20 years, from 1995 to 2014, the process but freezes rent adjustments on a false set of pretenses. The fallacy of net book assets has been exposed, and why hearing officer Hoffman, despite case law strenuously argued by the City to the contrary, rejected the findings, reports and testimony of Dr. Gibson.

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[10] p. 54, l. 15-21 "This park has also had appreciation benefits, which is part of a fair return consideration. The park -- this park has received over $2.2 million in gross appreciation since this park was purchased by the Neumanns. On a net basis, it's probably a little bit less than a million, but it's somewhere around $800,000 of appreciation." says Gibson

Yet, while saying the rents are already $85.00 too high, Gibson professes not to have quantified the relation of appreciation to the impact on rent levels:

> "CHAIRMAN McNEIL: . . . Isn't appreciation caused by increased rents? If not, what accounts for the appreciation?"
> "DR. GIBSON: I can't make any sense of that question. I don't know -- appreciation on what? I don't understand the question."
> "CHAIRMAN McNEIL: Okay. Next question, what amount of appreciation is there in this case?"
> "DR. GIBSON: Appreciation of what? I don't know what the question--"

Gibson had just testified to "appreciation" benefits, "which is part of a fair return consideration" he testifies. He assumes, without saying it, that "appreciation" is a "benefit" justifying denial of a rent increase without mathematical basis. If used to reduce rents, there is a failure to apply the evidence to make a "finding," a garden variety basis to overturn a decision for insufficient linkage between evidence and findings, and then findings and conclusion.

> "CHAIRMAN McNEIL: Okay. What is the amount of rent reduction justified by appreciation about which you testified?"
> "DR. GIBSON: Well, that's -- I don't know if I understand the question, but I'd like to point out that these proceedings are not symmetrical on the downside. In other words, I may come in and say this park is -- in this particular case, this park is receiving more than their fair return right now. The proceedings are not set up to say we should actually decrease the rents in this park because they're receiving excessive (inaudible). They're not symmetrical that way. No one likes to talk about this, but the benefit of the doubt is given to the owner because the owner has upside potential."

The only documented case which reflects both a theoretical and empirical condemnation of the Gibson approach lies in the records of the Neumann administrative proceedings records and reporter's transcripts.

The Gibson approach punishes long term ownership and hence does not serve to attract capital (it creates flight from the market); it relies on value-based criterion, a theory rejected by the court for decades, and discriminates between owners for reasons without rational relation to the purposes of rent controls, including duration of ownership.

Hopefully, the new turn taken in this case will be replicated in other cases as well, all toward the effort to educate the courts to correct a real injustice not apparently thus far absorbed into appellate thinking about "depreciable net book assets."

Terry R. Dowdall, Esq.

January, 2015.

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Please feel free to contact Terry R. Dowdall, Esq., for further information and questions.

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CITY OF OCEANSIDE

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August 14, 1996

James A. Gibson, Ph.D.
NewPoint Group
Management Consultants
555 Capitol Mall, Suite 650
Sacramento, CA 95814

Re: Draft Report Regarding El Camino 76 Special Adjustment Application

Dear Mr. Gibson,

I have received your draft report concerning the above referenced matter. I am presently analyzing the draft report in light of the City's manufactured home fair practices ordinance.

I am particularly concerned that your analysis seems to assume that the park owner is entitled to an approximately 9% profit in the first several years of ownership, which appears to be contrary to the common understanding that real estate investments, particularly at a 8.12 percent CAP rate, generally have a negative cash flow up front. There is also an apparent omission of an analysis of whether a maintenance of the NOI over the projected term of the investment will result in a unconstitutional denial of a fair rate of return.

I also note that if depreciation is not subtracted from both the numerator and denominator, the resulting rate of return very closely approximates the CAP rate. Finally, using the approach set forth in your letter, it would appear not only that a new park owner would always be entitled to a rent increase after a purchase, despite the apparent fact that the rent control regulations produced a net operating income that supported the purchase price using a capitalization of income approach, and that the annual rent stream after the purchase appears to continue to support the property value.

The analysis also appears to discount the regulatory environment which provides the owner with an opportunity to adjust the NOI, within limits, if necessary to prevent an unconstitutional denial of a fair return. Your report appears to contain an underlying assumption that maintenance of the NOI will not produce a fair return over the long run, but there is no analysis to support this apparent assumption.

At this point, please hold off any further work on the draft report and await further instructions. The rent review hearing previously scheduled for September 5, 1996 has been rescheduled.

I will be contacting you in the near future to discuss this matter further.

Very truly yours,

Daniel S. Hentschke
City Attorney

c: Margery Pierce, Assistant Housing Director

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