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Commonwealth of Kentucky

Court of Appeals

NO. 2015-CA-001617-MR

GRAND LODGE OF KENTUCKY FREE AND ACCEPTED MASONS; PATRICIA BOERGER; HAROLD ISERAL; JEAN ISERAL; BOBBIE COX; JOYCE WILSON; CHARLES WILSON, JERRY TREADWAY; CLAIRE J. DAUGHERTY; MARGARET OSTERHAGE; SHIRLEY BURDINE; DONALD BEAGLE; BETTY BEAGLE; NORA H. LEDFORD; STAN WERBRICH; ALICE WERBRICH; JAMES STEFFEN; SUE STEFFEN; CLARE KENTRUP; RAYMOND KENTRUP, MORRIS REED; MARTHA REED, JOHN NIEDEREGGER; KAY NIEDEREGGER; JESSIE EPPINGHOFF; MARY JO HUNT; EDWIN GINTER; CARL B. GAMEL; MARY SUE GAMEL; ESTATE OF PAUL TALBERT, DECEASED; AND ESTATE OF LOUIS TALBERT, DECEASED — APPELLANTS

v.

APPEAL FROM KENTON CIRCUIT COURT
HONORABLE GREGORY M. BARTLETT, JUDGE
ACTION NO. 14-CI-02367

CITY OF TAYLOR MILL; AND DARLENE PLUMMER, KENTON COUNTY PROPERTY VALUATION ADMINISTRATOR — APPELLEES

OPINION
AFFIRMING IN PART,
REVERSING IN PART, AND REMANDING

** ** ** ** **

BEFORE: KRAMER, CHIEF JUDGE; D. LAMBERT AND TAYLOR, JUDGES.

TAYLOR, JUDGE: Grand Lodge Of Kentucky Free and Accepted Masons (Grand Lodge), Patricia Boerger, Harold Iseral, Jean Iseral, Bobbie Cox, Joyce Wilson, Charles Wilson, Jerry Treadway, Claire J. Daugherty, Margaret Osterhage, Shirley Burdine, Donald Beagle, Betty Beagle, Nora H. Ledford, Stan Werbrich, Alice Werbrich, James Steffen, Sue Steffen, Clare Kentrup, Raymond Kentrup, Morris Reed, Martha Reed, John Niederegger, Kay Niederegger, Jessie Eppinghoff, Mary Jo Hunt, Edwin Ginter, Carl B. Gamel, Mary Sue Gamel, Estate of Paul Talbert, Deceased, and Estate of Louis Talbert, Deceased (collectively referred to as Residents) bring this appeal from an October 9, 2015, Judgment of the Kenton Circuit Court reversing a final order of the Commonwealth of Kentucky, Board of Tax Appeals. We affirm in part, reverse in part, and remand.

The primary question raised in this appeal is whether certain real property owned by Grand Lodge and exclusively occupied by individual senior citizens is subject to ad valorem taxation by Kenton County or is entitled to the charitable exemption found in Section 170 of the Kentucky Constitution. To answer this question, a thorough recitation of the underlying facts is necessary.

FACTS

Grand Lodge is a recognized public charity entitled to the constitutional exemption from ad valorem taxation upon real property it both owns and occupies per Section 170 of the Kentucky Constitution.[1] Grand Lodge owns a 24-acre tract of real property located in the City of Taylor Mill, Kentucky. In 2001, Grand Lodge leased the 24-acre tract to Masonic Retirement Village of Taylor Mill, Inc. (MRV). MRV was incorporated as a nonprofit and is an affiliated corporation of Grand Lodge. The stated purpose of MRV was to provide and maintain affordable housing to senior citizens by establishing a local retirement community in Taylor Mill, subsequently known as Springhill Village.

Under the terms of the lease, Grand Lodge leased the real property to MRV for twenty-four years, with the option to renew the lease for an additional twenty-four years. Upon termination of the lease, Grand Lodge possessed an option to purchase any improvements upon the property.

MRV began construction of Springhill Village in 2002 and ultimately constructed forty-eight residential units upon the real property. These residential units were available to senior citizens over fifty-five years of age who possessed the financial means to acquire a unit. To acquire a residential unit, a resident was required to execute a Resident Agreement. Under the terms of the Resident Agreement, the resident would pay an "entrance fee" of $151,000 to $252,000, depending upon the size of the particular residential unit. During the term of the Resident Agreement, the resident acquired the exclusive right of possession in his

[1] *See Com. Ex. Rel. Luckett v. Grand Lodge of Kentucky*, 459 S.W.2d 601 (Ky. 1970).

or her specific residential unit until termination of the agreement. The Resident Agreement terminated upon either the death of the resident, the physical/mental inability of the resident to continue to reside in the unit, the resident's relocation to a nursing home, or the resident's thirty-day notice of intent to terminate. Upon termination, the resident was entitled to a "refund" of the sale price of the unit minus certain costs incurred by MRV or, if not sold within six months by MRV, then the resident would be "refunded" eighty-two percent of the original entrance fee.

Since 1995, the real property comprising Springhill Village owned by Grand Lodge and the subsequent improvements constructed thereon by MRV were not subject to ad valorem taxation. The Kentucky Department of Revenue viewed it as exempt property under Section 170 of the Kentucky Constitution. In 2011, Taylor Mill and Kenton County filed a petition for declaratory judgment in the Kenton Circuit Court against the Kenton County Property Valuation Administrator (PVA) and the Department of Revenue. Therein, Taylor Mill and Kenton County maintained that the residential units in the Springhill Village had been leased or exclusive possession had been transferred to private individual residents and that such possessory interests were subject to ad valorem taxation. By agreed declaratory judgment, it was ordered that the fair market value of the private leaseholds or other possessory interests in the residential units at Springhill Village were subject to ad valorem taxation.

In the tax years of 2012, 2013, and 2014, the Kenton County PVA issued ad valorem tax assessments upon the real property at Springhill Village. In particular, the PVA issued to each resident an ad valorem tax assessment upon his or her respective unit. Thereafter, the Residents appealed the ad valorem tax assessments to the Commonwealth of Kentucky, Board of Tax Appeals (Tax Board). Kentucky Revised Statutes (KRS) 131.340. By a November 19, 2014, final order, the Tax Board voided the ad valorem tax assessments issued to the Residents of Springhill Village and concluded that the real property as a whole was entitled to the charitable property tax exemption provided by Section 170 of the Kentucky Constitution.[2] The Tax Board determined that both the Grand Lodge and MRV were purely public charities and entitled to the property tax exemption found in Section 170 of the Kentucky Constitution. As to the Residents, the Tax Board noted that the Residents were not the owners of the real property and did not possess sufficient interests in the real property to be subject to ad valorem taxation by reason of KRS 132.195(1).

Taylor Mill and Kenton County "appealed" the Tax Board's final order by filing an original action in the Kenton Circuit Court. KRS 131.370. By judgment entered October 9, 2015, the circuit court reversed the final order of the Tax Board. The circuit court concluded that the Residents were subject to ad valorem taxation upon their respective possessory interests pursuant to KRS 132.195(1):

[2] At issue before the Board of Tax Appeals were property tax assessments for 2012, 2013, and 2014 tax years.

In its Order voiding the assessments, the Board noted that both the Grand Lodge and MRV are charitable organizations which are tax exempt pursuant to Section 170 of the Kentucky Constitution. The Grand Lodge is title owner of the real estate and MRV is deemed to be the owner of the improvements, subject to the right of the Grand Lodge to purchase the improvements at the end of the ground lease. The Board concluded that the use of the property in providing housing for senior citizens was within the charitable purpose of MRV, and that fact ended the discussion of whether there could be any tax assessment.

In reaching its conclusion that neither the owners of the property nor the residents of the units would be subject to taxation, the Board focused on the use of the real estate from the perspective of the title owners of the property and improvements. In so doing, the Board opined that the provisions of KRS 132.195 did not apply. That statute, enacted in 1988, expressly allows for the taxation of property, which is otherwise exempt, when the leasehold or other interest is transferred to a natural person or other non-exempt entity. In this case, the Board failed to give proper recognition to the separate interests of the residents as part of the "bundle of rights" encompassed with the total of legal interests in the real estate. As in the case of *Freeman v. St. Andrew Orthodox Church Inc.*, Ky., 294 S.W.3d 425 (2009), a portion of real property owned by a charity can be subject to taxation if occupied by non-exempt entities such as renters.

This Court is of the opinion that the *Freeman* case applies to the case herein. While the Grand Lodge's fee simple ownership in the real estate and the MRV's interest in the improvements are exempt, the interests of the residents have value and, like the renters in *Freeman*, are subject to assessment. Although the agreements do not label what the residents' legal interests are, it cannot be said that they have no legal interests in the property. They pay an "entrance fee" of at least $151,000.00 (the average is $185,000.00) for the right to exclusive occupancy and enjoyment of the residential units for life.

> In addition, at termination of the agreement, the residents have the right to a refund of 82% of their entrance fee plus a percentage of any increase in value upon resale by MRV. Whether they are deemed to have leasehold interests or life estates, the residents have interests that have value that are subject to ad valorem taxes. The fact that the interests of the residents have restrictions, such as the prohibition against transfer or subletting, could affect the value but would not render such interest to be valueless.
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> As stated in *Iroquois Post No. 229, etc. v. City of Louisville*, Ky., 309 S.W.2d 353 (1958), the burden is on the organization to establish clearly that it is entitled to an exemption from payment of taxes, and the right to an exemption must always be strictly construed. Likewise, in *Freeman*, the Court noted that taxation of all property is the rule. In this case, the issue is not whether the ownership rights of the Grand Lodge and MRV can be assessed, but rather whether the lesser interests of the residents can be taxed. The total value of the residents' interests in 48 units was assessed at $6,491,000. Therefore, if their interests are tax exempt, 48 households, which certainly could not be considered low income housing, in Taylor Mill and Kenton County are receiving governmental services, but are paying no tax to support such services.
>
> It appears that the Legislature enacted KRS 132.195 to remedy or clarify the situation presented in this case. While the charitable organizations retain their status as exempt from taxation in accordance with Section 170 of our Constitution, the individual residents are subject to taxation on the fair value of their interests.

Order at p. 3-5 (citations omitted). This appeal follows.

STANDARD OF REVIEW

Judicial review of an administrative agency's decision is generally concerned with arbitrariness and is particularly set forth in KRS 13B.150:

(2) The court shall not substitute its judgment for that of the agency as to the weight of the evidence on questions of fact. The court may affirm the final order or it may reverse the final order, in whole or in part, and remand the case for further proceedings if it finds the agency's final order is:

(a) In violation of constitutional or statutory provisions;

(b) In excess of the statutory authority of the agency;

(c) Without support of substantial evidence on the whole record;

(d) Arbitrary, capricious, or characterized by abuse of discretion;

(e) Based on an ex parte communication which substantially prejudiced the rights of any party and likely affected the outcome of the hearing;

(f) Prejudiced by a failure of the person conducting a proceeding to be disqualified pursuant to KRS 13B.040(2); or

(g) Deficient as otherwise provided by law.

We, of course, step into the shoes of the circuit court and review the final order of the Tax Board in accordance with the above principles.

KENTUCKY CONSTITUTION SECTION 170 AND KRS 132.195(1)

Section 170 of the Kentucky Constitution exempts from taxation real property "owned and occupied by . . . institutions of purely public charity." Our case law has recognized that Section 170 was intended "to foster and encourage benevolences to the Commonwealth." *Banahan v. Presbyterian Housing Corp.*, 553 S.W.2d 48, 51 (Ky. 1977). Thus, the term "charity" was given a broad

meaning as including "activities which reasonably better the condition of mankind." *Hancock v. Prestonburg Indus. Corp.*, 365 S.W.3d 199, 201 (Ky. 2012). To constitute a purely public charity under Section 170, the charity must be "wholly altruistic in the end to be attained, and . . . no private or selfish interest should be fostered under the guise of charity." *Id.* at 201 (quoting *Preachers' Aid Soc. v. Jacobs*, 235 Ky. 790, 32 S.W.2d 343, 344 (1930)). And, the purely public charity must both own and occupy the real property to be entitled to the tax exemption afforded under the Section 170.

In *Freeman v. St. Andrew Orthodox Church, Inc.,* 294 S.W.3d 425 (Ky. 2009), the terms "own and occupied" within the meaning of Section 170 was squarely before the Kentucky Supreme Court. St. Andrew owned ten acres of real property that was divided into two five-acre parcels. Upon each parcel, a single-family residence was located, and these two homes were rented to third parties, who paid rent to St. Andrew. It was the intent of St. Andrew to eventually build church facilities on the ten acres of real property when the financial resources were secured to do so. As to the ten acres, it was revealed that the tenants were required to cut the grass around their residences, and church members would cut grass upon the remainder of the property. And, the remainder of the property was utilized by church members for various ecclesiastical activities, including a church picnic. PVA issued tax assessments upon the entire ten acres of property, but St. Andrew claimed that the ten acres were exempt from taxation under Section 170 of the Kentucky Constitution. The Supreme Court held that the tax exemption under

Section 170 was only available if the entity actually owned and occupied the real property. The Court pointed out that St. Andrew did not occupy the single family homes because those homes were leased to third parties. The Court specifically held:

> It simply defies reality and the plain meaning of the constitutional provision to conclude that the church "occupied" the houses on the subject property. This property is occupied by tenants who pay rent to the church.

Freeman, 294 S.W.3d at 428. Therefore, the Supreme Court concluded that the residential homes were "occupied" by the tenants and were not occupied by St. Andrew. As a consequence, Section 170 of the Kentucky Constitution could not be invoked to except the two residential homes from ad valorem taxation. As to the remainder of the ten acres, the Supreme Court believed that St. Andrew did, in fact, own and occupy same and was thus entitled to tax exempt status under Section 170.

Grand Lodge argues that the "owned and occupied by" analysis set forth in *Freeman*, 294 S.W.3d 425 is limited to religious institutions only under Section 170 of the Constitution. We disagree. In *Freeman*, the Supreme Court did not limit its interpretation of Section 170 to churches only, but rather to all entities, like Grand Lodge, that qualify for a tax exemption. The Court specifically held:

> Accordingly, our ruling here today in defining this term [occupied] is restricted to "institutions of religion" and other entities qualifying for tax exemption under Section 170 of our state Constitution.

Freeman, 294 S.W.3d at 429.

As in *Freeman*, 294 S.W.3d 425, the residential units at the Springhill Village were not "occupied" by either Grand Lodge or by MRV (the tax exempt entities). Rather, under the plain terms of the Resident Agreements and the undisputed facts, exclusive possession of the units was transferred to the Residents in exchange for valuable consideration ($151,000 - $252,000). Under the "plain meaning" of the term occupy, the residential units at Springhill Village are clearly occupied by the Residents and not by the Grand Lodge or MRV. *Freeman*, 294 S.W.3d at 428. Thus, neither Grand Lodge nor MRV "occupy" the residential units within the meaning of Section 170.

Either by design or accident, Grand Lodge/MRV have effectively attempted to create a legal fiction in structuring an interest in real property that has heretofore not been recognized by Kentucky Courts or the common law – that being an "occupancy" interest in real property. We can find no legal authority in Kentucky that recognizes an "occupancy" estate in land.

The Kentucky Supreme Court has defined property as:

> [E]verything which is the subject of ownership, corporeal or incorporeal, tangible or intangible, visible or invisible, real or personal, choses [sic] in action as well as in possession, everything which has an exchangeable value, or which goes to make up one's wealth or estate.

Button v. Drake, 302 Ky. 517, 195 S.W.2d 66, 69 (1946). This definition does not recognize an "occupancy" interest in real property. Occupancy is a logical consequence of possession of real property. Judge Palmore of the former Court of

Appeals, then Kentucky's highest court, eloquently analyzed the issue, quoting Oliver Wendall Holmes:

> For most practical purposes possession *is* ownership as against all but the legal titleholder. The principle was thus stated by Holmes: 'The consequences attached to possession are substantially those attached to ownership, subject to the question of the continuance of possessory rights which I have touched upon above. Even a wrongful possessor of a chattel may have full damages for its conversion by a stranger to the title, or a return of the specific thing. With regard to the legal consequences of possession, it only remains to mention that the rules which have been laid down with regard to chattels also prevail with regard to land. . . .' Holmes, The Common Law, pp. 241, 242, 244.

Marinaro v. Deskins, 344 S.W.2d 817, 819 (Ky. 1961).

As the residential units at Springhill Village are "occupied" by the Residents, we conclude as a matter of law that they have exclusive possession of said units, having paid a substantial consideration, and their respective possessory interests in the units are subject to ad valorem taxation. In particular, KRS 132.195(1) provides:

> When any real or personal property which is exempt from taxation is leased or possession is otherwise transferred to a natural person, association, partnership, or corporation in connection with a business conducted for profit, the leasehold or other interest in the property shall be subject to state and local taxation at the rate applicable to real or personal property levied by each taxing jurisdiction.

Under KRS 132.195(1), a leasehold or other type of possessory interest in tax-exempt property is subject to taxation if transferred to a private individual. As a

consequence, the tax-exempt owner of real property pays no ad valorem tax, but the private individual is subject to ad valorem taxation on the value of his possessory interest is the tax exempt property.

Under KRS 132.195(1), the Residents are responsible for property tax upon the value of their exclusive possessory interests in their respective residential unit. It is clear that the Residents contractually obtained exclusive possessory interests in the units and, by so doing, obtained valuable interests in real property. Accordingly, we conclude the Residents' possessory interests are subject to ad valorem taxation under KRS 132.195(1).

VALUATION

Under the Resident Agreement, the resident was transferred the exclusive possessory right to his respective unit. Also, each resident was required to maintain "Tenant Homeowners' insurance coverage," and upon termination of the Resident Agreement, the resident agreed to reimburse MRV for "costs incurred . . . to repair and refurbish the Unit to any extent required beyond reasonable wear and tear." In many aspects, the possessory interest created by the Resident Agreement is similar to that of a leasehold; however, the Resident Agreement also vests additional rights in the resident not typically found in a common lease.[3] While the exact property interest transferred to a resident is somewhat abstruse and indistinct as previously discussed, it is clear that the residents obtained exclusive

[3] Under the Resident Agreement, a resident is entitled to a partial refund of the entrance fee ($151,000 - $252,000), and the term of the Resident Agreement could be for the life of the resident.

possession of the units for a period of time. So, we think the residents' possessory interests in the units may be considered leaseholds for tax valuation purposes.[4]

The law is well-settled that a leasehold's fair market value for taxation purposes is obtained by subtracting the fair market value of the real property with the leasehold from the fair market value of the real property without the leasehold.[5] *Ky. Dept. of Revenue v. Hobart Mfg. Co.*, 549 S.W.2d 297 (Ky. 1977). Hence, a resident's possessory interest in a unit at the Springhill Village is only taxable to the extent of its fair market value. *See Pike Cty. Bd. of Assessment v. Friend*, 932 S.W.2d 378 (Ky. App. 1996); *Ky. Tax Comm'n v. Jefferson Motel, Inc.*, 387 S.W.2d 293 (Ky. 1965).

In this case, a review of the record reveals that the PVA neither valued the Resident's interest as a leasehold nor utilized the above formula to determine the fair market value of each Resident's possessory interest. We, therefore, conclude that the PVA erroneously valued the Residents' respective interests and vacate the tax assessments upon such ground. The PVA should consider each Resident's possessory interest as a leasehold for valuation purposes and should obtain the fair market value by subtracting the fair market value of the unit with the Resident's leasehold from the fair market value of the unit without the leasehold.

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[4] A leasehold is not ordinarily subject to ad valorem taxation as taxation is assessed against the fee simple owner of the nonexempt real property. *Fayette Co. Bd. of Supervisors v. O'Rear*, 275 S.W.2d 577 (Ky. 1955).

[5] While real property is assessed at its "fair cash value," our case law establishes that "[t]he terms 'fair cash value' and 'fair market value' are synonymous." *Ky. Dept. of Revenue v. Hobart Mfg. Co.*, 549 S.W.2d 297, 300 (Ky. 1977); Kentucky Revised Statutes 132.450.

The difference constitutes the taxable fair market value of the Resident's possessory interest in a particular unit.

MISCELLANEOUS ISSUES

The Residents allege that the ad valorem taxation of their respective property interests in the units was discriminatory and resulted from the improper collusion between the PVA and Taylor Mill. As evidence, the residents point to the declaratory judgment action and believe that they were "intentionally excluded" therefrom. The Residents specifically argue:

> Here, the intentionally discriminatory nature of the assessments of the Residents' interests' in their Units is apparent: their interests were assessed while no other non-commercial transferee of an interest in tax exempt property in Taylor Mill or Kenton County has been assessed. Indeed, the intent to discriminate was written into the Agreed Declaratory Judgment, which prescribed the application of KRS 132.195 to all leasehold or other occupancy interests transferred in otherwise tax exempt property, but went on to identify the Residents as their sole target. This was the first, last, and only such assessment by the Kenton County PVA of property which was used for an exempt purpose. (Citations omitted.)

Residents' Brief at 22. Considering the record, we do not believe that the ad valorem taxation of the Residents' property interests were discriminatory or the product of improper motives. And, the declaratory judgment action only bound the parties thereto. The legal propriety of the ad valorem taxation of the Residents' property interests has been adjudicated in this action.

In summary, we are of the opinion that the Resident's respective possessory interests in each unit is subject to ad valorem taxation under KRS 132.195(1) and affirm the circuit court upon such conclusion. We, however, hold that the Kenton County PVA incorrectly assessed the fair market value of each Resident's respective possessory interest. The PVA should obtain the fair market value of the Resident's specific property interest by subtracting the fair market value of the particular unit with the Resident's leasehold from the fair market value of the unit without the leasehold. The difference constitutes the fair market value of the Resident's possessory interest in that specific unit for ad valorem taxation purposes.

For the foregoing reasons, the Judgment of the Kenton Circuit Court is affirmed in part, and reversed in part and remanded for proceedings consistent with this opinion.

ALL CONCUR.

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