To: Arbitrator Biersmith
Re: March 2, 1017 remand

There is no dispute that Santa Barbara County Ordinance 11A allows pass-through (temporary increase treatment) to capital expenses and capital improvements—and only to capital expenses and capital improvements. There is no dispute that Santa Barbara County Ordinance Chapter 11A does NOT allow pass-through (temporary increase treatment) for ordinary operating expenses. The county's findings and requirements express this to the arbitrator:

"Point to the relevant evidence that supports that the costs to be subject to amortization are for capital improvements and/or expenses as permitted to be passed through by the Ordinance."

Ordinary operating expenses and capital expenditures make up 100% of a company's expenses. It is a complete defeat of the express language and intended purpose of the ordinance to allow pass-through treatment to ALL expenses. Under the theory that you can pass-through ordinary operating expenses as well as capital expenditures, how, exactly, does the ordinance "protect the owners and occupiers of mobilehomes from unreasonable rents," its express intent and direct language?

Management has consistently pointed to the hypothetical theories argued by the alleged 'experts.' Neither expert has knowledge of law, accounting, financial analysis or the ordinance. They, in fact, had not read the ordinance. Neither has any business experience that might lead to actually understanding the distinction between operating and capital expenses or how the ordinance expressly distinguishes the two, had they taken the time to read it.

Based on the County Code language, the finding regarding amortization must point to the relevant evidence that supports that the costs to be subject to amortization are for capital improvements and/or expenses, as well as the useful life of each capital improvement and/or expense. Based on that information, the arbitrator's conclusion should amortize the costs of capital expenses over the useful life of the capital improvements and/or expenses that are part of the temporary increase.

The Internal Revenue Code provides authoritative law on business expenses and the categorization of either capital or ordinary operating expenses.

26 U.S.C. 162 – Trade or business expenses: (a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business…

A taxpayer, whether a corporation, an individual, a partnership, a trust or an estate, generally may deduct from gross income the ordinary and necessary expenses of carrying on a trade or business that are paid or incurred during the tax year (Code Sec. 162; Reg. § 1.162-1). However, a deduction is not permitted for any expenditure that is a capital expense (¶ 903).

Legal expenses paid or incurred in connection with a business transaction or primarily for the purpose of preserving existing business reputation and goodwill are ordinarily deductible (F.W. Staudt, Dec. 20,040(M), 12 TCM 1417 (1953)).

26 U.S.C. 164 – Taxes: (a) General rule. Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued: (1) State and local, and foreign, real property taxes.

Local, state and foreign real property taxes are generally deductible only by the person upon whom they are imposed in the year in which they were paid or accrued (Code Sec. 164(a)(1); Reg. § 1.164-1(a)).41 Real property taxes are taxes imposed on interests in real property and levied for the general public welfare.

26 U.S.C. 167 – Depreciation: (a) General Rule. There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
(1) of property used in the trade or business, or
(2) of property held for the production of income.

(c) Basis for depreciation: (1) In General. The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011, for the purpose of determining the gain on the sale or other disposition of such property.

Depreciation is a reasonable allowance for the exhaustion, wear and tear, and obsolescence on certain types of property used in a trade or business or for the production of income (Code Sec. 167(a)). Depreciation is an accounting concept that treats an allocable part of the cost of certain limited-life assets as an expense (return of capital) in determining taxable income. This expense is also deducted (matched against income) over the number of years that the asset is expected to be used or a specified recovery period rather than deducted all in one year.

Amortization is similar to depreciation but generally refers to the periodic recovery of the cost of an intangible asset. Amortization and depreciation are both authorized by Code Sec. 167(a).

Property is depreciable if it (1) is used for business or held for the production of income; (2) has a **determinable useful life exceeding one year**; and (3) wears out, decays, becomes obsolete, or loses value from natural causes.

The cost of assets with useful lives in a taxpayer's trade or business that do not exceed one year may be currently deducted as expenses (rather than depreciated) for the year in which their costs are paid or incurred.

Under ACRS and MACRS, assets are generally assigned a recovery (depreciation) period which applies regardless of an asset's actual useful life in a taxpayer's business. However, if the actual useful life is one year or less, then the cost of the asset can be expensed. For example, industrial garments and dust control items (e.g., mops, towels, mats) which were leased to a variety of

customers had a useful life to an industrial laundry corporation of one year or less and could be currently expensed (Prudential Overall Supply, TC Memo. 2002-103, Dec. 54,723(M)).

Taxpayers' payment will be deductible under section 162 of the Code as a trade or business expense only if it is not a personal expenditure, a capital expenditure under section 263 of the Code, or subject to 162(f). The controlling test to distinguish business expenses from personal or capital expenditures is the "**origin of the claim**" test. Anchor Coupling Company v. United States, 427 F.2d 429, 433 (7th Cir.1970), cert. denied, 401 U.S. 908 (1971).

The origin of the claim test was first set forth by the Supreme Court in United States v. Gilmore, 372 U.S. 39 (1963). In Gilmore, the Court held that the controlling test of whether an expense is "business" or "personal" is to consider the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer. See also Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580 (1970).

Although these Supreme Court cases considered whether an expense was business or personal, the origin of the claim test has also been applied to distinguishing between business and capital expenditures. For example, in Anchor Coupling, the court held that examination of the origin and character of the claim with respect to which a settlement is made, rather than the estimation of the potential consequences of the claim upon the business operations of the taxpayer, is the controlling test in determining whether a settlement payment constitutes a deductible business expense or a nondeductible capital outlay. Anchor Coupling, 427 F.2d at 431 (citing Gilmore, Woodward, and Hilton Hotels, supra).

Business expenses are not converted into capital expenditures solely because they have some connection to a capital transaction. In determining whether litigation costs are deductible expenses or capital expenditures, the courts and the Service have looked to the "origin of the claim" to which the settlement or other litigation costs relate. See Woodward v. Commissioner, 397 U.S. at 577; United States v. Gilmore, 372 U.S. at 47. Under the origin of the claim test, the character of a particular expenditure is determined by the transaction or activity from which the taxable event proximately resulted. Gilmore, 372 U.S. at 47. The purpose, consequence or result of the expenditure is irrelevant in determining the origin of the claim and, therefore, the character of the litigation cost for tax purposes. McKeague v. Commissioner, 12 Cl. Ct. 671 (1987), aff'd without opinion, 852 F.2d 1294 (Fed. Cir. 1988).

Finding for Award No.6 (previously 5) - Escrow Account and Costs Expended

The arbitrator must now explain how each item is a capital asset and its class life or recovery period. In the alternative, the arbitrator must explain, using the origin of claims test, how and to what capital asset does the line item attach, what is that asset's basis and its depreciable or amortizable class life.

For example, the arbitrator must determine the useful life of a $20,760 deposit on work that was never done and, therefore, returned to management. The express requirement of the county is to

"**Point to the relevant evidence that supports what is the useful life of the capital improvements and/or expenses**."

Finding for Award No.7 (previously 6) - Professional Fees

The Internal Revenue Code and its associated revenue rulings and regulations, as well as generally accepted accounting principles (GAAP), classify these legal 'professional' fees as ordinary operating expenses. Management treated these legal fees as ordinary expenses, as proven by their financial statements.

These fees cannot, on their own, be classified as capital asset costs that can be passed on per Ord. section 11A-6. And there is no asset to apply the origin of claims test for these fees.

The express requirement of the county is for the arbitrator to "…specifically identify which Professional Fees were awarded out of the requested $50,000." And to "Point to the relevant evidence that supports how the awarded Professional Fees are properly categorized as a cost of capital improvements and/or expenses as permitted to be passed through by the Ordinance."

Finding for Award No. 8 (previously 7) - Architecture and Engineering Fees

The Internal Revenue Code requires that these types of expenses be added to the basis of the capital asset only if the tangible asset is actually acquired or produced and the costs are inherently facilitative (IRS Reg. 1.263(a)-2(f)).

The 2004 and 2005 paperwork relates to a long-abandoned project of the previous park owner and is not inherently facilitative, or related in any way, to current management. Management's financial statements prove that there was never a monetary transaction and, therefore, management's basis in this old paperwork is zero. Because there was never a purchase transaction, management never treated the prior owner's fees as either capital or ordinary.

These fees cannot, on their own, be classified as capital asset costs that can be passed on per Ord. section 11A-6, and there is no asset to apply the origin of claims test for these fees.

The express requirement of the county is for the arbitrator to "…specifically identify which Architecture and Engineering Fees were awarded out of the requested $90,000." And to "Point to the relevant evidence that supports how the awarded Architecture and Engineering Fees are properly categorized as a cost of capital improvements and/or expenses as permitted to be passed through by the Ordinance."

Finding for Award No. 9 (previously 8) - Past Payments by Park Owners for Increased Real Property Taxes

The Internal Revenue Code and its associated revenue rulings and regulations, as well as generally accepted accounting principles (GAAP), Judge Anderle's ruling and the county ordinance all classify property taxes as ordinary operating expenses.

Internal Revenue Code §164 specifically includes property taxes as an allowable deduction for the taxable year within which paid or accrued. The county's finding specifically quotes ordinance section 11A-5(f)(1), which delineates property tax as "an expense in connection with operating the park" and different from capital improvements or capital expenses.

The county requires the arbitrator to "bridge the analytic gap" between considering property taxes per 11A-5(f)(1) and passing them through as a capital expense per 11A-6, the exclusive domain of capital assets. The expressed requirement is for the arbitrator to "Point to the relevant evidence that supports that the costs to be subject to amortization are for capital improvements and/or expenses as permitted to be passed through by the Ordinance." And to "Point to the relevant evidence that supports what is the useful life of the capital improvements and/or expenses."

The arbitrator must conclude that the property taxes do not a have determinable useful life exceeding one year. Each tax payment is, in fact, for a specific six month period. There is no 'relevant evidence' that supports that the property tax costs to be subject to amortization are for capital improvements and/or expenses. It is, therefore, impossible to assign a useful life.

Finding for Award No. 12 (previously 11) - Legal Fees Associated with the Challenge to the Rent Increase

The Internal Revenue Code and its associated revenue rulings and regulations, as well as generally accepted accounting principles (GAAP), Judge Anderle's ruling, the county ordinance and the board's finding ("Baar's testimony is substantial evidence that legal fees, if reasonable in amount, are appropriately included as a basis for a rent increase as an **ordinary and necessary operating expense**.") all agree that legal fees are to be treated as ordinary operating expenses.

The county requires the arbitrator to "bridge the analytic gap" between considering legal fees "as a basis for a rent increase as an ordinary and necessary operating expense" per 11A-5(f)(1) and passing them through as a capital expense per 11A-6, the exclusive domain of capital assets. The expressed requirement is for the arbitrator to "Point to the relevant evidence that supports that the costs to be subject to amortization are for capital improvements and/or expenses as permitted to be passed through by the Ordinance." And to "Point to the relevant evidence that supports what is the useful life of the capital improvements and/or expenses."

Finding for Award No. 13 (previously 12) - Total Permanent and Temporary Increase

The board found that the arbitrator did not abuse his discretion in calculating the increases. However, the ordinance has an expressed formula for calculating any increase. Ord. 11A-5 requires that:

> *(h) The arbitrator may allow an increase in excess of the automatic increase for increased costs where increases in expenses and expenditures of management justify such increase.*
>
> *(i) To determine the amount of any increase in excess of the automatic increase, **the***

arbitrator shall*:*

(1)

First, grant one-half of the automatic increase to management as a just and reasonable return on investment. The arbitrator shall have no discretion to award additional amounts as a just and reasonable return on investment;

(2)

Next, grant one-half of the automatic increase to management to cover increased operating costs. The arbitrator shall have no discretion to award less than this amount for operating costs.

(3)

Next, add an amount to cover operating costs, if any, in excess of one-half of the automatic increase. The arbitrator shall have discretion to add such amounts as are justified by the evidence and otherwise permitted by this chapter.

(4)

Next, add an amount to cover new capital expenses. Where one-half of the automatic increase is more than the actual increase in operating costs **for the year then ending***, the arbitrator shall offset the difference against any increases for new capital expenses.*

(5)

Next, add an amount to cover old capital expenses. Where one-half of the automatic increase is more than the actual increase in operating costs **for the year then ending***, the arbitrator shall offset the difference against any increase for old capital expenses unless such difference has already been used to offset an increase for a new capital expense or another old capital expense. The arbitrator shall have discretion to review operating costs and the sufficiency of any offset, but not to redetermine the right of management to reimbursement for an old capital expense.*

(6)

Finally, add an amount to cover increased costs for capital improvements, if any. The arbitrator shall have discretion to add such amount as is justified by the evidence and otherwise permitted by this chapter.

Shall Legal Definition: **An imperative command; has a duty to or is required to**. For example, the notice shall be sent within 30 days. Usually “shall” used here is in the mandatory sense.

When used in statutes, contracts or the like, the word "shall" is generally imperative or mandatory.[Independent School Dist. v. Independent School Dist., 170 N.W.2d 433, 440 (Minn. 1969)]

"In common, or ordinary parlance, and in its ordinary signification, the term 'shall' is a word of command, and one which has always, or which must be given a compulsory meaning; as denoting obligation. It has a peremptory meaning, and it is generally imperative or mandatory. It has the invariable significance of excluding the idea of discretion, and has the significance of operating to impose a duty which may be enforced, particularly if public policy is in favor of this meaning, or when addressed to public officials, or where a public interest is involved, or where the public or persons have rights which ought to be exercised or enforced, unless a contrary

intent appears; but the context ought to be very strongly persuasive before it is softened into a mere permission,…" [People v. O'Rourke, 124 Cal. App. 752, 759 (Cal. App. 1932)]

Therefore, the arbitrator is required to follow the ordinance formula and, per the county's express requirement, "Include a relevant calculations sheet supporting the total permanent and temporary increase.

Management will undoubtedly ask the arbitrator to ignore and completely disregard the law, as they have for the past six years. The homeowners ask the arbitrator to follow county's express requirements. The arbitrator necessarily must conclude that the ordinary operating expenses that management is illegally charging the homeowners are not a pass-through temporary increase and must be returned from the trust account, as required by Ord. 11A-8 ("any portion of an increase in excess of seventy-five percent of the CPI increase shall be placed in an interest-bearing account in the name of management as trustee for the homeowners of that park.") The arbitrator must provide his calculations, not only per the county's requirement, but in the express manner promulgated by the ordinance 11A-5(h) and (i)(1)-(6).

The homeowners are prepared to continue all legal actions and remedies necessary to protect themselves, and the ordinance, against management's tortious and criminal acts.

Homeowners of Nomad Village
Representative Debra Hamrick