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SUPERIOR COURT DISTRICT OF COLUMBIA TAX DIVISION

SUPERIOR COURT OF THE DISTRICT OF COLUMBIA

TAX DIVISION

1111 - 19TH STREET ASSOCIATES, Petitioner,	:	
	:	
v.	:	Tax Docket No. 4082-88
DISTRICT OF COLUMBIA, Respondent.	:	

FINDINGS OF FACT, CONCLUSIONS OF LAW, AND JUDGMENT

This matter came before the Court for trial on petitioner's appeal from an assessment for real property taxes for tax year 1988. The parties filed stipulations pursuant to Super. Ct. Tax R. 11 (b). Upon consideration of the stipulations, the evidence adduced at trial, and having resolved all questions of credibility, the Court makes the following:

FINDINGS OF FACT

1. The subject property is owned by 1111 19th Street Associates, a limited partnership organized and existing under the laws of the District of Columbia. Petitioner, 1111 19th Street Associates, is obligated to pay all real estate taxes assessed against the subject property.

2. The subject property is located at 1111 19th Street, N.W., Square 140, Lot 90, in the District of Columbia. It is a 12-story office building, built in 1979, with three levels of underground

parking. The property has 375,843 gross square feet. It has 235,300 square feet of gross leasable office space, and 14,475 square feet of gross leasable retail space. The property also has 3,740 square feet of storage space and 250 parking spaces. The property is zoned C-4 and developed to a 10.0 FAR.

3. For tax year 1988, the valuation date being January 1, 1987, the District's proposed assessment was $41,607,000. Petitioner timely filed a complaint with the Board of Equalization and Review (BER). On May 11, 1987, the BER held a hearing and sustained the proposed assessment for tax year 1988. At trial, the District sought to uphold the assessment of $41,607,000 even though its expert appraiser valued the property at $37,000,000 for tax year 1988.

4. Petitioner paid the real estate taxes in full, as required by law, and timely filed this petition for reduction of assessment and refund of payment. In its petition, petitioner asserted that the fair market value of the property for tax year 1988 was $21,400,000. At trial, petitioner changed its claim as to the value of the property to $26,500,000. This figure reflects the value set by its expert appraiser.

5. The tax assessor for tax year 1988 was Phillip S. Appelbaum. Mr. Appelbaum is a commercial assessor with the Department of Finance and Revenue of the District of Columbia. For tax year 1988, Mr. Appelbaum used the mass appraisal technique and

ultimately applied the income approach to value in assessing the property.

6. Based on his opinion that the reported income for the subject property was substantially below current market rates and that 50% of the leases would expire within 2 years of the valuation date, Mr. Appelbaum determined the potential net operating income of the property to be $4,838,884. In contrast, the reported (actual) net operating income of the property was $2,702,356, $2,928,529, and $2,933,590 for the years 1984, 1985, and 1986 respectively. Mr. Appelbaum arrived at his figure for net operating income by conducting an economic income expense study of buildings built in the 1970's. Mr. Appelbaum examined the expense and income figures of these buildings as reported to the District. He then averaged the expense and income figures and applied them to the subject property as the net operating income. Without making any adjustments to the potential net operating income, Mr. Appelbaum divided his net income figure by a capitalization rate of 11.63%. Mr. Appelbaum stated that this was the proper rate for buildings in that age category. Based on these figures, Mr. Appelbaum calculated the fair market value of the property to be $41,607,000.

7. At trial, Mr. Appelbaum testified that the actual net operating income may or may not be similar to the potential (market) net operating income when using the mass appraisal technique. He also stated that he did not make any adjustments for actual income,

actual expenses, lease-up costs, improvement costs, rent concessions or vacancy and collection losses. By not taking into account the experience of the property, Mr. Appelbaum's income figure is not relevant to the subject property and cannot be very reliable. As a result, his assessment cannot be very reliable either.

8. Both sides offered expert testimony. Ms. Michelle Saad testified for the petitioner, and Mr. Ryland Mitchell III, testified for the respondent. The Court accepted each as an expert witness.

9. Both Ms. Saad and Mr. Mitchell arrived at the land value by considering comparable sales and adjusting for dissimilarities with the subject property. Even though Ms. Saad originally valued the land at $85 per FAR foot or $22,300,000, for purposes of trial, she adopted the assessor's valuation of $20,929,805. Mr. Mitchell valued the land at $75 per FAR foot for a total value of $19,650,000. Since neither petitioner nor respondent challenged the District's valuation of the land, the Court accepts the value of the land to be $20,929,805 as set by the District's assessor.

10. In calculating the value of the improved property, both experts relied on the income approach and rejected the cost approach. Mr. Mitchell also utilized the sales comparison approach. Ms. Saad used the sales comparison approach but only to

support her valuation of the subject property by the income capitalization approach. In addition, both experts agreed that the highest and best use of the property was as developed.

11. Using different approaches, the experts calculated the net operating income of the property. Ms. Saad made a detailed examination of the property's operating history. She considered that the building was 100% leased, had an average rent of $17 per square foot, that 50% of the leases would expire in 1989, and that only leases relating to 2,000 square feet were to expire in 1987.

Ms. Saad then examined comparable rentals for office space and retail space. Rents for office space ranged from $17.50 to $26 per square foot and, for retail space, rents ranged from $14 to $25. Ms. Saad testified that after considering the age and condition of the improvements, location, leasing terms, and the demand for space in the area, it was her opinion that the average fair economic rent was $26 per square foot. After reducing the rent for concessions, Ms. Saad estimated the effective market rent for the property to be $20 per square foot. Using these figures and projections, petitioner's expert calculated the gross potential annual income for the property as of the valuation date to be $4,426,304. Ms. Saad adjusted this figure for a 5% vacancy and collection loss, resulting in a gross annual income of $4,204,989.

12. Mr. Mitchell calculated the value of the property using the income capitalization approach basing his calculations first on

existing leases and then on market rents. For income based on existing leases, Mr. Mitchell examined the 1984-1986 reported operating history of the property and determined the gross operating income to be $4,285,000. Mr. Mitchell adjusted this figure for a 2% vacancy and collection loss, resulting in a gross annual income of $4,200,000.

13. After subtracting estimated expenses, the experts arrived at the net operating income of the subject property. Ms. Saad determined the net operating income to be $2,919,389, and Mr. Mitchell computed the net operating income to be $2,940,000. The experts' respective figures differ by only $20,611.

Based on their appraisal reports, it appears that Ms. Saad considered both existing leases and market conditions in determining the net operating income of the property. However, Mr. Mitchell only considered existing leases or market conditions, but never both. This results in Ms. Saad's valuation being supported by more credible evidence. The Court will take into account both existing leases and market conditions since both affect the ability of the property to generate income. Accordingly, the Court adopts Ms. Saad's determination of the net operating income, $2,919,389.

14. To arrive at the overall capitalization rate of the property, Ms. Saad examined market attitudes and economic indicators as well as other factors related to the property (lease terms, expense ratios, location). Ms. Saad also considered bank rates and bond

yield rates. Due to the greater risk and non-liquidity of real estate investments, petitioner's expert determined that the higher rates of Corporate Baa and A bonds provided the most relevant basis for risk as compared to other bank rates and bond yields.

	Jan. 1987	July 1986	Jan. 1986	Jan. 1985
Corporate Bonds Baa	9.76	10.16	11.44	13.26
Corporate Bonds A	9.23	9.76	11.04	12.80

Ms. Saad obtained these figures from Moody's Bond Survey.

Ms. Saad examined new mortgage commitments and the average capitalization rate, both for the fourth quarter of 1986. The average capitalization rate was 9.8% for that quarter. Moreover, based on economic indicators, financial indicators, real estate investment criteria, and the Washington, D.C. market, Ms. Saad determined real estate yield rates, as of January 1, 1987, stratified by property specifics and locational characteristics. For the subject property type and location, the range of yield rates was 12.0% to 13.0%.

Ms. Saad also calculated a range of capitalization rates using the band of investment technique, a traditional method of capitalization often used when sufficient market data is available. Under the band of investment technique, the appraiser develops a weighted component of the mortgage and equity to develop the overall rate. In applying the band of investment technique, Ms.

Saad considered typical loan to value ratios, debt service, equity dividend rates, and points paid in the mortgage process. Using this formula, Ms. Saad determined a range of capitalization rates of 10.0% to 10.5%.

Considering all of the above information and calculations along with factors affecting buyer motivation, Ms. Saad decided on a formula for calculating the overall capitalization rate of the subject property: overall capitalization rate = overall yield minus annualized increase in value and income. Based on a yield of 12.5% and an annualized increase in value and income of 3.4392%, Ms. Saad calculated the capitalization rate to be 9.06% before adding the real estate tax rate of 2.03%. Therefore, the capitalization rate was 11.09% or 11%. After dividing the net operating income by a capitalization rate of 11%, Ms. Saad valued the property at $26,500,000.

Ms. Saad's capitalization rate is strongly supported by the evidence as so many factors were considered. Also, it should be noted that Ms. Saad's capitalization rate is very close to the capitalization rate used by Mr. Appelbaum.

15. For the income capitalization approach based on existing leases, Mr. Mitchell calculated a capitalization rate of 7% based on the market sales data of 4 improved comparable properties. After adding 2.03% for the tax rate, respondent's capitalization rate was 9%. Applying the 9% overall capitalization rate to respondent's estimated effective gross annual income, the property

was valued at $32,667,000. This was $6,167,000 higher than Ms. Saad's value.

16. An examination of the comparable properties revealed a problem with the comparability of the 4 properties and the subject property. Mr. Mitchell used 2 properties from his comparable sales analysis and 2 other properties to determine the capitalization rate based on market rents. The properties had capitalization rates ranging from 7.3% to 8.0%.

Improved Comparable Sale No. 4 located at 1101 Vermont Avenue, N.W., was of similar age to the subject property and in a desirable location. This property had a capitalization rate of 8.0%. However, Comparable Sale No. 4 involved a sale of the property where the seller, the major occupant of the property, leased the property back from the new owner following the sale. Because of the lessor/lessee relationship of the seller and purchaser, the Court has doubts that the sale of the property was a true "arm's length" transaction.

Improved Comparable Sale No. 6 was located at 1015 18th Street, N.W., and had a capitalization rate of 7.33%. Mr. Mitchell acknowledged that this property was older than the subject property, 9 years older, but he did not make any adjustment for this or explain why no adjustment was necessary.

Capitalization Rate Comparable No. 1 was located at 1140 19th Street, N.W., across the street from the subject property. Mr. Mitchell calculated the capitalization rate for this property based

on past history and arrived at 7.6%. This property was zoned differently and was much smaller than the subject property. It also involved a transaction that was too old for the property to be considered in the Market Data Approach to Valuation. Again, Mr. Mitchell did not discuss the effect that these facts would have on the property's utility as a comparable property.

Capitalization Rate Comparable No. 2 was located at the northeast corner of 19th and L Streets, N.W., immediately south of the subject property. Though this property was similar in age to the subject property, the sale as with the previous property was too old to be used in the Market Data Approach. Yet, Mr. Mitchell did not address what impact, if any, this would have on the property's comparability. This property had a capitalization rate of 7.3%.

This capitalization rate based on market sales data cannot be given much credibility, because without further explanation or adjustment, the properties do not appear to be comparable to the subject property.

17. For the income capitalization approach based on market rents, Mr. Mitchell calculated that the gross potential income based on market rents would be $5,910,000. To arrive at this figure, Mr. Mitchell ignored existing leases and assumed that 100% of the property would be available for leasing at current market rents. Mr. Mitchell then determined current market rents and applied them to the subject property. Respondent's expert also increased the

vacancy rate from 2% to 9% to account for an increased vacancy and collection loss. Mr. Mitchell then subtracted projected expenses from the gross potential income. This resulted in a net operating income before taxes and after a deduction for vacancy and collection loss of $4,080,000.

Based on the appraiser's knowledge and experience, he selected an overall capitalization rate of 9% for use in applying the income capitalization approach based on market rents. Mr. Mitchell increased the capitalization rate by 2% from the 7% rate used for existing leases because of the greater risk regarding uncertain market conditions in the future. With an additional 2% adjustment for the tax burden, the total capitalization rate is 11%.

Applying the capitalization rate to an estimated projected income of $5,910,000, which might be achieved upon total re-leasing, the property was valued at $37,090,000 as of January 1, 1987. This figure is $10,590,000 higher than Ms. Saad's estimate for the value of the property.

However, the income on which this property estimate is based required unrealistic assumptions. If someone were to buy the property today, he or she may not be able to achieve the income which Mr. Mitchell projects, because it is speculative that the new owner would be able to immediately rent 100% of the property at market rents. The new owner would have to wait for current leases to expire and then as the old leases expire sign new ones at market rents. This would take time and cost money. In addition, improvements to the property and rent concessions may be necessary.

These costs would further reduce the property's potential net operating income.

18. Both experts also calculated the value of the property by applying the sales comparison approach, also called the market data approach. Under this approach, the subject property was valued by comparing it with similarly improved properties which had been recently sold or were in the process of being sold. Utilizing this approach, Ms. Saad valued the property at $26,500,000, and Mr. Mitchell valued the property at $38,720,000.

19. In his final analysis, Mr. Mitchell gave "relatively similar weight" to each valuation approach. (Mr. Mitchell's appraisal report, p. 40). After considering the values achieved by each approach, all other available information, and his own experience as an appraiser, Mr. Mitchell determined the market value of the subject property to be $37,000,000.

20. Ms. Saad used the sales comparison approach as a check, giving it very little weight. She relied on the income capitalization approach for determining the value of the property. Thus, Ms. Saad found the market value of the property to be $26,500,000.

21. A cash flow analysis of the property using Mr. Mitchell's income and expense figures indicated that Mr. Mitchell's value of the property, $37,000,000 was not the fair market value of the

property. At trial, Mr. Mitchell applied his figures to the subject property. The result was a negative cash flow after debt service. It is not likely that a prospective purchaser would buy the property when market rents yield a negative cash flow after debt service. This is very strong evidence that Mr. Mitchell's valuation does not reflect market value. However, a cash flow analysis of Ms. Saad's figures yielded a positive cash flow after debt service.

Conclusions of Law

This Court has jurisdiction over this appeal pursuant to D.C. Code §§ 47-825 and 47-3303 (1990 Repl.). The Superior Court's review of a tax assessment is de novo, therefore requiring competent evidence to prove the issues. Wyner v. District of Columbia, 411 A.2d 59, 60 (D.C. 1980). Petitioner bears the burden of proving that the assessment appealed from is incorrect. Safeway Stores, Inc. v. District of Columbia, 525 A.2d 207, 211 (D.C. 1987). However, petitioner is not required to establish the correct value of the property. Brisker v. District of Columbia, 510 A.2d 1037, 1039 (D.C. 1986).

Petitioner has met the burden of proving the incorrectness of the assessment. Also, there is sufficient competent evidence on the record for the Court to determine the fair market value of this property. When a taxpayer appeals an assessment to this Court, the Court can affirm, cancel, reduce or increase the assessment. D.C.

Code § 47-3303 (1990 Repl.).

In assessing this property for tax year 1988, the District's assessor, Mr. Appelbaum, used a net operating income based on the average income and expense figures for properties built in the 1970's, but he admitted not taking into consideration the actual income, actual expenses, current leases, or lease-up costs of the subject property. These factors affect the ability of the property to achieve market rents today and in the future. Without consideration of these factors, utilizing the average net operating income of buildings in a particular age group is an arbitrary and impractical method for determining a property's net operating income for purposes of valuation.

In District of Columbia v. Washington Sheraton Corp., 499 A.2d 109, 115 (D.C. 1985), the Court stated that "[w]hen an income-producing property has been in operation for a period of time, its past earnings assist the assessor in projecting future earning ability." The Court also stated that the market value of an income-producing property includes the present value of the property's future income. Washington Sheraton Corp., supra, 499 A.2d at 115. Therefore, to arrive at a reliable estimate for the net operating income of the property, the District must consider not only market conditions, but the experience of the property as well.

The District failed to take into account the property's actual income. This resulted in a substantial increase in value as

determined by the District. Moreover, at trial, the District's expert rejected the Tax Year 1988 assessment of $41,607,000. Rather, the respondent's expert relied on a lower figure; a figure that was $4,607,000 lower than the figure that the District requests the Court to uphold.

The Court must weigh all the evidence to determine which property valuation is the most credible. For the reasons already stated in the findings of fact, the Court rejects the property valuation proposed by Mr. Mitchell and accepts the property valuation proposed by Ms. Saad. Having considered the testimony and the appraisal reports, the Court sets forth the reasons for the different operating incomes and capitalization rates.

The reason for the different net operating incomes was the failure of Mr. Mitchell to consider both existing leases and market conditions. A prospective purchaser would consider both in estimating current and future income, and therefore, Mr. Mitchell must too. The reason for the difference in the capitalization rates was that Mr. Mitchell did not make the necessary adjustments for differences between the comparable properties and the subject property. Therefore, based on the above conclusions, the Court finds that a preponderance of the evidence supports a figure of $26,500,000 as the market value for the subject property as proposed by Ms. Saad. This figure adequately represents the value of the property as of the valuation date, January 1, 1987.

The Court has generally recognized 3 approaches to value and it has been held that all 3 must be considered. <u>District of</u>

Columbia v. Washington Sheraton Corp., 499 A.2d 109, 113 (D.C. 1985); Safeway Stores, Inc. v. District of Columbia, 525 A.2d 207, 209 (D.C. 1987). Both experts and the District's assessor examined all 3 approaches and all 3 rejected the cost approach. Mr. Appelbaum rejected the sales comparison approach while the 2 experts relied on it to different degrees.

Both experts and the District's assessor gave considerable weight to the income capitalization approach. Of the 3 recognized approaches, the income capitalization approach is the preferred method for valuing income-producing properties. 1015 15th Street, N.W., Associates Limited Partnership v. District of Columbia, Tax Docket No. 3266-83 (Sup. Ct. November 13, 1984). Under the income capitalization approach, the stabilized net operating income is divided by a capitalization rate reflecting the rate the taxpayer must recover annually to pay the mortgage, to obtain a fair return on equity, and to pay real estate taxes. Rock Creek Plaza-Woodner, Ltd. v. District of Columbia, 466 A.2d 857, 858 (D.C. 1983).

For the reasons already stated, there were differences in the experts' opinions. The Court examined the reasons for these differences and determined that the evidence supported Ms. Saad's opinion as she considered both existing leases and market conditions as compared to the respondent's expert who did not. Moreover, respondent's expert relied on properties that were not sufficiently comparable to the subject property.

In assessing real property, the value of the land and improvements must be identified separately. D.C. Code § 47-821 (a)

(1990 Repl.). The parties did not contest the value that the District's assessor assigned to the land. Therefore, as stated previously, the Court adopts $20,929,805 as the value of the land. The remaining portion of the assessment is allocated to the building.

It is therefore by the Court this 21st day of February, 1992, 12:20 p.m.

ORDERED, that the assessed value for the subject property is determined to be as follows for the tax year 1988:

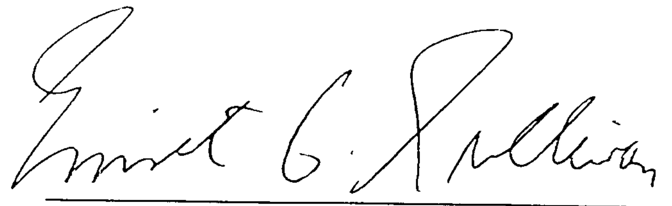
Land	$20,929,805
Improvements	$ 5,570,195
Total	$26,500,000

It is further

ORDERED, that the assessment record card for the property maintained by the District shall be adjusted to reflect the value determined by this order.

It is further

ORDERED, that the petitioner shall submit a proposed order providing for a refund of the overpayment of taxes due to the petitioner, along with interest as allowed by law. A copy of the proposed order shall be served on respondent and filed with the Court by no later than 3/17/92.



Emmet G. Sullivan, Judge

(signed in chambers)

Copies mailed to:

Joseph F. Ferguson, Jr., Esq.
Assistant Corporation Counsel
D.C. Office of Corporation Counsel
4th Floor
1133 North Capitol Street, N.E.
Washington, D. C. 20002

Gilbert Hahn, Jr., Esq.
Tanja H. Castro, Esq.
Amram and Hahn, P.C.
1155 - 15th Street, N.W.
Suite 1100
Washington, D.C. 20005