

SUPERIOR COURT OF THE DISTRICT OF COLUMBIA
TAX DIVISION

TAX DIVISION

TRILON PLAZA COMPANY, et al.
: Petitioners :
: v. : Tax Docket Nos. 4089-88 &
: : 4204-89
DISTRICT OF COLUMBIA :
: Respondent :

FINDINGS OF FACT AND CONCLUSIONS OF LAW

This matter came before the Court on petitioners' appeal from an assessment for real property taxes for tax years 1988 and 1989 and the answer of the District of Columbia. The parties filed Stipulations pursuant to Super. Ct. Tax Rule 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 property is a three story mall with a twelve story office building containing 900,000 plus square feet. According to the property owner there are 321,087 square feet of net rentable area within the mall, and 153,301 square feet in the

office building. The property was built in 1972 or 1973. Originally, the mall was to be two stories. Since the second floor did not attract tenants, it was converted to office space. Escalators were built to service the second floor of the mall, but they are now closed off. The property is designed for single tenant use. The property contains asbestos and has poor ventilation. The property would have to be vacated to remove the asbestos which would leave the property vacant for 6-12 months. The property has no sprinkler system in portions of the building. Therefore, no occupancy permit can be obtained above the fourth floor.

2. The tax assessor for tax years 1988 and 1989 was Mr. Troy Davis. Mr. Davis is a commercial assessor with the Department of Finance and Revenue of the District of Columbia. For 1988, Mr. Davis made the assessment based upon the mass appraisal technique. He considered both the comparable sales approach and income approach to value. However, Mr. Davis testified, there were very few sales of buildings comparable to the subject. Thus, he ultimately relied upon the income approach to value.

3. Employing the income approach to value, Mr. Davis looked at the owner's income and expense history, which was between \$2,303,096 in 1984 to \$2,464,770 in 1987, but did not rely on it. In calculating the value for the property for tax year 1988 by the capitalization of income approach, Mr. Davis assumed a net operating income of \$2,803,537. To arrive at this

net operating income, Mr. Davis did a study of economic rents of other buildings in the Southwest area and rents of buildings built in the 1960's. He examined reported expenses and recent leases signed in these properties. Without making any adjustments, he determined the median of the expense and income figures and applied them to the subject property. These projections of the assessor regarding income are not supported by the evidence. Thus, the assessor's stabilized income appears to be overstated and must be rejected.

4. Mr. Davis also assumed a capitalization rate of 10.03. This figure was provided to him (together with another capitalization rate of 11.03) by Mr. Klugel at the Standards and Review Division of the Department of Finance and Revenue. He testified that he chose the lower rate because he assumed a 5% per year appreciation. Thus for tax year 1988 the assessor simply used the figures provided by the Office of Standards and Review and made a mathematical calculation to determine the assessed value of \$27,877,000 for the property. This was identical to the assessment of \$27,877,000 for tax years 1985, 1986 and 1987.

5. For tax year 1989, Mr. Davis arrived at the same assessed value of \$27,877,000. He indicated that he again used the "mass appraisal technique," relying upon the income approach. He used a net operating income of \$2,796,073 although the actual operating income for 1986 was \$2,311,816. Mr. Klugel at Standards and Review again provided him with the same

capitalization rate sheet which contained the same two capitalization rates as the prior year of 10.03 and 11.03. He divided his market net operating income by his provided capitalization rate and got the identical assessment of \$27,877,000 as the prior four years.

6. These procedures were arbitrary and unreasonable and were not reasonably calculated to derive at the actual market value of the property and resulted in erroneous assessments.

7. Both sides offered expert testimony. Michelle Saad appeared for petitioners, and Ryland Mitchell, III appeared for respondent. Both witnesses are expert real estate appraisers. Ms. Saad's qualifications are set forth in petitioner's Exhibit 14 at Exhibit A. The qualifications as stated are incorporated herein by reference. Mr. Mitchell's qualifications are set forth on the last page of respondent's Exhibit 1. His qualifications as stated are incorporated herein by reference. The Court qualified each as an expert witness.

8. Each expert witness arrived at the land value by considering comparable sales and adjusting for dissimilarities with the subject. Ms. Saad, for purposes of the trial, valued the land at \$18.40 per FAR or \$12,400,000. Mr. Mitchell valued the land at \$20.00 per FAR for a total value of \$13,450,000.

9. In estimating the value of the whole property, both experts rejected the cost approach to value. Both found the cost approach inappropriate for an income producing property like the subject. Mr. Mitchell concluded that both the income

approach and comparable sales approach were relevant for the subject property. Ms. Saad deemed the income approach to value most pertinent. In addition to using the sales comparison approach to estimate the land value, Ms. Saad used it to support the valuation of the subject by the income capitalization approach.

10. In estimating the stabilized net income for the building, petitioners' expert considered the property's condition. The building is not located in the central business district. Therefore, its appeal as an office building is somewhat limited. The property was not sufficiently attractive to retail tenants to allow use of all retail space as originally planned. Thus, some space had to be converted to office usage. The building was constructed with asbestos tile which has carpet over it. The corridors and lobby also have plaster over which asbestos has been sprayed. The cost of removal of the asbestos is estimated at \$3,000,000. This does not include loss of income during the period of removal, since tenants could not occupy the building during removal. In addition, the figure does not include any cost of marketing and releasing which could be necessary after completion of the work. The electrical system is insufficient for a building of comparable size. A portion of the building does not have a sprinkler system in violation of existing codes. The heating and ventilation systems are somewhat inadequate. Considering the condition of the building, petitioners' expert concluded that the existing rent structures

represented economic rent.

11. As of January 1, 1987 and as of January 1, 1988 all office space in the building was leased to General Services Administration (GSA) for occupancy by a government agency. This GSA lease expired in 1992. The site is zoned UR which restricts use and occupancy to offices for government agencies, retail, personal and professional services. Except for 11,933 square feet, all retail space in the mall was occupied at the valuation dates. Gross income for the property was essentially flat between 1984 and 1987 ranging from \$2,311,396 in 1984 to \$2,464,770 in 1987.

12. Considering the restrictions in use and the condition of the building, it was the opinion of petitioners' expert that the office space in the building could not be rented for more than it was rented. For the unleased retail space, the witness projected a rental rate of \$24.00 per square foot. Comparable rents for retail space ranged between \$11.00 to \$39.00 per square foot. The most recent retail lease in the property was signed in October 1985 at \$23.15 per square foot. The indicated overall rate at which the subject was leased to tenants as of January 1, 1987 was \$10.55 per square foot of net rentable area. As of January 1, 1988, it was \$11.12 per square foot of net rentable area. Using these figures and projections, petitioners' expert estimated gross annual income for the subject for purposes of the January 1, 1987 valuation date at \$5,006,176, and for the January 1, 1988 valuation date at \$5,274,404.

13. In doing an income analysis for the subject for purposes of considering the fair market value of the property, respondent's expert projected gross potential income for the subject property at \$4,850,000 as of January 1, 1987 and at \$4,975,000 for January 1, 1988. With allowances for vacancy and credit losses, the estimated effective gross annual income as determined by the two experts in connection with the income approach to value are as follows:

<u>January 1, 1987</u>		<u>January 1, 1988</u>	
<u>Petitioners</u>	<u>Respondent</u>	<u>Petitioners</u>	<u>Respondent</u>
\$4,855,991	\$4,650,000	\$5,116,172	\$4,775,000

The difference between the two experts for these estimates is minimal, and in fact, petitioners' expert was higher.

14. The expense projections made by the two experts are also within close range of each other. The estimated expenses for each witness are reflected below with projected income to arrive at estimated net operating income before real estate taxes.

	<u>January 1, 1987</u>		<u>January 1, 1988</u>	
	<u>Petitioners</u>	<u>Respondent</u>	<u>Petitioners</u>	<u>Respondent</u>
Effective Gross Income	\$4,855,991	\$4,650,000	\$5,116,172	\$4,775,000
Less Estimated expenses (w/o real estate taxes)	2,372,799	2,250,000	2,362,212	2,275,000
Estimated Net Operating Income	\$2,483,192	\$2,400,000	\$2,753,960	\$2,500,000

Thus, the two experts' net operating incomes were very similar with petitioners' expert's figures slightly higher.

15. As a result, for both tax years 1988 and 1989, both expert witnesses' estimates of gross income, expenses and net operating income were close enough so as to cause no significant difference between the expert witnesses as to net operating income. Since both expert witnesses preferred the capitalization of income technique, this left open for consideration only the viability of each expert's estimate of the appropriate capitalization rate in each tax year, the comparison to the comparable sales approach and the deduction, or not, of \$3,000,000 estimated cost of asbestos removal.

16. In developing her capitalization rate, Ms. Saad used both the band of investment technique and yield capitalization. These are two traditional ways of determining a capitalization rate. A third method is the use of market comparables. However, petitioners' expert found no true comparables for that purpose. As Ms. Saad stated in her report,

Without having sales of truly similar properties from which to extract an overall capitalization rate from the market, it is appropriate to derive a capitalization rate based on market financing and equity requirements. The application of the overall rate derived from the marketplace must be used with caution. This is particularly true because the motivations of the buyer are specifically affected by the factors of location, physical characteristics and risk.

Thus, she stated on direct and cross examination that the possible so-called comparable sales, from which data could be acquired, produced such widely diverse data as to be unusable. Moreover, Ms. Saad testified that when you are dealing with data which requires more than 25-33% adjustments, the usefulness of the data acquired either for comparable sales or for market capitalization rates are virtually useless.

17. In selecting a capitalization rate, petitioners' expert considered evidence from prevailing market attitudes and economic indicators. She considered the bank rates and bond yield rates. Higher rates are warranted for real estate investments because of the greater risk and non-liquidity of the investment. Corporate Baa and A bonds were deemed most relevant by petitioner's expert. Corporate Baa bonds had yields of 9.27 in January 1987. The Corporate A bonds were 9.23 in January 1987. The witness also considered the interest rates on loans for nonresidential mortgages during the time near the valuation dates considering the risk and unfavorable aspects of the property.

18. The band of investment method used by Ms. Saad considers the typical loan to value ratios, debt service, equity dividend rates and points paid for the mortgage. By this method, petitioner's witness reached a range of .10046 and .10365 before adding the tax rate of 2.03 for January 1, 1987.

19. Ms. Saad also used the "yield capitalization" method, selecting yield rates of 13-15% in the southwest area

(page 40 of her report). She selected a yield rate of 13.5%, reduced it 3% for annualized increase to get a capitalization rate of .105 before the 2.03% tax add on. The rate Ms. Saad concluded was appropriate was .1253 or .1250 rounded. Thus, petitioners' expert provided market data as support for the capitalization rates arrived at by both the band of investment method and the yield capitalization method.

20. For tax year 1988, petitioners' witness applied the capitalization rate to her stabilized net operating income to arrive at the following indication of value:

$$\frac{2,483,192}{.1250} = \$19,865,536$$

For tax year 1989, petitioners' witness applied the capitalization rate to her stabilized net operating income to arrive at the following indication of value:

$$\frac{2,753,961}{.1250} = \$22,031,688$$

21. Ms. Saad then deduced \$3,000,000 from her capitalized value for the cost of removing asbestos from the property. Mr. Bresler, general partner of the owner of the property and an experienced investor, developer and banker, testified that a buyer of the property would be required to either remove the asbestos or escrow the funds to remove it. Ms.

Saad agreed. Alternatively, Ms. Saad analyzed the cost as if amortized. However, this resulted in a lower value. Thus, her opinion was that it should be deducted as a lump sum.

22. Finally, in testing her conclusion of value for the subject property, Ms. Saad completed a cash flow analysis. Applying the stabilized net operating incomes she had derived for the subject to the real estate taxes and mortgage requirements at the then-prevailing market rates for mortgages, Ms. Saad concluded that, if an investor purchased the property for the value that she ascribed to it, the property would have a positive cash flow sufficient to render it competitive in the market place for investors' dollars.

23. Respondent's expert witness derived an overall capitalization rate from market sales data. The witness developed a capitalization rate of 8.5% for tax year 1988 and tax year 1989. Adding the adjustment for the tax burden of 2.03, results in a total capitalization rate adjusted for taxes of 10.5% for both years. The capitalization rate was derived by this witness from sales of so-called improved comparables.

24. The properties used as so-called comparables in this analysis were not comparables. In fact, two of the four were not included in his market data approach because they were not sufficiently comparable to derive a value conclusion. Both were sale and lease-back arrangements. The other two required adjustments of between 50% and 100% and, as Mr. Mitchell admitted, were of limited usefulness. Adjustments should be made

when non-comparable sales are considered to develop a capitalization rate. Here, the properties used by Mr. Mitchell to develop the capitalization rate were not sufficiently comparable to reflect the risk of investment in the subject. Mr. Mitchell valued the property for a prior tax year, 1987, and used the same sales of so-called comparables for the subject property but got differing estimated market capitalization rates. Moreover, he valued a neighboring property, L'Enfant Plaza North, for value dates identical to those at issue in this case, using the identical so-called comparables and got still a third capitalization rate. This calls into question the reliability of his capitalization rate in the subject cases.

25. Using the 10.5% overall capitalization rate, respondent's expert reached an indicated value for the property of \$22,850,000 for tax year 1988 and \$23,800,000 for tax year 1989.

26. During cross-examination by petitioners' counsel, Mr. Mitchell examined the cash flow of the subject property if Mr. Mitchell's income and expense conclusions based on market rents were applied. Mr. Mitchell admitted that, under market conditions as of the value date, his analysis would yield almost no cash flow after debt service for both years. A willing buyer would not buy the subject property at Mr. Mitchell's value based on market rents yielding a negative cash flow after debt service.

27. Both expert witnesses considered value by the sales comparison approach. Value is estimated based on an

analysis of comparable improved sales. The properties compared to the subject should be similar when this approach is used. Appropriate adjustments must be made by the appraiser for dissimilarities. The adjusted sales price of comparable properties indicate a range within which the value of the subject property should fall. The usefulness of this approach to value is limited in this case by the absence of true comparables and the necessity for substantial adjustments in an effort to make comparisons. For this reason, petitioners' expert used the value obtained by this approach only as a check on valuation by the income capitalization approach. Through this approach, she arrived at an estimated value of \$16,900,000 for tax year 1988 and \$19,000,000 for tax year 1989.

28. Each of the expert witnesses are of the opinion that the present use of the property represents its highest and best use.

29. Ms. Saad adjusted her indication of value down by \$3,000,000 for asbestos removal. Mr. Mitchell did not. Mr. Bresler, Ms. Saad and even Mr. Mitchell on cross examination testified to the need to make a reduction. Mr. Mitchell testified that he did not dispute Ms. Saad's estimate of \$3,000,000 to remove the asbestos. Mr. Mitchell agreed that in his reports for the tax years 1986 and 1987 cases he made a reduction for asbestos of \$3,800,000 for the same property. Mr. Bresler, Ms. Saad and Mr. Mitchell all agreed that as a general rule, lenders require asbestos removal or an escrow for the

costs. GSA, the only likely tenant for the property requires asbestos removal, as will any new major tenant in a new leasing in 1992.

30. The only question arises on the application of the asbestos cost. Ms. Saad showed the cost \$3,000,000 as a straight reduction of the indicated market value. The Court in the prior case has shown that it prefers the amortization of the cost. Ms. Saad made that calculation in an exhibit which shows a lower indication of value in each year. Mr. Mitchell agreed that the cost of asbestos removal of \$3,000,000 was certainly reasonable.

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, which necessitates competent evidence to prove the issues. Wyner v. District of Columbia, 411 A.2d 59, 60 (D.C. 1980). Petitioners bear 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); Brisker v. District of Columbia, 510 A.2d 1037, 1039 (D.C. 1986). Petitioners have met that burden.

To determine the assessed value for tax years 1988 and 1989, the assessor used the mass appraisal technique. The income figure used by the assessor in the calculation of value is not related to the income experienced by the subject property, which

had been stable for a number of years. Past earning should be utilized to assist in determining income earning potential. See District of Columbia v. Washington Sheraton Corp., 499 A.2d 109, 115 (D.C. 1985). The assessor gave inadequate consideration to the actual income, expenses or current leases at 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 incomes of buildings in a particular category is an arbitrary and unreasonable method for determining a property's net operating income. The income capitalization approach results in a reasonable estimate of value when an appropriate stabilized net income and capitalization rate are used. The methodology and the resulting assessment for tax year 1988 was flawed and incorrect as shown by the evidence.

Further, the tax year 1988 and tax year 1989 assessment of \$27,877,000 was rejected by the District's own expert, Mr. Ryland Mitchell. In valuing the subject property as of January 1, 1987, Mr. Mitchell reached a value of \$24,000,000 and as of January 1, 1988 of \$25,000,000. Mr. Mitchell's values are less than the assessments by \$3,877,000 and \$2,877,000.

Petitioners were able to demonstrate that the value of the subject property was substantially less than the value assigned by respondent. Thus, they have met the required burden of proving that the assessments appealed from were incorrect. Brisker v. District of Columbia, 510 A.2d at 1039.

The Court finds that petitioners' expert was more credible than respondent's expert and that petitioners provided credible evidence as to the value of the subject property for tax years 1988 and 1989. Upon review of the testimony and documentation presented, the Court concludes that the income analysis was properly performed by petitioners' expert, thereby producing the correct estimate of market value.

Real property taxes are based upon the estimated market value of the subject property as of January 1st of the year preceding the tax year. D.C. Code §47-820 (1981). "Estimated market value" is defined as:

One Hundred per centum of the most probable price at which a particular price of real property, if exposed for sale in the open market with a reasonable time for the seller to find a purchaser, would be expected to transfer under prevailing market conditions between parties who have knowledge of the uses to which the property may be put, both seeking to maximize their gains and neither in a position to take advantage of the exigencies of the other.

D.C. Code §47-802(4) (1981).

To determine the estimated market value of a property, the District must take into account factors bearing on that subject, including but not limited to, sales information of similar properties, mortgages or financial considerations, reproduction cost less accrued depreciation because of age or condition, income earning potential, zoning and government restrictions. D.C. Code § 47-820(a). Respondent's expert considers such factors not as the property is, but as it could be

if substantial expenditures and improvements were made.

The District of Columbia Court of Appeals has consistently held that all three approaches to value must be considered. District of Columbia v. Washington Sheraton Corp., 499 A.2d 109, 113 (D.C. 1985); Safeway Stores, Inc. v. District of Columbia, 525 A.2d 207 (D.C. 1987). Both the taxpayers' expert and the District's expert examined but correctly rejected as inapplicable one of those approaches, the cost approach.

In this case the recent sales were quite dissimilar from the subject requiring adjustments of a magnitude which render the comparable sales approach unreliable. The position of petitioners' expert witness, who used the comparable sales approach only as a check on the findings made by the income approach, is supported by the evidence.

The capitalization of income method is the most appropriate approach for income producing properties such as the subject. consideration of both the contract rent and market rent is required in determining the fair market value of the property using the income capitalization method. Wolf v. District of Columbia, 597 A.2d 1303 (D.C. 1991). In the instant case, both experts, considered both the contract and market income and expense.

Both expert witnesses relied primarily on the income approach to value. The income and expense data used by the two witnesses was quite comparable. Both witnesses relied upon the reported experience of the owner to reach the net operating

income for the subject. The differences in the totals reached by the two witnesses are negligible. The owners used a slightly higher income. Petitioners gave appropriate consideration to the history of the property. Under the circumstances, the Court credits the estimated net operating income figures of petitioner in arriving at the value determined by the income approach.

The major difference in the two experts in estimating value by the income approach is in the capitalization rate used. Respondent's expert used a flawed capitalization rate for his analysis. The witness estimated an 8.5% real estate rate plus the tax rate for an overall rate of 10.5%. Respondent's expert developed the capitalization rates from sales of properties which were not comparable. Testimony showed that Mr. Mitchell used the same 3 or 4 properties to get different rates. Petitioners' expert on the other hand developed a capitalization rate by a recognized method, the band of investment technique. The rate determined is supported by a wide range of local and national economic indicators and supported by the "yield capitalization" method. As real property investments have less liquidity and increased risk, higher rates are deemed appropriate. The rationale for the conclusions reached by petitioners' expert and the other evidence supporting her position on the capitalization rates are persuasive and are accepted.

The capitalization of income approach requires that stabilized annual net income (determined by reference to the actual income and expense pattern generated by the property over

a number of years) be 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). Applying the net operating income figure and the capitalization rate found appropriate by a preponderance of the evidence, the following indicated value results:

Tax Year 1988

$$\frac{2,483,192}{.1250} = \$19,865,536$$

$$\begin{array}{r} \text{less the cost of asbestos} \\ \text{removal} \end{array} = \frac{3,000,000}{\$16,865,536}$$

Tax Year 1989

\$16,900,000 rounded

$$\frac{2,753,961}{.1250} = \$22,031,688$$

$$\begin{array}{r} \text{less the cost of asbestos} \\ \text{removal} \end{array} = \frac{3,000,000}{\$19,031,688}$$

\$19,000,000 rounded

These figures are adjusted by costs to remove asbestos. Any potential buyer of the property on January 1, 1987 or January 1, 1988 would be required to either remove the asbestos or to escrow the funds to remove the asbestos. Amortization of these expenses results in a lower value. Petitioners' expert chose to treat the expense as a lump sum adjustment and the Court finds this persuasive.

Ms. Saad tested her concluding value by applying a cash

flow analysis. As both experts acknowledged, a willing buyer of real estate would examine the cash flow of the property before he determined the price at which it would be purchased. Ms. Saad testified that, for value placed on the property by the District's expert, the subject property would have negative cash flow. Ms. Saad's valuation, however, would yield a positive cash flow after debt service.

The Court concludes that the method of deriving value from the capitalization of income method as applied by Ms. Saad was more reliable and a better indicator of value than the methods applied by Mr. Mitchell.

The fair market value of the subject property as of January 1, 1987 and January 1, 1988, is most appropriately determined by the use of the income capitalization method, the actual income and expenses of the subject property must be considered and the \$3,000,000 for asbestos costs must be deducted. As the respondent's expert did not derive a credible capitalization rate or deduct asbestos expenses and based his estimate on market rents, the value arrived at is invalid and does not represent fair market value. Therefore, the Court concludes that fair market value of the subject property as of January 1, 1987, is \$16,900,000 and as of January 1, 1988, is \$19,000,000.

An allocation must be made between land and improvements. D.C. Code §47-821(a) (1981). Petitioners' expert witness adopted the land's value of \$12,600,000. The remaining

portions of the assessment is allocated to the building.

It is therefore by the Court this 24th day of June, 1994, hereby

ORDERED, ADJUDGED and DECREED as follows:

1. That the estimated value for the subject real property is determined to be as follows:

Tax Year 1988

Land	\$12,400,000
Improvements	<u>4,500,000</u>
Total	\$16,900,000

Tax Year 1988

Land	\$12,400,000
Improvements	<u>6,600,000</u>
Total	\$19,000,000

2. That the assessment record card for the property maintained by the District shall be adjusted to reflect the value determined by this Order.

3. That respondent shall refund to petitioners any excess taxes collected for tax years 1988 and 1989 resulting from assessed values which are in excess of the values determined by this Order.

4. That entry of decision shall be withheld pending submission of a proposed Order under the provision of Super. Ct. Tax R.15.

SO ORDERED.



Eugene N. Hamilton
Chief Judge

(See Attached Service List)

Trilon Plaza Company, et al.
Tax Docket Nos. 4089-88, 4204-89

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