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SUPERIOR COURT OF THE DISTRICT OF COLUMBIA TAX DIVISION

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SQUARE 36 OFFICE JOINT VENTURE, et al.,

Petitioners,

v. Tax Nos. 6304-94; 6621-95

DISTRICT OF COLUMBIA,

Respondent.

MEMORANDUM OPINION AND ORDER

This case came before this Court for argument on Petitioners' Motion for Partial Summary Judgment. The Motion was opposed by the District. These consolidated cases involve precisely the same property and the pending legal issue is equally at stake.

The issue raised in the Motion for Partial Summary Judgment can be summarized as follows. Petitioners urge this Court to conclude, as a matter of law, that the District of Columbia is required to base its assessment of all commercial real property on the value of all legal interests in the property, i.e. the interests of both the owner/landlord and the tenant -- treating them as separate and distinguishable interests and then adding them together to derive the overall value of the property. The Petitioners present this issue in the form of seeking partial summary judgment, so as to set the stage at trial for attacking the

assessed value of the property. Based upon certain factual assertions, it is evident that the Petitioners seek to demonstrate that the separate leasehold interests are so fraught with negative elements that they effectively reduce the value of the property as a whole. In other words, the assessment formula that the Petitioners urge upon the Court is intended to serve as a vehicle for automatically compelling a rejection of the assessed values at trial.

The District of Columbia opposes the conceptual underpinnings of the Motion in several respects. The District principally contends that the formula proffered by the Petitioners is at odds with existing, statutory elements for the assessment of real property. The District argues that the statute itself (in light of developed case law) requires the valuation of the property's future income stream, necessarily implicating both market data and actual income data. Furthermore, the District emphasizes that a leasehold interest is nonetheless personalty and should not be confused with realty itself or blended into the assessment of realty.

Having reviewed the record herein and the full arguments of the parties, the Court is convinced that the instant Motion must be denied. The movant's suggested method for constructing an assessment of a commercial property is faulty for various reasons. It is also based upon proffered facts that cannot be adjudicated in summary fashion prior to trial on the merits. This is so, even if the Court views the proffered facts in the light most favorable to the taxpayers, because the District still may be able to overcome

the factual arguments or their impact on the assessments.

I. BACKGROUND FACTS NOT IN DISPUTE

-The Petitioners have appealed the real property tax assessment for Tax year 1994 and Tax Year 1993 on an income-producing property known as 2300 N Street, N.W. in the District of Columbia. This property is located in Square 36, Lot 48. This property operates as an office building. The office building was erected in 1986.

The assessment for Tax Year 1994 was $81,774,000. The assessment for Tax Year 1995 was $80,485,000. The objective of the Petitioners in a trial de novo is two-fold: to demonstrate that the assessments were flawed and then to bring forth their own evidence that the property had a fair market value in each Tax Year that was lower than the assessed value.

As of the assessment dates, this office building was encumbered with two long-term leases. As of 1986, 75% of the total rentable area was leased to the law firm of Shaw, Pittman, Potts and Trowbridge, with a lease term of 20 years, with a four 5-year renewal options. The remainder of the rental space was leased to an entity known as Strategic Planning for a 10 year term, with one 5-year renewal option.

Where the Shaw, Pittman lease is concerned, the lease itself states, "Nothing in this Lease shall be construed as creating a partnership or joint venture of or between Landlord and Tenant, or to create any other relationship between the parties hereto other than that of landlord and tenant."

II. STATUTORY REQUIREMENTS FOR ASSESSMENT OF COMMERCIAL REALTY

In order to adjudicate the instant Motion, it is necessary to recapitulate the existing law that mandates exactly how the District must formulate its annual assessments of real property, particularly where commercial realty is concerned.

Real property taxes are based upon the estimated market value of the subject property as of January 1st of the calendar year that precedes the tax year for an annual assessment and, as of December 31st for a second half supplemental assessment. This is prescribed clearly in the District of Columbia Code. See 47 D.C. §§ 820 and 830 (1997 Repl.); see District of Columbia v. Washington Sheraton Corp., 499 A.2d 109, 112 (D.C. 1985). "Estimated market value" is defined as:

> 100 per centum of the most probable price at which a particular piece 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 being in a position to take advantage of the exigencies of the other.

47 D.C. § 47-802(4)(1990 Repl.).

The Court of Appeals in Washington Sheraton further emphasized, "In determining the estimated market value, the assessment shall take into consideration:

> [A]ll available information which may have a bearing on the market value of the real property including but not limited to government imposed restrictions, sales information for similar types of real property, mortgage or other financial considerations, replacement costs less accrued

> depreciation because of age and condition, income earning potential (if any), zoning, the highest and best use to which the property can be put, and the present use and condition of the property and its location.

Id. at 112.

A person who appraises a property for the purpose of determining its value for taxation

> may apply one or more of the three generally recognized approaches of valuation when considering the above factors. Those approaches are the replacement cost, comparable sales, and income methods of valuation. Usually the appraiser considers the use of all three approaches, but one method may be most appropriate depending on the individual circumstances of the subject property.

Id. at 113 [citations omitted].

The "replacement cost approach," also called simply the "cost approach," involves deriving the "'cost of replacing property with new property of similar utility at present price levels, less the extent to which the value has been reduced by depreciation because of age, condition, obsolescence, or other factors.'" Id. at 113, quoting 16 DCRR § 108(b)(2); 9 DCMR § 307.4. The replacement cost may "'be estimated either by (1) adjusting the property's original cost for price level changes, or (2) applying current prices to the property's labor and materials components and taking into account any other costs typically incurred in bringing the property to a finished state.'" Id.

The "comparable sales approach" requires the comparison of "[r]ecent sales of similar property" and "the price must be adjusted to reflect dissimilarities with the subject property." Id.

As to the "income capitalization approach, the District of Columbia Court of Appeals has articulated the fundamental factors in the application of this appraisal method.

> This method entails deriving a 'stabilized annual net income' by reference to the income and expenses of the property over a period of several years. That annual net income is then divided by a capitalization rate -- a number representing the percentage rate that taxpayers must recover annually to pay the mortgage, to obtain a fair return on taxpayers' equity in the property, and to pay real estate taxes.

Rock Creek Plaza-Woodner Ltd. v. District of Columbia, 466 A.2d 857, 858 (D.C. 1983).

Both contract rents and market rents must be considered in arriving at the fair market value of an office building, when using the income capitalization method. See Wolf v. District of Columbia, 597 A.2d 1303, 1309 (D.C. 1991). To be sure,

> [e]stimated market value is not determined. . . . by reference to 'income available to the property as of the assessment' but by reference to 'income earning potential.' The fundamental notion that the market value of income-producing property reflects the 'present worth of a future income stream' is at the heart of the income capitalization method.

District of Columbia v. Sheraton Washington Corp., supra, 499 A.2d at 115 (citations omitted).

In Wolf v. District of Columbia, supra, the Court of Appeals stressed,

> Actual earnings, of course, may be relevant evidence of a building's future 'income earning potential,' but it is the future potential, not the current earnings themselves, that must constitute the legal

basis for valuation.

Wolf v. District of Columbia, supra, 597 A.2d at 1309.

As a practical matter, the statute and case law cited above is the standard framework within which to adjudicate whether a commercial real property assessment was fatally flawed and the extent to which the Court ought to accept the worth of any different appraisal that may be offered at trial by a Petitioner.

III. ANALYSIS OF THE INSTANT MOTION

In order to understand why the instant Motion is not meritorious, it is essential to recall the crux of Petitioners' basic contention. In their Motion, Petitioners ask the Court "to rule as a matter of law that, for real property taxation purposes, the D.C. Code requires Respondent [to] base its assessment of the Property on the value of all legal interests in the Property -- the interests of both the owner/landlord and the tenant -- rather than a lesser interest that reflects only the value of the owner/landlord's interest."[1]

The Petitioners elaborate further on their unique legal theory, stating:

> Respondent appears to have abandoned its prior -- and correct-- reading of D.C. law to base its assessment solely on the owner's interest in the Property. In past cases, the value of the owner's and the tenant's legal interests in the assessed property was greater than the owner's interest alone and assessing only the owner's interest would result in **a portion of**

[1]Memorandum in Support of Motion for Partial Summary Judgment, at page 1.

> **the Property's being left untaxed.** In this case, however, the combined value of the owner's and tenant's interests in the Property is **less than the value of only the owner's interest**. This apparently anomalous result is due to the fact that **the tenant's interest has a significant negative value caused by the above market rent the tenant is paying.** Thus, Respondent's assessment of only the owner's interest produces an unlawfully high assessment of, and an excessive tax on, Petitioner's Property.

See Memorandum in Support of Motion for Partial Summary Judgment, at pages 2-3 [emphasis supplied].

Without regard to the specific points and authorities raised by the District, the highlighted language quoted above is sufficient to compel this Court to deny the instant Motion.

First, in the scenario that seems to drive the Petitioners' premise, there is an erroneous presumption that in any tax assessment there is a danger that some portion of a commercial property will be "untaxed." This is not correct. The District is duty-bound to impose property taxes on the record owners of all realty. There is no division of taxation between rented space and unrented space or among various portions of rented space within the same property. The record owner of a particular property pays all property taxes that are due. The District does not look to tenants for payment of property taxes.

Second, the quoted language from the Petitioners' pleading reveals that the root of this case is a **factual** allegation that the assessments did not sufficiently take into account a longterm, allegedly above-market lease. To the extent that this is a correct interpretation of the ultimate issue, these cases must go to trial.

The matter of whether the assessments sufficiently accounted for the leases is certainly a trial issue that should be subject to full cross-examination and evidentiary presentation. Thus, for this reason alone partial summary judgment is inappropriate.

It is evident from the pleadings that Petitioners believe that the assessments were based upon the District's interpretation of market data alone, without any reliance upon the actual income and leasing data concerning the subject property. The District may dispute the lack of consideration to actual expenses and income data and has raised this issue in its Opposition.

In the past, the Court has issued opinions in which the exclusive reliance upon market data, in total ignorance of actual expense and income data for the subject property, resulted in a judgment for the taxpayer. This occurred, for example, in the case of Square 118 Associates v. District of Columbia, Tax Docket No. 4508-90 (January 3, 1996)(Long, J). In 118 Associates, this Court observed that it is appropriate to look to the entire "mosaic" of information concerning the property in question.

In yet another case in which this Court rejected the District's total reliance upon market data in determining a tax assessment, this Court emphasized that a tax assessment is necessarily confined to "the fair market value of what the owner could actually convey if the property were offered for sale on the date of the valuation. A taxpayer can only convey what the taxpayer owns, subject to limitations such as leases or easements." 1301 E Street Associates v. District of Columbia, Tax Docket Nos.

5286-92 and 5780-93 (June 22, 1995)(Long, J.) at page 24. This Court elaborated,

> Where an office building is concerned, the taxpayer who owns that building can only be taxed on the value of the property subject to the leasehold rights of the tenants. That leasehold interest is not being ignored. Rather, it is being examined for its genuine impact on the property as a whole, i.e. the fee as a whole.
>
> In the instant case, it is clear that a long term, below market lease does indeed affect the value of the leased space that would be included in the hypothetical sale. Each and every case involving the taxation of an office building that is encumbered by below market, long term leases will dissolve into a factual issue of how such a lease affects the overall value of the property. The answer to this question, translated into dollars and cents, will be unique in every case.

Id. at page 24.[2] These observations apply to the instant case.

Accordingly, in practical effect, this Court's previous conclusions were that the taxpayer does indeed "own" that portion of the realty that is subject to a lease or an easement.

The true significance of a lease is that it limits what the owner can actually do with the property for a period of time. For purposes of tax assessment, the significance of a lease is that it

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[2]This trial court opinion is not to be confused with an earlier opinion, issued by the Hon. Eugene N. Hamilton, in the cases of 1301 E Street Associates v. District of Columbia, Tax Docket Nos.4471-90 and 4972-91 (May 3, 1993). In that opinion, the trial court found that the assessments were flawed because the assessor "did not give any weight to actual income, actual expenses, lease-up costs, improvement costs, rent concessions or vacancy and collection losses." Opinion at page 4. In this particular case, the same building was encumbered with a 30-year lease that covered 45% of the office area. That lease contained one five-year renewal option. The tenant in this space was then the National League of Cities.

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limits what a potential buyer also can do with the property. This factor, however, is nothing more than one more component to establishing the fair market value -- whatever it might be.

-The tax assessment is intended to represent the price at which a willing buyer would purchase the property on the date of assessment. Thus, it must reflect what this longterm lease means to a buyer who would still want to purchase that property in spite of it. These considerations, however, are not in any way premised upon an arbitrary excision of the leasehold interest from the global picture. This is where the logic of the Petitioners disintegrates.

The taxpayers herein argue that the principle of equalization somehow requires that all real property assessment be confined to the "unencumbered" fee simple interest of the owner. Petitioners appear to define the taxable fee interest as one that excludes rented space. This definition, however, flies in the face of the controlling statute, because the statute neither permits nor mandates that leased portions of a property are to be excluded from the scope of the taxable property, as if the leased portions simply do not exist -- and as if the "landlord" is not responsible for taxation of such space.

In the District of Columbia, there is no such thing as a real property tax paid by a landlord and some other real property tax paid by a tenant. Yet, this is exactly the system that the taxpayers herein urge this Court to impose. This Court cannot engage in legislating a new law or deviating from an existing law.

Having isolated the threshold reasons why it would be imprudent to grant partial summary judgment, the Court must also pause to address the arguments of the parties in further depth.

-First, the District accurately contends that a leasehold interest, in and of itself, is personalty. This concept is well established in the District of Columbia Code and case law. The Code provides that "estates at will or by sufferance shall be chattel interests. . . ." 45 D.C. 204.

As the United States District Court noted, "It is well settled in the District of Columbia that a leasehold interest in land for a term of years is personal property and subject to execution as such. This was true under the common law, which has been enacted as 45-804 of the District of Columbia Code." Stagcrafter's Club, Inc. v. Dist. of Col. Div. of American Legion, 110 F.Supp. 481, 483 (D.D.C. 1953), aff'd 94 U.S.App.D.C. 74, 75, 211 F.2d 811, 12 (1954)("The statutory term 'goods, chattels, or effects' is broad enough, in this jurisdiction at least, to include the interest of a lessee for a term of years."). The essential content of the former Section 804 is currently found in 45 D.C. § 204.

Since a leasehold interest is personalty, the arbitrary format of determining a separate value for a leasehold interest is not properly a part of the assessment of realty. Such a tax assessment formula would be illogical and contrary to law.

Second, the irony in this litigation is that the taxpayers may be able to demonstrate at trial that the District's methodology for deriving the assessment is flawed. The issue of exactly how the

District determined the assessments is a matter that must be left for trial.

If the Petitioners' evidence shows that the District utterly ignored the actual income and expense data for this property and if the District cannot produce a legitimate excuse for such an approach, it is likely that the taxpayers will clear the first hurdle of proving that the assessments were flawed. However, this scenario is disputed by the District in its Opposition pleading. This Court will not make any premature assumptions about how the assessments were actually composed.

In other words, the Petitioners may have simply proffered their good factual points in a procedurally inappropriate motion.[3]

The parties are now urged to engage in further settlement discussions, so that the additional expense of trial might be avoided.

If additional mediation services would be useful, the parties may request such services through the Court at the next status hearing.

WHEREFORE, it is by the Court this 21st day of November, 1997

ORDERED that Petitioner's Motion for Partial Summary Judgment is hereby denied; and it is

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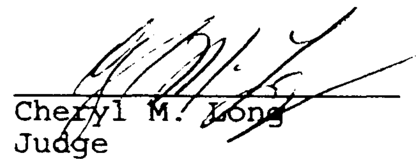
[3]For this reason, and for the sake of brevity, this Court will not pause to explore herein all of the foreign case law that was cited by the Petitioners in their effort to show that actual property data should be viewed along with market data in making tax assessments. Many of the District's responses to these cases are worthwhile, e.g. that some of these cases are factually and legally distinguishable from the instant cases. This Court, ultimately, must base its decisions on our own statute and the law that strictly relates to the Code.

FURTHER ORDERED that counsel shall appear in these cases for further status hearing on **Monday, January 12, 1998 at 9:30am** in courtroom 215.



Cheryl M. Long
Judge

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