

SUPERIOR COURT OF THE DISTRICT OF COLUMBIA
TAX DIVISION

New York Life Insurance Company :
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 Petitioner :
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 v. : Tax Docket No. 4079-88
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 District of Columbia :
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 Respondent :
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MEMORANDUM OPINION AND ORDER

This case was tried by the Court upon Petitioner's appeal from an assessment for real property taxes for tax year 1988.¹ 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 and conclusions of law. The Court also pauses to recapitulate the applicable case law.

I. APPLICABLE LAW

The fundamental law that applies to real property assessment

¹This case has been pending in the court system for a lengthy time, primarily due to appellate litigation that commenced after the first trial in this case, during which the trial court ruled (mid-trial) that summary judgment should be granted for the petitioner. This ruling was reversed by the Court of Appeals and remanded for a full trial on the merits. District of Columbia v. New York Life Ins. Co., 650 A.2d 671 (D.C 1994). Thus, the instant judgment is derived from a new trial.

appeals is well established. It is summarized herein as follows.

The Superior Court's review of a tax assessment is de novo. In appealing from assessments of real property for tax purposes, the taxpayer has the burden of proving that the assessment was incorrect or flawed. Brisker v. District of Columbia, 510 A.2d 1037, 1039 (D.C. 1986). After demonstrating that the assessment was flawed, the Petitioner then must come forward with convincing evidence, de novo, as to the fair market value of the property on the valuation date.

Real property taxes are based upon the estimated value of the subject property as of January 1st of the year preceding the tax years for annual assessments. 47 D.C. §§ 820, 47-830. "Estimated market value" is defined as:

One Hundred 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 in a position to take advantage of the exigencies of the other.

47 D.C. §47-802(4).

The District of Columbia Court of Appeals has generally recognized three approaches to estimating value of real property and has held that all three must be considered. District of Columbia v. Washington Sheraton Corp., 499 A.2d 109, 113 (D.C. 1985); Rock Creek Plaza-Woodner, Ltd. Partnership v. District of Columbia, 466 A.2d 857 (D.C. 1983). These methods are known as the

"income capitalization approach," the "cost approach," and the "comparable sales approach." In the instant case, both the Petitioner's expert and the District's expert appraiser examined all three approaches and both of them rejected the cost approach.

Of the three recognized approaches, the income 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 this mode of analysis, the stabilized net operating income is divided by a capitalization rate, reflecting the rate that 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. Partnership v. District of Columbia, *supra*, 466 A.2d at 858; Wolf v. District of Columbia, 611 A.2d 44, 47 (D.C. 1988) (Wolf II).

Both the existing contract rents and market rents are relevant to determining the income earning potential of the property, to conclude its fair market value using the income capitalization approach. Wolf v. District of Columbia, 597 A.2d 1303, 1309 (D.C. 1991) (Wolf I).

Once a stabilized annual income is determined, it must be divided by a capitalization rate in order to determine an indication of value. Rock Creek Plaza-Woodner, Ltd. v. District of Columbia, *supra*, 466 A.2d at 858.

The capitalization rate represents the amount that must be earned annually in order to pay the mortgage, expenses and a fair

return on equity and the property taxes. Id.

II. FINDINGS OF FACT

1. The subject property is owned by New York Life Insurance Company (NYLIC), a corporation organized and existing under the laws of New York. Petitioner NYLIC is obligated to pay all real estate taxes assessed against the subject property.

2. The subject property is located at 1333 H Street, N.W., Square 250, Lot 46, in the District of Columbia. It consists of a 12-story office building built in 1913 and remodeled during 1982-1983, as well as an 11-story office building built in 1982. The buildings are located on the northeast corner of 14th and H Streets, N.W. A portion of the building, the Landmark Building, is an historic structure which had to be rehabilitated and retained in accordance with certain standards. The building has three levels of underground parking with spaces for 245 cars. The main building has 213,409 square feet of net rentable area (211,019 for office space and 1,100 for retail). The Landmark portion of the building has a total of 34,615 square feet of net rentable area (32,395 for office and 2,223 for retail). These figures are derived from the lease rolls which reflect actual space, both leased and vacant. The two buildings are accessible to each other only on the ground floor level.

3. Leasing in the property has been poor. The Landmark Building has a small floor plate that makes it difficult to lease because it is less desirable. As of the valuation date, January 1, 1987, five floors of office space and the first floor of the

Landmark Building were still vacant and in a gutted shell condition. Another 24,000 square feet was vacant in the East Building.

4. The assessment for tax year 1988 as of January 1, 1987 was \$49,133,000. Petitioner timely appealed to the Board of Equalization and Review (BER). The BER reduced the assessment to \$33,661.876.

5. Petitioner timely paid the real estate taxes and timely filed the petition for a reduction of the assessment and refund of excess taxes paid for tax year 1988. In its amended petition, Petitioner asserted that the fair market value of the property for tax year 1988 was \$31,300.00. This figure reflects the value set by its expert appraiser.

6. Both parties offered expert appraisal testimony. The District of Columbia employed Ms. Shinn Back who valued the property at \$39,600,000, approximately \$10 million less than the proposed assessment.

7. The Petitioner offered expert testimony by Mr. Anthony Reynolds, who appraised the subject property for the Petitioner. Mr. Reynolds is a member and former national president of the Appraisal Institute and has the MAI designation. Mr. Reynolds is also designated as an instructor by the Appraisal Institute. He has qualified as an expert in the field in various courts. Respondent stipulated to his expert qualifications. The Court accepted him as an expert witness and received his tax year 1988 report in evidence.

Mr. Reynolds testified that the subject property had a fair market value of \$31,300,000, as improved, including land and building, as of the valuation date of January 1, 1987.

8. As noted above, the District also offered expert testimony. Respondent called Ms. Shinn Back as its appraiser. While Ms. Back has been designated as a member of the Appraisal Institute, she has testified only once previously in this Court as an expert in a real property assessment appeal. Prior positions include work as an assessor for the District of Columbia and as an appraiser for Citibank in New York City. Ms. Back was nonetheless qualified as an expert in the field of real property appraisal.

9. Ms. Back began her testimony by stating that she had made an error in her report and that she was revising her estimate of value downward from \$40,300,000 to \$39,600,000. To explain this change, she said that she recognized that real estate tax pass-throughs should be excluded as an income item when excluding real estate taxes as an expense.

It was not clear from her testimony when Ms. Back had actually made the change. She initially testified that she had made the change in conjunction with her preparation for trial in 1992, regarding the separate, tax year 1989 case for this property. However, she also testified that she made the changes during the 1992 trial.

When shown the trial court's opinion on the tax year 1989 case which states that she had included real estate tax pass-throughs, Back admitted that she must have made the changes **after** the

conclusion of the tax year 1989 trial.² In any event, counsel for Petitioner were not notified of the change until Ms. Back testified at the instant trial on the subject property for tax year 1988.

The Court finds Ms. Back's explanation implausible. There is no good reason why an expert appraiser should have included real estate tax pass-throughs in an appraisal for an assessment appeal at the outset. Moreover, there is no good reason to fail to inform Petitioner of her change prior to the trial.

This Court has the impression that the belated change in Ms. Back's appraisal was prompted by her conclusion that Mr. Reynolds' testimony would discredit her at trial, or at least that part of his analysis was more reliable than hers.

10. Both of the expert appraisers considered and rejected the "cost approach" for use in the appraisal of the subject property.

11. For purposes of trial, Mr. Reynolds accepted the assessor's land valuation of \$13,711,809.

Ms. Back did not accept the original assessment of the land portion of the property. Instead, she performed her own comparable sales analysis to value the land, as if vacant.

She made adjustments for date of sale, location and size. Some sales required significant adjustments of up to 35%. She concluded that the land was valued at \$18,000,000 or \$65.00 per square foot FAR.

12. Mr. Reynolds commenced his valuation of the property, as

²The trial of the tax year 1989 case occurred in 1993. A formal, written decision was filed by the trial court, the Hon. Eugene N. Hamilton, on August 23, 1993.

improved, by observing the real estate market. He testified that, as of the valuation date, the market was characterized by low inflation and stable interest rates.

He also observed the neighborhood as of the valuation date. Mr. Reynolds testified that the immediate neighborhood was (on the valuation date) still populated by adult entertainment sites (a euphemism). Thus, there was still reluctance on the part of many potential tenants to move into the area.

13. Mr. Reynolds then observed the actual condition of the property on the valuation date, January 1, 1987. He testified that the property was really two different buildings: the older Landmark Building built in 1913 and the new East Building built in 1982. The buildings are only connected on the lobby level. He emphasized that the Landmark Building has small floor plates. The entire property was 82.4% leased as of the valuation date.

He also noted that the building was experiencing leaking in the basement after heavy rains.

14. In estimating the value of the whole property, both appraisers applied both the income approach and the comparable sales approach. In performing their income approach analyses, both estimated a stabilized net operating income and capitalized it into value. Both made deductions from their stabilized value to reach a value as of January 1, 1987.

15. To arrive at an indication of value by the income approach, Mr. Reynolds examined the income and expense history for the property for the years between 1984 and 1986. He also reviewed

the rent rolls and leasing history for the building. Mr. Reynolds testified that he used the actual rents received by Petitioner for the space actually leased.

For the vacant space, he reviewed rental comparables and determined an economic rent of \$21.00 per square foot for the vacant space in the East Building and \$20.00 per square foot for the vacant space in the Landmark Building. Mr. Reynolds added parking income of \$226,073 which excluded income from spaces in the "vault space" portion (i.e. certain areas beneath the adjacent sidewalk). He also added escalation income for existing tenants. He excluded real estate tax pass-throughs. This resulted in a total potential gross income of \$5,101,419. From this figure, he subtracted a stabilized 5% vacancy and rent loss factor to arrive at an effective gross income of \$4,846,348.

16. In making her appraisal based upon the income approach, Ms. Back testified that she also examined comparable leases to arrive at her estimate of economic rent of \$23.00 per square foot for both buildings. She applied this rate to the vacant office space and the rate of \$20.15 to the leased office space. She also included escalations and reimbursements totaling \$329,719.

This figure is a revised figure from her original appraisal report in which she included a total for escalations and reimbursements of \$409,107.

In making her revision, Ms. Back excluded some of the real estate tax pass-throughs. She made the change sometime **after** she reviewed Mr. Reynolds' appraisal report **and** after both of them had

testified at the trial on tax year 1989. However, Ms. Back failed to exclude all of the real estate tax pass-throughs. Mr. Reynolds' total escalation income estimate was \$140,000. At Ms. Back's capitalization rate, the difference between their total escalation figures accounted for about \$1,460,000 in value.

Ms. Back ultimately deducted a vacancy factor of 10% to arrive at her revised effective gross income of \$5,033,174.

17. Ms. Back's calculation of net operating income differed from Mr. Reynolds as a result of several other items.

First, in estimating her stabilized net income, Ms. Back made several mathematical errors. For example, she miscalculated the rental income from retail space.

Second, Ms. Back included \$67,000 more in garage income than Mr. Reynolds did.

Third, she also included "phantom" storage space, or space which she double counted. This amounted to \$781,442 in value.

18. Mr. Reynolds stabilized expenses at \$5.50 per square foot, based on the operating expense history at the subject and typical operating expenses in comparable buildings.

The subject's 1986 expenses were at \$4.09 per square foot and the range reported for his comparables was \$5.84 to \$6.64 per square foot, excluding real estate taxes. Mr. Reynolds's net operating income was \$3,490,724. Mr. Reynolds then applied his capitalization rate of .1028 to the net operating income of \$3,490,724 to reach the sum of \$33,956,463, as stabilized.

19. Ms. Back determined that the expense rate should be \$4.80

per square foot. This expense rate was called into question, however. Ms. Back listed the expenses of three comparable buildings in her report. Excluding real estate taxes, they ranged from \$5.06 to \$5.95 per square foot or an average of \$5.61. However, Ms. Back used \$4.80 per square foot.

Ms. Back's revised net operating income was \$3,857,243, which she capitalized at .096 to yield a value of \$40,179,613, as stabilized.

20. Both experts capitalized their stabilized net income figures.

Mr. Reynolds developed his capitalization rate with reference to rates from sales of comparable properties, the American Council of Life Insurance (ACLI) surveys of rates (the premier list of investment-grade properties' mortgage terms), the opinions of the Appraisal Institute, and yield rates for comparable investments.

Mr. Reynolds testified that the subject is not a prime office building and has an inefficient split nature. The comparative risk and lack of liquidity of a real estate investment suggests the requirement of higher yield rates than treasury bonds. All of the sources examined pointed to a capitalization rate of 8.25% for January 1, 1987 not including the tax rate. The higher the capitalization rate, the lower the value. Adding the tax rate, his overall rate was .1028.

21. Ms. Back developed her rate from sales of other office buildings using the actual prior year's income, in most cases. She testified that rates from the sales that she examined ranged from

6% to 7.4%. Ms. Back relied particularly on two sales which she claimed were similar in age and location and which were stabilized. However, one of those sales (the property known as One Thomas Circle) was actually the sale of only a one-half interest in the property.

She estimated a real estate rate of 7.5% to which she added the tax rate for a total rate of 9.53%.

Upon examination, Ms. Back admitted that her own capitalization rate applied to the 1986 net income of the subject resulted in a value of approximately \$25,000,000.

Ms. Back also testified that she used the Ellwood mortgage equity technique to check her rate from sales. In her applying the mortgage equity formula, she made an assumption of a 40% appreciation in value over an **assumed** 10 year holding period. She testified that the 40% appreciation was "in keeping with inflation". However, the appreciation factor in the Ellwood technique must not be confused with the concept of inflation. From what the Court learned from Mr. Reynolds, the Ellwood appreciation factor is designed to account for appreciation **in value and in income**.

The assumption used by Ms. Back resulted in a substantial adjustment downward of the capitalization rate. This assumption was highly speculative. Upon examination, Ms. Back testified that the capitalization rate **without** the assumption of an appreciation in value was .1263. She testified that applying a capitalization rate of .1263 instead of her rate of .0957 resulted in a difference

in assessment of approximately \$10,000,000 too high a figure. Ms. Back could give **no justification** for applying such a large appreciation factor to the subject property.

Ms. Back also admitted that the capitalization rate that she used was not high enough to cover payment of real estate taxes, the annual mortgage payment, and to provide a fair return on the cash investment, even on a stabilized basis. In fact, a cash flow test showed that her capitalization rate would produce a negative return to the equity investment. Thus, the Court rejects the capitalization rate urged by the District of Columbia's appraiser.

22. The Court finds that the overall capitalization rate developed by Mr. Reynolds is credible and strongly supported by the evidence and the range of factors that he considered. The Court therefore adopts for tax year 1988 the capitalization rate of .1028. The Court rejects the capitalization rate urged by the District of Columbia.

23. Both Mr. Reynolds and Ms. Back made a series of deductions to reflect the costs to take the property from stabilized to "as is". Mr. Reynolds testified that as of the valuation date, 40,746 square feet remained vacant and in "shell" condition. Thus, he deducted the cost to finish that space at 5% of 5 years' rent and finally, the lost rent associated with the 40,746 square feet of vacant space at \$20.70 per square foot. The total of these deductions is \$1,873,599.

Mr. Reynolds next made a deduction for "incentive on occupancy" costs (profit) at 15% or \$281,040.

Finally, he deducted \$484,180 to correct the problems in the basement. These problems included flooding and damaged structural supports underpinning the sidewalks. After these deductions his final value, rounded, is \$31,300,000.

24. Ms. Back also made deductions for tenant improvements and leasing commissions. However, she failed to make additional deductions for lost rent, incentive on occupancy/profit, and the noted basement problems. In total, Ms. Back deducted only \$563,400 whereas Mr. Reynolds deducted \$2,638,819. After her deductions, Ms. Back's final value was \$39,600,000.

25. Both Mr. Reynolds and Ms. Back made valuations based upon comparable sales. Mr. Reynolds testified that he examined the market and determined five sales of comparable properties. After adjustments for differences with the subject, the sales ranged from \$139.03 to \$143.46 per rentable square foot or a mean of \$141.46. Mr. Reynolds determined that \$141.70 was appropriate for the subject, prior to adjustments. He testified that adjustments for the parking income attributable to vault space and inefficiencies due to the two-building plan resulted in a rate of \$133.20 per square foot, as stabilized. After further deductions to get to an "as is" value, Mr. Reynolds concluded that by the comparable sales approach, the property was valued at \$30,200,000 rounded.

26. In her comparable sales approach, Ms. Back selected several of the same sales as Mr. Reynolds. However, her adjustments for location ranged from only 2% to 10%, while the comparable land sales were adjusted up to 35% for location. Even

though she made adjustments in her income approach for the "as is" nature of the subject property, Ms. Back failed to adjust her conclusion by the comparable sales approach to reflect the non-stabilized nature of the property on the valuation date. Her conclusion by the comparable sales approach was \$44,100,000.

27. Mr. Reynolds reconciled his two values by choosing the higher of the two values, \$31,300,000, reached by the income approach. He testified that the income approach more carefully highlights the factors unique to the appraised property and that a potential purchaser would indeed rely on this approach. Ms. Back also chose her estimate of value reached by the income approach as her final value.

28. Mr. Reynolds, as part of his trial testimony, critiqued the original assessment, performed by Mr. Troy Davis. He testified that the assessor made several errors.

First, his income estimate did not recognize the distinction between the two buildings and ignored the actual income and expenses at the subject.

Second, the assessor's capitalization rate was too low. Mr. Reynolds testified that the assessor's capitalization rate resulted in a negative cash flow so that it did not provide a fair return on the equity after payment of the taxes and mortgage.

Finally, and most importantly, the assessor failed to account for the costs that formed the difference between an "as is" value and a stabilized value.

29. Ms. Back also testified regarding the original assessment

of \$49,133,000. She stated that it was not "her value," although it was within the realm of reason. She testified, "\$49 million is more than I would pay." She added that the assessor failed to make any deductions to reflect the "as is" nature of the property and that the property was not in fact stabilized.

30. The Court finds that the stabilized income and expenses estimated by the Petitioner's expert, Mr. Reynolds, are credible and based upon a thorough analysis of both historical and market data. As stated above, the Court also finds that the over-all capitalization rate developed by Mr. Reynolds is credible and strongly supported by the evidence and the range of factors that he considered.

31. Accordingly, the Court having adopted Mr. Reynolds' testimony, finds that the market value and assessment for the tax year 1988 is \$31,300,000.

III. Conclusions of Law

The Court concludes as a matter of law that Petitioner has met its burden of demonstrating that the original assessment was flawed and that its own de novo evidence establishes the fair market value of the subject property by a preponderance of the evidence, when compared to the District's trial evidence.

In essence, the key factors that convince this Court to rule in favor of the Petitioner is that the Petitioner's expert was more believable and persuasive than Respondent's appraiser and that Petitioner provided significantly more credible and more logical underlying evidence as to the value of the subject property for tax

year 1988. Several problems in the District's evidence are worth emphasis.

For example, the capitalization rate used by the Respondent's appraiser in this case was erroneous. When the capitalization rate figure derived by this appraiser was tested, it produced a substantial negative cash flow. This negative cash flow is strong evidence that Ms. Back's valuation does not reflect fair market value. The Court concludes that a willing buyer would not necessarily purchase the subject property at the assessor's value, based on an assumed net operating income during 1987, when the property was destined to produce a negative cash flow based upon her calculations.

Second, this Court observes that Ms. Back, in failing to take into consideration the full costs of taking the subject property from a stabilized value to an "as is" value, and in making several mathematical errors, did not correctly or properly estimate market value as required by the District of Columbia Code.

The appraiser for the Respondent did not realistically base her value on "the amount that investors would be willing to pay to receive the income that the property could be expected to yield..." or what a willing buyer would pay for the property. 9 DCMR § 307.5 (1994).

The Court notes that Ms. Back was not precise in making her calculations. For example, as already noted herein, she developed her capitalization rate based partly upon a sale that only actually involved the sale of a one half interest in that property.

Certainly, this error skewed the accuracy of her rate.

Furthermore, in establishing the difference between a stabilized value and "as is" value for this property, the limited character of Ms. Back's deductions was too simplistic to illustrate the expectable income stream for a potential buyer of this property. In appraising a building with a significant vacancy, adjustments to income should be more sophisticated than what Ms. Back considered and reported. Moreover, she failed to account for the problems in the basement which a prudent purchaser would consider in buying the subject property on January 1, 1987.³

The Court recalls that there was an additional, unique deficiency in the development of Ms. Back's capitalization rate. The problem is conceptual, although it translates into a concrete flaw that directly affects the ultimate value that she has assigned to this property.

In short, she has relied upon an erroneous and misleading definition of "cash flow" and her definition has a direct impact upon the extent to which her capitalization rate fails to comport with the requirements of Rock Creek Plaza-Woodner. This point

³In post-trial pleadings, the Government emphasizes that the repairs to the basement had not yet started as of the valuation date. The Government implies that Mr. Reynolds estimate of the cost for such repairs should be ignored by the Court simply because no formal estimates for such repairs had been requested or investigated by the taxpayer as of the valuation date. This fact, however, has nothing to do with the estimate used by Mr. Reynolds. As an expert in real property appraisal, Mr. Reynolds was entitled to estimate what he regarded as reduction in value based upon the nature of the problems with the physical plant. Ms. Back did not provide alternative estimates on this subject. The Court has no basis for rejecting the testimony of Reynolds out of hand.

requires elaboration.

One, the appellate opinion in Rock Creek Plaza-Woodner plainly states that a capitalization rate must be high enough to cover "annually" three expenses that are separate items: (1) payment of real estate taxes; (2) payment of the mortgage; and (3) obtaining a fair return on equity.

Two, Ms. Back has constructed a cash flow analysis that reflects an unfortunate blending of two of these three components (the second and the third).

She has testified that a return on equity for this property is demonstrated by a sum of money that she characterizes as "equity build-up." This is nothing more than pointing to the amount of principal that has been paid down through the basic process of making mortgage payments.

She has confused this build-up of principal with the concept of making a profit on the investment. They are clearly not the same thing. This confusion of concepts starkly compromises the value of her expert opinion.

Three, compounding this misunderstanding, Ms. Back does not offer any convincing or plausible explanation for how such "build-up" can be considered part of "cash flow." The term "cash flow" means exactly what it appears to mean, i.e. actual flow of cash to the property owner.⁴

More precisely, the essence of cash flow analysis simply

⁴At trial, Ms. Back stated that principal "build-up" is "like cash because the owner can spend it." This Court disagrees with that interpretation.

reflects whether the property is currently operating at a loss or a profit and, if so, how much of a profit has resulted during the particular period of time that is under review.

Four, Ms. Back's error (for purposes of tax valuation in a de novo trial) is that her method of determining whether there has been a fair "return" on equity runs totally afoul of the language in Rock Creek Plaza-Woodner, i.e. the reference to an "annual" stream of income to cover the three components.

Back's theory is that the question of whether a property has produced a return on equity can only be answered at the point at which the property is actually sold. This Court does not accept such a notion. For purposes of tax valuation, neither a tax assessor nor a trial court can wait for the property to be sold. Instead, the Court is obligated (pursuant to the teaching of the Court of Appeals in Rock Creek Plaza-Woodner) to examine whether the property is capable of producing a future income stream that will yield a profit of some kind (i.e. a return to equity). Thus, if the property is literally operating at a loss during the particular tax year itself, one can scarcely say that there has been a return on equity merely because the mortgage is being paid.

The obligation to pay the mortgage is an obligation that exists **regardless** of whether the property is making a profit as an office building. Borrowing money -- and paying interest for the opportunity to borrow it -- is a cost of doing business. It is a contractual expense. The repayment of the principal that has been loaned to the investor is manifestly not profit.

Back's treatment of the cash flow analysis makes no sense. Consequently, her decision to add "principal build-up" to the cash flow totally skews her capitalization rate. It surely does not comport with Rock Creek Plaza-Woodner. Clearly, her rate is not high enough to cover all of the three components cited therein.

To be sure, since the focus of the Court's attention must be the present value of the property's future income "stream," it is most difficult to set a present value for an income stream if the worth of the property is dependent upon the recognition of principal build-up as some form of profit.⁵

There is yet another troublesome flaw in Back's view that principal build-up should be considered return on equity. In her trial testimony, she sought to justify her position by contending that owners of office buildings may not really care whether the buildings actually earn a profit so long as the investors have mortgage interest to deduct on their tax returns. She trivializes the whole concept of investing in office buildings for the purpose of earning money from the rental market itself. Her testimony on this point came in the context of her assertion that she employed a presumption of a ten year "holding period" for this property.

Mr. Reynolds, in contrast, took the position that investors in office building do indeed desire to earn a profit and that they do generally intend to hold such properties for a period of time, although he did not attempt to identify a hard number as an

⁵Even if Back controversial interpretation of principal build-up were not a part of her testimony, there are ample other bases upon which to reject her opinion as to value.

expectable holding period that should be used blanketly in calculating value. On balance, he rejected the idea that an arbitrary period of ten years is the norm.

It is possible that, when a building is **not** exposed for sale in the open market, the owner may be content to reap the benefits of mortgage interest deductions as a consolation for lack of profit from actual rentals. However, the mere idea that some investors may tolerate this situation during a poor rental market is not proof that most investors enter the office building market for the primary purpose of acquiring debt.

The Court is obligated to consider how the property's realistic value should appear to a willing buyer -- on the date of valuation, assuming that the property is **indeed exposed for sale, absent any unusual pressures upon either buyer or seller.**

Ms. Back ignores the core tenet of the legal definition of estimated market value. The statute and the relevant regulation both require that the assessor assume that a willing buyer and a willing seller are both "seeking to maximize their gains." The Court must do likewise.

It is not appropriate to assume or conclude that the owner of an office building (or the potential buyer) is maximizing gains if the investor merely acquires the property for purposes of having interest deductions -- with no regard to office rental income itself.

In this case, the Petitioner has shown not only that the assessment made by the District was flawed, but Petitioner has

produced competent evidence of the actual value of their property by a well-qualified real estate appraiser. There is no substantial basis for rejecting or disbelieving Petitioner's expert testimony in this case. Therefore, it will be accepted. See Rock Creek Plaza-Woodner, Ltd. v. District of Columbia, supra, 466 A.2d at 859.

Mr. Reynolds valued the subject property for the tax year using the income approach to value. In appraising the property, Mr. Reynolds was concerned with the actual estimated value. Real property taxes are required to be based upon the estimated value of the property as of January 1 of the year preceding the tax year. Estimated market value is defined in 47 D.C. § 802(4) (1981). Mr. Reynolds considered the full value of this property consistent with the statutory definition.

As required, Mr. Reynolds considered and rejected the other approaches to value. The building had sufficient income history to allow for meaningful projection of value by the expert. The witness considered the rental history for the property and made reasonable projections about the future based upon the property's performance. It is important to keep in mind the stream of income when valuing a commercial property. The methodology and rationale of the Petitioner's expert were sound.

Petitioner's expert developed his capitalization rate by reference to the market and by the so-called "band of investment" technique. Using this technique, Mr. Reynolds estimated a loan to value ratio, the appropriate mortgage constant (derived from the

interest rate, amortization and term), and an equity income rate.

The capitalization rate of .1028, as developed by Reynolds, is accepted by the Court as being high enough to account for the cost of the mortgage, the real estate taxes, and to provide a fair return on equity. Rock Creek Plaza-Woodner Ltd. Partnership v. District of Columbia, *supra*, 466 A.2d at 858.

This case presents a classic instance of crediting the testimony of one expert over that of another. The law is clear that "[i]n resolving factual issues presented by conflicting expert testimony, the trial court is in the best position to evaluate the experts' qualifications, demeanor, experience, reasoning, and testimony." *Id.* at 859 citing Designers of Georgetown v. E.C. Keyes & Sons, 436 A.2d 1280, 1281 (D.C. 1981). "Thus, as a general proposition, when faced with conflicting expert testimony, the trial court may credit one expert over the other or even disregard both in rendering its judgment." *Id.*⁶

In the instant case, there was a clear choice to be made in the factfinding process. The better choice was to accept the opinion of Anthony Reynolds, based upon his superior logic, his reliance upon the band of investment technique in deriving his capitalization rate, and his realistic method of illustrating the present worth of the future income stream for this property.

Mr. Reynolds was more credible as a witness, than Ms. Back.

⁶"Indeed, the trial court is free to make its own independent evaluation of the evidence; even when uncontradicted, an expert's testimony is not binding on the court." *Id.*, citing Mann v. Robert C. Marshall, Ltd., 227 A.2d 769, 771 (D.C. 1967); Urciolo v. Sachs, 62 A.2d 308, 309 (D.C.Mun.App. 1948).

interest rate, amortization and term), and an equity income rate.

The capitalization rate of .1028, as developed by Reynolds, is accepted by the Court as being high enough to account for the cost of the mortgage, the real estate taxes, and to provide a fair return on equity. Rock Creek Plaza-Woodner Ltd. Partnership v. District of Columbia, supra, 466 A.2d at 858.

This case presents a classic instance of crediting the testimony of one expert over that of another. The law is clear that "[i]n resolving factual issues presented by conflicting expert testimony, the trial court is in the best position to evaluate the experts' qualifications, demeanor, experience, reasoning, and testimony." Id. at 859 citing Designers of Georgetown v. E.C. Keyes & Sons, 436 A.2d 1280, 1281 (D.C. 1981). "Thus, as a general proposition, when faced with conflicting expert testimony, the trial court may credit one expert over the other or even disregard both in rendering its judgment." Id.⁶

In the instant case, there was a clear choice to be made in the factfinding process. The better choice was to accept the opinion of Anthony Reynolds, based upon his superior logic, his reliance upon the band of investment technique in deriving his capitalization rate, and his realistic method of illustrating the present worth of the future income stream for this property.

Mr. Reynolds was more credible as a witness, than Ms. Back.

⁶"Indeed, the trial court is free to make its own independent evaluation of the evidence; even when uncontradicted, an expert's testimony is not binding on the court." Id., citing Mann v. Robert C. Marshall, Ltd., 227 A.2d 769, 771 (D.C. 1967); Urciolo v. Sachs, 62 A.2d 308, 309 (D.C.Mun.App. 1948).

This is amply demonstrated by the conflicting statements that she made regarding the timing and circumstances under which she had changed a part of her original appraisal in this case. This aspect of her testimony damaged her believability. It is difficult to discern exactly why Ms. Back was not more straightforward about this issue. The implication from this episode is that she did not want to acknowledge that certain aspects of Mr. Reynolds' appraisal were better justified than hers and that she wanted to change her own work to counteract this fact. The Court need not engage in speculation on this point however. The fact remains that she was not as direct as she should have been on this issue and her approach did not aid the Respondent at all.

The Court duly noted the debate between the two experts on the subject of the "holding period." The Court solicited post-trial memoranda on the subject of the significance of the holding period on the composition of the capitalization rate. The pleadings of all counsel were helpful. For the sake of brevity, the Court will not herein repeat the full content of those pleadings. It suffices to say that the arguments of the Petitioner were more persuasive.

Essentially, while being careful not to regard these pleadings as additional, unsworn expert testimony, the Court agrees with the logic of the Petitioner's arguments.

The upshot of the Petitioner's contention is that any investor may indeed have in mind a holding period that is idiosyncratic to that particular investor. Nonetheless, it is not appropriate for the Court to use an arbitrary holding period of ten years in its de

novo determination of value for one particular property. The statutory definition of estimated market value requires the Court to rely upon what would occur in an open market, with nothing strange or arbitrary going on. The appraisal performed by Mr. Reynolds has accomplished that much. The appraisal performed by Ms. Back has not.

Over all, this was not a close case. Accordingly, the Court finds that the market value of the subject property is \$31,300,000 as of January 1, 1987.

An allocation must be made between land and improvements. 47 D.C. § 821(a). Having no quarrel with the District's original allocation of land value, Mr. Reynolds accepted the allocation as made by the District as supported by the other evidence that he examined. For tax year 1988, the total valuation as of the valuation date of January 1, 1987 was \$31,300,000, with \$17,588,191 allocated to the improvements and \$13,711,809 allocated to the land.

Having accepted the finding of value as determined by the Petitioner's appraiser, the Court must reduce the assessment in accordance therewith. A refund shall be ordered.

For the foregoing reasons, it is by the Court, this 7th day of January, 1997,

ORDERED, ADJUDGED AND DECREED as follows:

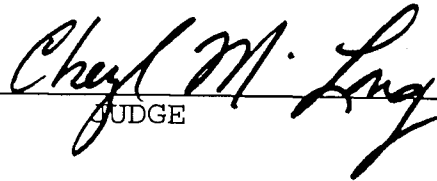
1. That the estimated market value of this subject property was \$31,300,000 for tax year 1988, of which \$13,711,809 is attributed to the land component and \$17,588,191 to the

improvements;

2. That the assessment record cards for the property maintained by the District of Columbia shall be adjusted to reflect the values determined by the Court in this order;

3. That the Respondent shall refund to Petitioner any excess taxes collected for tax year 1988 resulting from assessed values used as the basis for such taxes which exceed those determined by this order;

4. That the entry of decision shall be withheld pending submission of a proposed final order under the provisions of the Superior Court Tax Rules.



JUDGE

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SUPERIOR COURT OF THE DISTRICT OF COLUMBIA
TAX DIVISION

FILED

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CLERK OF
SUPERIOR COURT OF THE
DISTRICT OF COLUMBIA
TAX DIVISION

NEW YORK LIFE INSURANCE CO. :
ET AL. :

Petitioners :

v. :

DISTRICT OF COLUMBIA :

Respondent :

Tax Docket No. 4079-88

ORDER

This case came on to be heard before the Court on July 18, 1995. Upon the Petition filed herein, as amended, the stipulations between the parties and upon consideration thereof and the evidence adduced at trial, the Court having entered its Memorandum Opinion and Order filed January 2, 1997, it is by the Court this 6th day of March, 1997 hereby

1. ORDERED, ADJUDGED and DECREED that the correct estimated value for lot 46 in square 250, the subject property, is determined to be as follows:

Tax Year 1988

Land	13,711,809
Improvements	17,588,191
Total	31,300,000

2. ORDERED, that Respondent be and hereby is, directed to reduce the assessment on lot 46 in square 250 for purposes of District of Columbia real estate taxes for Tax Year 1988 from \$33,661,876 to \$31,300,000 consisting of \$13,711,809 for the land and \$17,588,191 for the improvements.

3. ORDERED, that the Respondent be and hereby is, directed to refund to Petitioner Tax Year 1988 real estate taxes on lot 46 in square 250 in the amount of \$47,946.08 with interest from March 31, 1988 to the date of refund, at the rate of six (6) percent per annum, the statutory rate as provided by law.



JUDGE

copies to:

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