SUPERIOR COURT OF THE DISTRICT OF COLUMBIA
TAX DIVISION

SQUARE 118 ASSOCIATES,

Petitioner,

v. Tax Docket No. 4508-90

DISTRICT OF COLUMBIA,

Respondent.

MEMORANDUM OPINION AND ORDER

The instant case was tried de novo by this Court, pursuant to the process for appealing commercial real property tax assessments. The property in question is a downtown office building, with certain unique physical features. The subject property is located at 1919 Pennsylvania Avenue, N.W. in the District of Columbia. At trial the petitioner challenged the assessment for tax year 1990 on several grounds and offered the testimony of an expert appraiser in support of its view that the taxes assessed were too high.

In performing the assessment, the District employed a methodology known as the "capitalization of income approach" or more simply the "income approach." The issues before the Court chiefly concerned certain alleged flaws in two aspects of the assessment under this methodology, chiefly: (1) the failure to take into account the actual expense and income history of the property and (2) the lack of sufficient evidence underlying the capitalization rate that was employed by the assessor.

Based upon the following applicable law, the findings of fact, and conclusions of law, this Court has determined that the

petitioner should prevail and that a partial refund must be ordered.

I. THE CONTROLLING STATUTE AND CASE LAW

The factual findings must be viewed in light of the fundamental law that applies to the judicial process of fixing a value on commercial property for purposes of providing relief from an excessive tax assessment.

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 (1990 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" bases assessed value on the price or prices at which reasonably comparable properties have recently sold, in accordance with the following guidelines:

> (a) Sales which represent arm's length transactions between buyer and seller shall be used in analyzing market value. Sales which to do not represent arm's length transactions shall either be adjusted for differences or disregarded;
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> (b) Sales comparisons should be made by property type within an assessment area; Provided, that if sufficient sales data for an assessment area is not available, sales data from other similar areas may be used.

9 DCMR § 307.3.

Regarding 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). This definition of what must be included in the capitalization rate has governed judicial decisions through the years. See Wolf v. District of Columbia, 597 A.2d 1303, 1309 (1991).[1]

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[1]See Rose Associates v. District of Columbia, Tax Nos. 5282-92 and 5772-93 (November 30, 1995)(Long, J.); Square 118 Associates v. District of Columbia, Tax Docket Nos. 4084-88 and 4266 (August 25, 1993(Wagner, J.); 1111 19th Street Associates v. District of Columbia, Tax Docket No. 4082-88 (February 21, 1992)(Sullivan, J.).

As a practical matter, the statute and case law cited above is the most useful, 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 the different appraisal offered by the petitioner's expert witness.

In the instant case, both parties agree that the income approach was properly utilized in assessing the subject property. This is not the contested issue. Rather, the de novo issues in the case focus upon the correct execution of the income approach to value.

II. FINDINGS OF FACT

The subject property is found in Square 118, Lot 29 in the District of Columbia. As a combined office and retail venue, it is known as "National Place."

The Petitioner herein, Square 118 Associates Limited Partnership, QS Limited Partnership and UB Limited Partnership, general Partners, is a limited partnership organized and existing under the laws of the District of Columbia. Petitioner is the owner of the subject property and is responsible for payment of real estate taxes.

The Assessment. The District's tax assessment for tax year 1990 (as of January 1, 1989) was $53,840,000. This included $37,817,206 for the land portion and $16,022,794 attributed to the

improvements.[2] At trial, Petitioner amended its claim that the fair market value of the property was $38,960,000. This reflects the value that was derived by Petitioner's expert appraiser.

The property itself consists of an 8-story, high-rise office building that was erected in 1979. It has first floor and mezzanine-level retail space. It is located on the north side of Pennsylvania Avenue (between 19th Street on the east and 20th Street on the west) and Eye Street on the north. There are three levels of parking.

The net rentable area of this building totals 243,316 square feet (208,818 for office space and 34,498 for retail space).

Notably, the building contains a PEPCO substation, which comprises 20,647 square feet of space.

The assessor for this tax year was Phillip Appelbaum, then a commercial assessor with the Department of Finance and Revenue. He was called as a trial witness by the Petitioner.

As to the land portion of the assessment, the trial record reflects that the land underlying this property had not been assessed consistently on an annual basis. The last re-assessment had been performed for tax year 1989. Appelbaum testified that he increased the land assessment for this property specifically using the developed floor area ratio (FAR) of the property, rather than valuing the land as if it were vacant. The applicable zoning regulations permits an "allowable" FAR of 6.5. The actual,

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[2]The Petitioner did timely appeal the assessment and the Board of Equalization and Review upheld the assessment.

developed FAR is 7.1. Finally, Appelbaum admitted that he did not engage in a fresh market survey or data analysis in determining the assessment of the land. Rather, he simply repeated the last known assessment figure with an upward adjustment for a different FAR.

To arrive at an assessment for the total property, as improved, Appelbaum testified that he used the mass appraisal technique. He utilized the income approach to value.[3]

Appelbaum did not actually use or even partially rely upon the owner's particular income and expenses history regarding this property in computing figures that led to his assessment.[4]

The net operating income (NOI) for this property was derived by Appelbaum solely through his reference to marketplace (or "economic") income and expenses data relating to other office buildings that were erected in the 1970s. As to income information, he testified that he collected data from newly-signed leases for office buildings in the same age group as the subject property. Yet, at trial he could not identify which properties he used.[5] He then averaged the rents and used them as an assumption for the subject property. He stated that the Department of Finance

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[3]The sale approach was used as a check. He determined that the cost approach was not applicable because the subject property was a mature building with an established income stream.

[4]Vaguely, he stated that he "considered" it; but such "consideration" cannot be connected to any particular formula or concrete role in his calculations. Thus, the Court draws the inference that he ignored the actual history of the property.

[5]Thus, there was no corroborating documentary evidence that the Government could have used (for de novo purposes) to reconstruct the soundness of his conclusions.

and Revenue, as a "policy" matter, directed him to value the property by using economic rents only.

The reported gross office income for 1988 for the subject property was approximately $3,000,000.[6] However, the assessor more than doubled that figure in his estimate of over $6,100,000, based upon his purported marketplace study.[7]

Appelbaum admitted that he ignored the older leases that were still in place at the subject property. Moreover, he testified that the actual income history of the subject property had no effect on his estimate of income.

In the final stage of developing the NOI, the assessor did not make any adjustments for actual income, actual expenses, or vacancies. He testified that he did not assume that the property owner or a potential buyer could achieve the net income that he estimated.

The assessor's capitalization rate that he applied to his NOI was .0983. It was developed in the manner described as follows.

Appelbaum testified that this particular rate was one of only two rates that were supplied to him by the office of Standards and Review, within the Department. He chose the lower of the two rates.[8]

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[6]This figure comes from a report submitted by the owner to the District of Columbia Government.

[7]The current office leases in the subject property were approximately $15.00 per square foot below market rental rates.

[8]He testified that Standards and Review, to the best of his knowledge, had developed the capitalization rates using the mortgage equity technique, Akerson format. In any event, the

Upon examination at trial, Appelbaum effectively acknowledged errors in the Department's use of the mortgage equity technique. For example, he testified that there was an "appreciation consideration" of 30% over five years. Appelbaum testified that he personally did not assume that the property would appreciate by 30% over five years. Without the factor of this appreciation consideration, the capitalization rate would have been .1419. At this particular capitalization rate, even using the assessor's own NOI figure, the value of the property would have been calculated to be $37,296,920 (or $16,500,000 less than his own figure of $53,840,000).

Appelbaum admitted that his capitalization rate was not high enough to pay the real estate taxes on his assessment and that it was not high enough to pay the assumed mortgage and to provide a fair return on the equity investment. Moreover, his rate was demonstrated to yield a substantial negative annual cash flow.

Finally, in testifying concerning his "check" on his income approach figures, Appelbaum claimed to have examined comparable sales to support his estimate of value. However, he admitted that there were no sales of truly comparable properties. While he stated that he examined sales of similarly-aged properties in the same neighborhood, he could not recall which sales he actually had reviewed at the time that he performed the assessment. He also admitted that he made no adjustments for the details of comparability. Thus, the Court finds that he did not perform a

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assessor did not personally calculate a capitalization rate.

comparable sales analysis.

Expert Testimony. Only the petitioner offered expert testimony at trial. No expert was called by the Government to support the assessment, once it was under attack by the Petitioner expert.

The petitioner's expert witness was Harry Horstman, an appraisal expert and teacher of appraisal courses at American University. He is a member of the Appraisal Institute, with the MAI designation. In Horstman's opinion, the fair market value of the subject property for tax year 1990 was $38,960,000, as improved.

Horstman testified first about the historical backdrop of the real estate market for this particular tax year. He stated that the office building market in 1988 was generally positive. However, while rental rates remained level, vacancy rates were increasing, due to much new construction. Thus, the market was beginning to show the effects of speculative over-building.

According to Horstman, it was important to keep in mind the unique features of the subject property. Its configuration was unusual because there is a PEPCO substation in the property itself and this permanently limits the square footage that is available for lease. In his opinion, due to the presence of the substation and the unusual shape of the building, the parking garage is cramped and difficult to navigate. Logically, this has a neglative impact on the worth of the building overall.

As to land value, Horstman determined the value of the land by

considering comparable land sales and then adjusting them for dissimilarities with the subject property. The sales ranged from $84.24 per square foot of FAR, to $140.56 per square foot of FAR. After adjustments to comparables, Horstman used the figure of $120.00 of allowable FAR. He ultimately valued the land at $30,760,000 (as compared to the assessment of $37,817,206).

Horstman stressed that there were two factors that impacted the valuation of the land. First, the location of the subject is better than most of the locations of the comparable vacant land sales that he observed. Second, the odd shape and large size of the parcel, in his expert view, negatively impact the land's value.

As far as FAR is concerned, Horstman criticized the assessor's reliance upon "developed" FAR, stating that in valuing land, the allowable FAR is always used. He also criticized the assessor's failure to examine new sales of vacant land.

Where the improvements (i.e. the building) are concerned, he considered all three major approaches to value and finally decided to utilize the income approach.

The NOI derived by Horstman was $4,382,857. The development of NOI proceeded as follows.

Horstman examined the actual income and expense history of the property for a three-year period, between 1986 and 1988. He also reviewed the actual rent rolls and leasing history for this building. He testified that historical data provided the best evidence of what a property is able to achieve. He learned, for example, that the office portion had less than 1% vacancy for

calendar year 1988.

Horstman testified that he based his stabilized income first on the collected rents for 1986 through 1988. He carefully analyzed what was occurring with the leasing of this building. He testified that a majority of the tenants' leases were due to expire in 1989 and several of them, occupying about 45,000 square feet, had already indicated that they were moving out. Others had indicated that they were renewing their leases. Horstman testified that the contractual office rents for 1988 were approximately $20.00 per square foot and that market rents were $27.50 per square foot. The base rent for the renewed leases is expected to increase. However, at the same time,the escalation income is reset with a new base year. As a practical matter, then, the new effective rent is **not** expected to be as high as market rents.

Horstman conducted a similar analysis of the retail leases in arriving at his gross potential income. From this figure, he subtracted a minimal stabilized vacancy and credit loss factor of 5%, to arrive at an effective gross income of $5,964,528. Expenses were subtracted in order to yield his final NOI.

The Petitioner's expert appraiser capitalized his stabilized NOI using the capitalization rate of 11.25%. This resulted in an appraised value of $38,960,000.

The development of Horstman's capitalization rate is summarized as follows.

The mortgage equity band of investment technique was also used by Petitioner's expert. This is a traditional method of

capitalization that is employed when sufficient market data is available. Under this technique, the appraiser develops a weighted component of the mortgage and equity component to develop an overall rate.

Horstman considered typical loan to value ratios, debt service, equity dividend rates, and points paid in the mortgage process. He made a study of the real estate market, including interest rates, yield rates, and surveys of rates that are conducted by the American Council of Life Insurance. He testified that the survey is based upon loans made by insurance companies on investment-grade properties throughout the United States.

The comparative risk and lack of liquidity of a real estate investment suggests the requirement of the higher yield rates. Examples include Corporate "Baa" bonds, at approximately 10.41% and "A" bonds at approximately 10%, as opposed to Treasury bonds at approximately 8.89%. Based upon this study, Horstman concluded a loan to value ratio of 73.2%, 9.84% interest rate, 25 year amortization, and an equity dividend rate of 5%.

To verify this data, Horstman used three other methods to validate his conclusion: debt coverage ratio, Ellwood yield analysis (Akerson format) and implied value change. In addition, he applied the test that is required by the District of Columbia Court of Appeals, which calls for a capitalization rate that is high enough to provide an adequate return to the equity position after paying the real estate taxes and a mortgage.

Finally, Horstman critiqued the assessor's valuation. He

testified that the assessor failed to take into account the actual income history of the property. He also testified that the difference between his and the assessor's NOI accounted for over $9 million of value. He added that the difference in capitalization rates accounted for almost $7 million in value, for a total of about $16 million difference in value.

III. CONCLUSIONS OF LAW

The de novo adjudication of an assessment appeal requires the trial court to engage in a two-pronged process. First, the Court must determined if the original assessment is "flawed" or incorrect. Petitioner bears the burden of proving that the assessment is flawed or incorrect.[9] If so, the Court secondly must consider the competing valuations that are offered at trial. On both points, the Petitioner herein must prevail as a matter of law.

At the very least, the flaws in the present assessment are: (1) the assessor's arbitrary and incorrect valuation of the land portion of the assessment; (2) his wholesale failure to concretely use and consider the actual expense and income history of the property in determining the NOI; (3) the Department's application of an arbitrary and unsupported 30% appreciation assumption; (4) the use of a capitalization rate that was not high enough to account for taxes, mortgage, and fair return on equity. The intimate details of how the assessment was derived reflect that

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[9] 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).

there are levels of missteps within the listed flaws. However, these four items are discrete, categorical mistakes that are readily discernable.

It is significant to note that the District offered no expert testimony to rebut the critique of its assessment by Mr. Horstman.

Certain aspects of the flawed assessment deserve emphasis.

First, as to the land assessment, this portion of the total assessment was derived in an incorrect and arbitrary fashion. This alone is a sufficient basis upon which to grant relief to the Petitioner. It is fundamental that the land underlying an improved property must be assessed as if it is **vacant**, not as if it has been improved by buildings with particular floor space. Clearly, if the land must be valued as vacant the only FAR that can be used for taxation purposes is the FAR that is "allowable" by zoning regulations, not the FAR that is actually built out after the property has been developed for retail purposes.[10]

Second, the failure to include the actual expense an income history in the calculation of the NOI is itself a fatal flaw to the assessment. This is a subject that has been discussed at length by the Court of the Appeals and the Superior Court as well. It is not a close question.

The Court of Appeals has stated, "When an income producing property has been in operation for a period of time, the past

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[10]Logically, the applicable zoning regulations would state rather objectively the parameters of what a potential investor could legally do with the land if it were purchased on the date of valuation.

earnings assist the assessor in projecting future earning ability." District of Columbia v. Washington Sheraton Corp., supra, 499 A.2d at 115.

The Court of Appeals has further emphasized, "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 approach." Id. Moreover, the Court subsequently observed that "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 of valuation." Wolf v. District of Columbia, supra, 597 A.2d at 1309.

The law does not require that an assessor rely **exclusively** on actual income and expense records -- and indeed the Court of Appeals has warned that estimated market value is not determined merely by a one-year, snapshot reference to "income available to the property as of the assessment" date. District of Columbia v. Washington Sheraton Corp., supra, 499 A.2d at 115. In the instant case, this is not what the Petitioner's expert did. Rather, he recreated a mosaic of the salient parts of both actual data and market information. Moreover, he did not extrapolate the estimated market value purely upon examination of the most recent, single year of the property's history. He examined several years in order to map a trend.

The pivotal problem is that the assessor (with no justification) utterly ignored what had been happening with the

subject property over a period of time, while still purporting to fix a present value on its future income stream. The direction of a "stream," of course, can scarcely be determined without tracking recent history.

It is difficult to envision how a potential investor can reliably gauge the future income potential of a particular property without resorting to a careful analysis of an office building's own past history. Even the Court of Appeals has not ventured how this might be done. Thus, for an established office building, such as National Place, there is no ready excuse for failing to consider its actual history. Viewing its history in the context of the overall real estate market is the optimum way of estimating what a future buyer would be prepared to pay in order to acquire the property. This, after all, is exactly what the tax valuation process is mandated to quantify.

This Court has addressed this identical flaw in yet another assessment appeal, in that opinion this Court concluded:

> It would be virtually impossible for a potential buyer to analyze the trends occurring with the income stream of a commercial property if such a potential investor literally ignores (or is not told) what has actually occurred with the property as a profit-seeking venture. . . . The reference to "a" future income stream is that of the subject property, not the income stream of some other particular property or sampling of properties.

Rose Associates v. District of Columbia, supra, at 18-19.

This Court's observation in Rose Associates applies equally in the instant case and naturally would apply to any case in which an

assessor has totally ignored the actual income and expense history of a mature, office building property.

The District, in failing to call an expert witness at trial, has left the Court with no competing expert view of why the failure to include actual historical data about the property's own income stream is not a fatal flaw in the assessment.[11] The District also offered no legal argument as to why this flaw should not emperil the assessment in the instant case.

Third, the Court concludes as a matter of law that the assessment was also flawed because it was based in part on an arbitrary and unsupported presumption that this property would appreciate by 30% over the next five years. The District offered no evidence to show the exact origins of this assumption or

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[11]Unfortunately, the District has not become motivated to take a close look at how it assesses this property. This particular property has been in constant litigation regarding taxation since tax year 1988 . In a previous trial de novo, the Superior Court set aside the assessments for both tax years 1988 and 1989, for reasons that are strikingly similar to those found by this Court. Square 118 Associates v. District of Columbia, Tax Docket Nos. 4084-88 and 4266-89 (August 25, 1993)(Wagner, J.). The instant case represents the third consecutive tax year's assessment in which the District's valuation of this property has been set aside.

In the earlier case, the District did call an expert witness, Ms. Shinn Back. One of the reasons why Judge Wagner rejected Back's appraisal was its failure to comport with the Rock Creek definition of what a capitalization rate must cover. Back's appraised value, once scrutinized by the Court, reflected a negative cash flow for this property and thus did not account for a fair return on equity. The District undoubtedly received Judge Wagner's August, 1993 opinion well in advance of the trial in the instant case (commencing April 24, 1995). The appraiser and all counsel have remained the same. By the begining of trial in the instant case, the District was already on notice that the manner in which the assessment was developed was legally defective. Thus, in light of the District's failure to use any expert witness at trial, the District's litigation strategy in this case was illusive.

whether, in retrospect, it can now be supported. This mysterious factor alone accounts for an over-valuation of over $16,000,000.

Fourth, the assessment must be rejected as flawed and incorrect because the assessor's capitalization rate did not comport with the requirements of Rock Creek Plaza-Woodner Ltd. Partnership v. District of Columbia, supra. The appellate court's definition of a proper capitalization rate is controlling on the Superior Court of the District of Columbia. This Court has reiterated this point at length in its earlier opinion in Rose Associates, supra. The practical effect of not complying with Rock Creek renders the assessment to be an overvaluation of the subject property. Here, the assessor made no pretense of attempting to comply with Rock Creek.

It is important to note that any one of the above four defects in the assessment is legally sufficient to invoke a de novo valuation of the property based upon the trial evidence. Certainly as a group, any two or more of these defects seriously compound the unreliability of the original assessment. In toto, they reflect a strong case presented by the Petitioner.

Since the Petitioner's expert is very credible and knowledgeable, the Court has no sound basis upon which to reject his opinions or his appraisal. His testimony shows that he has a firm and practical understanding of the local real estate market and a thorough understanding of the subject property as well. Having considered the entire record at trial, the Court accepts the opinion of Petitioner's expert. It makes sense and is well

supported.

WHEREFORE, it is by the Court this 30th day of December, 1995

ORDERED, ADJUDGED, AND DECREED that the estimated market value of the subject property for tax year 1990 is **$38,960,000**, of which $30,760,000 is attributed to the land component and $8,200,000 to the improvements; and it is

FURTHER ORDERED, ADJUDGED, AND DECREED that the assessment record card for the subject property, maintained by the Department of Finance and Revenue, shall be amended to reflect the values determined by the Court herein; and it is

FURTHER ORDERED, ADJUDGED, AND DECREED that Respondent shall refund to the Petitioner any excess taxes collected for tax year 1990 from the assessed value that was used as the basis for such taxes, which exceed those determined by this order; and it is

FURTHER ORDERED that entry of judgment shall be withheld pending submission of a proposed order under the provisions of Rule 15 of the Superior Court Tax Rules.

Cheryl M. Long
Judge

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