

FILED

SUPERIOR COURT OF THE DISTRICT OF COLUMBIA
TAX DIVISION

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SUPERIOR COURT OF THE DISTRICT OF COLUMBIA
TAX DIVISION

SQUARE 345 ASSOCIATES
LIMITED PARTNERSHIP,

Petitioner,

v.

Tax Docket Nos. 4670-90;
4977-91; and 5281-92

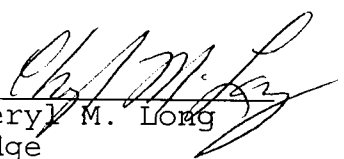
DISTRICT OF COLUMBIA,

Respondent.

ORDER

On May 22, 1995, this Court issued a Memorandum Opinion and Order in this action. One editorial correction is necessary. Wherefore, it is by the Court this 16th day of June, 1995

ORDERED that on page 17, line 9, the name "Reynolds" is hereby deleted and changed to read "Mitchell."


Cheryl M. Long
Judge

Copies mailed to:

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Tax Year 1992

Land	50,437,525
Improvements	3,462,475
Total	53,900,000

2. ORDERED, that Respondent be and hereby is, directed to reduce the assessment on lot 41 in square 345 for purposes of District of Columbia real estate taxes for Tax Year 1990 Second Half from \$81,759,980 to \$52,200,000 consisting of \$38,750,980 for the land and \$13,449,020 for the improvements.

3. ORDERED, that the Respondent be and hereby is, directed to refund to Petitioners Tax Year 1990 Second Half real estate taxes on lot 41 in square 345 in the amount of \$300,033.80 with interest from October 15, 1990 to the date of refund, at the rate of six (6) percent per annum, the statutory rate as provided by law.

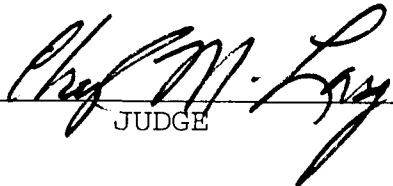
4. ORDERED, that Respondent be and hereby is, directed to reduce the assessment on lot 41 in square 345 for purposes of District of Columbia real estate taxes for Tax Year 1991 from \$81,759,980 to \$52,200,000 consisting of \$38,750,980 for the land and \$13,449,020 for the improvements.

5. ORDERED, that the Respondent be and hereby is, directed to refund to Petitioners Tax Year 1991 real estate taxes on lot 41 in square 345 in the amount of \$635,539.57 with interest from April 1, 1991 to the date of refund, at the rate of six (6) percent per annum, the statutory rate as provided by law.

6. ORDERED, that Respondent be and hereby is, directed to reduce the assessment on lot 41 in square 345 for purposes of

District of Columbia real estate taxes for Tax Year 1992 from \$99,632,000 to \$53,900,000 consisting of \$50,437,525 for the land and \$3,462,475 for the improvements.

7. ORDERED, that the Respondent be and hereby is, directed to refund to Petitioners Tax Year 1992 real estate taxes on lot 41 in square 345 in the amount of \$983,238.00 with interest from March 31, 1992 to the date of refund, at the rate of six (6) percent per annum, the statutory rate as provided by law.



JUDGE

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SQUARE 345 ASSOCIATES
LIMITED PARTNERSHIP,

Petitioner,

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Tax Docket Nos. 4670-90;
4977-91 and 5281-92

DISTRICT OF COLUMBIA,

Respondent.

MEMORANDUM OPINION AND ORDER

These consolidated cases are all appeals from real property assessments for the same piece of property. These cases relate to the payment of taxes for the second half of tax year 1990, tax year 1991, and tax year 1992. The real property that is the subject of this litigation in all three cases is: Square 345 of Lot 41, known as 1001 G Street, N.W., Washington, D.C. One of the contested matters in these cases is an issue of first impression, i.e. the determination of the proper appraisal methodology for the valuation of a brand new, substantially unleased office building.

On the basis of the following findings of fact and conclusions of law, this Court is convinced that the valuations calculated by the assessors for each of the tax periods in issue were incorrect and that the fair market values determined by the petitioner's expert are the correct valuations. As will be apparent from this Court's decision, the key to determining the correct value of the property is the use of the proper analytical model and its practical components.

A major issue in this case is the threshold choice to be made between the so-called "capitalization of income approach" or the so-called "cost approach" to the valuation of this commercial property. This Court has determined that the use of the "cost approach" for the valuation of this property was an improper methodology that was destined to lead to an incorrect assessment. The method of valuation that should have been used for all tax years is the "capitalization of income approach."

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" 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 best framework within which to adjudicate whether the assessments were fatally flawed and the extent to which the Court ought to accept the worth of the differing appraisals offered by the petitioner's expert witness and the District's expert witness.

Two individual assessors were involved in the instant case. The "cost approach" to valuation was selected by one of them as the basis for formulating the assessment for tax year 1990 (second half) and tax year 1991. The petitioner's expert ultimately relied upon the "capitalization of income approach" in order to appraise the property for all of the tax years involved. The District also presented an expert witness who performed an appraisal of this property. He relied upon the "capitalization of income approach" but arrived at valuations that differed greatly from those of petitioner's expert.

Without doubt, the petitioner bears the burden of proving that the assessment under review "is incorrect or illegal, not merely that alternative methods exist giving a different result." Safeway Stores, Inc. v. District of Columbia, 525 A.2d 207, 211 (D.C. 1987); see also Brisker v. District of Columbia, 510 A.2d 1037, 1039 (D.C. 1986). The role of the Superior Court is to afford the petitioner a trial de novo. 47 D.C. § 3303. Thus, this Court must scrutinize the entire process by which the petitioner's expert, the District's assessors, and the District's expert witness arrived at their conclusions. The law provides a clear structure for doing so.

II. FINDINGS OF FACT

A. The Subject Property. This property is physically located at 1001 G Street, N.W. and is improved by a 12-story office building. It was constructed in the period of 1987-1989. This building is the redeveloped shell of the former Woodward & Lothrop North Building and the McLachlen Bank Building. The improvements feature five levels of underground parking, in addition to a new interior.

This building has 399,727 square feet of gross building area above grade, i.e. above sidewalk level. There is 327,325 square feet of leasable office space and 15,457 square feet of leasable retail space. In addition, there is 31,675 square feet of storage space, a 9,438 square foot exercise facility, and approximately 239

parking spaces.¹

B. The Original Tax Assessments and the Competing Appraisals.

For the second half of 1990, the tax assessment was \$81,759,980. The date of this valuation was December 31, 1989. The petitioner's expert appraiser testified at trial that the value of the property as of this date was \$52,200,000.

For the tax year 1991, the District assessed the property at a value of \$81,759,980. The date of this valuation was January 1, 1990. The petitioner's expert testified at trial that the value of the property as of this date also was \$52,200,000.

For tax year 1992, the District's assessment was \$99,632,000. The date of valuation was January 1, 1991. At trial the petitioner's expert appraiser stated that the correct value of the property on this date was no more than \$53,900,000.²

¹The zoning is categorized as C-4 and the property is developed to a 10.0 FAR, i.e. floor to area ratio.

²In open court, as a preliminary matter, this Court determined that the petitioner had met all jurisdictional prerequisites for seeking judicial review through a trial de novo in Superior Court. The Government had moved to dismiss the petition with respect to the second half of tax year 1990, on the grounds that petitioner had not filed a timely appeal. Petitioner's witness, Leonard W. Horton, III, was Vice President and General Counsel of the taxpayer entity. His uncontradicted and credible testimony was that he did not receive notice of a tax assessment for the second half of 1990 until at least March 4, 1990. The respondent's witness was Deon Anthony Daniels, an assessment technician. He explained his process for preparing batches of notices. However, he was not able to account for whether the notice to this petitioner had ever been placed in the mail. At best, he indicated that the Government contracts with an outside company to perform the actual mailing and that batches of notices are merely picked up from a particular out box. No one from the contractor testified. On balance, then, the District could not rebut the petitioner's claim that no notice was received in sufficient time for an appeal to be filed by the normal deadline. The motion to dismiss was denied.

at all. At most, he generally looked at sales prices per square foot of net rentable area, purely as a check on the value that he ultimately derived by employing the "cost approach."

As to the "cost approach," it is clear that his execution of this analysis included errors. For example, in the context of valuing a vacant, non-stabilized property, he erroneously included the developer's profit, as well as the cost of interest on the construction loan. Additionally, he failed to make any adjustments, in terms of cost and expenses which would be required to get the property from "as is" value on the date of valuation to an "as stabilized" value. Davis admitted that he made no adjustments to the sales that he reviewed and that he **did not** take into account the fact that the subject property was vacant and clearly not stabilized.

Quinton Harvell was also called as a witness by the petitioner, to establish how he arrived at the assessed value of this property for tax year 1992. Unlike Mr. Davis, Mr. Harvell relied upon the "capitalization of income approach."

Harvell's assessment was performed with the aid of the 1989 income and expense form that had been submitted to the Department of Finance and Revenue, as well as with the aid of the rent roll of the taxpayer. As of the end of 1989, this property had only two or three retail tenants and no office tenants at all. Due to the dearth of information from the subject property, Harvell looked to the market data to determine what would constitute a "stabilized" net operating income. He testified that he used a 4% vacancy rate,

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indicating his working assumption of the amount of vacant but rentable space that would be existing. However, he admitted that he made no adjustments to income to reflect the fact of the 85% vacancy in the property for this particular tax year.

With regard to the capitalization rate, Mr. Harvell testified that he used a rate of .085, which was selected from a range of rates that were given to him by the Office of Standards and Review, within the Department.⁴ The staff of Standards and Review had published a schedule, calculating a capitalization rate using the mortgage equity band of investment technique (often called the Akerson format). This schedule, in turn, included a substantial downward adjustment of the rate, as a result of their assumption of a large appreciation in value. Mr. Harvell stated that without the inclusion of this assumption, the capitalization rate otherwise would have been .1205.

Several flaws are to be found in Harvell's assessment. First, he was unable to give any justification for applying such a large appreciation factor to this property. He acknowledged that applying a capitalization rate of .1205 instead of his rate of .085 resulted in a difference in assessment of approximately \$29,000,000.

Second, Harvell admitted that the capitalization rate that he used was not high enough to cover real estate taxes, the annual mortgage payment, and to provide a return on the cash investment.

⁴To this extent, the assessment process is somewhat of a committee effort.

Third, Harvell admitted that he failed to make any adjustments to the value from "as stabilized" to "as is." He did not compute the present worth of his estimated future income stream. This fails to account for the amount of money that investors would be willing to pay to receive that income stream.

In addressing its burden of proof and burden of persuasion, the taxpayer produced testimony of an expert appraiser who concluded that the property was of a substantially lower fair market value on the dates of valuation.

Mr. Anthony Reynolds is a longtime appraiser and is a member and former President of the Appraisal Institute. The District stipulated to his qualifications as an expert. He prepared one detailed written appraisal report that covered all of the tax periods that were the subject of this trial.

Mr. Reynolds concluded that the correct fair market value for this property for the 1990/1991 tax years was \$52,200,000. For tax year 1992, he concluded that the correct value was \$53,900,000. The details of his analysis are summarized as follows.

Reynolds commenced by observing the actual condition of the property on the three assessment dates. The building was finally completed and roofed in 1989. Nonetheless, it had no office tenants until much later. It was anticipated that at least \$25,000,000 of additional expenses and losses would be incurred in order to get the property to the point of stabilization. Indeed, it was because the building was not yet occupied and stabilized that Reynolds considered but rejected the "sales comparison" and

"cost" approaches.

One, he found that a direct sales comparison would not have been valid because, even if there had been any sales of partially complete (but comparable) buildings, such sales would be suspect because of the likelihood that they had been the product of duress (due to the poor real estate market in 1991).

Two, Reynolds rejected the cost approach because the cost to replicate this building cannot be equated with the value of a partially complete building unless successful completion can be guaranteed. He further determined that as of the valuation dates, any prospective developer of this property would decide not to build this building because it would not be economically feasible.

Three, the capitalization of income approach was ultimately selected by Reynolds because, he said, most potential buyers would use this method to first determine a value "as-completed." Moreover, any potential buyer would then make several deductions to arrive at a value "as is."

As his next step, Mr. Reynolds calculated a stabilized net income as of each of the valuation dates. He estimated the market value of the office and retail space, based upon rentable comparables and he factored in the few existing leases. He then deducted stabilized expenses to arrive at a net income of \$8,352,883 in the first year. He then capitalized this income by a rate of .10775, to achieve a rounded value of \$77,500,000 for December 31, 1989 and January 1, 1990, "as stabilized."

The capitalization rates that were developed by Reynolds were

derived from the financial band of investment technique. Specifically, he made a study of the market, including interest rates, yield rates, surveys of rates conducted by the American Counsel of Life Insurance and the American Institute of Real Estate Appraisers. In the first year, he applied factors based upon a 75% mortgage at 8.8% interest for 30 years. He estimated the equity rate at 6%, to arrive at a conclusion that the capitalization rate should be .10775 for the first year.⁵

As a foundation for his work product, Reynolds noted that he took into account the opinion of the District of Columbia Court of Appeals, in Rock Creek Plaza-Woodner Ltd., supra, as to what the capitalization rate must address, i.e. a rate that would be sufficient to insure payment of the mortgage, real estate taxes, and a fair return on the taxpayer's equity in the property.⁶ Reynolds emphasized that, except for the tax rate (fixed by law), all of the other components in the formula that he used were selected from the market.

As a final step to arrive at the "as is" value, Reynolds applied several adjustments to the figure of \$77,500,000. He deducted \$4,000,000 for what he terms the "unearned risk reward," since there was additional risk to the owner until the building was

⁵His calculations are set forth on page 14 and 15 of his written report that is a trial exhibit.

⁶It is certainly appropriate for an appraiser who is to testify about the value of the property to recognize existing law that would govern the relevance of his or her opinion. Having to account for legal requirements in defining fair market value is a factor that would and should naturally affect the content of the appraisal that is offered in court.

complete.⁷ Also, Reynolds deducted other sums: \$15,146,711 for the lost rent during the lease-up period; \$4,030,000 for tenant improvements that were not yet made; and \$3,118,875 for leasing commissions. He also applied a credit of \$981,975 for the reduced expenses during the lease-up period. The sum of these adjustments was \$25,300,000, rounded. Thus, the final "as is" value of this property for the first two valuation dates was \$52,200,000.

As to tax year 1991, the market value was derived by Reynolds in similar fashion.

First, Reynolds stabilized the net operating income at \$8,639,664, capitalized it at .11382 to achieve a rounded value (as completed/occupied) of \$75,900,000. He made the same adjustments, totalling \$22,000,000, rounded. His "as is" value as of January 1, 1991 was \$53,900,000.

The District's challenge to Reynolds' conclusions came principally in the form of cross-examination and the presentation of its own expert.

On cross-examination, Reynolds was questioned regarding an appraisal report that he had prepared for this very same property, for the benefit of First Chicago National Bank in 1986. The District focused upon the fact that this appraisal indicated that there was a value higher than any appraisal that was recently produced by Reynolds for the petitioner herein and that Reynolds had employed all three of the traditional approaches to value. The

⁷Such risks would include matters such as botched construction and occupancy problems.

District highlighted the inconsistency in his opinions, in an effort to suggest that the appraisal produced for the petition was too low and not reflective of his true opinion of the property's worth.

On balance, Reynolds provided a cogent explanation for the differences in his appraisals. First, he pointed out that his appraisal for First Chicago was done for the express purposes of justifying a loan, for which the situation and the assumptions were different from those that are relevant to taxation. The 1986 appraisal assumed that the investment would be the development of a completed building that would be fully occupied with a stabilized income stream.

Significantly, in the 1986 appraisal, the net operating income that Reynolds assumed was based upon market conditions that existed in 1986, as well as his own prediction and presumption that this favorable market would continue as such for several years into the future -- by the time that the property was stabilized.⁸ Realistically, however, the District of Columbia commercial real estate market was experiencing a virtual collapse by the era of 1991-1992. Thus, the value of the partially completed project turned out to be substantially lower than what was originally

⁸He testified that rental rates in 1986 were significantly greater than those that existed in 1991. Reynolds observed that both Harvell and Davis seemed to be unaware of this or oblivious to these facts.

envisioned and predicted in 1986.⁹

Finally, as a practical matter the opinion rendered in 1986 by Reynolds should not be called an "appraisal" as such, because the building had not yet been developed.¹⁰ His work product is more precisely an evaluation, not an appraisal.

A second aspect of the testimony of Mr. Reynolds was his critique of the manner in which the District's assessments had been formulated. He concluded that they were erroneous for several reasons. For example, as to Mr. Harvell's assessment, Reynolds noted that the assessor failed to analyze whether the cost to erect this building necessarily equalled "value." In fact, Reynolds stated, the assessor did not do a genuine "cost approach" but instead simply added up costs.

Where Mr. Davis' assessment is concerned, Reynolds stressed his failure to perform the calculation of the income approach. Reynolds testified that Harvell did accurately estimate the property's income, but that he employed a faulty capitalization rate. That rate did not provide a fair return on the investor's equity after payment of the taxes and mortgage. Further, the assessor failed to make **any** deductions to reach the "as is" value.

The District of Columbia also presented testimony from an

⁹There is a great difference between a firm appraisal of what a willing buyer would have paid for a property as of a specific valuation date in the past and a mere prognostication that was set forth several years prior to that date. The benefit of hindsight and known historical data cannot be downplayed.

¹⁰Certainly, he was not dealing with such matters as adjustments to income.

expert real estate appraiser, Mr. Ryland Mitchell. In his opinion, the fair market value of this property was \$68,000,000 as of December 31, 1989 and January 1, 1990. Mitchell testified that, in his opinion, the fair market value for the property on January 1, 1991 was \$70,000,000. Clearly, Mitchell found that the District's assessments were too high. Yet, his own valuations were higher than those derived by Mr. Reynolds, for reasons that indicate an incorrect analysis.

The Court received detailed testimony from Reynolds concerning his own opinion as to value. This testimony was marked by a strange shift in his viewpoints on the eve of trial.¹¹

In two written appraisal reports, Mitchell stated that the value of the property on the earlier two valuation dates was \$75,000,000. As to tax year 1992, he originally determined the fair market value to be \$76,500,000. By the time of trial, both values had been lowered by several million dollars. Mitchell claimed that he lowered his figures because he realized that it was necessary to adjust his calculations to show "as is" value rather than "as stabilized" value.

The Court finds this explanation to be incredible. There is no good reason why an expert appraiser should not have known at the very inception of the appraisal process that all valuations must be made on an "as is" basis. For a building that was largely **vacant**, the difference between "as is" and "as stabilized" is not

¹¹Trial commenced on October 13, 1994. The amended report of Mitchell was FAXed to petitioner's lawyer on October 12, 1994.

sufficiently subtle to justify a lowering by only a few million dollars. It is not subtle at all. Ultimately, this Court has the firm impression that the relatively sudden and belated change in Mitchell's appraisal opinion was prompted by nothing more than a realization that his original conclusions were faulty and that the expert opinion of Reynolds would discredit him at trial.

Mr. Mitchell used all three approaches to value, but his application of these approaches was flawed.

Where the cost approach was concerned, he merely estimated the cost to build the property. In addition, he failed to make appropriate adjustments to get the property's valuation from "as stabilized" to "as is."

In the sales comparison approach, Mitchell acknowledged that there were no sales of similar properties that were not yet complete. Thus, it was not possible to do a direct sales comparison. Rather, Mitchell used an indirect sales comparison by relying upon sales of completed, fully occupied and stabilized buildings. Aside from the obvious differences between occupied and vacant buildings, these sales were plagued with unique characteristics that rendered them unhelpful as useful comparisons.

The capitalization of income approach was virtually ignored in the first valuation year. The capitalization rate used by Mitchell was 9.1%. Mitchell, however, arrived at a rate that was unreliable, in the Court's view, because he took the position that the market data reflected only "all cash" comparable sales. Unjustifiably, he seemed to suggest that only "all cash" buyers

would have been interested in purchasing brand new office building properties.

There are at least two serious defects in Mitchell's use of these sales to determine a capitalization rate. First, he relied upon the sales data published by Peter Korpacz in a newsletter distributed within the commercial real estate industry. On cross-examination, it became clear that Korpacz data is merely a survey of opinions rather than a compilation of **actual** sales transactions. In effect, then, Mitchell had insufficient factual support for his capitalization rate.

Second, as Mr. Reynolds pointed out in rebuttal testimony, the term "all cash" is not necessarily accurate because if the purchaser of a commercial property was a limited partnership, the purchase money was borrowed from **somewhere** -- a third party. There might not be a readily identifiable commercial lender; but someone other than the purchaser of record was likely to be the source of a loan that must be repaid eventually. Thus, there is an inescapable need for the capitalization rate to account for payment of some type of financing.

Overall, Mitchell's capitalization rate was not high enough to pay an assumed mortgage, to pay the real estate taxes, and to provide a fair return on investment. This was demonstrated by a cash flow analysis that showed a negative return.

III. CONCLUSIONS OF LAW

As a matter of law, this Court concludes that the original assessments in each tax year were incorrect. They were incorrect

due to the illogical use of the cost approach to value that was utilized by the assessor for the 1990 (second half) and 1991 tax periods. In any case, the execution of the cost approach was destined to be of no use in arriving at a fair market value because the assessor merely calculated the cost of erecting the building on the land. This, of course, does not reflect anything about return on investment. To recapture only what it costs to build a building (as a reward for taking on the risks of development) is not what commercial investors are endeavoring to do in creating and selling office buildings.

For a new office building, the cost of acquisition also includes an amount of money that the purchaser of a new building is prepared to pay for various expenses during a time when there is no appreciable income in sight. For this reason, the more sophisticated capitalization of income approach more realistically reveals the worth of the property when it is "exposed for sale" to potential buyers who are going to be forced, immediately, to devote more and more money to the project.

The replacement cost approach simply does not reflect income-related factors that would influence a purchaser. See District of Columbia v. Washington Sheraton, supra, at 113 n.5 Reference to "income-related factors" is key to understanding more precisely why the cost approach usually must be rejected where office building properties are concerned and why it is specifically rejected in the instant case.

If anything, the cost-replacement approach is dramatically

less likely than the income approach to produce an accurate picture of property value where office buildings are concerned.

Where **income-related** factors are concerned, the income streams of office building properties can be naturally endangered by the negative financial impact of constant cycles of re-decorating, renovation, finishing, and leasing expenses. An office building constantly undergoes internal change to suit the needs of both long term and short term tenant populations.¹² The negative impact of such costs can be at its worst when the property is new. The impact, whatever it may be, is not considered when the cost approach is employed. By contrast, this impact is and should be classically a part of the capitalization of income approach.

For all of the reasons set forth herein, the cost replacement approach to value should not be applied to the taxation of the land and improvements that constitute new office buildings.

A second phase of reaching legal conclusions is, of course, the Court's scrutiny of the competing expert testimony. The Court draws the conclusion that the valuations calculated by petitioner's expert are more accurate and reliable than those proffered by the respondent's expert witness.

As a practical matter, the major difference between the expert opinions of Reynolds and Mitchell was the level of deductions that each witness made to adjust the "as stabilized" value to "as is"

¹²This is utterly different from other kinds of commercial properties such as hotels, in which rooms remain the same and are not renovated at the request of the occupants who will rent them. Renovation of the rentable portions of a hotel or motel is totally at the discretion of the owner's need, taste, and budget.

value. The greater deductions selected by Reynolds make more sense. For example, he was careful to include an adjustment to income to account for "unearned risk reward." This is very important in a newly developed property because the owner, during this nascent era of the property, is still subject to serious financial risk until the building is completed.

Mitchell, by contrast, made deductions only for tenant improvements and leasing commissions. The limited character of these adjustments is too simplistic to illustrate the expectable income stream for a potential buyer of this property. In assessing a new and almost empty office building,¹³ however, adjustments to income should be more sophisticated than what Mitchell considered and reported.

The other chief difference between the two experts is, of course, the difference in the quality of their selection of the capitalization rate. The Reynolds analysis was detailed, convincing and based upon data that is relevant. In contrast, the Government's expert heavily relied upon data that is not even factual, i.e. the Korpacz newsletter. Mitchell's error in this regard casts a major shadow over his entire testimony and it compromises the validity and reliability of his opinions in this trial.¹⁴

¹³In the first two disputed tax periods, the building was still virtually a shell. In tax year 1992, only about 15% of the rental space had been leased.

¹⁴The reference to sales of similar commercial properties is important to the establishment of the capitalization rate, because sales information is a known indicator of the financial terms on

An incomplete or faulty derivation of the capitalization rate is a fatal flaw. This is because the accurate capitalization of the property's income is the key to describing the "future income stream" that is to be considered by a potential purchaser of the property. If the capitalization rate is insufficient to meet the investment requirements set forth in Rock Creek Plaza-Woodner, then the assessment or appraisal must be rejected by the Court even if it is not otherwise defective.¹⁵

This Court has carefully examined all of the testimony and documentary evidence and is convinced that the valuations provided by the petitioner's expert are the accurate reflection of the fair market value of the subject property on the taxation dates in issue.¹⁶ Here, there was no need for the Court to obtain any independent expert opinion.

This case presents a classic instance of crediting the

which buyers are actually investing in properties -- and what kinds of sales prices were acceptable to the sellers to reflect a return on their own investment. The degree to which such sales involve properties that are truly comparable is important. For example, capitalization rates based upon fully occupied properties are not helpful when analyzing a vacant building that has not yet been successful in attracting tenants.

¹⁵At the conclusion of trial, counsel for petitioner isolated and summarized a host of problems with the appraisal opinion of the District's expert. The Court finds that those arguments are meritorious but does not repeat all of them herein, for the sake of brevity.

¹⁶This Court carefully considered and rejected the District's emphasis on the existence of the mortgage-related appraisal rendered years ago by Mr. Reynolds. This Court chooses to give no weight to the reference to the prior mortgage appraisal because this Court is satisfied that it has no importance in light of the realities of the local real estate market as of the dates of the tax valuation dates.

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." Rock Creek Plaza-Woodner Ltd. v. District of Columbia, supra, 466 A.2d at 859, citing Designers of Georgetown v. E.C. Keys & Sons, 436 A.2d 1280, 1281 (D.C. 1981).

Certainly, "the trial court may credit one expert over the other or even disregard both in rendering its judgment." Rock Creek Plaza-Woodner Ltd. v. District of Columbia, supra. In the instant case, there was a clear choice to be made and the better choice was to accept the opinion of Anthony Reynolds, based upon his superior logic, his reliance upon actual sales data in deriving a capitalization rate, and his realistic technique for illustrating the present worth of the future income stream for this property.

WHEREFORE, it is by the Court this 22nd day of May, 1995

ORDERED, ADJUDGED AND DECREED as follows:

1. That the estimated market value for the subject real property is determined to be \$52,200,000 for Tax Year 1990 Second Half (\$38,750,980 attributable to land and \$13,449,020 attributable to improvements);

2. That the estimated market value for the subject real property is determined to be \$52,200,000 for Tax Year 1991 (with \$38,750,980 attributable to land and \$13,449,020 attributable to improvements);


3. That the estimated market value for the subject real

property is determined to be \$53,900,000 for Tax Year 1992 (\$50,437,525 attributable to land and \$3,462,475 attributable to improvements);

4. That the District of Columbia's tax assessment record card for the subject property shall be adjusted to reflect the values determined herein by the Court;

5. That respondent shall refund to petitioner, with interest, any excess taxes collected for the second half of Tax Year 1990, 1991, and 1992 resulting from assessed values which are in excess of the values determined by this Court;

6. That the entry of judgment shall be held in abeyance pending submission by petitioner's counsel of a proposed Order under Rule 15 of the Superior Court Tax Rules.


Cheryl M. Long
Judge

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