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SUPERIOR COURT OF THE DISTRICT OF COLUMBIA
TAX DIVISION

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SUPERIOR COURT OF THE
DISTRICT OF COLUMBIA
TAX DIVISION

SQUARE 118 ASSOCIATES,

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Petitioner,

v.

Tax Docket Nos. 4971-91
5241-92

DISTRICT OF COLUMBIA,

Respondent.

MEMORANDUM OPINION AND ORDER

This matter came before the Court for trial upon the petition for a partial refund of real property taxes for Tax Years 1991 and 1992. The parties filed stipulations pursuant to Rule 11(b) of the Superior Court Tax Rules. Upon consideration of the stipulations, the evidence adduced at trial, the applicable law, and having resolved all questions of credibility, the Court makes the following findings of fact and conclusions of law.

FINDINGS OF FACT

1. The Petitioner, Square 118 Associates Limited Partnership, is the owner of the land and improvements on Lot 29 in Square 118, located at 1919 Pennsylvania Avenue, N.W., in the District of Columbia ("subject property").

2. The subject property was built in 1979 and is improved by an eight-story office building. The building consists of 208,818 square feet of leasable office space, 20,142 square feet of leasable retail space, three sublevels of underground parking comprising 156 parking spaces, 5,874 square feet of storage space, and 20,142 square feet of service space (the majority of which is incorporated in a Pepco substation). The property is located in the Central Business District and is zoned C3C, allowing for development to a maximum FAR (floor area ratio)¹ of 6.5. It is, however, only developed to a 6.4 FAR. The property is unique due to the unusual shape of the building and the existence therein of the Pepco substation. The unusual shape of the property reduces the ability of the owner to divide the floors for subleasing, and the substation impacts upon the efficiency of the parking garage, resulting in less parking spaces per 1000 square feet of office space.

3. The assessed value of the subject property for Tax Year 1991 was \$71,285,000. The assessed value for Tax Year 1992 was \$61,372,000. The Petitioner timely filed an appeal with the District of Columbia Board of Equalization and Review (BER), which reduced the Tax Year 1991 assessment to \$59,274,909, and sustained the Tax Year 1992 assessment.

¹ The FAR (floor area ratio) is the ratio of the square footage of the building that can be built above grade to the square footage of the land.

4. Petitioner timely paid all real estate taxes assessed against the subject property valued at \$59,274,909 for Tax Year 1991, and valued at \$61,372,000 for Tax Year 1992, as required by law, and timely filed a petition for reduction of assessment and refund of excess taxes paid for both tax years. Petitioner initially asserted that the fair market value of the subject property for Tax Year 1991 was \$44,500,000, which it reduced at trial to \$41,000,000, reflecting the value set by its expert appraiser. For Tax Year 1992, the Petitioner initially asserted a fair market value of \$47,400,000, which it reduced at trial to \$42,130,000, again reflecting the value set by its expert appraiser. The District, at trial, sought to uphold the original assessments of \$71,285,000 for Tax Year 1991, and \$61,372,000 for Tax Year 1992.

5. The tax assessor for Tax Year 1992 was Mr. Troy Davis, a Supervisory Assessor with the Department of Finance and Revenue. Mr. Davis assessed the subject property for Tax Year 1992 at \$61,372,000.

6. In determining the assessment for Tax Year 1992, Mr. Davis employed the capitalization of income approach. The capitalization of income approach entails dividing a stabilized net operating income (NOI) by a capitalization rate. The

stabilized NOI used by Mr. Davis was \$5,216,617, which was divided by his capitalization rate of 8.5% to yield an estimated market value for the property of \$61,372,000.

7. In deriving the \$5,216,617 NOI for Tax Year 1992, Mr. Davis did not use the actual income and expense forms from the taxpayer. Rather, he relied on market rents that were exhibited by leases that he had examined in other comparable buildings. The Pertinent Data Book for 1992, which was compiled by the District of Columbia, gave a range of market rents.

8. The assessor's Tax Year 1992 NOI of \$5,216,617 was based on the following estimated market rents: \$27/SF (square foot) for the office space; \$40/SF for the retail space; \$1280 per space for the parking spaces; \$13/SF for the storage area; 3% for vacancy and credit loss; and \$7.75/SF for the operating expenses. The assessor multiplied these market rents by the appropriate number of square feet in the subject property to derive his NOI.

9. The market rents in the 1992 Pertinent Data Book were based on a study of typical rents observed in recent leases that were executed for comparably aged buildings in the Central Business District. For instance, the \$40/SF market rent for the office space was based on the 1989 income and expense forms, and

particularly the leasing forms, submitted by the owners of comparable properties in the Central Business District. The \$40/SF rate was selected from the range of rates, with the extremes eliminated, established by the comparable sales information.

10. The leases in the subject property were executed around 1979. All of the leases had an expiration date beyond the valuation date of January 1, 1991, except for two leases accounting for approximately 6,000 square feet of net rentable area.

11. Mr. Davis selected his 8.5% capitalization rate from a range of rates calculated by the Office of Standards and Review, a division of the Department of Finance and Revenue. Standards and Review employed the "direct extraction from comparable sales" method to derive the capitalization rates. That method entails dividing pro forma NOIs by their respective sell prices to produce a range of capitalization rates. The high and low extremes of the range are excluded, and the assessor selects his rate from the final range. The assessors receive the recordation forms of the sales from the Recorder of Deeds, verify the information, and then present it to Standards and Review. Standards and Review then calculates the capitalization rates.

12. "Pro forma" net operating incomes are estimated by Standards and Review from market information rather than the actual historical incomes of the properties. When these NOIs are divided by the comparables' respective sale prices, capitalization rates result.

13. Standards and Review also derived capitalization rates by dividing the comparable sales properties' actual NOIs by their actual sales prices. Generally, the capitalization rates were lower for the actual income studies as compared to the pro forma capitalization rate studies. Thus, the overall assessment values would generally be lower using pro forma capitalization rates rather than the actual capitalization rates from the comparable sales properties.

14. The assessor did not test his 8.5% capitalization rate against the net operating income to determine whether or not that capitalization rate was high enough to allow the taxpayer to pay real estate taxes at the assessed figure, to pay the mortgage based on a 75% loan to value ratio, and to obtain a fair return on equity.

15. A cash flow analysis for Tax Year 1992 is as follows: For an assessment of \$61,372,000, the taxes due at 2.15% are \$1,319,498. The mortgage, based on a 75% loan to value ratio and

a mortgage constant of 0.1031 is $(\$61,372,000) (75\%) (0.1031) =$ \$4,745,590. For Tax Year 1992, the assessor used a net operating income of \$5,216,617. Subtracting the taxes due and the mortgage from the NOI results in a negative cash flow of \$848,471, without even considering the fair return on equity.

16. Mr. Davis conducted a comparable sales analysis to check the reasonableness of his figure achieved under the income approach. He examined eight different properties in the District of Columbia and adjusted their estimated values for differences with the subject property. The comparable sales produced a range of property values from \$252/SF to \$408/SF of net rentable area. The \$61,372,000 assessment resulting from the income approach equates to \$252/SF of net rentable area for the subject. Mr. Davis, consequently, considered the value resulting from income approach to be very conservative.

17. The assessor for Tax Year 1991 was George Toll, an assessor with the District of Columbia Department of Finance and Revenue. This Court did not accept Mr. Toll as an expert witness.

18. Mr. Toll estimated the market value of the subject property for Tax Year 1991 at \$71,285,000.

19. To arrive at his Tax Year 1991 value, Mr. Toll relied on the capitalization of income approach. Mr. Toll derived a stabilized NOI of \$5,881,150, which he divided by a capitalization rate of 8.25% to get an overall assessment of \$71,285,000.

20. In deriving his stabilized NOI, Mr. Toll looked at the subject property at the time of the assessment and examined the rent rolls, but did not use the actual rents that the existing tenants were paying. Instead, the assessor used market rents per square foot for the different types of space comprising the property and multiplied these rates by the corresponding square footage for that type of space. For example, the assessor used a market rate for the office space of \$28/SF, which he multiplied by the total square footage of office space in the building. Like Mr. Davis, the assessor for Tax Year 1992, Mr. Toll reviewed the income and expense forms for comparable properties in a similar location as the subject property to achieve the market rates.

21. While the actual NOI reported by the taxpayer for Tax Year 1991 was \$3,342,286, Mr. Toll estimated a NOI of \$5,881,150. This NOI was based on the income that he estimated the building would generate if it were vacant and re-leased at market rates.

At the time of Toll's assessment, however, there were several leases in existence that were generating less income than the market value leases. While the assessor testified that most of the leases in existence were about to expire, he could not recall which of them had renewal options.

22. Mr. Toll selected his 8.25% capitalization rate from a range of capitalization rates established by the Office of Standards and Review ranging from 8% to 9%.

23. To establish the range of rates, Standards and Review estimated pro forma NOIs for actual sales of comparable properties and divided each pro forma NOI by its respective actual sale price to calculate the capitalization rate.

24. The assessor for Tax Year 1991 did not test his 8.25% capitalization rate against the NOI to ascertain whether the capitalization rate was high enough to allow the taxpayer to pay taxes, pay the annual mortgage, and obtain a fair return on equity.

25. A cash flow analysis for Tax Year 1991 is as follows: For an assessment of \$71,285,000, the taxes due at 2.15% are \$1,532,628. The mortgage, based on a 75.6% loan to value ratio and a mortgage constant of 0.107 is $(\$71,285,000) (75.6\%) (0.107) =$ \$5,766,386. For Tax Year 1991, the assessor used a net operating

income of \$5,881,150. Subtracting the taxes due and the mortgage from the NOI results in a negative cash flow of \$1,417,864, without even considering the fair return on equity.

26. The assessor verified the estimated market value for Tax Year 1991 that he achieved under the income approach by comparing it to the value achieved under the comparable sales approach. The standard measurement of estimated market value under the comparable sales approach is a dollar value per square foot of net rentable area. His \$71,285,000 value from the income approach equates to \$293.17/SF of net rentable area.

27. Under the comparable sales approach, the assessor examined properties similar to the subject property in location, age, and condition. Of all the comparable properties that he examined, none had sold for less than \$300/SF of net rentable area. As the \$293.17/SF value achieved under the capitalization of income approach was considerably lower than any of the rates derived from the comparable properties, the assessor was confident that the income approach value was a fair and reasonable assessment.

28. Petitioner presented Mr. Harry A. Horstman, who the District stipulated to be an expert in the field of commercial real estate appraisals.

29. Mr. Horstman appraised the subject property for Tax Years 1991 and 1992.

30. For Tax Year 1991, the appraiser estimated the fair market value of the subject property to be \$41 million, attributing \$32 million to the land value and \$9 million to the value of the improvements. For Tax Year 1992, Mr. Horstman appraised the overall value of the subject property to be \$42,130,000 and independently calculated the value of the land to be \$28,200,000. While both the appraiser's final appraisal report as well as the Petitioner's Proposed Findings of Fact and Conclusions of Law assert that these two figures lead to \$12,930,000 as the value of the improvements, this Court finds that the intended value of the improvements is \$13,930,000, the simple result of subtracting the independently-derived land appraisal from the independently-derived overall property appraisal.

31. Near the valuation date of January 1, 1990, the real estate market experienced some very major changes. The Financial Institution Reform and Recovery Enforcement Act, enacted in August 1989, took funding for real estate out of the market. Thereafter, the real estate market entered into a recession, resulting in less sales transactions and increased vacancy rates.

There was also a supply increase through the construction of new buildings.

32. In appraising the subject property for Tax Year 1991, the appraiser conducted an independent valuation of the land and an independent valuation of the overall property.

33. In valuing the land, the appraiser examined the land as if vacant and available for development to its highest and best use, which would be as an office building for the subject property. The property was then compared with other properties in the District sold prior to January 1, 1990, which were adjusted to account for such differences in the subject property as its unusual shape and the presence of the Pepco substation. Based on the adjustments to the comparables, the price per square foot of FAR for the subject was calculated to be \$125/SF of FAR.² Applied to the 6.5 FAR allowable for the subject property, the figure gives a total value of \$32 million attributable to the land.

34. In valuing the overall property as improved, the appraiser relied on the income approach. The appraiser first determined a stabilized NOI for the property and then divided it by his derived capitalization rate.

² A price per square foot of FAR is used so that comparison of properties with different FARs can be made.

35. In calculating the NOI, the appraiser divided the property into relet space and currently leased space. The relet space comprises the space that rolls over without a release option and the current vacant space. For the relet space, the appraiser calculated the NOI by using market rents derived from comparable sales. For the currently leased space, the appraiser used the actual leasing data to calculate the NOI.

36. To determine the market rate that would be applied to the relet space, the appraiser employed the comparable sales method. The comparable sales produced a range of rates from \$26.45/SF to \$32.86/SF. Based on the subject property, as of January 1, 1990, the appraiser selected \$30/SF for the relet space. As of that date, there was only 4,152 square feet of relet office space and 4,678 square feet of retail space. There was no available storage space.

37. To calculate the NOI for the leased space, the appraiser used the actual leasing information available for the subject property. As of January 1, 1990, most of the tenants who had renewal options exercised those options. Those options prevent the leases from rolling over to the market rates. Use of market rates applies only to that space which could in fact be leased in the market. The rent that can be collected for space

that is already occupied by the tenants is determined by the lease agreements with those tenants.

38. Based on the existing contractual rates paid by the tenants, the appraiser calculated the following average gross operating incomes (GOI) per square foot of leased space: \$16.94/SF for the leased office space; \$22.81 for the leased first-floor retail space; and \$18.63/SF for the leased mezzanine retail space. To determine the overall GOI for the leased space in the building, the appraiser then summed the results of multiplying these rates by the square footages of the applicable space.

39. To convert the GOIs for both the relet space and the leased space into NOIs, the appraiser deducted operating expenses which were estimated to be \$1,681,962.

40. The appraiser's stabilized NOI for Tax Year 1991 was \$4,679,734.

41. After achieving the stabilized NOI, the appraiser developed a capitalization rate that reflected what the market was paying for property of similar economic characteristics.

42. To calculate his capitalization rate, the appraiser employed the band of investment technique. The appraiser referred to the American Counsel of Life Insurance Company

investment bulletin during the quarter immediately prior to the valuation date. From that bulletin was selected normal loan to value ratios and annual mortgage constant information. Then, the appraiser talked to investors, buyers, and sellers from the market place to determine the cash on cash rate of return expected for particular properties on that date in order to develop a cash on cash or equity dividend rate. Assuming a 73.7% loan to value ratio, an annual mortgage constant of 0.102419 (based on a 25 year loan at 9.425% interest), and a 6% cash on cash rate, the appraiser estimated a market capitalization rate of 0.092589, which, added to the 0.0215 tax rate, yields an overall rate of 0.1141.

43. The band of investment method was selected by the appraiser to develop his capitalization rate as he considered the subject property to be fairly stable. The income approach applied to a stable income stream eliminates many of the individual assumptions as to what may happen to the value of the property in the future. Those assumptions are built into the band of investment method.

44. The appraiser divided the \$4,679,734 NOI by this 0.1141 capitalization rate to get a rounded market value of \$41 million for Tax Year 1991.

45. The appraiser performed three separate tests to validate his capitalization rate: the debt coverage ratio test, the Ellwood yield analysis, and the implied value change test. In addition, the appraiser performed the D.C. adequate return test, which tests whether the capitalization rate provides an adequate return to cover the mortgage payments, tax payments, and the fair equity return. The appraiser concluded that the selected overall capitalization rate met all of these tests.

46. For Tax Year 1992, the appraiser conducted a similar appraisal of the subject property as he did for Tax Year 1991. He estimated the value of the land portion of the property to be \$28,200,000. Under the capitalization of income approach, he again derived different rental rates for the relet space and the leased space to achieve a stabilized NOI, which he capitalized to achieve an overall value of \$42,130,000 for the subject property as improved.

47. Mr. Toll, Mr. Davis, and Mr. Horstman, after considering the capitalization of income, comparable sales, and replacement cost approaches to value as required by statute, all agreed that the capitalization of income was the most appropriate approach to value for the subject property.

48. In criticizing the assessment for Tax Year 1992 conducted by Mr. Davis, Mr. Horstman explained that in deriving his NOI, Mr. Davis failed to take into account the fact that there were existing leases on the subject property and that a number of them extended in the future, having options to renew. The rents paid were substantially below the assessor's estimate of what should be paid to lease the building. The assessor's estimated NOI could not be achieved in the following year. The assessor's estimated value of the property could not be captured by the owner selling the property.

49. Mr. Horstman also explained that the assessor's capitalization rate was too low to cover the mortgage payment, a fair return on the equity, and the tax payments. Mr. Horstman testified that Mr. Davis's explanation of the source and development of the capitalization rates constituting the range from which he selected his capitalization rate was not consistent with generally accepted appraisal practices. Specifically, Mr. Horstman referred to the comparable property located at 2010 Massachusetts Avenue, N.W. used by the Office of Standards and Review to derive one of the capitalization rates in the range. Mr. Horstman testified that that property was not leased to anyone at the time it was sold and, as a result, did not have any

income. Since there was no NOI for that property, the pro forma income estimated for the property was too speculative and thus, not an indication of what the market was doing. Furthermore, Mr. Horstman felt that four other properties located at 1015 18th Street, N.W., 1899 L Street, N.W., 1030 15th Street, N.W., and 122 C Street, N.W., representing arm's length sales of similar types of buildings, should have been included in the 1992 Pertinent Data Book, but for some reason were not.

50. Similarly, for Tax Year 1991, Mr. Horstman criticized the Government's use of the property located at 1130 Connecticut Avenue, N.W. to calculate a capitalization rate. According to Mr. Horstman, that property was not a typical representation of market condition.

51. Mr. Horstman substantiated the cash flow analyses offered by the Petitioner for Tax Years 1991 and 1992. For Tax Year 1991, he explained that the negative cash flow of \$1,417,864 indicated that the capitalization rate used by the Government was too low, and that the negative cash flow of \$848,471 for Tax Year 1992 indicated the same.

52. After reviewing the methodology employed by both assessors, Mr. Horstman generally criticized the derivation of their capitalization rates. He testified that in some

circumstances, the same comparable property was used to generate different capitalization rates for two different years. To achieve such a result, the District simply changed the estimated income for the second year. Mr. Horstman testified that changing the pro forma incomes from one year to another is not appropriate for deriving overall rates. He also testified that some of the capitalization rates were derived from property sales with high vacancy rates, indicating that the properties were not stabilized. According to Mr. Horstman, the evidence used by the District was not market evidence for a stabilized property such as the subject property.

53. The Government did not put on an expert witness to contradict the testimony of Mr. Horstman. Further, this Court finds Mr. Horstman to be a credible expert witness who provided reliable testimony.

LEGAL ANALYSIS

This Court has jurisdiction over this matter pursuant to D.C. Code §§ 47-825 and 47-3303 (1990 Repl.). The Superior Court's review of a tax assessment is a trial de novo necessitating competent evidence to prove the matters in issue. Wyner v. District of Columbia, 411 A.2d 59, 60 (D.C. 1980).

"The assessed value of property for real property taxation purposes shall be the 'estimated market value' of the property on January 1st of the year preceding the tax year." District of Columbia v. Washington Sheraton Corp., 499 A.2d 109, 112 (D.C. 1985) (citing D.C. Code § 47-820(a) (1981)). In this case, the property was assessed on January 1, 1990 for Tax Year 1991 and on January 1, 1991 for Tax Year 1992. The "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 being in a position to take advantage of the other.

D.C. Code § 47-802(4) (1990 Repl.).

The factors that the assessor must consider in assessing real property are specified in § 47-820(a) of the D.C. Code:

The Mayor shall take into account any factor which might have a bearing on the market value of the real property including, but not limited to, sales information on similar types of real property, mortgage, or other financial considerations, reproduction cost less accrued depreciation because of age, condition, or other factors, income-earning potential (if any), zoning, and government-imposed restrictions.

D.C. Code § 47-820(a) (1990 Repl.).

According to Super. Ct. Tax R. 11(d), with respect to tax assessment challenges, "[t]he burden of proof shall be upon the

petitioner, except as otherwise provided by law." See Wyner, 411 A.2d at 60 (citing Rule 11(d)). The Petitioner can satisfy its burden of proof by showing that the assessment is incorrect, erroneous, arbitrary, or unlawful. See Brisker v. District of Columbia, 510 A.2d 1037, 1039 (D.C. 1986); District of Columbia v. Burlington Apt. House Co., 375 A.2d 1052, 1057 (D.C. 1977). The petitioner is not required to establish the correct value of the property in order to meet this burden. See Brisker, 510 A.2d at 1039. Furthermore, a taxpayer bears the burden of proving that an assessment is incorrect or illegal, not merely that alternate methods exist giving a different result. Safeway Stores, Inc. v. District of Columbia, 525 A.2d 207, 211 (D.C. 1987).

In this matter, Petitioner met its burden of proving incorrectness in the District's assessment. In its case, Petitioner advances two arguments: (1) that the District erred in failing to take into account the actual income, expenses, leases, and lease-up costs of the subject property; and (2) that the capitalization rates used by the District assessors were not high enough to meet the case law requirements. as stated in Rock Creek Plaza. This Court finds both arguments meritorious.

MARKET DATA v. ACTUAL DATA

Petitioner first argues that the District erred in solely relying on market data to calculate the net operating income for the subject property under the capitalization of income approach to value. The capitalization of income approach entails deriving a "stabilized annual net income" by reference to the income and expenses of the property over a period of several years. Rock Creek Plaza-Woodner Ltd. v. District of Columbia, 466 A.2d 857, 858 (D.C. 1983). Petitioner argues that in deriving its stabilized net annual income, the District failed to give adequate weight to the actual income, actual expenses, current leases, and lease-up costs of the subject property. Consequently, Petitioner argues, the District's reliance upon only market rates to derive a stabilized net operating income is arbitrary and incorrect.

The District, on the other hand, cites Wolf v. District of Columbia, 597 A.2d 1303 (D.C. 1991), to support its argument that each assessor was entitled to base its derivation of net operating income solely on market rents. The Court of Appeals in Wolf stated: "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." 597 A.2d at 1309. The District interprets this language to mean that since estimated market value is determined by the property's future

income earning potential rather than current earning potential, the District is entitled to disregard current earnings in its assessments. The Court of Appeals has time and time again rejected this rationale now offered by the District. See Wolf, 597 A.2d 1303; Washington Sheraton, 499 A.2d 109.

This Court does not fault the District's reliance on Wolf for the proposition that it is the future income earning potential of the property that should constitute the basis for valuation. Rather, this Court takes issue with the District's assertion that since estimated market value is determined by the property's future income earning potential, the assessment can be based solely on market rates. On the contrary, the thrust of the decision in Wolf is that assessors are not required to confine themselves to current earnings, but rather could take into account other information relevant to estimating the future income stream of the property. See id. Nowhere in the Court's reasoning is it asserted that a District assessor is warranted in disregarding current earnings altogether. In this respect, the Court's decision in Wolf comports with § 47-820(a) of the D.C. Code, which mandates that an assessor "take into account any factor which might have a bearing on the market value of the real property" D.C. Code § 47-820(a); see D.C. Mun. Regs. tit. 9, § 307.1 (1994). Both the D.C. Code and the D.C. Municipal Regulations require an assessor to take into account the current earnings if they might have a bearing on the market

value of the property. While future income earning potential is determinative of estimated market value, to the extent that actual earnings bear on the future "income earning potential," they must be taken into account. See D.C. Code § 47-820(a); D.C. Mun. Regs. tit. 9, § 307.1; Wolf 597 A.2d at 1309.

The Court of Appeals in both District of Columbia v. Washington Sheraton Corp., 499 A.2d 109 (D.C. 1985), and Wolf, supra, has rejected the District's argument that assessors are entitled to rely solely on market rates to determine future income earning potential where the property's actual income and expenses differ significantly from the market rates in existence as of the valuation date. In Washington Sheraton, the Court recognized that "past earnings assist the assessor in projecting future earning ability. Profit data for the past several years may indicate a trend and 'help avoid error which could be cause from examining a short, possibly abnormal period.'" 499 A.2d at 115 (citing California Portland Cement Co. v. State Board of Equalization, 432 P.2d 700, 704 (Cal. 1967)). While the Court in Washington Sheraton considered past earnings most useful in avoiding excessive reliance on the data of a particularly abnormal year, the case does illustrate that the subject property's earnings can in fact have a bearing on the calculation of the future income earning potential of a property.

The Court of Appeals's reasoning in Wolf is more helpful than Washington Sheraton in resolving the issues in this case.

In Wolf, the Court reiterated the fact that the income approach "bases assessed value on the amount that investors would be willing to pay to receive the income that the property could be expected to yield" 597 A.2d at 1309 (citing D.C. Mun. Regs. tit. 9, § 307.5); see also D.C. Code § 47-802(4). The Court explains that the point of measuring future income potential rather than actual income is that the actual income of the property may not reflect the future income that the property could be expected to yield. See 597 A.2d at 1309. For example, where the owner of a building secures non-arm's length leases below market rates in order to minimize tax payments, the actual income statements produced by the owner would not reflect the future income potential of the property if arm's length leases were secured. See id. This Court certainly supports the use of market rents over actual leases in such situations where the owner has attempted to avoid tax obligations.

The Court of Appeals in Wolf, however, also addresses the opposite situation in which the property is encumbered by long-term below-market leases entered into at arm's length, which the purchaser would be required to assume. See id. at 1310. The Court recognizes that in these situations where the property cannot generate income at market rates, the purchaser "would probably be unwilling to pay full market value for [the] property." See id. In order to achieve an accurate estimate of fair market value in both of these situations, the Court held

that "[p]roper application of the definition of 'estimated market value' found in § 47-802(4) requires consideration not merely of actual earnings, but of an adjusted income figure reflecting a variety of factors (including the impact of current leases) that influence the market value of the potential income stream of the building." See id.

The results of both Washington Sheraton and Wolf have been consistently upheld by the Judges in the Tax Division. For example, in 1111 19th Street Associates v. District of Columbia, Tax Docket No. 4082-88 (Sullivan, J., Feb. 21, 1991),³ the Judge stated:

[T]o arrive at a reliable estimate for the net operating income of the property, the District must consider not only market conditions, but the experience of the property as well. . . . The reason for the different net operating incomes was the failure of [the District's expert] to consider both existing leases and market conditions. A prospective purchaser would consider both in estimating current and future income, and therefore, [the District's expert] must too.

Opinion at 14. Thus, according to Judge Sullivan, the District's failure to take into account the property's actual income constituted error.

³ A copy of this unpublished opinion may be obtained in the Tax Office of the Superior Court of the District of Columbia.

Furthermore, in 1301 E Street Associates v. District of Columbia, Tax Docket Nos. 5286-92 & 5780-93 (Long, J., June 22, 1995),⁴ the Judge interpreted Washington Sheraton and Wolf to stand for the proposition that in determining the fair market value of commercial properties under the income capitalization method, there should be consideration of both the contract rents and market rents. See Opinion at 19. Where "the actual facts surrounding the leases and the actual income are highly relevant[,] . . . [t]his data is essential to a solid understanding of the future income potential of th[e] particular property." See id. This Court further opined that:

Without consideration of [the actual income, actual expenses, current leases, or lease-up costs of the property], the assessor's tactic of utilizing his own estimate of net operating income and giving no weight to actual income and expenses is an arbitrary and impractical method for determining a property's net operating income for purposes of valuation.

Id. Thus, Trial Court opinions have repeatedly interpreted the Court of Appeals's decisions as prohibiting assessors from relying solely on market rates to derive net operating incomes for a particular property while failing to take into account the property's actual incomes and expenses.

Based on the decisions of the Court of Appeals in Washington Sheraton and Wolf, and other trial Judges' application of those

⁴ A copy of this unpublished opinion may be obtained in the Tax Office of the Superior Court of the District of Columbia.

decisions, this Court today finds that the assessors for the District erred in failing to adequately take into account the actual income, expenses, leases, and lease-up costs for the subject property. Petitioner proved, through the testimony of its expert appraiser, Mr. Horstman, that the current leases encumbering the subject property had a bearing on the future income earning potential, and that the appraisers' failure to reflect the current leases in their respective appraisals resulted in an overestimation of the property's net operating incomes for Tax Years 1991 and 1992. Mr. Horstman testified that the assessors' estimates of the net operating incomes for the two tax years could not be achieved by the owner. He explained that the actual rents were so substantially below the market rents estimated by the assessors that the estimated value of the property could not be captured by the owner selling the property. That these below-market leases affected the future income earning potential of the subject was illustrated by the fact that many of the leases were not due to expire at the valuation date, and those that were due to expire shortly after the valuation date contained options to renew, which would prevent the leases from rolling over to the market rates. Furthermore, the Government failed to present an expert witness to contradict any of the assertions made by Petitioner's expert witness. Consequently, this Court finds that the District's failure in both tax years to adjust the net operating incomes to reflect the influence of the

below-market leases on the future income earning potential renders both assessments incorrect.

This Court finds that the instant case exemplifies the circumstances described in Wolf in which "a purchaser would probably be unwilling to pay full market value for property encumbered by long-term below-market leases which the purchaser would be required to assume." See 597 A.2d at 1310. In this case, the subject property was encumbered by below-market leases in that the District, for example, estimated market rates for the subject property's office space at \$30/SF for Tax Year 1991 and at \$27.50/SF for Tax Year 1992, whereas the expert appraiser estimated a leased rate for the office space at \$17/SF and at 19.47/SF for each year. Furthermore, the existence of renewal options for the current leases rendered them long-term leases. Consequently, as a result of the current leases, a purchaser of the subject property would probably be unwilling to pay full market value, which the Court finds indicative of a reduction in the future income earning potential.

While this Court feels that the use of market rents over actual incomes to calculate future income earning potential is appropriate where the owner of a property has intentionally entered into below-market non-arm's length leases for the purpose of reducing taxes, there has been no allegation by the District to that effect nor any evidence substantiating such a claim. In fact, the assessors' employments of comparable sales approaches

both to substantiate the assessment calculated under the capitalization of income approach as well as to derive pro forma capitalization rates illustrates the assessors' assumption that all of the leases in the subject property were secured at arm's length, for all of the comparable properties were comprised of arm's length leases. That the District, in supporting the assessments at trial, did not disagree with the use of comparable sales comprised solely of leases secured at arm's length further demonstrates its assumption that all of the leases in the subject property were secured at arm's length. As a result, the rationale in Wolf supporting the use of market rents for those situations in which the owner of a property has intentionally secured below-market leases in order to reduce taxes cannot be relied upon in this case.

The principle authority cited by the District to support its argument that the assessors were warranted to rely exclusively upon market rates to value the subject property was Greene v. District of Columbia, Tax Docket No. 3561-85 (June 12, 1986). This Court stated at trial that the unpublished Greene decision has no precedential value, and in response, the Respondent withdrew its reference to that decision. In any event, this Court is more persuaded by the Court of Appeals's holdings in Wolf and Washington Sheraton requiring consideration of actual earnings if it is shown that they influence the market value of

the potential income stream of the building. See Wolf, 597 A.2d at 1310; Washington Sheraton, 499 A.2d at 115.

A subtle issue involved in determining whether the assessors have complied with the statutory requirements for calculating estimated market value is: "How much effort must be made by the assessors so that they are deemed to have sufficiently 'taken into account' the actual earnings of the property as required by D.C. Code § 47-820(a)?" The District may argue that by examining the actual income and expense data for the subject property, but opting to rely solely on market rents, the assessors have still sufficiently "taken into account" the actual income of the subject property. This Court finds that the language in Wolf dispels this argument. The Court in Wolf explained that "[p]roper application of the definition of 'estimated market value' found in § 47-802(4) requires consideration not merely of actual earnings, but of an *adjusted* income figure *reflecting* a variety of factors (including the impact of current leases) that influence the market value of the potential income stream of the building." 597 A.2d at 1310 (emphasis added). The Court of Appeals explained that the income figure used in the capitalization of income approach must reflect a variety of factors, explicitly naming current leases as an example. Thus, to the extent that the current leases have a bearing on the future income potential for the property, the assessor must

adjust the NOI to reflect that influence. See id. at 1309-10; D.C. Code § 47-820(a).

In the instant case, both assessors testified that they reviewed the actual income for the subject property, but opted instead to rely exclusively upon market rates for their assessments. Through the testimony of its expert witness, Mr. Horstman, Petitioner has demonstrated that the actual leases have a significant effect on the calculation of the future income earning potential. As a result, the assessors, by failing to adjust their respective net operating incomes to reflect the effect of the actual leases, have not sufficiently "taken into account" those leases for purposes of D.C. Code §§ 47-802(4) or 47-820(a).

CAPITALIZATION RATE REQUIREMENTS

Petitioner's second argument supporting a finding of error in the District's assessment is that the capitalization rates used by the District under the capitalization of income approach were not high enough to meet common law requirements. Those requirements were set out by the Court of Appeals in Rock Creek Plaza-Woodner v. District of Columbia: "[The] capitalization rate [is] a number representing the percentage rate that taxpayers must recover annually to pay the mortgage, to obtain a fair return on taxpayer's equity, and to pay real estate taxes." 466 A.2d at 858. Petitioner's expert substantiated the cash flow

analyses for 1991 and 1992 contained in Petitioner's Exhibits 10 and 14, which were admitted into evidence without objection by the Government. According to the cash flow analysis for Tax Year 1991, at a tax rate of 2.15%, the taxes owed on the property assessed at \$71,285,000 are \$1,532,628. Using a 75.6% loan to value ratio and a mortgage constant of 0.107, the mortgage amounts to \$5,766,386. According to Petitioner's expert's interpretation of these figures, the District's estimated NOI of \$5,881,150 for Tax Year 1991 resulted in a negative cash flow of \$1,417,864, even without consideration of the additional amount that would be necessary to obtain a fair return on the taxpayer's equity.

Similarly, for Tax Year 1992, the overall assessment of \$61,372,000 yields a \$1,319,498 tax burden, and at a 75% mortgage rate and a mortgage constant of 0.1031, a mortgage burden of \$4,745,590. The Tax Year 1992 estimated NOI of \$5,216,617 produced an \$848,471 negative cash flow, without accounting for the amount required to provide the taxpayer a fair return on equity. The Petitioner's expert explained that the negative cash flows indicated that the capitalization rates were not high enough to meet the Rock Creek Plaza-Woodner requirements of allowing the taxpayer to pay the mortgage, to pay real estate taxes, and obtain a fair return on taxpayer's equity. See id. Based on the Petitioner's expert's uncontested testimony at trial, this Court finds that the capitalization rates used to

establish the assessments of \$71,285,000 for Tax Year 1991 and \$61,372,000 for Tax Year 1992 do not meet the requirements of Rock Creek Plaza-Woodner. Accordingly, this Court finds that the assessments incorporating the District's capitalization rates are incorrect.

When a taxpayer appeals an assessment to this Court, the Court can affirm, cancel, reduce, or increase the assessment. D.C. Code § 47-3303 (1990 Repl.). In this case, Petitioner's expert provided sufficient evidence to support its appraisal of the subject property for Tax Year's 1991 and 1992. As the District assessors did, Mr. Horstman relied on the capitalization of income approach to establish his \$41,000,000 assessment for Tax Year 1991 and his \$42,130,000 assessment for Tax Year 1992. The NOIs for each appraisal sufficiently took into account the actual leases of the subject property in existence at the date of valuation. His capitalization rates for each year were subject to the debt coverage ratio test, the Ellwood yield analysis, the implied value change test, and the D.C. adequate return test, all of which tested whether the capitalization rate provided an adequate return to cover the mortgage payments, tax payments, and fair return on equity. Each test was independently met, indicating that the capitalization rate was sufficient to meet the requirements of Rock Creek Plaza-Woodner. With respect to the other calculations used by Mr. Horstman to establish his appraisals of the property, this Court finds that he provided

sufficient evidence to indicate their reliability, and considering that the District did not present an expert to challenge the two appraisals, this Court accepts Petitioner's expert's appraisals as correct estimations of the fair market value of the subject property for Tax Years 1991 and 1992. Therefore, this Court finds the values of \$41,000,000 for Tax Year 1991 and \$42,130,000 for Tax Year 1992 reflective of the correct market value of the subject property.

Therefore, it is this 25th day of March 1997,

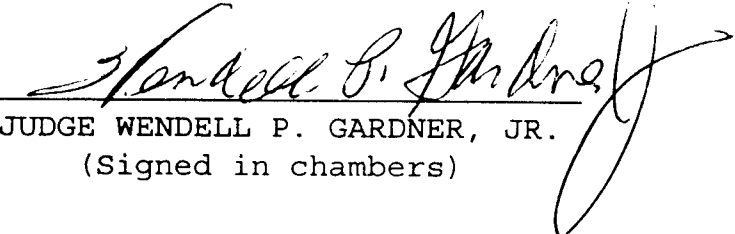
ORDERED, that the assessed value for the subject property is determined to be as follows:

<u>Tax Year 1991:</u>		<u>Tax Year 1992:</u>	
Land	\$32,000,000	Land	\$28,200,000
Improvements	<u>\$ 9,000,000</u>	Improvements	<u>\$13,930,000</u>
Total	\$41,000,000	Total	\$42,130,000

It is **FURTHER ORDERED**, that the assessment record card for the property maintained by the District shall be adjusted to reflect the values determined by this order; and it is

FURTHER ORDERED, that the Petitioner shall submit a proposed order providing for a refund of the overpayment of taxes due to the Petitioner, along with interest as allowed by law. A copy of the proposed order shall be served on Respondent and filed with

the Court no later than fifteen (15) days following receipt of this Order.


JUDGE WENDELL P. GARDNER, JR.
(Signed in chambers)

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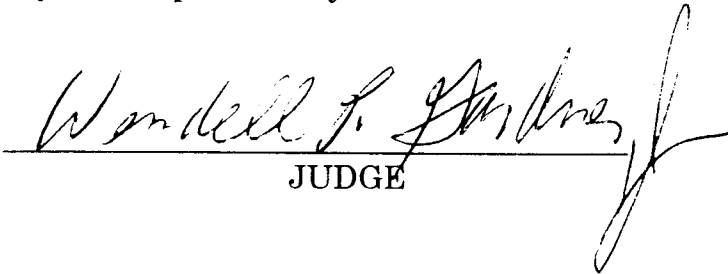
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taxes for Tax Year 1991 from \$59,274,909 to \$41,000,000 consisting of \$32,000,000 for the land and \$9,000,000 for the improvements.

3. ORDERED, that the Respondent be and hereby is, directed to refund to Petitioner Tax Year 1991 real estate taxes on lot 29 in square 118 in the amount of \$392,910.54 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.

4. ORDERED, that Respondent be and hereby is, directed to reduce the assessment on lot 29 in square 118 for purposes of District of Columbia real estate taxes for Tax Year 1992 from \$61,372,000 to \$42,130,000 consisting of \$28,200,000 for the land and \$13,930,000 for the improvements.

5. ORDERED, that the Respondent be and hereby is, directed to refund to Petitioner Tax Year 1992 real estate taxes on lot 29 in square 118 in the amount of \$413,703.00 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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