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SUPERIOR COURT OF THE DISTRICT OF COLUMBIA
TAX DIVISION

UNION INVESTMENT REAL ESTATE GMBH, Petitioner, v. DISTRICT OF COLUMBIA, Respondent.	)	Docket No. 2010 CVT 10219

ORDER

This matter came before the Court for trial over the course of some 10 days, themselves spread over almost two years between November 2012 and October 2014.[1] The trial was on the appeal of petitioner Union Investment Real Estate GmbH ("Union Investment") from the Tax Year 2010 assessment of an office building located at 600 13th Street, NW, and identified as Lot 847 in Square 253. Respondent District of Columbia assessed the property for $154,230,350. The District's assessor for this property had retired by the time of trial. Thomas Stevens, another assessor working for the Office of Tax and Revenue, testified to explain his understanding of what the original assessor concluded. Mr. Stevens was also qualified by the Court to testify for the District as its expert for a counterclaim, for which Mr. Stevens calculated the property's value to be $159,995,600. Union Investment's trial expert, Richard Harps, valued the property at $122,000,000.

For the reasons stated below, the Court agrees fully with Union Investment that the District's assessment is incorrect. The Court also agrees that Mr. Harp's valuation is accurate and

[1] The trial lasted longer than the parties originally predicted, after which an array of scheduling conflicts and delays resulted in this attenuated schedule.

persuasive. Accordingly, the Court concludes that the estimated market value of the property as of January 1, 2009, should be reduced to $122,000,000 for tax valuation purposes.

Standard of Review and Burden of Proof

This Court's review of real property tax assessments is de novo. *Wyner v. District of Columbia,* 411 A.2d 59, 60 (D.C. 1980). Petitioner bears the burden of proving that the assessment is "incorrect or illegal, not merely that alternative methods exist giving a different result." *Safeway v. District of Columbia*, 525 A.2d 207, 211 (D.C. 1987). A taxpayer may do this by showing that the District's choice or implementation of methodology is "irrational or unfounded," *id*., or that there is "a defect in the methodology." *YWCA v. District of Columbia*, 731 A.2d 849, 850 (D.C. 1999). Showing merely that there is a different way of doing it, with a different outcome, is no enough. As the Court of Appeals has recognized, "there are various ways for determining an accurate estimate of fair market value," *District of Columbia v. Rose Assoc.*, 697 A.2d 1236, 1238 (D.C. 1997); "the government therefore is given sizable discretion in 'choosing the method or approach for an assessor to use in estimating the market value of a particular property.'" *YWCA v. District of Columbia*, 731 A.2d at 851 (quoting *Wolf v. District of Columbia*, 597 A.2d 1303, 1308 (D.C. 1991)). A further implication of this is that a taxpayer's burden is not met simply by proving that the methodology advocated by its own expert is itself a sound alternative. Nevertheless, the taxpayer may prevail by showing that the District's methodology is <u>not</u> sound, *YWCA v. District of Columbia*, 731 A.2d at 851 (citing cases), or that its own expert's methodology is superior to – that is, more accurate than – the District's. *Id*. at 852.

Though the taxpayer bears the burden of proof, it is "not required to establish the correct value of [the] property." *Brisker*, 510 A.2d at 1039. Once the taxpayer has met its burden, "[t]he Court may affirm, cancel, reduce, or increase the assessment." D.C. Code §47-3303 (2010).

Facts

The property at issue here is an eleven-story "Class A" office building on 13th Street, NW, between F and G Streets. It was constructed in 1997. As of the valuation date of January 1, 2009, the principal tenant was the law firm McDermott Will & Emory (MW&E), occupying approximately 90% of the leasable office space. MW&E's several leases expired in late 2012, less than four years after the valuation date. They were renewable, at the tenant's option, at the prevailing market rent.

As noted, Mr. Stevens testified for the District regarding the Tax Year 2010 valuation, since the actual assessor had retired. According to his testimony, the property was valued using what is called the income capitalization approach, which is the most common method for similar large commercial office buildings. For such properties, OTR uses certain pre-set formulas, which are built into an Excel worksheet designed for this purpose. For the Tax Year 2010 assessment cycle, the assessor of record would first assign the existing leases on a property to one of two groups: those that expired more than three years from the date of value (long-term leases), and those that expired within three years of the date of value (short-term leases). For the long-term leases, the assessor used the actual contract rents in place, derived from reported rental data from two calendar years before the date of value. The assessor would then project those rents forward one year, resulting in a stabilized potential gross income for the calendar year immediately preceding the valuation date. For short-term leases (expiring within three years), however, the assessor would impute a market rent to the applicable space. Mr. Stevens testified that this decision to divide leases based on a three year window reflected an OTR policy decision, that no market evidence exists to support this three year window, and that he did not know why this time horizon had been selected by OTR.

As to the subject property, Mr. Stevens testified that because the leases at the property expired more than three years after the valuation date, the assessor took the actual contract rents from the calendar year 2007 Annual Leasing Report, and projected them forward one year to calendar year 2008. This produced a potential gross income of $13,868,738. The assessor then applied a standard vacancy rate of 6%, which the parties stipulated was the appropriate vacancy rate for this property for Tax Year 2010. After providing for additional items of income for parking and storage, and accounting for an expense allowance, the assessor calculated a net operating income ("NOI") of $10,570,424.

To arrive at his final indicated value of $154,230,346, the assessor then applied a loaded capitalization rate (that is, a rate that factors in real estate taxes) of 6.80% to the derived NOI of $10,570,424, and made small adjustments for lease-up costs related to a non-MW&E lease and upcoming capital expenditures. The assessor selected his capitalization rate from among the four standard OTR rates determined by the class of the building (Trophy, Class-A, Class-B, Class-C). Although the subject property is a Class-A building, the assessor appears to have used a Class B rate. There was no explanation in the record, or provided by Mr. Stevens, for this decision. In keeping with OTR's three-year window on lease expirations, the assessor made no adjustments to his indicated value to account for any future costs or risks associated with the upcoming MW&E lease expirations, such as tenant improvements, leasing commissions, or rent loss.

Discussion

As the petitioner persuasively argued at trial, OTR's valuation of this property suffered from at least two fundamental errors that, together, rendered its assessment defective and incorrect. The first error is that OTR's valuation failed to take account of the unique and dramatic damage to the economy and the market caused by the collapse of Lehman Brothers in September 2008 – shortly before the January 1, 2009, valuation date – and the financial crisis that followed. Petitioner accurately describes this as a "one-in-a-generation shock to the financial markets." – one that cannot be ignored by pre-set valuation formulae. In commercial real estate markets, according to the Petitioner's evidence, this crisis translated primarily into sharp increases in capitalization rates throughout the country, including in the District of Columbia. Two independent experts called by the petitioner, Gregory Leisch and Richard Harps, both testified that the value of large commercial office buildings in the District of Columbia fell sharply in the wake of the Lehman collapse, causing an equally sharp rise in the appropriate capitalization rates to be used to value them. The conclusions to be drawn from this testimony is that any analytical methodology that failed to account for this distinctive market condition is, inherently, irrational and defective.

The evidence was plain, however, that OTR's analysis took no rational account of this event. Mr. Stevens resisted acknowledging these conclusions at trial, but was unpersuasive in doing so. He referred to September 2008 and its aftermath as "a blip in the economy," although he did admit that sales in the relevant market slowed significantly. Through its witness Doug Collica, OTR did acknowledge that its annual tax rate study, found in its Tax Year 2010 "Pertinent Data Book," yielded counter-intuitive capitalization rates. But its seat-of-the-pants solution to this was not to turn to other outside resources to attempt to derive a capitalization rate that was rationally related to actual data, but instead simply to add 30 basis points to its previous year's rates. No OTR witness could say why 30 basis points was selected, and even Mr. Stevens admitted that there was no methodological basis for deriving a capitalization rate in this way.

A capitalization rate must be derived by a "generally accepted method." *District of Columbia v. Rose Associates*, 697 A.2d 1236, 1238 (D.C. 1997). The capitalization rated used by OTR to value this property does not meet that test, and cannot be accepted. The petitioner's evidence established that the 6.8% rate used in OTR's analysis was essentially random, unmoored to any recognized methodology, and was demonstrably too low, resulting in a significant over-assessment of this property.

OTR's second basic error was its inflexible and arbitrary use of a three-year cutoff to separate what it considered long-term leases from those it classified as short-term. Proper valuation methodology counsels that the principle of "anticipation" is fundamental to the income capitalization methodology. Accepted valuation methodology requires that when utilizing the income capitalization approach one must "analyze[] a property's capacity to generate future benefits and capitalize[] the income into an indication of present value." *The Appraisal of Real Estate*, 445 (13^{th} Ed. 2008). This principle is also reflected in the D.C. Municipal Regulations, *See* 9 D.C.M.R. §307.5 (a), and has been adopted as the appropriate approach for D.C. assessments by the D.C. Court of Appeals. The Court of Appeals has noted that when using the income approach "[a] 'stabilized annual net income' figure must reflect an appraiser's estimation of a property's yearly 'income earning potential' because the income approach is based on the 'fundamental notion that the market value of income-producing property reflects the present worth of a future income stream.'" *Wolf v. District of Columbia,* 611 A.2d 44 (D.C. 1992)(*Wolf II*)(quoting *District of Columbia v. Washington Sheraton Corp.,* 499 A.2d 109, 115 (D.C. 1985)).

see BLT Burger DC, LLC v. Norvin 1301 CT, LLC, 86 A.3d 1139, 1151 (D.C. 2014)("[O]ur case law, based on standard real estate appraisal literature, indicates that under the income method of valuation, an appraiser should rely *not* on a property's current income but, rather, on an imputed income, which this court has characterized as 'stabilized annual net income' derived by reference to income and expenses over a period of several years.")(internal citations omitted). In other words, it is the future earnings that are relevant – not the current earnings. In *Washington Sheraton,* the Court of Appeals specifically stated that "[e]stimated market value is not determine … by reference to 'income available to the property as of the assessment' but by reference to 'income earning potential.'" *Washington Sheraton Corp.,* 499 A.2d at 115 (internal citations omitted).

In this matter, the difficulty is that OTR's inflexible reliance on its three-year window rule means that it used existing (but soon to expire) above-market leases instead of imputing significantly lower actual market rents. The uncontroverted conclusion reached by both Mr. Harps, OTR, and Mr. Stevens was that the revenue generated by the property would likely fall precipitously – by as much as 20% - when the leases to the building's primary tenant, McDermott Will & Emory, expired in under four years from the date of value. Moreover, both Mr. Harps and Mr. Stevens testified that an investor would consider and reflect in his analysis this projected decrease in revenue. Nevertheless, the Tax Year 2010 assessment of the property failed to reflect the property's "income earning potential." Instead OTR simply relied upon the income currently available to the property, thereby capitalizing the existing above-market contract rents into perpetuity. This is the exact approach that was rejected by the Court of Appeals in *BLT Burger, Wolf I*, and *Washington Sheraton*.

Mr. Harps' valuation, in contrast to the District's, took a real-world investor's perspective, declined to rely on the existing contract rents, and instead imputed market rent to the expiring leases and this added back the excess above-market rent that the property would collect in the interim. Mr. Harps' approach accurately reflects the property's "income earning potential." OTR's exclusive reliance on the "income currently available to the property" has resulted in the property being significantly over-assessed for Tax Year 2010.

The Court concludes, for these reasons, that petitioner Union Investment has satisfied its burden of proof and has proved that OTR's valuation of this property for Tax Year 2010 was materially defective, resulting in a value that is irrationally derived and incorrect.

The Court now must weigh the evidence to determine a correct market value. The Court concludes that it should accept the valuation offered by petitioner's expert Richard Harps. Mr. Harps' impressive credentials and qualifications were detailed at trial. Most importantly, of course, his appraisal report is the only one that purports to reflect, in a rational and systematic way, the substantial financial disruptions that beset the market in the fourth quarter of 2008 and thereafter. His valuation also is the only one to reflect accurately the key principle of "anticipation," discussed above, which requires valuing a property's income earning potential (as an actual market participant would do) rather than its existing current income. In contrast, OTR's assessment (as explicated by Mr. Stevens), as well as Mr. Stevens' own report offered to support the District's counterclaim, do not sufficiently consider and weigh the 2008 market upheavals or the income earning potential of the property. Mr. Stevens' testimony, in short, whether offered in defense of OTR's assessment or as his own supposedly independent valuation, provides no persuasive counterweight to the testimony and the opinions of Mr. Harps. For the same reasons, the District has failed to carry its burden of proof as to its counterclaim.

Conclusion

Union Investment has met its burden of proof here to show fatal errors in OTR's assessment of this property, and has proven in addition that the current valuation of the property as of January 1, 2009, is $122,000,000.

9/27/16
Date

John M. Campbell
Associate Judge

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