SUPERIOR COURT OF THE DISTRICT OF COLUMBIA FILED

PROBATE DIVISION

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SUPERIOR ... DISTRICT ... OF THE ... TAX D... ...MBIA

SQUARE 118 ASSOCIATES, Petitioners,	)	
v.	)	Tax Docket Nos. 4084-88 4266-89
DISTRICT OF COLUMBIA, Respondent.	)	

FINDINGS OF FACT, CONCLUSIONS OF LAW, AND JUDGMENT

These cases come on for consolidated trial upon Petitioner's appeals from assessments for real property taxes for tax years 1988 and 1989. The parties filed Stipulations pursuant to Super. Ct. Tax R. 11(b). Upon consideration of the stipulations, the evidence adduced at trial, and having resolved all questions of credibility, the Court makes the following:

FINDINGS OF FACT

1. The subject property is owned by Square 118 Associates (Square 118). Petitioner is obligated to pay all real estate taxes assessed against the subject property.

2. The subject property is located at 1919 Pennsylvania Avenue, N.W,, Square 118, Lot 29, in the District of Columbia. It consists of an 8-story high-rise office building built in 1979 with first and mezzanine level retail space. The building is located on the north side of Pennsylvania Avenue between 19th Street on the east, 20th Street on the west, and Eye Street on the north. The building has three levels of underground parking. It has 247,575

square feet of net rentable area (207,846 for office space and 39,729 for retail). There is also a Pepco substation which comprises 20,647 square feet.

3. The assessment for tax year 1988 as of January 1, 1987 was $41,103,000. The assessment for tax year 1989 as of January 1, 1988 was $54,771,000. Petitioner timely appealed both assessments to the Board of Equalization and Review (BER). The BER sustained both assessments.

4. Petitioner paid the tax year 1988 taxes of $834,390.90 and 1989 taxes in the amount of $1,111,851.30 in full.

5. Petitioner filed petitions seeking a reduction in the assessments and refunds of excess taxes paid. In its Petition, Petitioner asserted that the fair market value of the property for tax year 1988 as of January, 1987 was $25,000,000. At trial, Petitioner amended its claim to $31,900,000, the value set by its expert appraiser. The Petitioner asserted in the tax year 1989 Petition that the fair market value as of Januaruy 1, 1988 was $31,400,000. Petitioner amended this claim at trial to $33,200,000.

6. Mr. Philip Appelbaum was the tax assessor for the subject property for both tax years 1988 and 1989. Mr. Appelbaum stated at trial that he used the mass appraisal approach, which encompasses the three statutory approaches to value to arrive at a value for the subject property. He testified that he primarily relied on the income approach. The comparable sales approach was used only as a check.

7. Employing the income approach to value, Mr. Appelbaum looked at the owners' income and expense history, but he did not rely on it. Mr. Appelbaum determined the potential net operating income of the property by conducting an economic income expense study of buildings built in the 1970's. He collected data concerning new leases signed in properties in the same age group. However, he did not know which specific properties he used. He then averaged the income and expense figures and applied them to the subject property. Mr. Appelbaum stated that he did not make any adjustments for the taxpayer's actual income, actual expenses, or actual vacancies in its real property in this case. No reasonable basis was offered for this by the witness. The stabilized net income for tax year 1988 used by this witness in his calculation, $4,780,287, was substantially in excess of the actual income experienced by the taxpayer-owner. The 1986 net income was shown at $3,787,835. For tax year 1989, Mr. Appelbaum used a stabilized net operating income of $5,493,510. The actual 1987 income was $3,999,601. The projections of the assessor regarding income are not supported by the evidence and are unreasonable. It is unreasonable to conclude that a reasonably informed buyer would base his decision to purchase the property on these estimates. The Court finds that the assessor's stabilized projected income appears to be overstated.

8. For tax year 1988, the assessor then applied an overall capitalization rate of .1163. Mr. Appelbaum testified that he calculated this rate from sales of office buildings in the general

vicinity of the subject property. He derived an economic net operating income for each property. Then he divided the income by its sale price to yield the capitalization rate. Mr. Appelbaum testified that he developed different capitalization rates to be applied to properties grouped by their age. For taxyear 1989, Mr. Appelbaum used a capitalization rate of .1003. The witness was instructed to use this capitalization rate by the Department of Finance's Chief of Standards and Review. The exact basis for this capitalization rate was not known by Mr. Appelbaum.

9. The values and procedures used by the assessor were flawed which resulted in an erroneous assessment.

10. Both sides offered expert testimony. Ms. Michelle Saad appraised the subject property for Petitioner. Ms. Saad has the M.A.I. designation (member of the Appraisal Institute). At trial, this court qualified her as an expert witness.

11. Respondent called Ms. Shinn C. Back as its appraiser who was offered and accepted as an expert witness. Ms. Back has also been designated a member of the Appraisal Institute.

12. Both appraisers considered and rejected for use in the appraisal of the subject property the cost approach. It is useful for new or nearly new improvements. The indication of value is derived by deducting from total production cost the amount of depreciation from all sources.

13. Each appraiser arrived at the land value by considering comparable sales and adjusting for dissimilarities with the subject. Ms. Saad valued the land at $25,700,000 for tax year 1988

and $29,500,000 for tax year 1989. For the same years, Ms. Back valued the land at $30,800,000 and $33,000,000, respectively.

14. In estimating the value of the whole property, both appraisers relied on the income approach. Ms. Back also utilized the comparable sales approach. Ms. Saad used the sales approach to check her valuation by the income approach. To arrive at an indication of value by the income approach, Ms. Saad examined the income and expense history for the property for the five year period, between 1983 and 1987. She reviewed the rent rolls and leasing history for the building. She testified that historical data provided the best evidence of what a property is able to achieve. She also testified that she based her stabilized income on the actual rents received by petition for the property which was 100% occupied. Approximately 92% of the leases were not due to expire until 1989. This resulted in a total potential gross income of $4,977,546 for tax year 1988. From this figure, she subtracted a minimal stabilized vacancy and credit loss factor of 2.5% to arrive at an effective gross income was $5,261,747 and her effective gross income was $5,130,203.

15. In making her appraisal based on the income approach, Ms. Back testified that she examined seven of the approximately thirty-five leases at the subject property. As a result of this review of the leases, Ms. Back testified that she revised her report. However, there were two revisions to her original report. In her original report, Ms. Back had included real estate tax pass-thru

income. She testified that this income was included erroneously in her original report and should have been excluded. In her revised report she excluded approximately $480,000 in real estate pass-thrus in tax year 1988 and $550,000 in tax year 1989. The second revision was Ms. Back's inclusion of additional CPI pass-thru income. She testified that, based upon her review of seven of the leases and the market, the property owner should have collected approximately $500,000 more than it collected. She added that there was a significant upside potential since most of the leases were expiring in 1989. Ms. Back added approximately $500,000 in CPI income in tax year 1988 and approximately $550,000 in tax year 1989.

16. Ms. Back's revised estimate of total potential gross income was $5,417,684 for tax year 1988. She deducted a vacancy factor of .3% to arrive at her effective gross income of $5,397,684. In the second year, Ms. Back's revised potential gross income was $5,777,170 and her effective gross income was $5,757,170.

17. After subtracting estimated expenses, the experts arrived at the net operating income of the subject property. Ms. Saad determined the net operating income to be $3,518,531 for tax year 1988 and $3,662,973 for tax year 1989. Ms. Back's revised net operating income was $4,106,163 for tax year 1988 and $4,305,738 for tax year 1989.

18. Petitioner called Joanne Gould as a rebuttal witness. Ms. Gould is an accounting supervisor at Quadrangle Development

responsible for the accounting records of the subject property. She testified that not all the leases that were in effect in 1987 contained CPI clauses. She added that those tenants whose leases called for CPI pass-thrus paid that addition to rent to the property owner. Ms. Gould also testified most of the tenants renewed their leases in 1989. The lease renewals produced only a slight increase in income to the property.

19. Based on their appraisal reports, it appears that both experts considered both existing leases and market conditions in determining the net operating income of the property. However, Ms. Back's second revision to include additional CPI pass-thrus was not well supported by evidence from either the existing leases or market conditions. This results in Ms. Saad's valuation being supported by more credible evidence. Accordingly, the Court adopts Ms. Saad's determinations of net operating income.

20. To determine the capitalization rate for the subject property, Ms. Saad examined various rates derived from the market. She considered bank rates and bond yield rates. The comparative risk and lack of liquidity of a real estate investment suggests the requirement of the higher yield rates of Corporate Baa bonds at approximately 11% and A bonds 10.4% as opposed to treasury bonds at approximately 8.8%. She examined the American Council of Life Insurance tables and the Washington D.C. office building market. She used two methods to derive her rate. The traditional Band of Investment Method resulted in a range of 9.5% to 10%. Under this method, the appraiser develops a weighted component of the mortgage

and equity to develop the debt service, equity dividend rates and points paid in the mortgage process. Ms. Saad also used the Yield Capitalization Method in which indicated a rate of 9%. She used a yield of 12% and an annualized increase in income and value of 3%. Ms. Saad ultimately chose 9% as being at the lower end of the range. After deriving the overall rate, the appraiser adjusted for the tax factor by 2.03% to arrive at an overall rate of 11.03% for both years.

21. Ms. Saad applied her capitalization rate of .1103 to a stabilized net operating income of $3,518,531 to reach the sum of $31,900,000 (rounded) in the first year. For the second year, as of January 1, 1988, her conclusion was $33,200,000.

22. Ms. Back testified that her capitalization rate was derived from market data. She examined various rates in the market place. She derived capitalization rates from comparable sales. She testified that the rates from sales ranged from 5.9% to 7.6%. While most of the sales required some adjustment for location, condition, date of sale, etc., Ms. Back made no adjustments to the capitalization rates derived from her comparable sales. She added that the subject property had below market leases so that there was a significant upside potential. As a result, she testified that, her cap rate is lower to reflect that potential. He conclusions indicated capitalization rate of 7.5% for each year for the real estate. Her rate of 7.5% plus taxes to yield 9.5%, compares to Ms. Saad's 11.03%. Ms. Back applied her capitalization rate of 9.5% to her stabilized net operating income of $4,106,163 to yield

$43,100,000 rounded, for January 1, 1987. Her conclusions for the second year was $45,200,000.

23. Ms. Saad's capitalization rate is strongly supported by the evidence as so many factors were considered. Also, it should be noted that Ms. Saad's capitalization rate is very close to the rate used by Mr. Appelbaum is tax years 1988. Accordingly, the Court adopts Ms. Saad's conclusion of the appropriate capitalization rate.

24. Both appraisers also made valuations based upon comparable sales. Ms. Saad testified however, that there was insufficient data concerning each sale to use them as the basis for the primary valuation. She testified that she typically find wide variance without any explanation. Her values derived from comparable sales were $35,000,000 for tax years 1988 and $36,800,000 for tax year 1989.

25. Ms. Back also made an appraisal based on comparable sales. While she examined several of the same sales that Ms. Saad used, she concluded that the properties were, overall, inferior to the subject. Thus, in the first year, she adjusted most of her comparables up to an average of $185.00 per square foot of net rentable area. Ms. Saad adjusted her comparables down to $150.00 per square foot. Ms. Back's conclusions of value from sales were $44,900,000 for tax year 1988 and $48,500,000 for tax year 1989.

26. Cash flow analyses of the property using Ms. Back's own net operating incomes indicated that her values of $43,100,000 and $45,200,000 were not the fair market values of the property. At

trial, Ms. Back applied her figures to the subject property. The result was a negative cash flow after debt service. It is not likely that a prospective purchaser would buy the property when market rents yield a negative cash flow after debt service. This is very strong evidence that Ms. Back's valuation does not reflect market value.

Conclusions of Law

This Court has jurisdiction over this appeal pursuant to D.C. Code § 47-825 and 47-3303 (1990 Repl.). The Superior Court's review of a tax assessment is de novo. In appealing from assessments of real property for tax purposes, the taxpayer has the burden of proving that the assessment was incorrect or flawed. Brisker v. District of Columbia, 510 A.2d 1037, 1039 (D.C. 1986). The petitioner is not required to establish the correct value of their property. Id.

Petitioner has met the burden of proving the incorrectness of the assessment made by the District that it was erroneous and flawed in a number of respects. To the extent that the respondent employed the income approach to value, the projection of income utilized in the calculation was not based on actual experience or reasonable projections in light of specific factors relating to the subject property. The income approach to value requires a determination of a stabilized annual net income by reference to the income and expenses for the property over a period of years. District of Columbia v. Washington Sheraton Corp., 499 A.2d 109, 115 (D.C. 1985); Rock Creek Plaza-Woodner, Ltd. v. District of

Columbia, 466 A.2d 857, 858 (1983). The assessor for this property admitted that he gave little consideration to the actual income, expenses, current leases or lease-up costs of the property to achieve market rents today and in the future. Without appropriate consideration of these factors, utilizing the average net operating income of buildings in a particular category is an arbitrary and impractical method for determining a property's net operating income.

In District of Columbia v. Washington Sheraton Corp., 499 A.2d 109, 115 (D.C. 1985), the Court stated "[w]hen an income-producing property has been in operation for a period of time, its past earnings assist the assessor in projecting future earnings ability." The Court also stated that the market value of an income-producing property includes the present value of the property's future income. Washington Sheraton Corp., supra, 499 A.2d 115. Therefore, to arrive at a reliable estimate for the net operating income of the property, the District must accord appropriate consideration to not only market conditions, but to the actual experience of the property as well.

Once a stabilized annual income is determined, it must be divided by a capitalization rate in order to determine an indication of value. Rock Creek Plaza-Woodner, Ltd. v. District of Columbia, 466 A.2d at 858. The capitalization rate represents the amount that must be earned annually in order to pay the mortgage, expenses and a fair return on equity and the property taxes. Id. The capitalization rate used by the assessor for tax year 1988 was devised from sales. At 11.63, it was very similar to Ms. Saad's rate of 11.03. In fact, as a higher rate than Ms. Saad's, all other factors being equal, it would yield a lower value.

The capitalization rate used by the assessor for tax year 1989 was provided him by other members in his department. Its exact basis was not known by the assessor. There is no showing that it was derived from financial and economic information available in the market place. In any event, when the figure derived by the assessor was tested, it tended to produce a negative cash flow. The improper projection of the stabilized income and the use of a capitalization rate of unknown derivation make the estimate for this tax year by the assessor unreliable. All of the foregoing factors demonstrate that petitioner has met its burden of showing that the assessment for the tax years in question were erroneous and flawed.

In this case, the petitioner has shown not only that the assessments made by respondent were flawed and erroneous, but have shown by competent evidence the market value of their property. There is no basis to disbelieve the petitioner's expert testimony in this case, the petitioner has shown not only that the assessments made by respondent were flawed and erroneous, but have shown by competent evidence the market value of their property. There is no basis to disbelieve the petitioner's expert testimony in this case. Therefore, it will be accepted. See: Rock Creek Plaza-Woodner, Ltd. v. District of Columbia, 466 A.2d 857, 859 (D.C. 1983). For reasons already stated in the findings of fact, the court rejects the property valuation proposed by Ms. Back. Both appraisers valued the subject property for the tax years using the income approach to value. District of Columbia v. Washington Sheraton Corp., 499 A.2d 109, 113 (D.C. 1985). This approach takes into account the various factors mandated by D.C. Code § 47-820(a) (1981). In appraising the property, Ms. Saad was concerned with the actual estimated value. Real property taxes are required to be based upon the estimated value of the property as of January 1, of the year preceding the tax year. Estimated market value is defined in D.C. Code § 47-802 (4) (1981). Ms. Saad considered the full value of this property consistent with the statutory definition.

As required by the law of the District of Columbia, both witnesses considered and rejected the cost approach to value. While the building was of recent vintage, it had sufficient income history to allow for meaningful projections of value by the expert. Although all three approaches to value must be considered, one may be relied upon, provided the others have been considered and there is a reasonable basis for selecting one over the others. Wolf v. District of Columbia, No. 91-TX-166, slip op. at 7 (D.C. June 5, 1992) (Wolf II), Safeway Stores, Inc. v. District of Columbia, 525 A.2d 207, 209 (D.C. 1987). The reasons given for the selection of the income method of valuation over the comparable sales method by the witness are persuasive. The income approach to value is the prime approach to value for investment properties, including office buildings. Wolf II, slip op. at 7-8.

The Court must weigh all the evidence to determine which property value is most credible. For the reasons already stated in the findings of fact, the Court rejects the valuation proposed by Ms. Back and accepts the valuation proposed by Ms. Saad. Ms. Saad's capitalization rate reflected "the rate the taxpayer must recover annually to pay the mortgage, to obtain return on equity, and to pay real estate taxes". Wolf II, slip op. at 11. See also, 1111 19th Street Associates v. District of Columbia, Tax Docket No. 4082-88, Sullivan, J., Feb. 21, 1992. Ms. Back however, relied on rates derive from comparable sales that were not adjusted properly. The methodology and rationale of the petitioner's expert appear to be the most reasonable.

For tax year 1988, as of January 1, 1987, Mr. Saad's total value was $31,900,000 with $6,200,000 allocated to the improvements and $25,700,000 allocated to the land. For tax year 1989, the total valuation as of the valuation date of January 1, 1988 was $33,200,000 with $3,700,000 allocated to the improvement and $29,500,000 allocated to the land.

Accordingly, it is by the Court this 24th day of **August, 1993,**

ORDERED, ADJUDGED AND DECREED as follows:

1. That the estimated market value of this subject property for tax year 1988 was $31,900,000 of which $25,700,000 is attributed to the land component and $6,200,000 to the improvement.

2. That the estimated market value of this subject property was $33,200,000 for tax yea 1989, of which $29,500,000 is attributed to the land component and $3,700,000 to the improvement.

3. That the assessment record and card for the property maintained by the District of Columbia shall be adjusted to reflect the above values determined by the Court in this Order.

4. That the respondent shall refund to petitioner any excess taxes collected for tax years 1988 and 1989 resulting from assessed values used as the basis for such taxes which exceed those determined by this Order.

5. That the entry of decision shall be withheld pending submission of a proposed order under the provisions of Super. Ct. Tax R. 15.

SO ORDERED.

E. N. Hamilton

Eugene N. Hamilton
Judge

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