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SUPERIOR COURT OF THE DISTRICT OF COLUMBIA

TAX DIVISION

1301 E STREET ASSOCIATES et al	:	
Petitioners	:	Tax Docket Nos. 5286-92
	:	5780-93
v.	:	
DISTRICT OF COLUMBIA	:	
Respondent	:	

MEMORANDUM OPINION AND ORDER

The instant litigation culminated in a trial de novo concerning the real property tax assessment of an office building known as 1301 E Street, N.W. in the District of Columbia. A key feature of the analysis of this assessment is the role of major leases and their effect upon the fair market value of the property as a whole. Petitioners, the fee simple owners of real property located at 1301 E Street, N.W., Lot 835 in Square 254 (hereinafter the "subject property"), challenged the real property tax assessment for tax years 1992 and 1993 pursuant to 47 D.C. § 820 (1981). 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, and the resolution of all questions of credibility, the Court makes the following findings of fact and conclusions of law.

FINDINGS OF FACT

1. Lot 835 in Square 254 has a land area of 27,410 square feet. Its improvements are a mixed-use commercial structure of twelve stories plus two below ground levels containing office, retail, parking and storage facilities. The net rentable area is approximately 220,000 square feet of which some 205,507 square feet is appropriate for office use. There are 14,584 square feet of leasable retail space, 2626 square feet of storage space and 68,347 square feet of parking area. The subject site is currently zoned DD/C-5 PAD and is developed to a 9.2 FAR.

2. For tax year 1992, the District's assessment was $54,265,000. Petitioners timely filed a complaint with the Board of Equalization and Review (hereinafter "BER"). After a hearing, the BER reduced the assessment to $43,535,871.

3. Petitioners timely paid the real estate taxes and timely filed the petition for a reduction of the assessment and refund of excess taxes paid for tax year 1992. In its amended petition, petitioners asserted that the fair market value of the property for tax year 1992 was no more than $33,640,000. At trial, petitioners further amended the claim to a $30,830,000 valuation, which reflects the fair market value set by its expert appraiser.

4. For tax year 1993, the District's assessment was $45,147,000. Petitioners timely filed a complaint with the BER. After a hearing, the BER

sustained the original assessment.

5. Petitioners timely paid the real estate taxes and timely filed the petition for a reduction of the assessment and refund of excess taxes paid for tax year 1993. In their amended petition, petitioners asserted that the fair market value of the property for tax year 1993 was no more than $31,100,000. At trial, petitioners adjusted their claim to $33,420,000, which reflects the appraisal figure set by petitioners' expert.

6. The real estate tax assessments on the subject property have been in constant appeal and litigation since tax year 1987. As a matter of historical background, the tax assessments of the subject property have been reduced repeatedly by the BER and as a result of litigation in the Tax Division of the Superior Court.

Assessment History

	TY87	TY88	TY89	TY90	TY91
Land	18,912,900	18,912,900	30,151,000	30,151,000	30,151,000
Improvements	17,514,100	24,365,100	13,127,000	19,290,000	21,862,000
Total	36,427,000	43,278,000	43,278,000	49,441,000	52,013,000
BER	29,582,608	30,667,108	36,991,984	39,256,531	45,724,223
Court	29,582,608	30,667,108	33,734,000	32,632,424	32,555,026
	(no suit filed)	(settlement)	(settlement)	(judgment)	(judgment)

7. The tax assessor for tax years 1992 and 1993 was Larry Hovermale. Mr. Hovermale is a commercial assessor with the Department of Finance and Revenue of the District of Columbia.

8. Mr. Hovermale was called as a witness by the petitioners. For tax years 1992 and 1993, he used the mass appraisal technique and ultimately applied the income approach to value in assessing the property. The "income approach" is also sometimes called the "capitalization of income approach." It is one of three primary methodologies for the valuation of commercial real estate. Factually, there is no doubt as to what this analysis requires.

> 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. Partnership v. District of Columbia, 466 A.2d 857, 858 (D.C. 1983).

Based on Mr. Hovermale's opinion that the reported income for the subject property was substantially below current market rates, he testified that the potential net operating income of the property was $4,612,567 for 1991 and $4,288,924 for 1992. In contrast, the reported (i.e. actual) net operating income of the property was $3,797,933, $3,524,332, and $3,737,317 for calendar years 1989, 1990, and 1991 respectively. The term "reported income" denotes rent roll

information and so-called "income and expense" forms that were submitted by the taxpayer to the Department of Finance and Revenue. Mr. Hovermale testified that he reviewed the income and expense figures as reported by Petitioners to the District; but he gave them no weight. The assessor instead created his own estimate of income and subtracted his own estimate of expenses to arrive at his estimates of potential net operating income.

He then divided his net operating income figures by a capitalization rate of 8.50% in tax year 1992 and 9.50% in tax year 1993. Mr. Hovermale stated that these were the proper capitalization rates for buildings in the same age category as the subject property. Based on these figures, Mr. Hovermale calculated the fair market value of the property to be $54,265,000 for tax year 1992 and $45,147,000 for tax year 1993.

With regard to the Government's capitalization rate, both rates that were used were selected from a range of rates that were given to the assessor. The Standards and Review Division prepared and published a schedule calculating a capitalization rate using the mortgage equity band of investment technique (often called the Akerson format). This schedule included a substantial downward adjustment of the capitalization rate as a result of the assumption of a large appreciation in value.[1] The assessor indicated that the capitalization rate without the assumption of an appreciation in value was .1205 for tax year 1992 and .1251

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[1]Reducing the capitalization rate results in the increase of the property's appraised value.

for tax year 1993. A capitalization rate of .1205 instead of his rate of .085 resulted in a difference in assessment of approximately $15,986,930 too high a figure for the first year. For tax year 1993, the difference was $10,862,603.

There was no justification for applying such a large appreciation factor to the subject property. The assessor himself agreed that the capitalization rates were not high enough to insure the payment of real estate taxes, to pay the annual mortgage payment, and to provide a return on the cash investment because the rates produced negative cash flows in each of the two years. See further discussion, infra, in Conclusions of Law.

9. Mr. Hovermale admitted that he was aware that major large leases, or about 40% of the office space, had expired in 1990. However, he testified that he made no adjustments for lost rent, leasing commissions or tenant build-out. Instead, he used a 4% "typical" vacancy rate in his calculations.

10. The facts surrounding one particular lease demonstrated the assessor's overstatement of the property's income. Unquestionably, the building's most substantial tenant (space-wise) is the National League of Cities, which leases 91,180 square feet. This is approximately **45%** of the office space in the building. The lease runs for 30 years and does not expire until January 2011, plus a five-year renewal option at a predetermined rate. At trial, Mr. Hovermale admitted that in the first year he estimated $814,634 more in net income than was reported to the Department of Finance and Revenue by the taxpayer. This was due only to the

13. With regard to the land assessment, Mr. Hovermale testified that he reduced the land assessment 18% from tax year 1992 to tax year 1993 - or from $39,580,000 to $32,426,030. He also testified that he increased the land assessment from tax year 1991 to tax year 1992 by slightly more than **30%** - or from $30,151,000 to $39,580,040.

Mr. Hovermale explained that the reduction of 18% from tax year 1992 to tax year 1993 was directed by the Standards and Review Division of the Department of Finance and Revenue because it was "the opinion of the Department that land values were down". He agreed that the property is in the Downtown Development District but that he made no adjustment for this, as was required, in his assessment for tax year 1993.

The assessor was then asked to account for the over 30% **increase** in land assessment that he made from tax year 1991 to 1992. Other than a general reference to having "looked at current information," he could not provide any justification for such a large increase. He was asked if he had identified a significant number of comparable sales of vacant land in 1990 as a basis upon which to justify the increase. Mr. Hovermale's response was, "I don't know."

14. Mr. Philip Appelbaum was called as a witness by the petitioners. Mr. Appelbaum is a senior assessor in the Standards and Review Division of the assessor's office. He testified that his responsibilities included collecting and analyzing data on both land values and capitalization rates. Mr. Appelbaum testified

that he wrote and typed the District of Columbia Pertinent Data Books (used by assessors) for tax years 1992 and 1993.

15. An assessment must account for the value of land as well as buildings or other improvements. With regard to the land values, Mr. Appelbaum and his colleagues directed an across-the-board land reduction of 18% from tax year 1992 to tax year 1993. He testified that land values in the District of Columbia were increased significantly from tax year 1991 to 1992. However, he admitted that he observed a downward change in the market in the last half or quarter of 1990.

While there may have been some uncertainty as to whether land values should have been decreased in tax year 1992 as they were for 1993, neither Mr. Hovermale nor Mr. Appelbaum could provide any evidence to justify any increase -- much less a 30% increase – from tax year 1991 to tax year 1992.

16. Only petitioners offered expert testimony. Mr. Harry Horstman, an MAI, testified for the petitioners. The Court accepted Mr. Horstman as an expert witness. The record does not disclose why the District did not utilize an expert witness in this trial.

17. Mr. Horstman arrived at his land value by considering comparable sales and adjusting for dissimilarities with the subject property. Mr. Horstman testified that by January 1, 1991, the real estate market had "dried up", deals were falling apart and transactions had ceased. Mr. Horstman valued the land for tax year 1992 at $1,012.40 a foot or $27,750,000 and for tax year 1993 at

$996.80 a foot or $26,750,000. He testified that there was a significant drop in land values from 1991 to 1992. He also noted that the subject property is located within the Downtown Development District which has a **negative** impact on the land value. Mr. Horstman also testified that the District's assessed land values were "based on old historic data and is unreasonable, given the current market evidence".

18. The Court finds that the errors by the assessor caused a substantial over-assessment (even after partial reductions by the Board of Equalization and Review). Consequently, the Court concludes that both the assessor's tax year 1992 and tax year 1993 land assessments are in error. The Court accepts the value of the land to be Mr. Horstman's value of $27,750,000 for tax year 1992 and $26,750,000 for tax year 1993.

19. In calculating the value of the improved property, Mr. Horstman relied on the income approach. He rejected both the market and cost approaches. Mr. Horstman stated that the highest and best use of the property is as it is now developed (i.e. an office building).

20. In analyzing the property for his income approach, Mr. Horstman testified that when the property was being developed, the owner secured The National League of Cities lease. He testified that the lease term is for 30 years. Thus, the rent of The National League of Cities office space is fixed, with increases for pass-through expenses and the like, until at least the year 2011. Mr. Horstman testified that at the time that the lease was executed, this particular lease was

necessary to provide a stable income and permit the development of the project. The bank originally advanced funds to buy the land and build the building on the basis of this lease. Without this lease, the lender would not have loaned the funds to develop the building in the first place. Thus, the lease was for a sound business purpose. It is therefore improper to ignore the rent for this lease.

21. To calculate the net operating income of the property, Mr. Horstman first made a detailed examination of the property's operating history. He testified that the property had an average rent of $21.13 per square foot, including pass-throughs. Mr. Horstman noted that the property had been fully occupied over the period 1988 to 1990. Four major tenants, however, moved out at the end of 1990 and the vacancy rate in the property **skyrocketed to about 40% of the office space.**

22. In order to complete an appraisal using the income capitalization approach, it is necessary first to estimate "stabilized" income. Mr. Horstman estimated that it would take two years, until 1993, to achieve "stabilization." This technique, which Mr. Horstman testified he taught in various courses, is approved by the American Institute of Real Estate Appraisers and is used by its members when they are faced with valuation of a property that is experiencing a large vacancy on the valuation date.

23. For tax year 1992, Mr. Horstman estimated what the property would experience for the period between the valuation date, January 1, 1991, and

the stabilized date, January 1, 1993. After subtracting estimated expenses, Mr. Horstman arrived at the net operating income of the subject property. He determined the net operating income was projected to be $1,877,866 for 1991 and $3,316,085 for 1992. In his projections, Mr. Horstman projected that 50% of the vacancy would be absorbed each year during the following two years after the valuation date.

Since Mr. Horstman determined that the property would not have a stabilized operating income until 1993, he also projected a stabilized net operating income for 1993 at $4,122,300. See the table opposite page 42 of Pet. Ex. #1, Mr. Horstman's appraisal report for tax year 1992.

Mr. Horstman then subtracted from his estimate of 1991 income costs for tenant improvements and lease-up costs totaling $991,687 in order to arrive at a net cash flow of $886,179. He discounted this net cash flow back to the value date at a discount rate of 14.15%. This result was a net present value of $776,329.

Mr. Horstman next capitalized the 1993 net operating income of $4,122,000 at .1119 to reach a projected stabilized value as of January 1, 1993 of $36,839,142.

After capitalizing the 1993 income, Mr. Horstman added the 1992 income to that figure to yield $40,155,227. From this figure, he deducted costs for tenant improvements and lease-up totaling $991,687. The net cash flow for 1992 was $39,163,540. Applying the same discount factor of 14.15% yielded a net

present value of $30,055,926.

Finally, Mr. Horstman added the two net present values of $776,329 and $30,055,926 to arrive at his conclusion of value of $30,832,254 which he rounded to $30,830,000. The table facing page 46 Ex. 1, shows in detail each of these calculations.

24. In the case of tax year 1993, the property now had only one year to stabilize. Mr. Horstman estimated a 1993 net operating income ("NOI") of $4,296,100 and applied a capitalization rate of .1158 to achieve a stabilized value as of January 1, 1993 of $37,099,309. To this figure, he added his estimate of the net operating income for 1992 of $2,796,632 resulting in a total value of $39,895,941. From this figure he deducted $1,748,294 for the tenant improvements and lease-up costs. His net cash flow result was $38,147,647 which he discounted one year to reach a value as of January 1, 1992 of $33,418,876. He rounded this to $33,420,000. See table facing page 48 Pet. Ex. #2.

25. Mr. Horstman developed his capitalization rate using the mortgage equity band of investment technique. The band of investment technique is a traditional method of capitalization often used when sufficient market data is available. Under this technique, the appraiser develops a weighted component of the mortgage and equity components to develop the overall rate.

In applying the band of investment technique, Mr. Horstman considered typical loan to value ratios, debt service, equity dividend rates, and points

paid in the mortgage process. He made a study of the market including interest rates, yield rates, and surveys of rates conducted by the American Council of Life Insurance. In tax year 1992, Mr. Horstman applied factors based upon a 69.2% mortgage at 9.85% interest for 30 years. He estimated the equity dividend rate at 6.0% to arrive at his conclusion of .1119.

For the second year, tax year 1993, Mr. Horstman's capitalization rate was based upon a 71.4% mortgage at 9.88% interest for 30 years. He estimated the equity dividend rate at 6.0% to arrive at his conclusion of .1158.

Included in his analysis of the capitalization rates were four rate selection tests: a debt coverage ratio, Ellwood yield analysis (Akerson format), implied valuation change, and the District of Columbia adequate return test (cash flow analysis). Each of these tests confirmed his rate selections.

26. Mr. Horstman verified his result by performing a test. Mr. Horstman took the stabilized value as of January 1, 1993 of $36,839,142 and deducted the total tenant improvements and lease-up costs plus cost of capital from January 1, 1991 to January 1, 1993 to reach "as is" value on January 1, 1991 of $30,832,254, the same value by the previous method. Mr. Horstman performed the same test in the second year and arrived at $33,418,876.

27. The District cross-examined Mr. Horstman in great detail on two important parts of the assessment and appraisal process. One of them was the respondent's argument that by valuing the property based upon both the tenant's

interest and the landlord's interest, the assessor is valuing the entire property for taxation purposes. The argument assumes that any tenant who pays an actual rent that is below the market rent for its space thereby has a benefit that must be taxed to the building's owner. This theory or contention has been repudiated by the Superior Court at least twice prior to this trial. See Conclusions of Law, infra.

Mr. Horstman pointed out in detail that the District statute and the real estate market itself make it clear that the estimated fair market value of a property lies in what the seller can sell and what the buyer will buy.

For example, Government counsel inquired of Horstman whether the National League of Cities would realize a "value" from any market rate rents that the League was able to command from a subtenant. He asked, "Would that be fair to say?" Horstman replied,

> Which -- that would be fair to say and that i[t] belongs to the League of Cities and [it] that does not belong to the partnership that owns this building and they cannot go to the League of Cities and say give me this difference[,] because they negotiated those rights out when they signed this lease in order to get this building financed in 1978 and 1979. They don't have those rights.

Trial Transcript of December 22, 1994 at page 23. In other words, it is clear that the property owner cannot obtain for itself the income paid by any subtenant to the National League of Cities.

28. The Court finds that the two overall capitalization rates

developed by Mr. Horstman are credible and strongly supported by the evidence and the range of factors that he considered. The Court therefore adopts for tax year 1992 the capitalization rate of .1119 and for tax year 1993 the capitalization rate of .1158. The Court rejects the capitalization rates urged by the District of Columbia.

The assessor's assumption of a future rapid rise in appreciation is not justified by the evidence -- most particularly the undisputed evidence that the annual historic net operating income record is one of stability, rather than an increasing operating income. In addition, the cash flow analyses for each year show that the assessor's capitalization rate is too low to provide enough income to pay the taxes, to pay the annual mortgage expenses and to provide a fair return on the cash investment.

29. Accordingly, the Court having credited Mr. Horstman's testimony (unopposed by any other expert witness), finds that the market value and assessments for the two years as follows:

Tax year 1992	$30,830,000.
Tax year 1993	$33,420,000.

CONCLUSIONS OF LAW

This court has jurisdiction over this appeal pursuant to 47 D.C. §§ 825 and 3303 (1990 Repl.). The Superior Court's review of a tax assessment is de novo, therefore requiring competent evidence to prove the issues. Wyner v. District of

Columbia, 411 A.2d 59, 60 (D.C. 1980). Petitioners bear the burden of proving that the assessment appealed from is incorrect. Safeway Stores, Inc. v. District of Columbia, 525 A.2d 207, 211 (D.C. 1987).

There is sufficient competent evidence on the record for the Court to determine the fair market value of this property. When a taxpayer appeals an assessment to this Court, the Court can affirm, cancel, reduce or increase the assessment. 47 D.C. § 47-3303 (1990 Repl.).

The Court must weigh all the evidence to determine which property valuation is the most credible. For the reasons already stated in the findings of fact, the Court rejects the property valuations proposed by the District's assessor. The Court finds that petitioners' expert was more credible than respondent's assessor and that petitioners provided credible evidence as to the value of the subject property for tax years 1992 and 1993. Upon review of the testimony and documentation presented, the Court concludes that the analyses were properly performed by petitioners' expert, thereby producing a credible estimate of market value.

Real property taxes are based upon the estimated value of the subject property as of January 1st of the year preceding the tax years for annual assessments. 47 D.C. § 820 (1990 Repl.). "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. § 802(4) (1990 Repl.).

The District of Columbia Court of Appeals has generally recognized three approaches to value and it has been held that all three must be considered. District of Columbia v. Washington Sheraton Corp., 499 A.2d 109, 113 (D.C. 1985); Safeway Stores, Inc. v. District of Columbia, supra, 525 A.2d at 209; Rock Creek Plaza-Woodner, Ltd. Partnership v. District of Columbia, supra. These methods are known as the "income capitalization approach," the "cost approach," and the "comparable sales approach." The petitioners' expert and the District's assessor examined all three approaches and both of them rejected the cost approach and the sales comparison approach.

Of the three recognized approaches, the income capitalization approach is the preferred method for valuing income-producing properties. 1015 15th Street, N.W., Associates Limited Partnership v. District of Columbia, Tax Docket No. 3266-83 (Sup. Ct. November 13, 1984). To reiterate, under the income capitalization approach, the stabilized net operating income is divided by a capitalization rate reflecting the rate the taxpayer must recover annually to pay the mortgage, to obtain a fair return on equity, and to pay real estate taxes. Rock Creek Plaza-Woodner Ltd. Partnership v. District of Columbia, supra, Wolf v. District of

Columbia, 611 A.2d 44, 47 (D.C. 1992)(Wolf II).

The District of Columbia Court of Appeals has emphasized that "[w]hen an income-producing property has been in operation for a period of time, its past earnings assist the assessor in projecting future earning ability." District of Columbia v. Washington Sheraton Corp., supra, 499 A.2d at 115. Under these circumstances, there should be consideration of both the contract rents and market rents in a commercial property determining the fair market value of the property using the income capitalization method. Wolf v. District of Columbia, 597 A.2d 1303 (D.C. 1991)(Wolf I).

To be sure, as the appellate court warned in Wolf I, it is not proper to base a tax valuation merely upon a totalling of the income of the property during one year. "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. In the instant case, the actual facts surrounding the leases and the actual income are highly relevant. This data is essential to a solid understanding of the future income potential of this particular property.

The circumstances of the National League of Cities lease, for example, speaks loudly about the earning potential of this building on the valuation dates that are in issue in this litigation. The overall leasing situation and the figures on actual income are all part of a sophisticated mosaic that was illustrated in an accurate and

cogent manner by petitioners' expert witness.

In assessing this property for tax years 1992 and 1993, Mr. Hovermale used a net operating income based on his own estimate of income and expense figures. However, he admitted not giving any weight to the actual income, actual expenses, current leases, or lease-up costs of the subject property. These factors affect the ability of the property to achieve market rents today and in the future. Without consideration of these factors, 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. To boot, the assessor failed to take into account that the property's income was not "stabilized" as of the value dates.

The District of Columbia argues that, for real estate tax assessment purposes, the actual rent for the National League of Cities lease should be ignored because it is based upon "below market" rental rates. The District contends that the property should be assessed by the income-capitalization method using market rent rates **only** and that to do otherwise would be to allow the value of some of the leased office space to "escape taxation." This argument has been presented previously by the District and rejected by the Superior Court time after time. See 1301 E Street Associates v. District of Columbia, Tax Docket Nos. 4471-90 and 4972-91, (Hamilton, J. April 30, 1993).

In Chief Judge Hamilton's decision, the trial court concluded that "[t]he

reason for rejecting the higher net operating incomes selected by the DFR's assessor was the failure of the assessor to consider both existing leases and actual income as well as market conditions. A prospective informed buyer acting under no compulsion to purchase would consider both in estimating current and future income." Opinion at page 10.

This decision was later reaffirmed by an Order denying the District's Motion for Reconsideration on this very issue. No appeal was taken by the District. To that extent, the District of Columbia is bound by Judge Hamilton's decision and ought not continue to press a discredited theory -- particularly where the very same property is in litigation and where petitioner's expert witness is the same individual (Horstman).

The same ruling emerged in an earlier case, on the same issue of the critical importance of relying on both market data and actual income and expense information: 1111 19th Street Associates v. District of Columbia, Tax Docket No. 4082-88 (Sullivan, J., February 21, 1992). Finally, the District's position has been squarely rejected by the Supreme Court of one of our neighboring jurisdictions as well. See Clarke Associates v. County of Arlington, 369 S.E.2d 414, 416 (Va. 1988).

To be clear, this Court is satisfied that Horstman determined the value of the subject property in its entirety. Nothing that is taxable to the petitioners will "escape taxation" under his analysis. The law of the District of Columbia does not permit or require that the fair market value of a tenant's leasehold interest is subject

to tax payable by the property's owner. The District wrongly insists that local law does require such a result, citing legal authority that is either irrelevant or not instructive.

For example, in its closing argument at trial, the District cited the case of George Washington University v. District of Columbia, 563 A.2d 759 (D.C. 1989). There, the trial court ruled in the taxpayer's favor but reversed itself prior to any appeal. At the trial court level, the case did involve an issue of whether the District's assessment was "invalid because it failed to take into account the terms of the existing long-term lease encumbering the Building, effectively taxing PEPCO's leasehold interest. . . ." Id. at 760. The Petitioner appealed. The appellate panel noted a prior opinion of the Hon. Iraline G. Barnes, in which the trial court wrote that "[i]t is not axiomatic that the assessment is to be reduced because of a long-term lease." Id. at 760, quoting Greene v. District of Columbia, Tax Docket No. 3561-85 (D.C. Superior Court, June 12, 1986), at 11. Ultimately, there was no adjudication of this legal issue in the Court of Appeals. Instead, the litigation sputtered to a reversal and remand because of the trial court's failure to set forth an adequate basis for its judgment. Indeed, the Court of Appeals observed:

> This court, however, is not equipped to scour the record to select competent evidence we believe supports the trial court's ultimate legal conclusion. Even if the trial court's conclusion that leasehold interests can be taxable as real property is correct – **an issue we do not decide here** -- the court must still provide factual

> findings supporting its application of that rule of law to the assessment at issue in this case.

Id. at 761 [emphasis supplied]. The case was remanded so that the trial judge could make useable findings of fact and conclusions of law.

The result of the remand, whatever it was, did not spark any further appellate litigation. On balance, then, the District of Columbia Court of Appeals literally has never ruled on the true issue at hand.

The other appellate opinion cited by the Government is also unhelpful. The Government relies upon the decision in Folsom v. Spokane, 759 P.2d 1196 (Wash. 1988)(en banc).

In the jurisdiction of the State of Washington, there is a statute that facially **requires** the result that the Government now argues. There is no similar statute in the District of Columbia. The litigation in Folsom centered upon the mechanics of how the statute must be implemented. Accordingly, this appellate case is inapposite because the State's legislature had already foreclosed the issue. It suffices to say that the Government's position here is totally unconvincing.

For what it is worth, this Court does not in any way quarrel with the concept that it is not "axiomatic" that assessments should be reduced because of long term leases that may be below market rates. If anything, this entire discussion only underscores the principle that there is no magic formula for how a long term or below-market lease should be factored into an assessment or appraisal. Each case

must stand or fall on its own merits. In any event, the guiding concepts must come from the statute that is actually in force in the District of Columbia. Our local statute mandates that the tax on commercial real estate be levied upon the fair market value of what the owner could actually convey if the property were offered for sale on the date of the valuation. A taxpayer can only convey what the taxpayer owns, subject to limitations such as leases or easements.

Where an office building is concerned, the taxpayer who owns that building can only be taxed on the value of the property subject to the leasehold rights of the tenants. That leasehold interest is not being ignored. Rather, it is being examined for its genuine impact on the property as a whole, i.e. the fee as a whole.

In the instant case, it is clear that a long term, below market lease does indeed affect the value of the leased space that would be included in the hypothetical sale. Each and every case involving the taxation of an office building that is encumbered by below market, long term leases will dissolve into a factual issue of how such a lease affects the overall value of the property. The answer to this question, translated into dollars and cents, will be unique in every case.

For future purposes, it is clear that the prudent and correct approach, of course, is for an assessor or appraiser to scrutinize very carefully all long term leases and all below-market leases. That scrutiny probably will reveal an impact on the income earning potential of the property and the resultant tax liability; but nothing is guaranteed in the abstract. The scrutiny must be performed.

The mere mention of leases as a potential factor in proper tax assessment should not cause anyone to confuse the instant case with the problem described in Safeway Stores, Inc. v. District of Columbia, supra, wherein the Court of Appeals warned of the possible evasion of taxation by owners who "create artificial sale and leaseback arrangements solely to reduce their property tax obligations to the community." Safeway Stores, Inc. v. District of Columbia, supra, 525 A.2d at 211-212. In Safeway, the taxpayer itself sold and leased back some of its own properties on a long term basis with the obligation to pay real estate taxes on that same property. Id. at 208. These are not the facts in the instant case.

In the present litigation, this Court finds that the assessor, in failing to take into consideration the actual experience of the property and assigning market rental rates to the entire building, did not correctly or properly estimate market value as is required by the District of Columbia Code. The assessor did not base his values on "the amount that investors would be willing to pay to receive the income that the property could be expected to yield..." or what a willing buyer would pay for the property to a willing seller. 9 DCMR § 307.5 (1994).

The assessor used an unreasonably low capitalization rate, the effect of which is to raise the assessment figures unjustifiably. Mr. Hovermale's capitalization rate in both assessments failed to meet the test set forth in Wolf II and Woodner. His rates were not high enough to pay the taxes, to pay an assumed mortgage, and to provide a fair return on the cash investment.

The reason for rejecting the higher net operating incomes selected by the assessor was his failure to consider both existing leases and actual income as well as practical market conditions. A prospective purchaser would consider all of these factors in estimating current and future income, and therefore, the assessor must do the same.

In the case of capitalization rates, the Court considers the rates developed by Mr. Horstman to be correct as a matter of law and fact. Therefore, the Court is convinced that the preponderance of the evidence supports a figure of $30,830,000 for tax year 1992 and $33,420,00 for tax year 1993 as the market value for the subject property as proposed by Mr. Horstman. This figure correctly represents the value of the property as of the valuation dates, January 1, 1991 and January 1, 1992.

In assessing real property, the value of the land and improvements must be identified separately. 47 D.C. § 821(a) (1990 Repl.).

The Court concludes that there was an insufficient factual basis for the land value that was used by the assessor. In contrast, the Court concludes that the land value that was derived by Mr. Horstman was clear, factually supported, and credible. Therefore, the Court adopts $27,750,000 as the value of the land for tax year 1992 and $26,750,000 as the value of the land for 1993.

The remaining portion of the total assessment is allocated to the improvements, in each year.

Upon the findings of fact and conclusions of law made in the case above and upon the petitions filed herein, and upon the evidence adduced at trial, it is by the Court this 22nd day of June, 1995,

ORDERED, ADJUDGED and DECREED as follows:

1. That the correct assessment for the subject property for tax year 1992 is as follows:

Land	27,750,000
Improvements	3,080,000
Total	30,830,000

The correct assessment for the subject property for tax year 1993 is as follows:

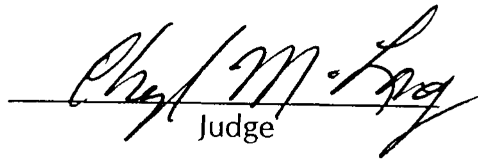
Land	26,750,000
Improvement	6,670,000
Total	33,420,000

2. That the assessment record card for the property maintained by the District shall be adjusted to reflect the value determined by this Order.

3. That respondent shall refund to petitioners any excess taxes

collected for tax years 1992 and 1993 resulting from assessed values which are in excess of the values determined by this Order.

4. That entry of decision shall be withheld pending submission of a proposed Order under the provision of Rule 15 of the Superior Court Tax Rules.



Judge

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SUPERIOR COURT OF THE DISTRICT OF COLUMBIA
TAX DIVISION

FILED
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SUPERIOR COURT
DISTRICT OF COLUMBIA
TAX DIVISION

1301 ASSOCIATES	:	
Petitioner	:	
v.	:	**Tax Docket Nos. 5286-92**
	:	**5780-93**
DISTRICT OF COLUMBIA	:	
Respondent	:	

ORDER

These cases came on to be heard before the Court on December 1, 1994. Upon the Petitions filed herein, as amended, the stipulations between the parties and upon consideration thereof and the evidence adduced at trial, the Court having entered Findings of Fact and Conclusions of Law filed June 22, 1995, it is by the Court this 20th day of July, 1995 hereby

1. ORDERED, ADJUDGED and DECREED that the correct estimated value for lot 835 in square 254, the subject property, is determined to be as follows:

Tax Year 1992	
Land	27,750,000
Improvements	3,080,000
Total	30,830,000
Tax Year 1993	
Land	26,750,000
Improvements	6,670,000
Total	33,420,000

2. ORDERED, that Respondent be and hereby is, directed to reduce the assessment on lot 835 in square 254 for purposes of District of Columbia real estate

taxes for Tax Year 1992 from $43,535,871 to $30,830,000 consisting of $27,750,000 for the land and $3,080,000 for the improvements.

3. ORDERED, that the Respondent be and hereby is, directed to refund to Petitioner's Tax Year 1992 real estate taxes on lot 835 in square 254 in the amount of $273,176.23 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.

4. ORDERED, that Respondent be and hereby is, directed to reduce the assessment on lot 835 in square 254 for purposes of District of Columbia real estate taxes for Tax Year 1993 from $45,147,000 to $33,420,000 consisting of $26,750,000 for the land and $6,670,000 for the improvements.

5. ORDERED, that the Respondent be and hereby is, directed to refund to Petitioner's Tax Year 1993 real estate taxes on lot 835 in square 254 in the amount of $252,130.50 with interest from March 31, 1993 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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