12-22-2017

Store Master Funding VI, LLC v. Franklin County Board of Revision, et al.

Supreme Court of Ohio

IN THE SUPREME COURT OF OHIO

STORE MASTER FUNDING VI, LLC,	:	
Appellant,	:	Case No. 2016-1328
v.	:	Appeal from Ohio Board of Tax Appeals BTA Case Nos. 2015-1492 & 1493
FRANKLIN COUNTY BOARD OF REVISION, et al.,	:	
Appellees.	:	

MERIT BRIEF OF APPELLEE GROVEPORT-MADISON LOCAL SCHOOL DISTRICT BOARD OF EDUCATION

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STATEMENT OF THE CASE AND FACTS

Appellee Groveport-Madison Local Schools Board of Education (the "Board of Education") and Appellant Store Master Funding VI, LLC ("Store Master") filed complaints with the Franklin County Board of Revision (the "BOR") for tax year 2014 upon that certain real property owned by Store Master located at 2888 Brice Rd. in Columbus, Ohio and identified as Auditor's Parcel No. 530-166430-00 (the "Subject Property"). Store Master sought a reduction in value from the Auditor's original valuation of $5,911,600 to $1,920,300 in its complaint, and the Board of Education sought an increase in value in its complaint to $6,446,000 based upon a recent sale of the Subject Property. The Subject Property is improved with a 128,022 square foot Lowe's Home Improvement store constructed in 1994.

At a consolidated BOR hearing on Store Master's and the Board of Education's complaints, the Board of Education appeared through counsel and presented evidence of a recent arm's-length sale occurring on October 17, 2014 in the amount of $6,445,959.34 (which the Board of Education rounded to the nearest hundred on its complaint). *See* Board of Education Complaint, Record. As evidence of such sale, the Board of Education attached to its complaint, and the BOR accepted into evidence, the Auditor's conveyance-fee statement and General Warranty Deed for the subject transaction. *Id.*

Store Master also appeared through counsel and presented an appraisal report and testimony of Richard Racek Jr., MAI, of Racek & Associates, LLC. *See* Real Estate Appraisal Report of Store Master Funding VI, LLC, 2888 Brice Road, Columbus, Franklin County, Ohio as of January 1, 2014 (the "Racek Appraisal"), Record. Mr. Racek utilized the sales comparison and income approaches to value the Subject Property at $2,600,000. *Id.* at p. 50. Mr. Racek selected three sales in close proximity to the Subject Property which sold after extended stays on

the market subsequent to the first-generation user vacating the property for approximately $2/SF to $7/SF. *Id.* at pp. 30-35. He explained that this retail corridor had flourished when it was developed in the 1990's but had been under severe decline for a number of years prior to the lien date. BOR Hearing Record ("H.R."). In selecting his rent comparables, he admitted that he omitted consideration of any leases of first-generation properties in continuing operation by their original build-to-suit occupant as was the Subject Property as of the applicable lien date. *Id.* Mr. Racek also confirmed that "fee simple" meant "vacant." *Id.*

In closing arguments before the BOR, Store Master contended that the recent revisions to R.C. 5713.03 prohibited the BOR from adopting the sale price as the best evidence of value since the Subject Property was subject to a lease to Lowe's as of the lien date. *Id.* The Board of Education countered in response that the BTA had previously rejected this argument on several occasions and that consideration of Store Master's appraisal evidence was inappropriate since it neither rebutted the arm's-length nature nor recency of the subject sale. The BOR adopted the sale price as the Subject Property's true value for tax year 2014 and Store Master appealed to the BTA.

At the BTA, the parties waived hearing and submitted legal argument upon the record generated before the BOR, largely repeating the arguments advanced to the BOR. On August 9, 2016 the BTA issued its decision affirming the BOR's acceptance of the recent sale price. *See* BTA Decision, Record. It initially noted that Store Master did not challenge the "arm's-length nature, recency or voluntariness" of the subject sale. *Id.* at p. 2. It rejected Store Master's argument that Store Master did not acquire a "fee simple" interest in the Subject Property since the right to occupy the property was only one of the "bundle of rights" and there was no evidence in the record that the seller retained a reversionary interest in the property through the sale. *Id.* at

pp. 2-3. It also rejected Store Master's appraiser's interpretation of Ohio law that appraising a "fee simple" interest in the property required him to value the property as if vacant at the time of the sale, noting that this Court had repeatedly rejected the appraisal industry's use of the term "leased fee." *Id.* at pp. 3-4. Regarding the recent revisions to R.C. 5713.03, the BTA held that the revisions did not "overrule the directive consistently set forth by the Supreme Court that this board rely on a recent arm's-length sale of the property if evidence of such sale is properly before us." *Id.* at p. 4. Finally, it also rejected Store Master's argument that the Court's recent decision in *Steak 'N Shake*, *infra*, required an adjustment to the sale of the Subject Property to account for the lease encumbrance. *Id.* Store Master appealed to this Court.

LAW AND ARGUMENT

BOARD OF EDUCATION'S RESPONSE TO PROPOSITION OF LAW NOS. 1 & 2

THE RECENT REVISIONS TO R.C. 5713.03 DO NOT REQUIRE DISREGARDING AN ARM'S-LENGTH SALE SIMPLY BECAUSE THE PROPERTY WAS LEASED AT THE TIME OF THE SALE.

In its first and second propositions of law, Store Master generally contends that the recent revisions to R.C. 5713.03 required the BTA to disregard the subject sale simply because the Subject Property was subject to a lease to Lowe's Home Centers at the time of the sale. It urges the Court to make two specific findings: first, it invites the Court to adopt the appraisal industry's definitions of "fee simple" and "leased fee"; and second, that the sale presumption does not apply if the opponent of the sale has presented appraisal evidence in support of another value when the property is leased at the time of sale. *See* Store Master's Initial Brief at pp. 8-9.

A. The Court should continue to reject the appraisal industry's use of the terms "fee simple" and "leased fee."

The recent revisions to R.C. 5713.03 do not require the Court to adopt the appraisal industry's use of the terms "fee simple" and "leased fee" and the Court should continue to reject

these as it has on numerous occasions for nearly a decade.[1] First, in *Meijer Stores L.P. v. Franklin Cty. Bd. of Revision*, 122 Ohio St. 3d 447, 2009-Ohio-3479, 912 N.E.2d 560, the Court initially recognized the distinction was not a legal distinction:

> The distinction between 'fee simple' and 'leased fee' is one drawn in the context of appraisal practice. *See* The Appraisal of Real Estate (13th Ed. 2008), 114. The appraisal industry uses the term 'fee simple' to refer to unencumbered property – or to property as if it were unencumbered. *Id.* This distinction is not one recognized by the law, however. A 'fee simple' may be absolute, conditional, or subject to defeasance, but the mere existence of encumbrances does not affect its status as fee simple. Black's Law Dictionary (8th Ed. 2004), 648-649.

Id. at ¶ 23, n. 4. Citing *Meijer*, in *HIN L.L.C. v. Cuyahoga Cty. Bd. of Revision*, 138 Ohio St. 3d 223, 2014-Ohio-523, 5 N.E.3d 637, the Court noted that it had "already pointed out that these definitions, though no doubt helpful for how appraisers understand their assignments, simply do not define the subjects of taxation under Ohio law***." *Id.* at ¶ 23. "Accordingly, the appraisal-profession standards espoused by HIN's experts do not alter our legal analysis." *Id.* Finally, and perhaps most importantly, the Court recently recognized:

> Our case law makes clear that the distinction drawn in the appraisal industry between the 'fee simple' and 'leased fee' does not reflect a distinction made in Ohio law: the 'fee simple' to be valued for purposes of Ohio law is the same whether or not that interest is encumbered by a lease.

[1] Not all of the appraisal industry concurs with the interpretation of these terms advanced by Store Master. In September of 2017, the International Association of Assessing Officers (IAAO) convened a Special Committee, in which nationally renowned appraiser Peter Korpacz, MAI, CRE, FRICS was a member, on Big-Box Valuation and published its "Commercial Big-Box Retail: A Guide to Market-Based Valuation." *See* Appendix. IAAO confirms that "leased fee" is "not a legal term and is rarely used by market participants in the sale transaction market." *Id.* at p. 9. Instead the "fee simple" interest to be valued for ad valorem tax purposes is that of the "fee simple absolute" interest in real property which "has absolutely nothing to do with leases/mortgages/liens deed restrictions or any other encumbrance or distribution of any of the property rights to others. It simply means that the current owner has full control of the disposition of the property. The fact that a property may have a deed restriction, lease, lien, or easement does not diminish or defeat the fee simple absolute property rights." *Id.* at pp. 7-8.

Copley-Fairlawn City School Dist. Bd. of Edn. v. Summit Cty. Bd. of Revision, 147 Ohio St. 3d 503, 2016-Ohio-1485, 68 N.E.3d 723, ¶ 26, n. 1.

Store Master's argument in support of adoption of the appraisal industry's definitions appears to arise from the Court's statement in *Steak 'N Shake, Inc. v. Warren Cty. Bd. of Revision*, 145 Ohio St. 3d 244, 2015-Ohio-4836, 48 N.E.3d 535, ¶ 36, acknowledging that encumbrances (i.e. leases) can affect the price for which a property sells. *Id.* However, *Steak 'N Shake* did not involve a recent arm's-length sale of the property at issue there, and its discussion of the special purpose doctrine in connection with a value-in-use challenge is superseded by the Court's more recent decision in *Johnson Coca-Cola Bottling Co. v. Hamilton Cty. Bd. of Revision*, 149 Ohio St. 3d 155, 2017-Ohio-870, 73 N.E.3d 503 ("*Coca-Cola*"). The Court clarified in *Coca-Cola* that consideration of a property's present use is indeed proper, and discussion of the special purpose doctrine unnecessary, so long as consideration of other factors relevant to exchange value is not excluded. *Id.* at ¶¶ 14-15. Regardless, and even if *Steak 'N Shake* was controlling regarding consideration of the present use of property, the Court's statement in *Steak 'N Shake* does not support its recognition of the term "leased fee" as utilized by the appraisal industry.

Nor does the Court's recent decision in *Terraza 8, L.L.C. v. Franklin Cty. Bd. of Revision*, 150 Ohio St. 3d 527, 2017-Ohio-4415, 83 N.E.3d 916, support Store Master's position. In interpreting the revisions to R.C. 5713.03, the Court concluded that such revisions served a limited purpose:

> The statutory amendment thus allows taxing authorities to consider non-sale price evidence – particularly evidence of encumbrances and their effect of sale price – in determining the true value of property that has been the subject of a recent arm's-length sale.

Id. at ¶ 27. Accordingly, "market rent becomes relevant only if an opponent presents it as evidence in an attempt to rebut a sale price." *Id.* at ¶ 34. While the market nature of a lease at the time of the sale may now be used in an attempt to prove that the sale price did not reflect true value, nothing in *Terraza* suggests that the Court intended to accept the appraisal industry's use of the term "leased fee." To the contrary, the owner's second proposition of law in *Terraza* essentially asked the Court to recognize these terms by reference to O.A.C. 5703-25-07(D)(2) and the Court declined to do so:

> The rule [O.A.C. 5703-25-07(D)(2)] does not require the use of the income approach in every valuation or require the proponent of a sale price to present evidence concerning market rent or the values of the 'leasehold' and 'leased fee,' terminology Terraza uses in its brief. We therefore reject Terraza's second proposition of law.

Terraza, at ¶ 38. As such, the Court should continue to reject these appraisal terms as lacking any legal basis.

B. <u>The sale presumption endures pursuant to *Terraza* and the Board of Education must be given the opportunity to submit additional rebuttal evidence on remand.</u>

Store Master's second request to the Court in its first two propositions of law is the identical argument the Court explicitly rejected in *Terraza.* Terraza contended that the board of education was required to produce affirmative evidence that the sale price reflected the fee simple unencumbered interest. *Id.* at ¶ 31. The Court unequivocally rejected this argument and held that the sale presumption endured, subject to rebuttal:

> Terraza's argument implicates two distinct, yet related, judicially created rebuttable presumptions. The first is the presumption that a submitted sale price 'has met all the requirements that characterize true value.' *Cincinnati School Dist. Bd. of Edn. v. Hamilton Cty. Bd. of Revision,* 78 Ohio St. 3d 325, 327, 677 N.E.2d 1197 (1997). In *Dublin City Schools Bd. of Edn. v. Franklin Cty. Bd. of Revision*, 118 Ohio St. 3d 45, 2008-Ohio-1588, 885 N.E.2d 934, we applied *Cincinnati School Dist.* in the context of encumbrances, stating that 'the burden lies upon the party who opposes the use of the sale price to show that the encumbrances on the property constitute a reason to disregard the sale price as an indicator of value."

> *Dublin City Schools*, at ¶ 16. This supports our conclusion that the proponent of a sale is not required, as an initial matter, to affirmatively demonstrate with extrinsic evidence that a sale price reflects the value of the unencumbered fee-simple estate. Once the BOE provided basic documentation of the sale, Terraza had the burden of going forward with rebuttal evidence showing that the price did not, in fact, reflect the property's true value. *See Cincinnati School Dist.*, at 327-328.
>
> The second presumption is rooted in the best-evidence rule of property valuation, which, as we explained earlier in this opinion, provides that '[t]the best evidence of the 'true value in money' of real property is an actual, recent sale of the property in an arm's-length transaction.' *Conalco*, 50 Ohio St. 2d 129, 363 N.E.2d 722, at paragraph one of the syllabus, quoting R.C. 5713.01; *Park Invest. Co.*, 175 Ohio St. at 412, 195 N.E.2d 908. We have said that this rule – which existed before R.C. 5713.03 was amended to refer to recent arm's-length sales, *see* 136 Ohio Laws, Part II, at 3247 – creates a rebuttable presumption that the sale price reflected true value. *See Ratner I*, 23 Ohio St. 3d at 61, 491 N.E.2d 680. Nothing suggests that the General Assembly intended to depart form this longstanding rule. Indeed, R.C. 5713.03 continues to refer to recent arm's-length sales by permitting the use of sale prices in determining value. This signals that the General Assembly still favors the use of recent arm's-length sale prices in determining value for taxation purposes.
>
> With this in mind, Terraza's argument is wrong in two respects. First, it incorrectly states that there is 'no evidence' that the sale price reflected the value of the unencumbered fee simple estate. The February 2013 sale price, which Terraza does not dispute, is the <u>best evidence</u> of the property's true value, subject to rebuttal. And second, R.C. 5713.03 does not now '<u>require</u>[ ] an inquiry into whether a lease in place reflects market rent at the time of the sale,' as Terraza maintains in its first proposition of law.

Id. at ¶¶ 32-34 (emphasis in original). Accordingly, Store Master's argument is also wrong here for the same exact reasons.

While Store Master praises the BTA's decision on remand in *Terraza*, it omits any discussion of the most crucial aspect of the decision. *Terraza 8, L.L.C. v. Franklin Cty. Bd. of Revision*, BTA Nos. 2015-279, 2015-280, 2017 Ohio Tax LEXIS 2604 (Nov. 8, 2017), *appeal pending*, 10th Dist. Franklin App. No. 17AP-000815; *petition to transfer to Supreme Court pending*, Case No. 2017-1702. In evaluating whether the actual lease rate at the time of the sale was at market levels, the BTA acknowledged its prior precedent that "the existence of

comparable first-generation sales and leases successfully refutes any evidence that suggests that the subject is marketable only to second-generation users" and that "where no evidence of such first-generation sales and leases have been presented," it had "declined to speculate about their existence." *Id.* at *7-8 (internal citations omitted). In determining that the sale did not reflect true value, it held:

> In the absence of any evidence of 'first-generation' leases demonstrating a different market in which the subject operates, as the BOE suggests, we must conclude from the record before us that Terraza has sufficiently demonstrated that the actual rent in place for the subject property at the time of the sale was above market. Accordingly, we find the sale is not reflective of the property's fair market value on tax lien date.

Id. at *8. Conspicuously absent from the BTA's decision is any mention of its denial of the board of education's motion to submit additional evidence regarding the market nature of the property's lease at the time of sale. *See Terraza 8, L.L.C. v. Franklin Cty. Bd. of Revision*, BTA Nos. 2015-279, 2015-280, 2017 Ohio Tax LEXIS 2074 (Interim Order Aug. 16, 2017). In its denial, the BTA found it relevant that the Court did not directly reference its discretionary ability to hear additional evidence pursuant to R.C. 5717.01 and that absent such reference, the Court must have intended to preclude it from doing so. *Id.* at *2-3.

Here, while the Board of Education acknowledges that a remand to the BTA is possible for consideration of Store Master's appraisal pursuant to *Terraza*, the Board of Education must be given an opportunity to submit rebuttal evidence on remand regarding the market nature of the subject's lease and its alleged impact upon the recent, arm's-length sale price. Contrary to the BTA's suggestion, it is not likely that the Court intended to divest the BTA of its statutory authority pursuant to R.C. 5717.01 to hear additional evidence as the Court has specifically directed the BTA <u>not</u> to hear such evidence when it so intended. *Worthington City Schools Bd. of Edn. v. Franklin Cty. Bd. of Revision*, 124 Ohio St. 3d 27, 2009-Ohio-5932, 918 N.E.2d 972, ¶

34 ("As in *Healthsouth*, the parties have had ample opportunity to present evidence, so the BTA shall not take additional evidence on remand.") (internal citation omitted).

Furthermore, the circumstances in this case (and *Terraza*) are much more similar to that in *Mason City School Dist. Bd. of Edn. v. Warren Cty. Bd. of Revision*, 138 Ohio St. 3d 153, 2014-Ohio-104, 4 N.E.3d 1027. There, a former owner had filed a complaint requesting a reduction in value and the property sold subsequent to the BTA hearing but prior to issuance of the BTA decision. *Id.* at ¶¶ 4, 11. The new owner appealed to the Court challenging the recency of a prior sale occurring before the lien date. *Id.* at ¶ 8. In remanding to the BTA to address the recency issue, the Court specifically held that the new owner had a right to be heard at the BTA on such issue:

> The scope of remand under the particular circumstances of this case differs from our earlier cases. In *Worthington City Schools*, we instructed the BTA to determine the recency issue 'in light of the entire record.' Because the parties had 'had an ample opportunity to present evidence,' we instructed the BTA to 'not take additional evidence on remand.' Squire Hill, however, is a new owner that did not have the opportunity to be heard before the BTA. Moreover, by appealing the BTA's decision to this court, Squire Hill preserved its right to be heard on the subject of the recency of the December 2006 sale.
>
> Accordingly, the BTA on remand shall make Squire Hill a party-appellee and shall take additional evidence regarding the recency of the December 2006 sale if Squire Hill requests it to do so. If Squire Hill does offer evidence relating to recency, the school board shall have the opportunity to offer evidence in rebuttal.

Id. at ¶¶ 49-50 (internal citations omitted).

Mason City School Dist. is instructive here as the Board of Education, like Squire Hill there, has not had an opportunity to be heard at the BTA on the market nature of the subject's lease and its alleged impact upon the recent sale. Since the Court confirmed in *Terraza* that the Board of Education does <u>not</u> have any obligation to present extrinsic evidence in support of the sale or the market nature of the lease, if *Terraza* is to be applied here and this appeal remanded to

the BTA for further consideration, the Board of Education has a fundamental right to be heard and the BTA's denial of this right in *Terraza* undoubtedly violated its due process rights. Accordingly, the Board of Education respectfully requests that the Court direct the BTA to allow the Board of Education to present additional evidence on remand in this appeal, and any other similar appeals in which the Court determines that a remand is required pursuant to *Terraza* and market rent then becomes "relevant." *Terraza*, at ¶ 34.

BOARD OF EDUCATION'S RESPONSE TO PROPOSITIONS OF LAW NO. 3

OTHER STATES HAVE RECOGNIZED THAT A FEE SIMPLE VALUATION ENCOMPASSES APPRAISING PROPERTY AT ITS HIGHEST AND BEST USE.

In its third proposition of law, Store Master cites to several cases outside of Ohio for support in urging the Court to adopt the appraisal industry's use of the term of "leased fee." However, several recent opinions of sister states explicitly recognize that valuing a "fee simple" interest in property necessarily involves appraising a property at its highest and best use and selecting appropriate sales and rent comparables consistent with the highest and best use, regardless of whether the property is owner-occupied or leased.[2]

First, regarding an owner-occupied property, the Court of Appeals of Michigan very recently rejected an appraisal valuing a Menard store not at its highest and best use as a "second-generation" property. *Menard, Inc. v. City of Escanaba*, 315 Mich. App. 512, 891 N.W.2d 1

[2] IAOO's discussion of market segmentation in connection with a proper highest and best use determination for big boxes is extremely insightful. It suggests that a number of factors are relevant to value and a property's competitive advantage and relative position in the market: "A property that has significant advantages over other properties of the same use because of location, demographics, and economic forces will command a higher price and rent. As such, stratifying properties into investment classes creates a logical hierarchy that reflects potential market participants' actions. This method assists the appraiser in identifying the highest and best use of the subject property and in selecting appropriate comparables." IAAO, Commercial Big-Box Retail (Appendix) at pp. 16-17.

(2016), *appeal not accepted*, 2017 Mich. LEXIS 2100, *1, 901 N.W.2d 901 (Oct. 20, 2017). In analyzing the sales-comparison approaches presented by Menard's and the City's appraisers, the Court of Appeals specifically acknowledged that Menard owned "a fee simple interest in the subject property" not subject to any deed or use restrictions. *Id.* at 523.

Menard's appraiser selected eight (8) comparable sales in his approach: a former Home Depot, a former Circuit City, a former Sam's Club, a former furniture store, a former Kroger and three (3) former Wal-Marts. *Id.* at 515-516. Only two (2) of these sales did not contain deed restrictions at the time of sale. *Id.* at 516. In determining that the only market for the property as vacant was a "second-generation" user, Menard's appraiser testified that he did not make any adjustments to the sales to account for the deed restrictions since they would not be concerning to a typical second-generation purchaser. *Id.* at 517. Although the Michigan Tax Tribunal accepted Menard's appraisal and granted a significant reduction in value, the Michigan Court of Appeals reversed, and the Michigan Supreme Court declined to accept Menard's appeal. *Id.* at 526; *see also* 2017 Mich. LEXIS 2100, 901 N.W.2d 901.

The Court of Appeals specifically held that Menard's appraiser inexplicably and unlawfully failed to value the property at its highest and best use. It noted that the deed restrictions, which were self-imposed by the seller big box stores, prevented the deed-restricted comparables from being sold for their highest and best use. *Id.* at 525. Accordingly, the Court aptly held:

> The tribunal did not value the subject at its HBU [highest and best use], an owner-occupied freestanding retail building, but instead valued it as a former owner-occupied freestanding retail building that could no longer be used for its HBU and could best be used for redevelopment for a different use. In doing so, the tribunal made an error of law by failing to value the subject property at its HBU.

Id. at 526.

Next, in *Rite Aid Corp. v. Borough of Roselle*, N.J. Tax Court Nos. 004481-2009, 001348-2010, 2017 N.J. Tax Unpub. LEXIS 23 (Apr. 13, 2017),[3] the New Jersey Tax Court considered the valuation of a leased Rite Aid pharmacy. While the owner's and the Borough's appraiser generally agreed on the highest and best use as an income-generating retail property, the appraisers selected extremely different lease comparables in their income approaches. *Id.* at *10. The owner's appraiser disregarded the actual lease, which resulted from a transaction only three (3) years prior to the lien date, because it was a "long-term lease with a national tenant that likely has excellent credit." *Id.* at *17-18. The appraiser opined that the desire to enter the market motivated the lessee and that the rent included a return on the cost of construction. *Id.* at *18.

In evaluating the credibility of the owner's position, the Tax Court recognized that the appraiser's general suppositions were unsupported by any evidence in the record:

> The court accepts the proposition that a lease related to a build-to-suit structure might not reflect market rent. It is possible that the rental rate in such a lease might reflect both market rent for the structure and a partial or full repayment of the cost of constructing the building. In addition, it may be true that a particular tenant is willing to pay above market rents in order to enter a particular market. To reach such conclusions, however, it would be necessary for the court to evaluate evidence concerning the circumstances of the transaction that resulted in the lease, and market rent for properties similar to the subject. Plaintiff's [the owner's] expert did not provide any such evidence. He was unfamiliar with the details of the formation of the lease at the subject property, and appears to have based his decision to disregard the subject lease on his supposition that all build-to-suit leases of pharmacies do not reflect market rent. In the absence of any evidence supporting his supposition, the expert's decision to disregard the subject lease undermines the credibility of his opinion of market rent.

Id. at **18-19.

On the other hand, the Tax Court recognized that the lease comparables selected by the Borough's appraiser, including the subject lease, "offered the more credible opinion of market

[3] Attached in the Appendix pursuant to N.J. Rules of Court 1:36-3.

rent." *Id.* at *21. The Court noted that all comparables were of first-generation national pharmacies, and most having a drive-through pharmacy as did the subject. *Id.* at *21-22. Although it rejected the Borough's two comparables that did not have drive-throughs and one comparable that was not free-standing, the remaining comparables supported the appraiser's opinion of market rent. *Id.* at *22-23. In ultimately adopting the Borough's appraisal as the only competent and credible opinion of value for the property, evident in the Court's acceptance is the consistency of the Borough's appraiser's selected comparables with the property's highest and best use.

Although the Board of Education agrees with Store Master that sister states' precedent is not binding upon this Court, what is instructive about both cases above is the critical importance of selecting appropriate comparables to accurately reflect a property's highest and best use. As the Court acknowledged in *Copley-Fairlawn,* valuation of the "fee simple" interest must be the same, and appropriate comparables selected by appraisers consistent with highest and best use, regardless of whether the property is leased or owner-occupied. *See Copley-Fairlawn*, at ¶ 26, n. 1. The recent revisions to R.C. 5713.03 do not alter, or eviscerate as Store Master seems to suggest, the obligation to value a property at its highest and best use. *See* Appraisal of Real Estate (10th Ed. 1992) at p. 278 (noting that in a proper highest and best use analysis as improved, the estimated rate of return for the purposes of the maximally productive requirement for a use different than the current use may be compared directly to returns under the current use only if no capital expenditures would be required to convert the property to such alternative use). Accordingly, R.C. 5713.03 does not require the Court to adopt the appraisal industry's use of "leased fee" as Store Master uses it, and valuation of the "fee simple unencumbered" interest must still recognize a property's actual highest and best use.

CONCLUSION

The Court should decline Store Master's first request to adopt the appraisal industry's use of the term "leased fee." Neither *Terraza* nor the recent revisions to R.C. 5713.03 compel the Court to reverse its repeated rejection of the term. The Court already rejected Store Master's second request in *Terraza* and the sale presumption endures, subject to rebuttal. Such that the Court determines that *Terraza* requires a remand for the BTA to consider the Racek Appraisal, the Board of Education respectfully requests that the Court direct the BTA to honor the Board of Education's due process right to be heard on the issues of market rent and impact upon the sale price since the Board of Education has not had an opportunity to be heard. Market rent was not "relevant" until *Terraza* and the Board of Education had no obligation to produce extrinsic evidence in support of a sale price or market nature of the lease at the time of sale.

Respectfully Submitted,

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CERTIFICATE OF SERVICE

The undersigned certifies that a true and accurate copy of the foregoing was served, by electronic mail transmission and/or regular U.S. Mail, postage prepaid, upon: Ryan J. Gibbs, Esq., The Gibbs Firm, LPA, 2355 Auburn Ave., Cincinnati, OH 45219; William J. Stehle, Esq., Assistant County Prosecutor, 373 S. High St., 17th Floor, Columbus, OH 43215; and Honorable R. Michael DeWine, Esq., Ohio Attorney General, 30 E. Broad St., 14th Floor, Columbus, OH 43215, this 22nd day of December, 2017.

/s Kelley A. Gorry
Kelley A. Gorry (0079210)

IN THE SUPREME COURT OF OHIO

STORE MASTER FUNDING VI, LLC,	:	
Appellant,	:	Case No. 2016-1328
v.	:	Appeal from Ohio Board of Tax Appeals BTA Case Nos. 2015-1492 & 1493
FRANKLIN COUNTY BOARD OF REVISION, et al.,	:	
	:	
Appellees.	:	

APPENDIX

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5713.03 County auditor to determine taxable value of real property.

The county auditor, from the best sources of information available, shall determine, as nearly as practicable, the true value of the fee simple estate, as if unencumbered but subject to any effects from the exercise of police powers or from other governmental actions, of each separate tract, lot, or parcel of real property and of buildings, structures, and improvements located thereon and the current agricultural use value of land valued for tax purposes in accordance with section 5713.31 of the Revised Code, in every district, according to the rules prescribed by this chapter and section 5715.01 of the Revised Code, and in accordance with the uniform rules and methods of valuing and assessing real property as adopted, prescribed, and promulgated by the tax commissioner. The auditor shall determine the taxable value of all real property by reducing its true or current agricultural use value by the percentage ordered by the commissioner. In determining the true value of any tract, lot, or parcel of real estate under this section, if such tract, lot, or parcel has been the subject of an arm's length sale between a willing seller and a willing buyer within a reasonable length of time, either before or after the tax lien date, the auditor may consider the sale price of such tract, lot, or parcel to be the true value for taxation purposes. However, the sale price in an arm's length transaction between a willing seller and a willing buyer shall not be considered the true value of the property sold if subsequent to the sale:

(A) The tract, lot, or parcel of real estate loses value due to some casualty;

(B) An improvement is added to the property. Nothing in this section or section 5713.01 of the Revised Code and no rule adopted under section 5715.01 of the Revised Code shall require the county auditor to change the true value in money of any property in any year except a year in which the tax commissioner is required to determine under section 5715.24 of the Revised Code whether the property has been assessed as required by law.

The county auditor shall adopt and use a real property record approved by the commissioner for each tract, lot, or parcel of real property, setting forth the true and taxable value of land and, in the case of land valued in accordance with section 5713.31 of the Revised Code, its current agricultural use value, the number of acres of arable land, permanent pasture land, woodland, and wasteland in each tract, lot, or parcel. The auditor shall record pertinent information and the true and taxable value of each building, structure, or improvement to land, which value shall be included as a separate part of the total value of each tract, lot, or parcel of real property.

Amended by 129th General AssemblyFile No.186, HB 510, §1, eff. 3/27/2013.

Amended by 129th General AssemblyFile No.127, HB 487, §101.01, eff. 9/10/2012.

Effective Date: 09-27-1983 .

Related Legislative Provision: *See 129th General AssemblyFile No.186, HB 510, §3 .*

See 129th General AssemblyFile No.127, HB 487, §757.51.

5703-25-07 Appraisals.

(A) Each general reappraisal of real property in a county shall be initiated by an entry and order of the tax commissioner directed to the county auditor of the county concerned which shall specify the time for beginning and completing the appraisal as provided by section 5715.34 of the Revised Code. In January of each year the commissioner shall adopt a journal entry wherein is set forth the status of reappraisals in the various counties and the tax year upon which the next reappraisal and the next triennial update of real property values in each county shall be completed.

(B) Each lot, tract, or parcel of land, and all buildings, structures, fixtures, and improvements to land shall be appraised by the county auditor according to true value in money, as it or they existed on tax lien date of the year in which the property is appraised. It shall be the duty of the county auditor to so value and appraise the land and improvements to land that when the two separate values for land and improvements are added together, the resulting value indicates the true value in money of the entire property.

(C) Land shall be valued in accordance with the provision of rule 5703-25-11 of the Administrative Code. All land shall be valued according to its true value except where the owner has filed an application under section 5713.31 of the Revised Code for such land to be valued for real property tax purposes at the current value the land has for agricultural use, and the land is qualified to be so valued and taxed as provided in section 5713.30 of the Revised Code.

Buildings, structures, fixtures, and improvements to land shall be valued in accordance with the provisions of rule 5703-25-12 of the Administrative Code.

(D) In arriving at the estimate of true value the county auditor may consider the use of any or all of the recognized three approaches to value:

(1) The market data approach - The value of the property is estimated on the basis of recent sales of comparable properties in the market area after allowance for variation in features or conditions. The use of the gross rent multiplier is an adaptation of the m-arket approach useful in appraising rental properties such as apartments. This is most applicable to the types of property that are sold often.

(2) The income approach - The value is estimated by capitalizing the net income after expenses, including normal vacancies and credit losses. While the contract rental or lease of a given property is to be considered the current economic rent should be given weight. Expenses should be examined for extraordinary items. In making appraisals by the income approach for tax purposes in Ohio provision for expenses for real property taxes should be made by calculating the effective tax rate in the given tax district as defined in paragraph (E) of rule 5703-25-05 of the Administrative Code, and adding the result to the basic interest and capitalization rate, Interest and capitalization rates should be determined from market data allowing for current returns on mortgages and equities. The income approach should be used for any type of property where rental income or income attributed to the real property is a major factor in determining value. The value should consider both the value of the leased fee and the leasehold.

(3) The cost approach - The value is estimated by adding to the land value, as determined by the market data or other approach, the depreciated cost of the improvements to land. In some types of special purpose properties where there is a lack of comparable sales or income information this is the

only approach. Due to the difficulties in estimating accrued depreciation, older or obsolete buildings value estimates often vary from the market indications.

(E) Ideally, all three approaches should be used but due to cost and time limitations, the cost approach as set forth in these rules is generally an appropriate first step in valuation for tax purposes. Values obtained by the cost approach should always be checked by the use of at least one of the other approaches if possible. In the event the auditor uses approaches of estimating true value other than the cost approach appropriate notations shall be shown on the property record.

(F) The appraiser is urged to refer to standard appraisal references as well as the excellent publications by many trade associations, etc., which provide valuable income, expense, and other types of information that may be used as bench marks in making the appraisal.

(G) Nothing set out in these rules shall be construed to prohibit the county auditor from the use of advanced techniques, such as computer assisted appraisals, in the application of the three approaches to the appraisal of real property for tax purposes. However, such programs must be submitted to the tax commissioner for the approval on an individual basis.

R.C. 119.032 review dates: 07/25/2014 and 07/25/2019
Promulgated Under: 5703.14
Statutory Authority: 5703.05
Rule Amplifies: 5713.01, 5715.01
Prior Effective Dates: 12-28-73; 11-1-77; 9-18-03

Prior History: (Eff 12-28-73; 11-1-77; 9-18-03
Rule promulgated under: RC 5703.14
Rule authorized by: RC 5703.05
Rule amplifies: RC 5713.01, 5715.01
Replaces: 5705-3-03
R.C. 119.032 review dates: 09/18/2008)

IAAO

COMMERCIAL BIG-BOX RETAIL:

A Guide to Market-Based Valuation

By the Special Committee on
Big-Box Valuation

SEPTEMBER 2017

Commercial Big-Box Retail:
A Guide to Market-Based Valuation

BY THE Special Committee on Big-Box Valuation

September 2017

International Association of Assessing Officers
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I. PURPOSE

This IAAO position paper provides guidance for the valuation of big-box retail properties. Over the last several years, issues involving these properties and theories about how to value them, such as the dark store theory, have resulted in great debate within both the appraisal and legal communities. Even though this paper concentrates on arriving at the market value of the fee simple interest of these properties, it provides guidance regardless of the specific law of a jurisdiction.

This analysis focuses on big-box retail stores from 50,000 to 200,000-plus square feet; however, the market trend for big-box retail is shifting to both smaller and larger stores. For example, one major retailer has six different prototype stores varying from 15,000 to 260,000 square feet, depending on the characteristics of the trade area. The concepts discussed in this paper apply to single-tenant retail stores of any size and also to other property types.

This paper does not explain how to mass appraise; rather, it describes the process that will help an appraiser support a market value estimate for big-box retail properties. The theories and methodologies discussed in this paper reflect market behavior. The paper identifies recurring issues in this controversy, clarifies the fundamental concepts used in appraisal practice, and explains the methodologies developed in arriving at the appropriate value required by the jurisdiction for assessment purposes.

II. BIG BOX RETAIL ISSUES AND THE DARK STORE THEORY

The dark store theory originates from claims that big-box retail stores have been unfairly over-assessed by taxing jurisdictions. This viewpoint maintains that real property assessments should not be based on what the property is worth to the current user, purported to be value-in-use or use value, but on what the property would be worth to another prospective (hypothetical) user in the open market. The argument alleges that the latter is a true reflection of value-in-exchange and market value. Advocates of this position assert that any costs associated with the property's construction must be ignored as an indication of value, and that a significant portion of those costs must be considered functional obsolescence. By this argument, a property is already functionally obsolete as soon as it is constructed. Leases-in-place must also be ignored, because they too are a reflection of use value or value-in-use, in that the rents are typically based on costs to cover construction.

The term *dark store* generally describes vacant stores (as in dark because they are without electricity). The term is used to identify the types of sales that dark store theorists claim are appropriate comparables for the subject property, regardless of whether the subject is a vacant property or an occupied property. Vacant subject properties are rarely identified in this contentious debate, because there is generally less disagreement that vacant stores have less value. However, the debate escalates when vacant, blighted, abandoned, deed-restricted sales are used as comparisons to functioning, occupied stores. While it is often true that big-box stores may close their doors after they have operated and made profits, and also true that these stores sometimes sit vacant for months or years before retrofit or demolition, critics of the dark store theory argue that vacant big-box stores have a highest and best use different from those of occupied ones.

For tax assessment purposes, the date of value is established and value is based on what actually physically exists—not what is hypothetical. Critics of the dark store theory also believe the value of the property in its current use, if rents-in-place are shown to be in line with market rents, is reflective of market value, and that leased-fee value is equal to fee simple value. Further, an occupied property is evidence that demand for the property exists, and valuing an occupied property as if it is a vacant property would require the appraiser to disclose a hypothetical condition. Hence the debate. This paper seeks to address these issues and provide the assessor with guidance on valuing these property types.

III. EXECUTIVE SUMMARY

During the research process, the following arguments were identified as repeatedly arising in the appeal of big-box retail ad valorem valuations. The following list summarizes some significant and recurring issues.

- *Dark store theory*. This theory suggests that occupied big-box stores should be valued as-if-vacant and available for sale or rent to a future hypothetical user rather than in the current use, which is often a functioning, occupied store.

  Valuing an occupied subject property as-if-vacant requires a hypothetical condition that the appraiser would be required to disclose. This is not to say that when the subject property itself is vacant as of the valuation date, the use of vacant comparables is inappropriate.

- *Build-to-suit and sale-leaseback transactions*. It is asserted that these transactions are based either on financing or on costs of customized improvements plus a premium paid for land acquisition. Thus, the rents reflect inflated costs. These transactions are non-arm's-length and should be excluded as comparisons for the subject property.

  Sales of first-generation transactions are scarce in the market, and an appraiser should examine whatever data are available. Neither build-to-suit nor sale-leaseback transactions should be automatically disregarded as improper comparables. As with all sales, the appraiser must carefully analyze the transaction to determine whether it is reflective of the market value of the fee simple estate, and if not, determine whether sufficient information is available to make the proper adjustments.

- *Value-in-use versus value-in-exchange*. Valuing the subject property with a lease-in-place sometimes raises the concern that the appraiser is arriving at value-in-use rather than value-in-exchange.

  If the appraiser determines the lease terms, including rent, are reflective of the market, then contract rent is equal to market rent and value-in-use is reflective of value-in-exchange.

- *Functional obsolescence in improvements designed for a specific user*. Improvements made for a specific big-box retailer are claimed to be functionally obsolete as soon as they are built, because they are worth something only to the current user and would contribute little or no value in the open market. In other words, improvements may cost $15,000,000 to build but are worth only a fraction of that amount to another user.

  Most big-box improvements are in fact not unique (with the likely exception of signage). Further, the value of the property is as of the date of valuation, not as of a future date, to a hypothetical prospective buyer. It will be for the market to determine whether the improvements are in demand, and it will be for the future buyer to make the economic decision to purchase the property and retrofit, demolish, or continue to use the improvements.

- *Abandoned, vacant stores*. The assertion is that abandoned, vacant stores are evidence of functional obsolescence and lack of market demand.

  Abandoned stores may or may not be evidence of functional obsolescence. Moreover, subsequent sale prices for those properties are often the result of the detrimental impact of deed restrictions or of changing demand in the marketplace on the pool of potential buyers.

- *Impact of restrictive covenants***.** Big-box retailers often assert that deed restrictions have no significant impact on property value.

  The impact of deed restrictions on value is difficult to quantify, because it is virtually impossible to determine the number of potential buyers who walked away from a deed-restricted sale. It is certain that deed restrictions, by design, are imposed to limit competition and force a change in highest and best use.

- *Fee simple is not unencumbered.* This notion suggests a fee simple valuation assignment (whether big-box or other types of property such as a corporate office center, office building, industrial property, among others) is the value unencumbered by a lease, i.e. a vacant property.

  A lease does not factor into the definition of fee simple absolute. A lease is a possessory right, and a property may be held in fee simple, subject to a lease. In a jurisdiction where market rent is the criterion for the calculation of rental income in an appraisal (market rent jurisdiction), sales of leased properties can and should be used as comparables, if adjustments are made for above- and below-market rents. In a jurisdiction where contract rent is the criterion for the calculation of rental income in an appraisal (contract rent jurisdiction), sales of leased properties can and should be used as comparables, with no rental adjustments required.

- *Highest and best use of big-box properties*. If a property is a certain size, regardless of investment class, occupancy, or deed restriction, it serves as an appropriate comparable for a subject property that is occupied and is not burdened with such a restriction.

The appraiser should be wary of arriving at an overly broad highest and best use conclusion of *general retail*. Market segmentation analysis indicates the existence of multiple investment classes of retail properties, similar to other property types such as offices, apartments, hotels, and other commercial properties. Simply because a property is similar in size to the subject property does not alone make it an appropriate comparable. Also, the appraiser is highly encouraged not to use a deed-restricted comparable if the subject property does not have a similar restriction.

IV. REAL PROPERTY RIGHTS IN REAL ESTATE

Ad valorem tax valuation is a legal construct. The specific laws, regulations, and case law of a jurisdiction control what is valued and how it is valued. This is one reason there is a jurisdictional exception in the *Uniform Standards of Professional Appraisal Practice* (TAF 2016). Because ad valorem tax valuation is a legal construct, interpretation of the law and regulations is controlled by legal analysis, not by appraisal analysis; thus, in some jurisdictions, what is required for ad valorem valuation may not be consistent with fee appraisal theory and practice. The appraiser must know exactly what a jurisdiction means by fee simple estate and what encumbrances must be taken in account.

A. Fee Simple Absolute

Many jurisdictions require a valuation of the fee simple absolute estate (or *fee simple*). *Black's Law Dictionary* defines fee simple as,

> *An interest in land that, being the broadest property interest allowed by law, endures until the current holder dies without heirs; esp., a fee simple absolute. Often shortened to fee.* (Garner 2014)

Alternatively, the *First Restatement of Property* §14 defines an estate in fee simple as follows:

An estate in fee simple is an estate which

(a) has a duration
  (i) potentially infinite; or
  (ii) terminable upon an event which is certain to occur but is not certain to occur within a fixed or computable period of time or within the duration of any specified life or lives; or
  (iii) terminable upon an event which is certain to occur, provided such estate is one left in the conveyor, subject to defeat upon the occurrence of the stated event in favor of a person other than the conveyor; and

(b) if limited in favor of a natural person, would be inheritable by his collateral as well as by his lineal heirs."

The important aspect to note is that "fee simple" has absolutely nothing to do with leases/mortgages/liens/deed restrictions or any other encumbrance or distribution of any of the property rights to others. It simply means that the current owner has full control of the

disposition of the property. The fact that a property may have a deed restriction, lease, lien, or easement does not diminish or defeat the fee simple absolute property rights.

The legal concept of fee simple merely states that the owner has a fee simple estate, rather than another lesser estate, such as a life estate, fee simple determinable, or other various estates. It does not address government limitations or private encumbrances on the property.

B. Encumbrances

Although the legal definition of fee simple implies the fee owner retains all rights in the property, all private property has limitations imposed by the government powers of taxation, eminent domain, police power, and escheat. These government restrictions on property are encumbrances.

In addition to government encumbrances, there may be private encumbrances placed on property, such as mortgages, deed restrictions, easements, covenants, and liens, to name a few. While none of these private encumbrances result in the owner not holding the property in fee simple, they can raise or lower the value of the real property.

Black's Law Dictionary defines encumbrance in part as follows:

> *A claim or liability that is attached to property or some other right and that may lessen its value, such as a lien or mortgage; any property right that is not an ownership interest.* (Garner 2014)

The Uniform Commercial Code defines encumbrance as follows:

> *Encumbrance means a right, other than an ownership interest, in real property. The term includes mortgages and other liens on real property.* (Legal Information Institute n.d.)

As noted above, the existence of these governmental and private encumbrances on real estate does not affect the fee simple estate.

It is critical that jurisdictions, courts and the property tax community specify what encumbrances the appraiser should and should not recognize when performing a property tax appraisal. Simply using the phrase "fee simple" is insufficient.

Sometimes the phrase "fee simple" is appended with the term "unencumbered". The problem with the word "unencumbered" from an appraisal standpoint is that the term is inconsistently applied and subject to misinterpretation. An appraisal of the fee simple unencumbered interest would mean the appraiser would ignore governmental restrictions, utility easements and the like – an unlikely assignment in property tax or any other appraisal assignment.

Because of this confusion, a primary debate in big-box valuation is whether stores should be valued based on the sale prices of vacant stores or on the sale prices of leased and owner-

occupied ones. This debate arises in part when the appraiser reads the term "unencumbered" (or appends the term to the phrase "fee simple") and concludes that the appraisal assignment must ignore the existence of a lease. The appraiser then takes the further step of determining that the property must then be valued as-if-vacant, even if the subject property is occupied. This same logic is then extended to sales of leased stores, which are also excluded because they too are encumbered. Excluding sales of leased properties leaves only vacant ones as potential comparables. To take this logic to the end assumes that all commercial property should be valued as-if-vacant. This erroneous conclusion is addressed below in Section V. Definitions of Value.

How jurisdictions treat encumbrances is a public policy issue. One overriding principle in ad valorem property taxation is that a parcel of property is typically assessed to one owner. Thus, regardless of whether the fee simple owner has transferred interests in the property, the holder of the fee simple estate is assessed for all of the property rights.

Jurisdictions may ignore the transfer of rights associated with liens, leases, and mortgages. However, not all jurisdictions treat easements and restrictive covenants similarly, and some jurisdictions continue to struggle with the issue.

C. Leased Fee (Fee simple subject to a lease)

The term *leased fee* is an appraisal term defined in *The Dictionary of Real Estate* (Appraisal Institute 2015). It is not a legal term and is rarely used by market participants in the sale transaction market. *Leasehold* is a legally defined term as well as an appraisal term. *Black's Law Dictionary* (Garner 2014) defines leasehold as, "a tenant's possessory estate in land or premises… ." The terms are used as follows:

- *Leased fee*. The ownership interest held by the lessor, which includes the right to receive the contract rent specified in a lease plus the reversionary right when the lease expires. (Appraisal Institute 2015, 128). The term is used by appraisers as a basis to estimate the lessor's value subject to a lease. It is based usually on the capitalization of net operating income (NOI) or the sum of the present value of the forecast NOI over a holding period and the present value of the reversion. In reality, leased fee is synonymous with fee simple, subject to a lease when possession but not the ownership is temporarily transferred to another.

- *Leasehold.* This is the possessory interest held by a tenant. The term is used by appraisers as a basis to estimate the value of the lessee's interest, usually calculated by capitalizing the difference between market rent and contract rent. If a lease exists that reflects market characteristics, including market rent, then the leasehold has no market value. However, if the tenant pays less than marktet, the difference between the present value of what is paid and the present value of market rents would be a positive leasehold value in the real estate for the tenant.

D. The Fee Simple and Leased-Fee Issue

Technically what is being referred to is a *fee simple interest subject to a lease*. However, the term *leased fee* is common appraisal terminology and is used throughout this document.

When arriving at a fee simple valuation value for ad valorem taxation, the appraiser must recognize that leases, easements, and estates other than fee simple exist in the real world of comparables the appraiser considers. A lease fulfills the basic wish of an owner to receive rent. It is not an encumbrance to ownership of real property rights—it is a contract for the use of the property to provide rental income to the owner. The appraiser must be able to make any necessary market-based adjustments to those comparables in order for them to be useful in arriving at the appropriate valuation goal required by the law of the jurisdiction.

If the appraiser is considering using leased-fee sales, then it must be determined whether the contract terms and contract rents are equivalent to market terms and market rents as of the valuation date or whether supportable adjustments can be made to the leased-fee sales.

V. DEFINITIONS OF VALUE

A. Jurisdictional Requirements

Most jurisdictions require a market value estimate; however, a jurisdiction may also use the terms market value, fair market value, cash value, or true cash value, among others. An appraiser should identify the applicable value as it is defined by the jurisdiction and carefully follow that definition. Usually the term market value is defined by statute or the courts and constitutes a willing seller and a willing buyer acting in full knowledge without duress in an open-market, arm's-length transaction. In general, the market value will be the *as-is* market value. If other value-related terms apply, they also should be examined for possible application in the assessment valuation.

B. Market Value

1. Definition

The Dictionary of Real Estate Appraisal defines market value as follows:

> *The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.* (Appraisal Institute 2015, 141)

2. Market Value and Big-Box Retail

An appraiser's conclusion of the market value of a big-box property should reflect the actual condition of the property on the date of valuation, including whether the property is occupied or vacant. If the property is occupied, whether by an owner or a tenant, the property should be valued as occupied. If the property is vacant as of the date of valuation, then the market value conclusion should arrive at a value as vacant.

This issue frequently arises in the sales comparison approach, in which an appraiser uses vacant comparables to value an occupied property without applying an appropriate adjustment to the vacant comparables. In fact, valuing the subject property as vacant when the subject property was occupied as of the date of valuation requires a hypothetical condition that the appraiser would be obliged to disclose.

Hypothetical condition is defined as follows:

1. A condition that is presumed to be true when it is known to be false.

2. A condition, directly related to a specific assignment, which is contrary to what is known by the appraiser to exist on the effective date of the assignment results, but is used for the purpose of analysis. Comment: Hypothetical conditions are contrary to known facts about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis. (TAF 2016)

The issue is clarified when the appraiser considers the other two approaches to value. Quite obviously, in an income approach, the appraiser is valuing the subject property as occupied, using market income and expense data. Less obviously, the cost approach also arrives at a value of the subject property as occupied (stabilized). As noted in *The Appraisal of Real Estate,*

> *The value of a property indicated by the cost approach is the value of a fee simple estate. For properties that are leased, the cost approach assumes stabilized occupancy and income.* (Appraisal Institute 2013, 565–566)

Thus, it now becomes clear that using vacant sale comparables (without adjustment) to value an occupied property is not proper appraisal practice.

If the subject property is vacant as of the date of valuation, lease-up costs should be considered when the comparables are leased at market terms, including the time it takes to lease the space. However, because of the speculative variables in these unknown lease-up assumptions, the appraiser is encouraged to use similarly comparable properties, that is, vacant with vacant and occupied with occupied.

C. Value-in-Use

The Dictionary of Real Estate Appraisal defines value-in-use as follows:

> *The value of a property assuming a specific use, which may or may not be the property's highest and best use on the effective date of the appraisal. Value-in-use may or may not be equal to market value but is different conceptually. See also* use value. (Appraisal Institute 2013, 245)

When the highest and best use of a property is defined as how the property currently exists in use, the value-in-exchange of the property is equivalent to the value-in-use of the property.

VI. THE HYPOTHETICAL SALE

As noted above, the classic definition of market value as arriving at an estimate of what the real property interest would sell for between a willing buyer and willing seller requires that the appraiser create a hypothetical sale of the property as of the date of valuation.

Although the appraiser is hypothesizing a sale of the property, what should not be hypothetical are the physical aspects of the subject property and the economic conditions surrounding the subject property. The appraiser cannot ignore the subject property's physical depreciation or functional obsolescence in the hypothetical sale. Nor can the property's location, market demand, or economic conditions be ignored.

While this seems obvious, appraisers sometimes erroneously attribute negative aspects of a comparable sale (such as a poor location with weak market demand, functionally obsolete features, and the like) to the subject property by failing to make adjustments for those differences.

A. Hypothetical Seller

When there is an actual sale of a property, the appraiser knows the identity of the seller of the property. However, in a hypothetical sale of the subject property as of the date of valuation, the actual owner of the property is not the hypothetical seller. Instead, the identity of the hypothetical seller is both unknown and not relevant. However, as the definition of market value requires, that unknown seller is knowledgeable and acts prudently and with self-interest.

B. Hypothetical Buyer

In a hypothetical sale, the appraiser does not have to identify an actual buyer of the property. As long as the appraiser identifies demand for the property, the market will supply a buyer. However, if the subject property is functionally obsolete, even a hypothetical buyer would take that obsolescence into account.

When determining demand for the subject property, the appraiser should not ignore the current owner/user as a part of that demand. If the current owner/user is ignored as part of the market demand, then the appraiser is improperly analyzing the market demand for the property.

VII. HIGHEST AND BEST USE

Highest and best use analysis must be conducted for both the subject property and other properties the appraiser is considering using as income or sales comparables.

> *Highest and best use is a theoretical concept that underlies valuation analysis. An appraiser must first perform general market analysis in order to then analyze the characteristics of the market that cause the subject property to have value. … Highest and best use is the use that generates the highest net return to the property over a reasonable period of time.* (Thimgan 2010)

The highest and best use of the land as-if-vacant and available for use may be the same as the existing use or may differ from the highest and best use as-improved. It is different when existing improvements are either an interim use or are approaching the end of their economic life but still contribute value to the real property in excess of the value of the land.

Analysis of highest and best use for as-if-vacant requires four tests done in the order listed below.

A. As-if-Vacant

1. Legally Permissible

Legally permissible uses considered first in a highest and best use analysis include legal limitations, such as zoning regulations or deed conditions and restrictions, that may have an impact on development potential. These constraints may be attributable to zoning, private restrictions, easements, historic districts, building codes, and environmental regulations.

2. Physically Possible

Factors such as site size, shape, frontage, topography, soil composition, flood zone, and access to utilities may limit use of the site to its fullest potential. A use may be legally permissible but only realized if the physical characteristics of the land support the use. Thus, a proposed property may or may not be a viable development on the site.

3. Financially Feasible

The determination of financial feasibility is largely dependent on supply and demand for the legally permitted and physically possible uses and the costs associated with the future development. Recent construction of other big-box properties in the market is evidence that a big-box use is financially feasible and shows that demand for such big-box properties exists.

4. Maximally Productive

The highest and best use for as-if-vacant is the use that produces the highest residual land value.

B. As-Improved

The same four criteria for the highest and best use analysis for as-if-vacant should be considered in the highest and best use analysis for as-improved.

1. Legally Permissible

The appraiser should determine whether the current use is a legally conforming use. If zoning has changed or if the improvements were built under a conditional use permit, reconstruction of the same type of building may not be allowed if the improvements are destroyed. When a first-generation big-box retailer vacates, it often places deed restrictions on the property to prohibit competition. This forces a change in highest and best use to something other than the property's original design.

The following is an example of such a deed restriction:

> TO HAVE AND TO HOLD said Land unto Grantee, and its successors and assigns, forever, with all tenements, appurtenances and hereditaments thereunto belonging, subject to easements and other matters of record, and subject to the following restrictions: For a period of TWENTY-FIVE (25) years from the date hereof, said Land may not be used as a discount department store whose overall retail concept is based on a discounting price structure, a wholesale membership club or warehouse store, a grocery or supermarket or similar type store, or a pharmacy (collectively, the "Use Restrictions"). Those portions of the building leased to (intentionally omitted for confidentiality) (collectively, the "Leases") shall be exempt from the Use Restrictions for those periods the Leases shall be in effect, however, in no instance shall the exemption for the building area leased by (ABC retailer) last beyond May 31, 2018. The aforesaid restrictions shall run with and bind said Land and shall inure to the benefit of and be enforceable by Grantor or an affiliated company or its successors, by any appropriate proceedings at law or in equity to prevent violations of such conditions and restriction and/or to recover damages for such violations from the then current owner of the Land. However, such conditions and restrictions shall remain in effect for Twenty-Five (25) years from the date hereof.

2. Physically Possible

Consider the land-to-building ratio. If the land-to-building ratio is greater than what is typical for the current use, the improvements may be an underutilization of the site, suggesting that a larger building may be developed. Underutilization may indicate the current improvements are not the highest and best use as-improved.

3. Financially Feasible

The third step in a highest and best use analysis is financial feasibility. This analysis requires consideration of the demand for the property. This step typically incorporates some degree of a marketability study. When considering market demand, the appraiser considers the likely *users* of the property, which include likely buyers/tenants. The result of this analysis in the consideration of operating properties versus vacant properties is often that the operating property is still financially feasible for its current use, whereas the vacant store is vacant because of a diminishing or absent demand. If the property is occupied, this is evidence that demand for the property exists.

For most properties with big-box stores and related improvements, one of the following four possible highest and best use conclusions is likely:

- Retain existing improvements for their current use.
- Renovate to address physical and functional items that need to be cured and/or convert to a different use to recognize changing trade area demand trends.
- Demolish existing improvements and redevelop the site with a different use that represents the highest and best use of the site.
- Demolish existing improvements and hold the site for future development.

Techniques such as the land residual, feasibility rent analysis, and the use of profitability index are methods that may be used to test financial feasibility. Another practical method that may be considered is a simple analysis showing that an improved property should not be worth less than vacant land. This methodology is particularly useful for big-box stores. Consider the following hypothetical:

> An occupied store of 150,000 square feet has a typical land-to-building ratio of 5:1 or land area of approximately 750,000 square feet. Purportedly the building is worth $20/square foot based on comparable sales of deed-restricted, converted stores, and/or vacant properties. This value implies the subject property is worth $20 × 150,000 square feet, or $3,000,000. This $3,000,000 for 750,000 square feet of land area also indicates that land must be worth less than $4/square foot. If comparable land sales indicate a value for land greater than $4/square foot, then the market value of the subject property is either greater than $3,000,000 or the occupied property has reached the end of its economic life because the improvements offer no contributory value.

From this example, the comparable properties are not appropriate for comparison to the occupied property or the current use is not the highest and best use. If continued use of the operating store is financially feasible, then the comparable properties are inappropriate because the resulting value is less than the land value.

The same test may also be used with rents. The $3,000,000 value implies that net operating income for the subject property would be approximately $270,000 annually using a market-based capitalization rate of 9 percent as an example. An annual net rent of $270,000 for 150,000 square feet implies a net rental rate of $1.80/square foot. If comparable leased properties in the subject's market reflect net income significantly higher than $1.80/square foot, then either the comparable leased properties are inappropriate or the property is approaching or has reached the end of its economic life. Again, the test reveals that the value of the land exceeds what is proposed as the contributory value of the improvements.

Comparable land sales provide the benchmark for the lowest value a property can be as-if-vacant; thus, the proper identification of land sales is an important step in determining the correct highest and best use.

4. Maximally Productive

According to *Property Assessment Valuation,*

> *In mass appraisal, the current highest and best use is usually considered to be the current use; that is, buildings will not be immediately demolished or replaced* (Thimgan 2010, 44).

If the subject property is occupied, that fact supports the premise that there is demand for the use for which the property was originally designed. Highest and best use is likely for the continued use of the property in its current use.

VIII. MARKET SEGMENTATION AND HIGHEST AND BEST USE

For retail properties, value is affected by size, age, condition, access, traffic counts, proximity to major employment centers, the concentration of surrounding properties, population size, and household purchasing power, to name just a few considerations. The competitive advantage of a property determines its relative position within the market. A property that has significant advantages over other properties of the same use because of location, demographics, and economic forces will command a higher price and rent. As such, stratifying properties into investment classes creates a logical hierarchy that reflects potential market participants' actions. This method assists the appraiser in identifying the highest and best use of the subject property and in selecting appropriate comparables.

A. Investment Class A

Investment class A big-box retail properties sell at the highest prices and lowest capitalization rates. The first-generation user generally occupies these properties. Buyers of investment class A big-box retail properties typically are national investors, such as real estate investment trusts, insurance companies, and retirement funds, looking for newer improvements with a creditworthy national or regional retail chain tenant under a long-term, generally triple-net, lease. These properties often have locations that generate high retail sales per square foot, usually above the

chain's nationwide average. The locations typically have greater visibility, such as a corner lot and high traffic counts. Leased class A properties generally are subject to long-term leases and are purchased with significant years remaining on the lease.

B. Investment Class B

Investment class B big-box retail properties are usually slightly older properties that sell in the mid-range price level at mid-range capitalization rates. These first-generation properties are in good locations but not as well located as class A properties. The retail sales per square foot usually meet or may exceed the chain's nationwide average sales per square foot. These properties may still attract national and regional investors. Remaining lease terms on these properties, while not as long as for investment class A properties, generally exceed 10 years.

C. Investment Class C

Investment class C big-box properties are nearing the end of their economic life for first-generation use and may be classified as second-generation space. These locations do not meet the minimum requirements for a new improvement of the same use or renovation of the current improvements by the first-generation user. Retail sales at these properties are usually below the chain's nationwide average. These properties sell toward the low end of prices and high end of capitalization rates. The continued use of the current use is likely an interim use. Remaining lease terms are relatively short, usually less than 10 years.

D. Investment Class D

Investment class D big-box retail properties sell at low prices and, when leased, indicate high capitalization rates. They are often vacant or soon-to-be-vacant properties with a highest and best use for a second-generation use. The original market demand for these properties has moved to more desirable retail locations. These vacant properties possibly are ready for redevelopment for a different use (e.g., low-end retail, office, or warehouse). The original design is no longer valuable or viable in the marketplace except by second-generation users at low prices or rents.

IX. THE THREE APPROACHES TO VALUE OF FEE SIMPLE PROPERTY RIGHTS

A. The Cost Approach

> *The cost approach to value provides a value indication that is the sum of estimated land value and the estimated depreciated cost of the building and other improvements* (Thimgan 2010).

The cost approach is a two-step process that provides a value indication of the land and an estimate of value for the cost to build a new or substitute property. Adjustments for depreciation caused by age, utility, or external factors are applied to the improvements, and the depreciated value of the improvements is added to the land value to arrive at a total value. The approach is premised on the Principle of Substitution, which asserts that,

> [A] *rational, informed purchaser will pay no more for a property than the cost of acquiring an acceptable substitute with like utility, assuming that no costly delay is encountered in making the substitution* (Thimgan 2010).

This approach reflects market behavior, especially in the valuations of new properties, well-maintained properties, proposed construction or renovations, and special-purpose properties or, in the case of big-box properties, when comparable sales and unrestricted-use sales are scarce.

1. Strengths of the Cost Approach

Courts frequently rely on the cost approach because it inherently values the fee simple property rights and eliminates the debate about leases and deed restrictions. The cost approach is useful when comparable sales and rental data are insufficient or lacking. Replacement cost new, rather than reproduction cost new, typically excludes any functional obsolescence relating to design and utility, such as superadequacies, for example. The cost approach can serve as a test of reasonableness against claims that build-to-suit costs exceed the market value of new improvements. For these reasons, the cost approach is especially useful for investment class A and class B properties that tend to be newer, well-maintained buildings. Big-box retailers consider land and improvement costs when determining financial feasibility for a project, so the application of the cost approach directly replicates market behavior.

2. Weaknesses of the Cost Approach

Limitations in the cost approach are attributed generally to estimating depreciation and entrepreneurial profit/incentive. The economic age-life and market extraction methods are widely used by appraisers to estimate depreciation because of their simplicity in application. However, lump-sum deductions and straight-line depreciation are often criticized for being oversimplified approximations. Effective age is based on an appraiser's opinion. Remaining economic life is based on the appraiser's judgment but can also be supported by a study of typical economic lives of similar buildings. Both tend to be less reliable as the property ages. Although the breakdown method is more detailed in measuring depreciation, many forms of depreciation are difficult to support with market evidence. In these cases there is a greater likelihood of a methodology's misapplication. With regard to big-box retail properties, some of these shortcomings are diminished, because these properties typically tend to be well-maintained and generally have minimal functional obsolescence.

3. Land Valuation

An accurate land value estimate is critical to the development of a reliable cost approach. Comparable land sales should have the same highest and best use as the subject property and should be similar in location, traffic count, demographics, zoning, size, visibility, access, and any other attributes deemed important by buyers and sellers. Often, investment classes C and D big-box properties may be approaching the end of their economic lives, and while depreciation and functional obsolescence may be difficult estimates to quantify, a reliable valuation of land may reveal whether the subject property is approaching or has reached the end of its economic

life. If the value of the land is close to the value of the property as-improved, this may indicate that the property is ready to be torn down or possibly redeveloped.

4. Entrepreneurial Profit/Incentive

Entrepreneurial profit is defined as,

> *[A] market-derived figure that represents the amount an entrepreneur receives for his or her contribution to a project and risk; the difference between the total cost of a property (cost of development) and its market value (property value after completion), represents the entrepreneur's compensation for the risk and expertise associated with development* (Appraisal Institute 2015, 76).

Entrepreneurial incentive is defined as,

> *The amount an entrepreneur expects to receive for his or her contribution to a project. Entrepreneurial incentive may be distinguished from entrepreneurial profit (often called developer's profit) in that it is the expectation of future profit as opposed to the profit actually earned on a development or improvement. The amount of entrepreneurial incentive required for a project represents the economic reward sufficient to motivate an entrepreneur to accept the risk of the project and to invest the time and money necessary in seeing the project through to completion* (Appraisal Institute 2015, 76).

Entrepreneurial profit/incentive, based on analysis of recent sales of similar properties and/or interviews with developers of similar improvements, is often difficult to support because of the lack of sufficient market evidence. It is often calculated as a percentage of direct and indirect costs and included in the total replacement cost of the improvements.

5. Functional Obsolescence

The issue of functional obsolescence often arises in the valuation of big-box retail properties in the context of whether the properties are in fact special purpose. A special-purpose property is defined as follows:

> *A property with a unique physical design, special construction materials, or a layout that particularly adapts its utility to the use for which it was built; also called a* special-design property (Appraisal Institute 2015).

> *The functional utility of a special-purpose building depends on whether or not there is continued demand for the use for which the building was designed. When there is demand, functional utility depends on whether or not the building conforms to competitive standards*. (Appraisal Institute 2013)

If the appraiser finds there is still demand for the uses served by the subject property that are similar to those for other newly constructed properties in the market, the property is probably not special purpose and there is likely no or limited functional obsolescence.

6. Signage/Facade

Some modification and level of customization are expected when a new tenant takes over a space. This does not make the property functionally obsolete. The appraiser may find that the signage and/or facade may be minimal and easily removed without significant damage to the underlying real estate.

B. The Sales Comparison Approach

Based on the concept of value-in-exchange, the sales comparison approach to value compares the property being appraised with similar properties that have recently sold. The characteristics of the sold property are analyzed for their similarity to those of the subject of the appraisal (Thimgan 2010).

The sales comparison approach to value is commonly employed in the appraisal process because it closely reflects how buyers and sellers in the marketplace engage in property transactions. The sales comparison approach is also heavily influenced by the economic Principle of Substitution, which holds that properties demonstrating similar economic utility command similar prices. Hence, the value of a property or highest price a property will likely obtain is determined by the cost of purchasing a substitute property of similar design, function, and utility. This is a straightforward approach that studies the market's reaction to similar properties and is especially reliable when there are ample data available in the market from which to make appropriate comparisons.

1. Strengths of the Sales Comparison Approach

The sales comparison approach is a well-founded methodology when there are abundant, truly comparable properties in the market that serve as appropriate substitutes to the subject in terms of functional utility and other relevant market characteristics. This straightforward approach is widely understood and relied upon by the courts. It reflects the actions of buyers and sellers and is used to estimate market value. For big-box properties, the appraiser will likely be able to find sales in the marketplace of such properties if he or she is willing to broaden the search area for other similar investment class sales that have a similar highest and best use.

2. Weaknesses of the Sales Comparison Approach

Properties that are not true comparables can lead to unreliable conclusions. For example, simply because a property is similar in size does not make it an appropriate comparison for another property. Closed sales transactions are historic and may not reflect current market value. There are generally few first-generation sales that convey to users, and sale-leasebacks and build-to-suit transactions may be the only first-generation sales available to an appraiser who is valuing investment class A properties.

3. Sales in the Big-Box Market

Some appraisers reject a comparable sale as a valid, open-market transaction if the property exchanged is a build-to-suit property, a sale-leaseback transaction, or a private sale. As indicated in the IAAO *Standard on Verification and Adjustment of Sales* (IAAO 2010, 12, 31), it is up to the appraiser to verify the transaction details. The standard suggests that during the sale verification process the appraiser ask first whether the sale was a sale-leaseback and then whether this influenced the sale price.

For big-box and single-property retailers overall, the current practice for financing construction of a new improvement is through a build-to-suit arrangement. This arrangement is as common, if not more so, than traditional mortgage financing. The developer obtains the financing to build the improvements for the occupant, and the occupant opts to make lease payments instead of mortgage payments to a bank. This is an economic decision of the user. It does not mean the transaction does not represent market value. While sale-leasebacks often relate to new construction, these types of transactions may also involve existing properties. In either scenario, subject to verification of the above facts, these may be regarded as potential open-market transactions.

Build-to-suit rents, sales of properties with a build-to-suit lease, sale-leasebacks, and private sales should not be automatically dismissed. Unless there is evidence to the contrary that is inconsistent with the applicable market value definition, these types of sale transactions may be used as comparable sales if they are arm's-length and verified to be reflective of market rent and price.

a. Build-to-Suit

To illustrate a market-driven transaction in a build-to-suit arrangement, consider the following. ABC Retail wishes to enter a new market location as part of its overall plans for expansion. ABC Retail is a creditworthy, regional player in its retail segment and has been making strides to expand nationwide. ABC Retail makes a business decision that the best way for it to continue a steady expansion is to not finance the new development with its own capital, for which it has sufficient funds available, and to forgo traditional lender financing.

ABC Retail sends invitations to bid to various developers and negotiates with Developer Jones to purchase the land and build the improvements as ABC Retail specifies, and on completion ABC Retail will lease the property from Developer Jones. Developer Jones obtains mortgage financing for the development. The lease rate is based on a negotiated rate to cover all of Developer Jones's soft and hard costs for the development (return of capital) and to provide Developer Jones with a profit margin (return on capital).

On the reverse side, ABC Retail knows its cost of capital for mortgage financing if it owned the subject. ABC Retail also knows its cost of capital for financing the purchase of personal property and inventory. It also has calculated expected sales at the new location and the associated costs of owning the subject rather than leasing it. In the negotiation of the lease rate, it too has

negotiated a rent that, when amortized over the life of the lease term, will be comparable to its cost of capital through other financing mechanisms.

ABC Retail and Developer Jones are not related. Both are knowledgeable, sophisticated parties. Neither party is forced into this arrangement. Both parties act in their own self-interest. Either party can walk away if the arrangement is not mutually beneficial. Developer Jones will not undertake a project that it does not think will be profitable. ABC Retail will not use Developer Jones if it cannot get what it needs for no more than its costs of capital from another developer or other sources. This build-to-suit arrangement, when both parties agree that the rental reflects market rent, is potentially an open-market transaction and may be used as a comparable rental.

b. Sale-Leasebacks

Now consider the same facts as above but in a sale-leaseback context. ABC Retail finances the project with its own capital or by mortgage financing because it allows for faster development than a build-to-suit plan. While the project is in development, ABC Retail markets the property on the triple-net lease market through a broker and negotiates with NNN Investments to purchase the subject from ABC Retail on completion and to lease the subject back from NNN Investments. Subject to verification, the purchase price and the rental rate are usually set at market, as agreed to by the parties.

ABC Retail and NNN Investments are not related parties. ABC Retail and NNN Investments are fully knowledgeable, sophisticated parties who negotiate an agreement that meets NNN Investments' required return on its purchase price, and ABC Retail has negotiated an agreement with NNN Investments for a market rental rate. ABC Retail is not paying more or less than what it would pay in rent through a direct lease with a developer. NNN Investments is not engaged in usury nor has it colluded with ABC Retail so that ABC Retail receives more benefit than it would have received by any other store development arrangement.

It is essential that each sale is verified to ensure it meets the necessary requirements of an arm's-length transaction between a willing buyer and a willing seller. Any sale that is not a valid market transaction should be disqualified. Especially in the case of sale-leaseback transactions, the appraiser should verify the sales, rather than simply rely on information provided by data services. It is important to determine whether the circumstances meet the market value criteria that would allow the transaction to be used in a sales comparison approach. If the sale is verified and qualified as arm's-length, additional consideration should then be given to the sale to determine whether it is reflective of market.

c. Private Sales

Now consider both scenarios in which Developer Jones or NNN Investments puts the property on the market and sells it to Retirement Fund subject to ABC Retail's leasehold. The transaction is not between related parties. All parties are knowledgeable and acting in their own self-interest and without duress. ABC Retail's prior business relationships with Developer Jones or NNN Investments are not relevant. This transaction is not a build-to-suit or a sale-leaseback transaction. This is an open-market transaction.

Given the uniqueness, size, and location of the property, the broker knows that there is a specific group of market participants who would be interested and financially capable. One in this group buys the property. This may be termed a private sale, but it is a valid market transaction. None of the parties are related; no one was under duress; and all parties acted in their own self-interest. The broker used segmentation marketing to target the most likely buyers. This is an arm's-length transaction.

4. Market Segmentation

In general, big-box properties are configured as single-tenant properties that may be modified to accommodate a variety of users. While it is ideal to narrow the property's highest and best use and those of the comparable sales as much as possible, care must be taken not to identify a specific user, because this may be interpreted as a value-in-use. Characteristics such as size, age, condition of the property, access, traffic counts, proximity to major employment centers, the concentration cluster of surrounding properties, and population size are among factors that influence a big-box retail property's competitive position in the market. These determinants contribute to establishing the appropriate trade area and also the suitable comparisons to use in the sales comparison approach. As such, differentiating the subject property and comparable properties into segments such as investment classes or retail types creates a logical hierarchy.

The proper selection of comparable sales is essential for the sales comparison approach to reach a reliable conclusion of value. Narrowing the highest and best use of the comparables assists an appraiser in identifying those properties most similar to the subject. Once the highest and best use of the subject and potential sales are determined, they may be classified into one of the investment classes (A, B, C, or D as described earlier) and/or segmented by type, such as home improvement, discount department store, and so forth. Segmenting sales properties into investment classes ensures that similar properties are being used as comparisons to the subject property, ideally with first generation compared to first generation and so on. With regard to vacant properties being used as comparisons with occupied properties, until vacant properties have tenants in-place, it is somewhat uncertain what investment class is appropriate or what adjustment would be required for the speculative lease-up period. Unless the property leases up quickly and this information is available, similar properties should be used in trying to measure market prices and investment classes.

5. Deed-Restricted Comparable Sales

Deed restriction is defined by *The Dictionary of Real Estate Appraisal* as follows:

> *A provision written into a deed that limits the use of land. Deed restrictions usually remain in effect when title passes to subsequent owners.* (Appraisal Institute 2015, 6)

If the subject property does not have a deed restriction, comparable sales with such deed restrictions should not be used as comparisons to the subject. It is difficult, if not impossible, to quantify an adjustment that accurately captures the number of prospective buyers who turned

away from a property that sold with a deed restriction. By design, deed restrictions are imposed to limit competition by forcing a change in that property's originally intended highest and best use, rendering the sale unsuitable as a comparable substitute for the subject property.

The following excerpt was taken from a deed restriction on a big-box property and serves as an example of the types of limitations that may be imposed:

> This conveyance is expressly subject to the following conditions and restrictions:
>
> (a) The Property will not be used for or in support of the following: (i) a grocery store or supermarket, as hereinafter defined below; (ii) a wholesale club operation similar to that of a (*retailers intentionally omitted*); (iii) a discount department store or other discount store, as hereinafter defined; (iv) a pharmacy (the "Property Restrictions"). "Grocery store" and "supermarket," as those terms are used herein, shall mean a food store or a food department containing more than thirty-five thousand (35,000) square feet of gross leasable area, for the purpose of selling food for consumption off the premises, which shall include but not be limited to the sale of dry, refrigerated or frozen groceries, meat, seafood, poultry, produce, delicatessen or bakery products, refrigerated or frozen dairy products, or any grocery products normally sold in such stores or departments. "Discount department store" and/or "discount store," as those terms are used herein, shall mean a discount department store or discount store containing more than fifty thousand (50,000) square feet of gross leasable area, for the purpose of selling a full line of hard goods and soft goods (e.g., clothing cards, gifts, electronics, garden supplies, furniture, lawnmowers, toys, health and beauty aids, hardware items, bath accessories and auto accessories) at a discount in a retail operation similar to that of (*retailer intentionally omitted*) or any parent company, affiliate subsidiary, or related company.
>
> (b) The property Restrictions shall remain in effect for a period of twenty (20) years from the recording of this deed. The aforesaid Property Restrictions shall run with and bind the Property, and shall inure to the benefit of and be enforceable by Grantor, or its successors and assigns, by any appropriate proceedings at law or in equity to prevent violations of such aforesaid Property restrictions or to recover damages for such violations.

C. Income Capitalization Approach

In the Income Capitalization Approach, market value is defined as the present worth of future benefits arising from the ownership of the property. This definition reflects the Principle of Anticipation. Income-producing real property typically is purchased for the right to receive the future income stream of the property. The assessor analyzes this income stream in terms of

quantity, quality, and duration and then converts it by means of an appropriate capitalization rate into an indication of market value (Thimgan 2010).

Big-box properties are mostly owner-occupied by retailers, but often these properties are owned by investors and occupied by the retailers under a long-term lease. Thus, the use of the income capitalization approach to value can be utilized with empirical evidence supporting market rent estimates and overall capitalization rates. The income capitalization approach emulates market behavior from the perspective of investors, particularly of big-box, net-leased sale transactions. Investors buy a property for the income stream, and they understand that there is a direct relationship between income characteristics and property value.

1. Strengths of the Income Capitalization Approach

Big-box properties are often leased. Thus, it is likely that the fee simple owner of the real estate is interested in the income stream of the property and consequently looks to an income approach to determine the value of the property. There are a few parameters to consider for a single-tenant, triple-net-leased, big-box property. Typically an appraiser ascribes market rent, nominal vacancy, a small amount for management and miscellaneous expenses, and a market-supported capitalization rate in order to derive an estimate of market value.

2. Weaknesses of the Income Capitalization Approach

A major concern with the income capitalization approach is the selection of an appropriate capitalization rate. While estimating the income and the projected operating expenses may be challenging, any slight error in either estimate is magnified on capitalization.

3. Yield Capitalization versus Direct Capitalization

A criticism of this approach, in jurisdictions in which market rent is the underlying valuation requirement, is that it incorporates speculative modeling criteria and is rarely used by market participants in the sale and purchase of big-box properties. Also, courts are often skeptical about the reliability of yield capitalization. Direct capitalization, on the other hand, uses the relationship of one year's net income, usually the first year of ownership, to determine a value. This method is preferred by buyers and sellers of big-box properties and is often quoted on broker marketing flyers and emails. This is the method generally accepted by appraisers and generally receives greater acceptance in courts. For mass appraisal, direct capitalization is used because it is simpler and less speculative and has more market evidence.

4. Direct Capitalization Methodology

a. Identification of Lease Comparable Properties

The first step in the direct capitalization approach is to determine market rent:

> *[T]he most probable rent that a property should bring in a competitive and open market reflecting the conditions and restrictions of a specified lease*

> *agreement, including rental adjustments and revaluation, permitted uses, use restrictions, expense obligations, term, concessions, renewal and purchase options, and tenant improvements (TIs)* (Appraisal Institute 2015, 140).

Market rent is the essential basis of fee simple valuations:

> *Market rent is the rental income a property would command in the open market. It is indicated by the current rents that are either paid or asked for comparable space with the same division of expenses as of the date of the appraisal ... .*
>
> *Rent for vacant or owner occupied space is usually estimated at market rent levels and distinguished from contract rent in the income analysis. In fee simple valuations, all rentable space is estimated at market rent levels*. (Appraisal Institute 2015, 447)

For a fully occupied, well-maintained, functional big-box property, recent comparable rents for first-generation space (investment classes A and B) should be used:

> *First-generation space—a building or space designed to be functionally and economically efficient for the original tenant or a similar class of tenants over a period of time during which the space retains its original utility and desirability* (Appraisal Institute 2015, 210).

Investment classes C and D improvements are losing or have lost their appeal to first-generation users and may be suitable only to second-generation users. Recent comparable rentals of these types of properties are appropriate for consideration of market rent estimates for properties that are no longer prime investments or are nearing the end of their useful lives for their intended use and utility when built.

The Dictionary of Real Estate Appraisal defines second-generation space as follows:

> *Second-generation space—a building or space used by a tenant other than the original tenant; often functionally obsolete before refurbishment but sometimes containing tenant improvements that can be reused by a new tenant* (Appraisal Institute 2015, 210).

We propose the following alternative definition, which is consistent with the concepts underlying the definition of first-generation space shown above and is a more accurate depiction of second-generation space:

> *Second-generation space—a building or space whose design is no longer functionally and/or economically desirable for the original tenant or a similar class of tenants. The space may no longer retain its original utility and/or desirability for the original tenant but may be used by a tenant other than the original or similar class of tenant*.

b. Vacancy and Collection Loss

Vacancy is typically determined by examination of the market. However, in the case of national credit, single-tenant, big-box retailers, the likelihood of incurring any vacancy or collection loss during the term of the lease is highly improbable. Nonetheless, a vacancy and collection loss, even if negligible, may be justified for future uncertainty.

c. Operating Expenses

In big-box retail, the lease structure generally is triple net or absolute net, so expenses to the owner are nominal. In the triple-net lease, the owner may be responsible only for structural repairs and a management fee. Because a big-box property is occupied by a single tenant, management involvement is minimal.

d. Capitalization Rates

Data extracted directly from market transactions may be the most reliable source for capitalization rates. However, when sales transactions and such data are scarce, additional examination should be given to investor surveys. Some surveys reflect investor expectations, not actual market transactions, and it is essential to understand the range indicated in investor surveys rather than simply relying on the average. Investor surveys cast a wide net and may not be market-specific, so care should be taken in considering what the surveys actually measure. The average will likely be higher than the capitalization rate for investment classes A and B big-box properties and lower than the capitalization rate for investment classes C and D big-box properties. The band-of-investment technique may also be used to determine overall capitalization rates using criteria that factor in current debt and equity parameters.

X. RECONCILIATION

In estimating a value for the subject property, the appraiser must consider and resolve multiple value indications produced by the three approaches to value. The reconciliation can also serve as a test of reasonableness in support of one approach over another or as additional support for an indication of value arrived through any of the approaches used.

The cost approach is useful when there is a scarcity of comparable sales in the market and another approach is needed to develop a well-founded valuation. The cost to acquire land and construct improvements is a fundamental financial feasibility analysis that big-box investors perform to assess the economic viability of new big-box construction, so this approach directly replicates investor behavior.

The cost approach also serves as a reliable indication of value, particularly for investment classes A and B properties that are new or well-maintained and for which depreciation is minimal. A supportable land valuation may also provide valuation support to investment classes C and D properties that are approaching the end of their economic lives. A well-founded estimate of land

value assists the appraiser in determining when a property is approaching or has reached the end of its economic life, as class D properties are often interim uses or potential redevelopment sites.

The sales comparison approach provides strong support when there are ample data with suitable substitute properties, but it is less reliable when true comparables are not available. Again, investment class identification for the subject property and stratification of potential sales will reveal which comparable properties are most appropriate comparisons for the subject property and whether the search may be broadened to identify other similar class properties for use in this analysis.

The income capitalization approach is a method used by investors to convert income into value, but this approach is dependable only when the data obtainable are comparable to the property being appraised. Investment classes A and B properties generally have the highest rents and lowest capitalization rates. By grouping the properties into investment classifications, the appraiser will be able to identify the appropriate estimate of market rent and market-supported capitalization rates to use for the subject property.

It is difficult to address all these big-box retail valuation issues in one approach to value; developing all three approaches reinforces one another. Each approach to value has its strengths and its weaknesses. Strengths are magnified when more approaches are applied, and weaknesses are amplified when approaches are eliminated.

When all three methodologies are used, they enhance the credibility of an equitable big-box retail property assessment. When using more than one approach to value, the appraiser should reexamine the entire appraisal, especially for accuracy, relevance, and market support of all of the data in each approach, and reconcile the differences in the value conclusion between the approaches. The final step is to exercise judgment in determining the approach or approaches to rely on for a final conclusion of value.

XI. CONCLUSION

Recent controversy and litigation surrounding big-box valuation claims that assessments are not equitable have prompted a need for this position paper. This paper provides guidance with using appraisal methodologies to derive the appropriate value required by the jurisdiction for big-box retail stores' assessments. A myriad of issues are involved in the valuation and defense of big-box retail, and it is recommended that an appraiser develop all three approaches to value when determining a property's market value.

The appraiser may ultimately discard or give no or little weight to a particular approach if a jurisdiction has specific requirements for methodologies to consider, disqualify, or rely on. Otherwise, it is important to employ all appraisal valuation approaches that will lead to credible conclusions.

XII. ACKNOWLEDGMENTS

This position paper was completed through the dedicated efforts of the Special Committee on Big-Box Valuation comprising the following:

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The committee worked closely with Margie Cusack, IAAO Research Manager, and thanks her for her significant support and assistance.

The committee acknowledges the many appraisal and assessment professionals, real estate consultants, lawyers, and tax agents who provided comments and content review throughout this process.

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Restatement of Property §14 (Am. Law Inst. 1936)

Rite Aid Corp. v. Borough of Roselle

Tax Court of New Jersey

April 13, 2017, Decided

Docket No. 004481-2009, Docket No. 001348-2010

Reporter
2017 N.J. Tax Unpub. LEXIS 23 *; 2017 WL 1376813

Re: Rite Aid Corporation v. Borough of Roselle

Core Terms

lease, subject property, ***tax*** year, pharmacy, Appraisal, market rent, ratio, highest and best use, comparable, opined, retail, drive-through, credible, rent, capitalization rate, tenant, property's, adjusted, mortgage, space, per square foot, true market ***value***, comparable sale, court finds, capitalization, cost approach, municipality, constructed, collection, vacancy

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Judges: Hon. Patrick DeAlmeida, P.J.T.C.

Opinion by: Hon. Patrick DeAlmeida

Opinion

Dear Counsel:

This letter constitutes the court's opinion after trial in the above-referenced matters challenging the assessments on real property leased by plaintiff for ***tax*** years 2009 and 2010. For the reasons explained more fully below, the assessments are affirmed.

I. *Procedural History and Findings of Fact*

The following findings of fact and conclusions of law are based on the evidence and testimony admitted at trial.

These matters concern real property in defendant Roselle Borough, Union County, owned by Roselle Equities, LLC. The property is designated in the records of the municipality as Block 7307, Lot 1.01 and is commonly known as 67 St. George Avenue. Plaintiff Rite Aid Corporation is a tenant at subject property and is responsible for paying local property ***taxes*** on the parcel.

The subject property is approximately 2.072 acres on which sits a one-story, freestanding, masonry with brick-face building constructed as a retail pharmacy. The structure has a two-lane, drive-through **[*2]** customer service area and 14,717 square feet of ground-floor rentable space, with a 414-square-foot storage mezzanine. Construction of the building was completed in 2005 for use as an Eckerd Pharmacy. Plaintiff acquired Eckerd Pharmacies in 2006, assumed the lease, and continued to operate a pharmacy on the property as a Rite Aid Pharmacy.

The subject property is located on a busy avenue in a neighborhood with a high concentration of retail establishments. The subject has direct access to St. George Avenue, as well as indirect access through a dedicated road to Wood Avenue, another heavily trafficked road with a concentration of commercial establishments. The property is in a commercial zone and the retail pharmacy use is consistent with zoning controls. The parcel has adequate on-site parking. There are a limited number of commercial vacancies in the vicinity of the subject property.

For ***tax*** years 2009 and 2010, the subject property was assessed as follows:

Go to table1

The Chapter 123 average ratio for the municipality for ***tax*** year 2009 is 42.32. When the average ratio is applied to the assessment, the implied equalized ***value*** of the subject property **[*3]** for ***tax*** year 2009 is

$5,150,284.

The Chapter 123 average ratio for the municipality for ***tax*** year 2010 is 43.22. When the average ratio is applied to the assessment, the implied equalized ***value*** of the subject property for ***tax*** year 2010 is $5,043,036.

Plaintiff filed timely Complaints in this court challenging the ***tax*** years 2009 and 2010 assessments on the subject property. The municipality did not file a Counterclaim for either ***tax*** year.

During the two-day trial, each party presented an expert real estate appraiser to offer an opinion of the true market ***value*** of the subject property on the relevant valuation dates. The opinions of the expert witnesses are summarized as follows:

Go to table2

Plaintiff's expert reached his opinion of true market ***value*** after considering all three of the commonly accepted approaches to determining ***value***: the cost approach, the income capitalization approach, and the comparable sales approach. He ultimately relied most heavily on his ***value*** conclusion under the income capitalization approach. The municipality's expert used only the **[*4]** income capitalization approach to formulate his opinions of true market ***value***, offering the opinion that the other approaches to determining ***value*** were inapplicable to the subject property.

II. *Conclusions of Law*

The court's analysis begins with the well-established principle that "[o]riginal assessments . . . are entitled to a presumption of validity." *MSGW Real Estate Fund, LLC v. Borough of Mountain Lakes, 18 N.J. **Tax** 364, 373 (**Tax** 1998)*. As Judge Kuskin explained, our Supreme Court has defined the parameters of the presumption as follows:

> The presumption attaches to the quantum of the ***tax*** assessment. Based on this presumption the appealing taxpayer has the burden of proving that the assessment is erroneous. The presumption in favor of the ***taxing*** authority can be rebutted only by cogent evidence, a proposition that has long been settled. The strength of the presumption is exemplified by the nature of the evidence that is required to overcome it. That evidence must be "definite, positive and certain in quality and quantity to overcome the presumption."

Ibid. (quoting *Pantasote Co. v. City of Passaic, 100 N.J. 408, 413, 495 A.2d 1308 (1985)*(citations omitted)).

The presumption of correctness arises from the view "that in ***tax*** matters it is to be presumed that governmental authority has been exercised correctly and in accordance with law." *Pantasote, supra, 100 N.J. at 413* (citing *Powder Mill, I Assocs. v. Township of Hamilton, 3 N.J. **Tax** 439 (**Tax** 1981)*; *see **[*5]** also Byram Twp. v. Western World, Inc., 111 N.J. 222, 544 A.2d 37 (1988)*. The presumption remains "in place even if the municipality utilized a flawed valuation methodology, so long as the *quantum* of the assessment is not so far removed from the true ***value*** of the property or the method of assessment itself is so patently defective as to justify removal of the presumption of validity." *Transcontinental Gas Pipe Line Corp. v. Township of Bernards, 111 N.J. 507, 517, 545 A.2d 746 (1988)*.

"The presumption of correctness . . . stands, until sufficient competent evidence to the contrary is adduced." *Little Egg Harbor Twp. v. Bonsangue, 316 N.J. Super. 271, 285-86, 720 A.2d 369 (App. Div. 1998)*(citation omitted); *Atlantic City v. Ace Gaming, LLC, 23 N.J. **Tax** 70, 98 (**Tax** 2006)*. "In the absence of a *R. 4:37-2(b)* motion . . . the presumption of validity remains in the case through the close of all proofs." *MSGW Real Estate Fund, LLC, supra, 18 N.J. **Tax** at 377*. In making the determination of whether the presumption has been overcome, the court should weigh and analyze the evidence "as if a motion for judgment at the close of all the evidence had been made pursuant to *R. 4:40-1* (whether or not the defendant or plaintiff actually so moves), employing the evidentiary standard applicable to such a motion." *Ibid.* The court must accept as true the proofs of the party challenging the assessment and accord that party all legitimate favorable inferences from that evidence. *Id. at 376* (citing *Brill v. Guardian Life Ins. Co. of Am., 142 N.J. 520, 535, 666 A.2d 146 (1995)*). In order to overcome the presumption, the evidence "must be 'sufficient to determine the ***value*** of the property **[*6]** under appeal, thereby establishing the existence of a debatable question as to the correctness of the assessment.'" *West Colonial Enters, LLC v. City of East Orange, 20 N.J. **Tax** 576, 579 (**Tax** 2003)*(quoting *Lenal Props., Inc. v. City of Jersey City, 18 N.J. **Tax** 405, 408 (**Tax** 1999)*, *certif. denied*, *165 N.J. 488, 758 A.2d 647 (2000))*, *aff'd*, *18 N.J. **Tax** 658 (App. Div. 2004)*.

Only after the presumption is overcome with sufficient evidence at the close of trial must the court "appraise

the testimony, make a determination of true ***value*** and fix the assessment." *Rodwood Gardens, Inc. v. City of Summit, 188 N.J. Super. 34, 38-39, 455 A.2d 1136 (App. Div. 1982)*. If the court determines that sufficient evidence to overcome the presumption that the assessment is correct has not been produced, the assessment shall be affirmed and the court need not proceed to making an independent determination of ***value***. *Ford Motor Co. v. Township of Edison, 127 N.J. 290, 312, 604 A.2d 580 (1992)*; *Global Terminal & Container Serv. v. City of Jersey City, 15 N.J. **Tax** 698, 703-04 (App. Div. 1996)*.

The court finds that plaintiff produced sufficient evidence to overcome the presumption of validity attached to the assessments. If taken as true, the opinion of plaintiff's expert and the facts upon which he relied, create a debatable question regarding the correctness of the assessment in each ***tax*** year sufficient to allow the court to make an independent determination of the ***value*** of the subject property. The expert opined that on each valuation date the subject property was worth at least $1 million dollars less than the implied equalized ***value*** reflected by the assessment for that year. If taken as true, **[*7]** the opinion of plaintiff's expert supports a conclusion that the property has been assessed significantly in excess of its true market ***value***.

The court's inquiry, however, does not end here. Once the presumption is overcome, the "court must then turn to a consideration of the evidence adduced on behalf of both parties and conclude the matter based on a fair preponderance of the evidence." *Ford Motor Co., supra, 127 N.J. at 312* (quotations omitted). "[A]lthough there may have been enough evidence to overcome the presumption of correctness at the close of plaintiff's case-in-chief, the burden of proof remain[s] on the taxpayer throughout the entire case . . . to demonstrate that the judgment under review was incorrect." *Id. at 314-15* (citing *Pantasote, supra, 100 N.J. at 413*).

A. *Highest and Best Use*

An essential element of the court's determination of the true market ***value*** of the subject property is a finding of the property's highest and best use. In *Clemente v. Township of South Hackensack, 27 N.J. **Tax** 255, 267-269 (**Tax** 2013)*, *aff'd*, *28 N.J. **Tax** 337 (App. Div. 2015)*, Judge Andresini succinctly explained the legal precedents that guide this court in making a highest and best use determination:

> For property ***tax*** assessment purposes, property must be ***valued*** at its highest and best use. *Ford Motor Co. v. Township of Edison, 127 N.J. 290, 300-01, 604 A.2d 580 (1992)*. "Any parcel of land should be examined for all possible uses and that use which will yield the highest return **[*8]** should be selected." *Inmar Associates, Inc. v. Township of Edison, 2 N.J. **Tax** 59, 64 (**Tax** 1980)*. Accordingly, the first step in the valuation process is the determination of the highest and best use for the subject property. *American Cyanamid Co. v. Township of Wayne, 17 N.J. **Tax** 542, 550 (**Tax** 1998)*, *aff'd*, *19 N.J. **Tax** 46 (App. Div. 2000)*. "The concept of highest and best use is not only fundamental to valuation but is a crucial determination of market ***value***. This is why it is the first and most important step in the valuation process." *Ford Motor Co. v. Township of Edison, 10 N.J. **Tax** 153, 161 (**Tax** 1988)*, *aff'd o.b. per curiam*, *12 N.J. **Tax** 244 (App. Div. 1990)*, *aff'd*, *127 N.J. 290, 604 A.2d 580 (1992)*; *see also Gen. Motors Corp. v. City of Linden, 22 N.J. **Tax** 95, 107 (**Tax** 2005)*.
>
> The definition of highest and best use contained in *The Appraisal of Real Estate*, a text frequently used by this court as a source of basic appraisal principles, has remained relatively constant for all of the years under appeal. Highest and best use is defined as:
>
> > The reasonably probable and legal use of vacant land or improved property that is physically possible, appropriately supported, and financially feasible and that results in the highest ***value***.
> >
> > [*Appraisal Institute*, The Appraisal of Real Estate, 22 (13th ed. 2008).]
>
> The highest and best use analysis requires sequential consideration of the following four criteria, determining whether the use of the subject property is: 1) legally permissible; 2) physically possible; 3) financially feasible; and 4) maximally productive. *Ford Motor Co., supra, 10 N.J. **Tax** at 161*; *see* ***[*9]*** *also The Appraisal of Real Estate* at 279. Implicit in this analysis is the assumption that the proposed use is market-driven; in other words, that it is determined in a ***value***-in-exchange context and that there is a market for such use. *WCI-Westinghouse v. Township of Edison, 7 N.J. **Tax** 610, 616-17 (**Tax** 1985)*, *aff'd o.b. per curiam*, *9 N.J. **Tax** 86 (App. Div. 1986)*. A highest and best use determination is not based on ***value-in-use***

because the determination is a function of property use and not a function of a particular owner's use or subjective judgment as to how a property should be used. *See* Entenmann's Inc. v. Borough of Totowa, 18 N.J. **Tax** 540, 545 (**Tax** 2000). The highest and best use of an improved property is the "use that maximizes an investment property's ***value***, consistent with the rate of return and associated risk." Ford Motor Co., supra, 127 N.J. at 301, 604 A.2d 580. Further, the "actual use is a strong consideration" in the analysis. Ford Motor Co., supra, 10 N.J. **Tax** at 167.

Highest and best use is not determined through subjective analysis by the property owner. *The Appraisal of Real Estate* at 279. The proper highest and best use requires a comprehensive market analysis to ascertain the supply and demand characteristics of alternative uses. *See* Cherry Hill, Inc. v. Township of Cherry Hill, 7 N.J. **Tax** 120, 131 (**Tax** 1984), *aff'd*, 8 N.J. **Tax** 334 (App. Div. 1986). Additionally, the proposed use must not be remote, speculative, or conjectural. *Id.* If a party seeks to demonstrate that a property's highest and best use is other than its current use, it is incumbent upon that party to establish that proposition **[*10]** by a fair preponderance of the evidence. Penn's Grove Gardens, Ltd v. Penns Grove Borough, 18 N.J. **Tax** 253, 263 (**Tax** 1999); Ford Motor Corp., supra, 10 N.J. **Tax** at 167. Property should be assessed in the condition in which it is utilized and the burden is on the person claiming otherwise to establish differently. Highview Estates v. Borough of Englewood Cliffs, 6 N.J. **Tax** 194, 200 (**Tax** 1983).

Although there was a suggestion during trial that the parties' expert witnesses offered differing views on the subject property's highest and best use, a close examination of the trial reveals that the experts agree that the highest and best use of the subject property is for rental to a retail establishment. The court accepts this highest and best use as credible.

Where the experts differ is the type of leases that provide the most credible evidence of market rent for the subject property. Plaintiff's expert offered the opinion that leases executed in connection with the construction of pharmacies are not credible evidence of market rent. He relies instead on leases of generic retail space and retail space rented to pharmacies in structures not built to suit for the pharmacy tenants. Defendant's expert, on the other hand, relies solely on leases to national retail pharmacies. The court will address market rent later in this opinion.

A. *Approach to Valuation*

"There are three traditional appraisal **[*11]** methods utilized to predict what a willing buyer would pay a willing seller on a given date, applicable to different types of properties: the comparable sales method, capitalization of income and cost." Brown v. Borough of Glen Rock, 19 N.J. **Tax** 366, 376 (App. Div.)(citing Appraisal Institute, *The Appraisal of Real Estate* 81 (11th ed 2006)), *certif. denied*, *168 N.J. 291, 773 A.2d 1155 (2001)*. "There is no single determinative approach to the valuation of real property." 125 Monitor Street, LLC v. City of Jersey City, 21 N.J. **Tax** 232, 237 (**Tax** 2004)(citing Samuel Hird & Sons, Inc. v. City of Garfield, 87 N.J. Super. 65, 72, 208 A.2d 153 (App. Div. 1965); ITT Continental Baking Co. v. Township of East Brunswick, 1 N.J. **Tax** 244 (**Tax** 1980)), *aff'd*, 23 N.J. **Tax** 9 (App. Div. 2005). "The choice of the predominate approach will depend upon the facts of each case and the reaction of the experts to those facts." Id. at 238 (citing City of New Brunswick v. Division of **Tax** Appeals, 39 N.J. 537, 189 A.2d 702 (1963); Pennwalt Corp. v. Township of Holmdel, 4 N.J. **Tax** 51, 61 (**Tax** 1982)).

The income capitalization approach is the preferred method of estimating the ***value*** of income producing property. Parkway Village Apartments Co. v. Township of Cranford, 108 N.J. 266, 270, 528 A.2d 922 (1987); Hull Junction Holding Corp. v. Borough of Princeton, 16 N.J. **Tax** 68, 79 (**Tax** 1996). "In the income capitalization approach, an appraiser analyzes a property's capacity to generate future benefits and capitalizes the income into an indication of present ***value***." Appraisal Institute, *The Appraisal of Real Estate* 445 (13th ed 2008). The court finds that the income capitalization approach is the best method for determining the ***value*** of the subject property, an income-producing building suited for use as a retail space. Both experts used this approach in formulating their opinions of ***value***. Plaintiff's expert relied most heavily **[*12]** on this approach among the three approaches that he used and defendant's expert relied only on this approach.

The court rejects the opinions of ***value*** offered by plaintiff's expert under the cost approach and the sales comparison approach. The expert's cost approach analysis suffered from a number of flaws that undermined the credibility of his opinion. As a preliminary consideration, "[t]he cost approach is normally relied on to ***value*** special purpose property or unique structures for which there is no market." Borough

of Little Ferry v. Vecchiotti, 7 N.J. **Tax** 389, 407 (**Tax** 1985); Dworman v. Borough of Tinton Falls, 1 N.J. **Tax** 445, 452 (**Tax** 1980), *aff'd*, 180 N.J. Super. 366, 3 N.J. **Tax** 1, 434 A.2d 1134 (App. Div.), *certif. denied*, *88 N.J. 495, 443 A.2d 709 (1981)*. There is no credible evidence in the record that the subject property fits into this category. The structure is suited for use as a retail space.

Second, plaintiff's expert did not accurately calculate the cost of constructing the subject property. The cost approach "involves a replication, through the use of widely accepted cost services . . . of the cost of the components of the building to be ***valued***, less . . . depreciation[s]." Gale & Kitson Fredon Golf, LLC v. Township of Fredon, 26 N.J. **Tax** 268, 283 (**Tax** 2011)(quotations omitted). "A cost approach has two elements - land ***value*** and the reproduction or replacement cost of the buildings and other improvements." International Flavors & Fragrances, Inc. v. Borough of Union Beach, 21 N.J. **Tax** 403, 417 (**Tax** 2004). Here, the expert failed to include in his calculations the costs associated with constructing **[*13]** the two-lane, drive-through component of the subject property. He admitted, however, that the drive-through lanes are an integral part of the structure, particularly for pharmacy tenants, but valuable to other retail tenants. It is clear to the court that this important feature of the building should have been included in the cost analysis. In addition, the expert failed to include the cost of constructing the mezzanine inside the subject property, as well as the site improvements, and used an incorrect height for the structure. The height of a building is an essential component of cost. Additionally, the expert used an incorrect year of construction for the subject property. Age is an important factor in the cost approach. Construction costs must be calculated from the year of construction and trended to the relevant valuation dates. In addition, depreciation is measured in large part by a structure's age.

Finally, the comparable land sales used by the expert to reach an opinion of ***value*** under the cost approach were unpersuasive. One of the comparable land sales was of property not zoned for retail uses. Other comparable land sales were associated with a bankruptcy or other distressed **[*14]** situations not investigated by the expert. Also, the expert opined that several of the comparable land sales were sold with development approvals in place. He admitted on cross-examination, however, that he was not sure that development approvals were in place for one of the sales and could not identify with certainty any of his comparable land sales in which development approvals had been obtained at the time of the sale. These are crucial admissions, given that an adjustment to the sales prices would certainly have been warranted had the purchase been made contingent on securing development approvals.

With respect to the comparable sales approach, the court concludes that the sales on which plaintiff's expert relied lack credibility as evidence of ***value*** of the subject property. Many of the comparable sales are not representative of the subject, as they concern generic retail properties lacking in the features and amenities that significantly contribute to the ***value*** of the subject property. For example, the expert's comparable sale No. 3 is of a former industrial building converted to retail use. The expert did not provide a date of construction of the structure or the date of its **[*15]** conversion. In addition, it is readily apparent from a photograph in the record, that the building, which has no windows, no drive-through lanes, and no distinguishing exterior characteristics, is entirely dissimilar to the relatively new retail pharmacy that is the subject of this appeal. Similarly, the expert's comparable sale No. 4 is of a masonry commercial building of unspecified age with limited on-site parking, no drive-through lanes, and two garage bays, apparently appropriate for car repair services. Again, this structure is dissimilar to the subject. The structures associated with the expert's comparable sale No. 1 were demolished shortly after the sale to make way for the construction of a new building, strongly suggesting that the sale price reflects only land ***value***. The expert's comparable sale No. 5, which he admitted is "not highly representative of the subject," is of a building constructed in 1955 and in average condition.

Importantly, plaintiff's expert did not make adjustments to the comparable sales to account for the fact that a number of the transactions involved properties with leases in place. The sales prices on these transactions likely represent not true market **[*16]** ***value***, but leased fee ***value***. That is, the parties to the transfer real property with a long-term lease in place are likely to arrive at purchase price that reflects the present day ***value*** of the income stream resulting from the lease. An existing lease might be at, below, or above, market rent. A purchase price determined based on the income generated by an existing lease, therefore, might not accurately reflect market ***value***, which is the foundation of a local property ***tax*** assessment. Because the sale of a leased fee interest will not necessarily reflect market

value "when analyzing a lease fee interest, it is essential that the appraiser analyze all of the economic benefits or disadvantages created by the lease." *International Flavors & Fragrances, supra, 21 N.J. **Tax** at 423* (quotations omitted).

B. *Calculation of **Value** Using Income Approach*

Determining the ***value*** of real property pursuant to the income approach can be summarized as follows:

Market Rent

x Square Footage
Potential Gross Income

- Vacancy and Collection Losses
Effective Gross Income

- Operating Expenses
Net Operating Income

÷ Capitalization Rate

Value of Property

*See Spiegel v. Town of Harrison, 19 N.J. **Tax** 291, 295 (App. Div. 2001)*, *aff'g*, *18 N.J. **Tax** 416 (**Tax** 1999)*; Appraisal Institute, *The Appraisal of Real Estate* 466 (13th ed 2008).

1. *Market Rent*

"Central to an income analysis is **[*17]** the determination of the economic rent, also known as the 'market rent' or 'fair rental ***value***.'" *Parkway Village Apartments, supra, 108 N.J. at 270*. This differs from the actual rental income realized on the property, which may be below market rates. *Parkview Village Assocs. v. Borough of Collingswood, 62 N.J. 21, 29-30, 297 A.2d 842 (1972)*. However, actual income is a significant probative factor in the inquiry as to economic income. *Id. at 30*. "Checking actual income to determine whether it reflects economic income is a process of sound appraisal judgment applied to rentals currently being charged for comparable facilities in the competitive area." *Ibid.*

Plaintiff's expert identified six leases he considered to be reflective of market rent for the subject. Notably, the expert did not consider the lease in place at the subject, which became effective in 2005, three years prior to the first valuation date. In general, a transaction relating to the subject property near in time to the valuation date is excellent evidence of market ***value***. The expert opined that the subject lease was not reliable because it is a long-term lease with a national tenant that likely has excellent credit. In addition, the expert disregarded the lease because the prior tenant made "a business decision" to locate a pharmacy on the subject property and arranged **[*18]** for a built-to-suit structure to be constructed by the property owner. The expert speculated that the original tenant, when agreeing to a rental rate for the subject, was not concerned with obtaining market rent but was motivated by a desire to enter the local retail pharmacy market. In addition, the expert speculated that the rental rate might include a return on the cost of construction of the building. The court is not convinced by the expert's testimony.

The court accepts the proposition that a lease related to a built-to-suit structure might not reflect market rent. It is possible that the rental rate in such a lease might reflect both market rent for the structure and a partial or full repayment of the cost of constructing the building. In addition, it may be true that a particular tenant is willing to pay above market rents in order to enter a particular retail market. To reach such conclusions, however, it would be necessary for the court to evaluate evidence concerning the circumstances of the transaction that resulted in the lease, the intentions of the parties when executing the lease, and market rent for properties similar to the subject. Plaintiff's expert did not provide **[*19]** any such evidence. He was unfamiliar with the details of the formation of the lease at the subject property, and appears to have based his decision to disregard the subject lease on his supposition that all built-to-suit leases of pharmacies do not reflect market rent. In the absence of any evidence supporting his supposition, the expert's decision to disregard the subject lease undermines the credibility of his opinion of market rent.

Of the six comparable leases on which plaintiff's expert relied, only two are leases of pharmacies, neither of which is in Union County. One is a lease of a Rite Aid pharmacy in Bergen County. This pharmacy is not a free-standing building and does not have drive-through lanes. It is instead a space within a strip mall constructed in 1958 and updated "recently." The ten-year lease began in 2006 with two optional five-year renewal periods. The expert reported an "initial" rent of $28.00 per square foot, which he adjusted downward to $25.93 per square foot after considering five months of free rent given to the tenant. Although the expert admitted that the lease includes subsequent "step ups" in rent after the "initial" rent, he did not know what the "step **[*20]** p" rents are or when they took effect. The

expert conceded that he did not review the actual lease, but only a lease summary, even though Rite Aid, the tenant at the property is the plaintiff, and his client, in this case.

The other pharmacy lease on which plaintiff's expert relied was of a building in Bergen County. This also is not a free-standing building, although it has a drive-through area. It was plain during cross-examination that the expert had not verified this lease and was unfamiliar with its terms. He did not know if the lease was a renewal and could not identify the tenant with certainty. The other four leases on which he relied are of generic retail space. The expert offered the opinion that the subject property was, in effect, a plain "vanilla" space that could be leased to any retail entity. He testified that he was aware of two instances in which space previously occupied by pharmacies was leased to non-pharmacy retailers. While the court finds credible the notion that space leased to a pharmacy might subsequently be leased to a non-pharmacy retailer, plaintiff's expert provided no credible evidence that the relatively new structure at the subject property was likely **[*21]** to be leased to the non-pharmacy tenant. Nor did the expert produce credible evidence of market rent to a non-pharmacy tenant in a structure with the characteristics of the subject, including drive-through access.

For example, one comparable lease upon which plaintiff's expert relied is related to a 4,000-square-foot space in a strip mall in Elizabeth. The expert could not identify the tenant or whether there was adequate parking for the tenant's use of the space. This location does not have a drive-through facility. Two other comparable leases are of retail spaces in strip malls, with no drive-through access. The expert was not aware that the remaining comparable lease was executed when the owner of a large shopping complex had a business need to relocate an existing tenant to accommodate the construction of a ***big box*** retailer on the site. This unusual motivation on the part of the property owner was not considered by the expert when analyzing whether the lease reflects market rent.

Defendant's expert offered the more credible opinion of market rent. He relied on six comparable leases, all of pharmacies. The expert's first comparable lease is lease of the subject. Averaging the rent **[*22]** step ups on the lease, the expert determined that the lease of the subject provided a rent of $31.56 per square foot.

The expert also relied on leases of freestanding pharmacy buildings Roselle Borough (the same municipality as the subject), Springfield Township (Union County), Roseland Borough (Essex County), and West Caldwell Township (Essex County). All but one of those structures has drive-through access. In addition, the expert relied on the lease of a space in a mixed-use complex in Summit City (Union County). Although this space has no drive-through area, the expert offered the opinion that a drive-through is not necessary at this location because the intended market is for tenants of the mixed-use building, who would not need the drive-through facility to avoid exiting their vehicles in bad weather, to accommodate elderly customers, or to protect children in a parking lot (the three primary purposes of drive-through access, according to the expert).

Prior to adjustments the comparable leases had rental rates ranging from $29.68 per square foot to $37.59 per square foot. The expert made time adjustments for changes in the market, resulting in adjusted rental rates ranging from **[*23]** $32.05 per square foot to $37.59 per square foot. The court finds the adjustments made by defendant's expert to be credible. The court will, however, disregard the adjusted rental rates from comparable lease No. 3 and comparable lease No. 6, the two pharmacies with no drive-through access. Also, comparable lease No. 6 is disregarded because the property is not a free-standing building and is in a mixed-use facility, two factors that render the lease less credible as evidence of market rent for the subject.

The remaining leases have adjusted rental rates per square foot of

$33.53
$34.08 (subject)
$37.21
$37.41

Defendant's expert opined a market rent of $34.00 per square foot for ***tax*** year 2009. This is quite close the rent reflected in the lease on the subject property. The court finds the expert's opinion credible in light of the adjusted rents accepted by the court. The expert adjusted the rent upward by 2% for ***tax*** year 2010 for time and market conditions. That court finds this to be a credible adjustment and adopts a market rent of $34.70 for ***tax*** year 2010.

2. *Building Size*

The experts offered differing views with respect to the size of the subject property. The trial testimony credible establishes **[*24]** that plaintiff's expert did not measure

the subject property and that his client did not give him access to inspect the property. He instead examined the property from the public areas, having entered the store during business hours as any member of the shopping public might do. Plaintiff's expert did not examine site plans or architectural drawings of the building when determining the rentable area of the structure.

Defendant's expert, on the other hand, inspected the property and measured the building. The court finds that, in light of his more detailed examination and measurement of the property, defendant's expert offered the more credible opinion of 14,717 square feet of rentable space.

3. *Vacancy and Collection Rate*

Plaintiff's expert utilized a 7% vacancy and collection rate, with 5% for vacancy and 2% for collection loss. He opined that this is a stabilized rate for the subject property, even though there was a lower vacancy in the generic retail market of 6.6% in northern New Jersey.

Defendant's expert relied on data from what he described as the "niche" pharmacy market to opine a vacancy and collection loss rate of 3%. He based his opinion, in part, on the fact that national **[*25]** pharmacy tenants, such as plaintiff, and the tenants in the comparable leases, are excellent credit tenants, highly likely to pay rent, sometimes even after a built-to-suit building is vacated as a pharmacy to prevent its lease to a competitor. The court concludes that the vacancy and collection rate opined by defendant's expert is more credible.

4. *Operating Expenses*

Plaintiff's expert opined an overall expense rate of 10% of effective gross income per year. He concluded that management and real estate commissions would account for 7% of effective gross income, miscellaneous expenses would be $6,000 per year, and structural repairs would amount to $0.25 per square foot per of rentable space year. He did not explain the market data upon which he relied to reach these opinions.

Defendant's expert opined an overall expense rate of 7% of effective gross income. He opined a management expense of 3% per year, opining that in triple-net leases, upon which he relied, the landlord's responsibilities are limited to collecting rent and inspecting the premises to ensure proper maintenance. He further opined that built-to-suit leases rarely incur real estate commissions, as tenants tend to stay in **[*26]** place. He opined an expense 3% for real estate commissions to account for the possibility that the property would be marketed to a second-generation pharmacy. Last, defendant's expert assigned an expense rate of 1% for reserves. The court finds defendant's expert opinion regarding operating expenses to be more credible.

5. *Capitalization Rate*

The capitalization rate is an "income rate for a total real property interest that reflects the relationship between a single year's net operating income expectancy and the total property price or ***value*** . . . ." Appraisal Institute, *The Appraisal of Real Estate* at 462. The overall capitalization rate is "used to convert net operating income into an indication of overall property ***value***." *Ibid.*

Both experts used the Band of Investment technique to calculate an overall capitalization rate. "This technique is a form of 'direct capitalization' which is used 'to convert a single year's income estimate into a ***value*** indication.' The technique includes both a mortgage and an equity component." *Hull Junction Holding, supra, 16 N.J. **Tax**. at 80-81* (quoting Appraisal Institute, *Appraisal of Real Estate* 467 (10th ed 1992)).

> Because most properties are purchased with debt and equity capital, the overall capitalization rate must satisfy the market **[*27]** return requirements of both investment positions. Lenders must anticipate receiving a competitive interest rate commensurate with the perceived risk of the investment or they will not make funds available. Lenders generally require that the loan principal be repaid through periodic amortization payments. Similarly, equity investors must anticipate receiving a competitive equity cash return commensurate with the perceived risk, or they will invest their funds elsewhere.
>
> [Appraisal Institute, *Appraisal of Real Estate* 505 (13th ed 2008).]

In "using the Band of Investment technique, it is incumbent upon the appraiser to support the various components of the capitalization rate analysis by furnishing 'reliable market data . . . to the court as the basis for the expert's opinion so that the court may evaluate the opinion.'" *Hull Junction Holding, supra, 16 N.J. **Tax** at 82* (quoting *Glen Wall Assocs., supra, 99 N.J. at 279-80, 491 A.2d 1247*). "For these purposes, the ***Tax*** Court has accepted, and the Supreme Court has sanctioned, the use of data collected and published by the American Council of Life Insurance." *Id. at 82-83*. "Relevant data is also collected and published by . . .

Korpacz Real Estate Investor Survey." *Id. at 83*. "By analyzing this data *in toto*, the court can make a reasoned determination as to the accuracy **[*28]** and reliability of the mortgage interest rates, mortgage constants, loan-to-***value*** ratios, and equity dividend rates used by the appraisers." *Ibid.*

Plaintiff's expert opined a capitalization rate of 8.65% for ***tax*** year 2009. This figure is based on a 65% to 35% loan-to-***value*** ratio, a 25-year mortgage with a 6.25% interest rate, with a mortgage constant of 5.15%, and a 10.0% equity return. For ***tax*** year 2010, plaintiff's expert opined a capitalization rate of 8.42%, based on a 65% to 35% loan-to-***value*** ratio, a 25-year mortgage with a 6.5% interest rate, a mortgage constant of 8.1%, and 9% equity return.

Defendant's expert opined a capitalization rate of 7.73% for ***tax*** year 2009. This figure was based on a 70% to 30% loan-to-***value*** ratio, a 25-year mortgage with a 7.0% interest rate, with a mortgage constant of 8.48%, and a 6.0% equity return. For ***tax*** year 2010, defendant's expert opined a capitalization rate of 8.3%, based on a 70% to 30% loan-to-***value*** ratio, a 25-year mortgage with a 7.5% interest rate, a mortgage constant of 8.87%, and 7% equity return.

Based on the data submitted by both experts, the court finds that the figures offered by defendant's expert are well supported by the record **[*29]** and commensurate with the rate of risk of investment that is likely to attract investors to the subject property. Thus, the court will apply a 7.73% capitalization rate for ***tax*** year 2009 and an 8.3% capitalization rate for ***tax*** year 2010.

6. *Calculation of* ***Value***

Given that the court accepts as credible each component of the analysis of defendant's expert, the court also accepts the expert's ***value*** conclusions:

For ***tax*** year 2009, the true market ***value*** of the subject property as of October 1, 2008 was $5,839,500.

For ***tax*** year 2010. The true market ***value*** of the subject property as of October 1, 2009 was $5,550,000.

C. *Applying Chapter 123*

Pursuant to *N.J.S.A. 54:51A-6(a)*, commonly known as Chapter 123, in a non-revaluation year, an assessment must be adjusted when the ratio of the assessed ***value*** of the property to its true ***value*** exceeds the upper limit or falls below the lower limit of common level range. The common level range is defined by *N.J.S.A. 54:1-35a(b)* as "that range which is plus or minus 15% of the average ratio" for the municipality in which the subject property is located.

The true ***values*** determined above must, therefore, be compared to the average ratio for Roselle Borough for each of the relevant ***tax*** years. The formula **[*30]** for determining the subject property's ratio is:

Assessment ÷ True ***Value*** = Ratio

1. ***Tax*** *Year 2009*

$2,179,600 ÷ $5,839,500 = .3733

The Chapter 123 average ratio for Roselle Borough for ***tax*** year 2009 is .4232 with an upper limit of .4867 and a lower limit of .3597. The ratio for the subject property for this ***tax*** year is .3733, which is within the common level range. No adjustment is warranted. The court will enter Judgment affirming the assessment for ***tax*** year 2009.

2. ***Tax*** *Year 2010*

$2,179,600 ÷ $5,550,000 = .3927

The Chapter 123 average ratio for Roselle Borough for ***tax*** year 2010 is .4322 with an upper limit of .4970 and a lower limit of .3674. The ratio for the subject property for this ***tax*** year is .3927, which is within the common level range. No adjustment is warranted. The court will enter Judgment affirming the assessment for ***tax*** year 2010.

Very truly yours,

/s/ Hon. Patrick DeAlmeida, P.J.T.C.

Table1 (Return to related document text)

Land	637,700
Improvement	$1,541,900
Total	$2,179,600

Table1 (Return to related document text)

Table2 (Return to related document text)

Tax Year	2009	2010
Valuation Date	*10/1/2008*	*10/1/2009*
Plaintiff's Expert Appraiser	$4,000,000	$3,810,000[1]
Defendant's Expert Appraiser	$5,839,500	$5,550,000

Table2 (Return to related document text)

End of Document

[1] The court notes that the report of plaintiff's expert and his original testimony reflect the opinion that the true market ***value*** of the subject property as of October 1, 2008 was $3,770,000 and as of October 1, 2009 was $3,640,000. After a number of errors in his analysis came to light during cross-examination, the expert revised his opinions of ***value*** to $4,000,000 as of October 1, 2008 and $3,810,000 as of October 1, 2009.