BEFORE THE STATE TAX APPEAL BOARD
OF THE STATE OF MONTANA

KMT STORES LIMITED PARTNERSHIP, Appellant/ Respondent,	)	DOCKET NO.: PT-2004-8 and cross appeal PT-2004-9
-vs-	)	FACTUAL BACKKGROUND, CONCLUSIONS OF LAW, ORDER AND OPPORTUNITY FOR JUDICIAL REVIEW
THE DEPARTMENT OF REVENUE OF THE STATE OF MONTANA, Respondent/ Appellant.	)	

These are appeals of a decision of the Yellowstone County Tax Appeal Board. The hearing was held on May 25,2005 in Billings, Montana, in accordance with an order of the State Tax Appeal Board of the State of Montana (Board). The notice of the hearing was duly given as required by law. KMT Stores Limited Partnership was a limited liability partnership that built, and then leased, store facilities to K-Mart Stores. At the time of the hearing, the successor in interest to the appellant was an entity known as ORIX Capital, and Robert Christenson, an independent tax consultant, represented them at the hearing. Appraiser Vicky Nelson who was assisted by appraiser Ross Halvorson represented the Department of Revenue (DOR). The duty of this Board is to determine the appropriate market value for the property based on a preponderance of the evidence. Testimony was taken from both the taxpayer and the Department of Revenue, and exhibits from both parties were received.

This Board modifies the decision of the Yellowstone County Tax Appeal Board and establishes a value of $2,798,971 on the property for tax year 2004 and the balance of the current appraisal cycle.

FACTUAL BACKGROUND

1. Due, proper, and sufficient notice was given of this matter, the hearing hereon, and of the time and place of the hearing. All parties were afforded opportunity to present evidence, oral and documentary.

2. The subject property is described as follows:

> An 86,479 square foot single-tenant big box building situated on a 7.73-acre site at the northeast end of Main Street in Billings Heights, Montana. The physical address is 2376 Main Street with an assessor #11832.

3. For tax year 2004, the Department of Revenue appraised the subject land and improvements at a value of $3,831,100 using an income approach to value.

4. Taxpayer submitted an AB-26 form to request review of the property by the department. This review used actual income and expense information submitted by the taxpayer and resulted in a new value, based on the income approach, of $2,990,209.

5. Taxpayer then appealed to the Yellowstone County Tax Appeal Board and requested a value of $2,574,325. DOR sought to maintain the value established by the AB-26 review ($2,990,209). The Yellowstone County Tax Appeal Board granted the value requested by the Taxpayer.

6. As noted earlier, both parties initiated an appeal to this Board.

TAXPAYER'S CONTENTIONS

At the valuation date for this reappraisal cycle, January 1, 2002, the subject property was wholly leased to a solvent tenant, K-Mart Stores. However, on July 1, 2002, K-Mart, a large national retailer, declared bankruptcy and ceased operations (and thus lease payments) on the subject property.

The owner of the property, KMT Stores Limited Partnership, and its successors in interest have sought to sell the property since that time in 2002. They have been unsuccessful. According to Mr. Robert Christenson, who appeared at the hearing for the taxpayer, there is a limited market for retail space of that magnitude for a single tenant. The location of the property at the edge of Billings Heights is also a problem, and is clearly a secondary, or less desirable, market.

Initial efforts to market the property placed a value of 4 million dollars on the property. In August of 2003 there was an appraisal of the subject property undertaken (Taxpayer Ex. #1) which came up with a value conclusion of $1,900,000. On the basis of this appraisal the property was offered for sale at $2,350,000. During the course of the next year, there were two offers received on the property (Taxpayer's Ex.'s 2 and 3). One was for $580,000 and the other was for $688,000. Since neither offer was close to the asking prices there were no further negotiations.

In 2004 KMT DIL LLC acquired the property. In August they ordered a new appraisal to determine the current market price of the property. This appraisal (Taxpayer's Ex. 4) came up with a value conclusion of $1,500,000 for the subject property. On the basis of this appraisal, the property was listed at its current list price of $1,975,000.

At the beginning of the hearing before this Board, Mr. Christenson, as tax agent for ORIX Capital Market, LLC, stated that the value they were requesting for the subject property was the amount indicated in the first appraisal dated August 11, 2003. The indicated value in that appraisal is $1,900,000 for the property.

Given the fact that the subject property has stood empty since June of 2002 and has not attracted any serious offers in the market, taxpayer asserts that the value of the property for tax purposes should be reduced from its current value of $2,574,325.

DOR'S CONTENTIONS

For the current appraisal, DOR appraised the subject property at a value of $3,831,100, according to DOR appraiser Vicky Nelson. In August of 2003, at the request of KMT Stores Limited Partnership and after the property had been vacant for a year, the property was reviewed pursuant to an AB-26 request. According to the notes on the Property Record Card (DOR's Ex. A) several adjustments were made. The largest adjustment was that the actual expense data provided by the taxpayer was used and the income was based on the actual lease rate rather than the higher amount suggested in DOR's model ($5.12 per square foot versus $8.00 per square foot annual lease rate). The lower amount of net income resulted in a lower indicated value for the property due to the use of the income model (DOR's Ex. D). The new indicated value which DOR applied beginning in the 2003 tax year was $2,990,200. This is the amount reflected in the current Property Record Card offered as Exhibit A.

While sympathetic to the plight of the taxpayer, DOR feels it has made every effort that it could reasonably make under the law in this instance. According to appraiser Vicky Nelson, the statute requires DOR to value the property the way it exists at the valuation date at the beginning of the cycle, not at some point later in time.

BOARD DISCUSSION

As testified by the DOR, they reviewed the subject property for tax year 2003 pursuant to an AB-26 request. In this review they “plugged in” some actual income and expense data presented by the property owner. DOR used an annual square foot rental rate of $5.12, which is the rate that K-Mart was paying during its tenancy, and applied actual expense figures supplied by the owner. They also applied a 90% occupancy figure as well as giving an allowance of 5% of effective gross income for management fees. Even though the actual leasing arrangement was a triple net lease, the DOR added an effective tax rate into the capitalization rate (1.8%) in allowing an overall capitalization rate of 10.9%. These calculations are contained in DOR exhibit G and resulted in a value of $2,990,200 for the subject property derived from the income approach to value. DOR chose to use this figure as its final value for the subject property and rejected a higher figure derived from the cost approach.

The taxpayer, through Mr. Christenson, has submitted two fee appraisals, one from August of 2003 and one from August of 2004, as well as information concerning “asking prices” for the property and two offers that were made on the property. For purposes of this evaluation, this Board will analyze the first appraisal on the property, which is dated August 11, 2003. The second appraisal is very similar in approach but is further away from the beginning value date of the cycle.

On page 73 of the appraisal (Taxpayer's Exhibit 1), the reconciled value of the subject property is stated as $1,900,000 as of August 11, 2003. It is clear that the appraisal gives the greatest reliance on the income capitalization approach to value, which is to be expected with income-producing commercial property. It does, however, direct our attention to the details of the income capitalization approach used in the appraisal.

The "direct capitalization summary" is contained on page 65 of the appraisal. It uses an annual square foot rental of $4.25 which it justifies by referencing other large, "big box" spaces throughout the western United States.(See pages 56 through 58 of the appraisal, where some of the following properties are used: comp.1, former Walmart in Alamagordo, New Mexico-- $7.00 per square foot; former Kmart in Farmington, Utah-- $6.25 per square foot; former Kmart in Fargo, North Dakota---$6.50 per square foot; former Ernst in Kalispell, Montana---$4.25 per square foot.) From this information the appraisers selected $4.25 per square foot on a triple net lease basis to use as market rent. It appears that this is at the definite bottom of the surveyed rents and would give the lowest amount of imputed income. It should also be remarked that all of the surveyed "big box" retail spaces are outside of the Billings, Montana commercial area and most are outside of the state.

As shown on the "direct capitalization summary" on Page 65 of the appraisal, the Net Operating Income, after applying imputed expenses to the effective gross income, amounts to $307,887 per year. The appraisal then develops a "cap rate" of 11%, which appears to be justified. It is not substantially different than the "cap rate" developed by DOR. Applying this cap rate of 11% to the Net Operating Income produces an indicated income approach value of $2,798,971.

Up to this point, it should be noted, DOR and the taxpayer are not very far apart in value. The DOR has come up with a value, based on the income approach, of $2,990,200; and the taxpayer, in the August 2003 appraisal, has shown a value of 2,798,971.

The taxpayer's appraisal, however, takes one additional step, which has large implications for the indicated value of the subject property. Taxpayer's appraisal deducts the amount of $940,000 from the indicated value as a "lease up discount".

The stated purpose of the “lease up discount” is to recognize that the “subject [property] is currently below a stabilized occupancy position [i.e., it is vacant] and requires a deduction for lease-up to stabilization.” Taxpayer’s Exhibit No.1, p. 63. The appraisal provides further detail in a “lease up summary” on Page 64 of the appraisal where two of the major items are “rent loss from down time” ($330,782) and “retrofit/tenant improvement allowance” ($345,916).

This “retrofit/tenant improvement” strategy appears to conform to the statement in an earlier part of the appraisal under consideration of the highest and best use of the property. In that discussion, found on pages 37-39 of the appraisal, the appraisal concluded that the “highest and best use” of the subject property is “for division of the existing space and use as a multi-tenant commercial building” (Taxpayer’s Ex. No. 1, p. 39)

We do not really have any quarrel with this approach to value and obtaining the highest and best use of the property. It seems apparent that the property could return more income to the owner as a broken up, multi-tenant office and commercial building, rather than the current configuration as “big box” retail.

Our problem with this approach is that the appraisal did not go back to the income and state the amount of additional income that the taxpayer could anticipate from undertaking these improvements to the property. Taxpayer has delineated in great detail and substantial amount, the cost of these improvements; but nowhere in the appraisal is there any assessment of the anticipated additional income that could be derived from these changes.

It is the Board's opinion that the return to the taxpayer, either actually or hypothetically, would be substantially more as a multi-tenant, small commercial facility than it would in its present configuration as "big box" retail space. However, because the appraisal is deficient in providing any comparables in the market on this "highest and best use", this Board is unable to give validity and credibility to the final figures derived in the appraisal.

We will, therefore, not recognize the "lease-up discount" as stated in the appraisal. However, we will recognize the remainder of the appraisal and the value indication of the subject property of $2,798,971 as contained on page 65 of the appraisal (Taxpayer's Exhibit No. 1)

The DOR also appealed the CTAB decision seeking a value of $2,990,209. When the DOR was provided the income and expense information for the subject property they applied it to their income model in establishing the market value. It was testified that the tenant, KMART, had a triple-net lease and paid a reported rent of $5.12 SF. A triple-net lease assumes that the tenant is responsible for all expenses. The landlord would undoubtedly have some expenses, i.e., reserves for replacement, management, and possibly other incidentals. The DOR's income approach assumes that the landlord is responsible for the real estate taxes when they added an effective tax rate of 1.8% to the capitalization rate of 9.1%. If the DOR is giving credence to the triple-net lease, it is inappropriate to apply an effective tax rate.

The DOR testified that their capitalization rate was established from sales of retail property. It is the opinion of the Board that the sales used to develop the capitalization rate for the subject property are not appropriate based upon the physical differences, i.e., size, location, etc. In addition, the DOR testified that the net operating income for the sales was determined by the DOR, and not from the actual property at the time of sale. It is therefore the Board's opinion that the best indication of an appropriate capitalization rate is 11%, as concluded in the independent fee appraisal.

CONCLUSIONS OF LAW

1. The State Tax Appeal Board has jurisdiction over this matter. §15-2-301, MCA.
2. Section 15-8-111 MCA. Assessment - market value standard - exceptions. (1) All taxable property must be assessed at 100% of its market value except as otherwise provided.
3. Section 15-8-111 MCA. Assessment – market value standard - exceptions. (2) (a) Market value is the value at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.
4. Section 15-7-102 MCA. Notice of classification and appraisal to owners—appeals. (3)…. As a part of the review [of the DOR appraisal], the department may consider the actual selling price, independent appraisals of the property, and other relevant information presented by the taxpayer in support of the taxpayer's opinion as to the market value of the property.
5. The appeals of both the taxpayer and the DOR are modified and the value of the land and improvements of the subject property, formerly the K-mart store in Billings Heights, shall

be entered on the tax rolls of Yellowstone County at $2,798,971 (Land - $675,000: Improvements - $2,123,971).

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ORDER

IT IS THEREFORE ORDERED by the State Tax Appeal Board of the State of Montana that the subject property shall be entered on the tax rolls of Yellowstone County for tax year 2004 by the local Department of Revenue office at:

Land:	$ 675,000
Improvements	$2,123,971
Total Value	$2,798,971

The decision of the Yellowstone County Tax Appeal Board is modified accordingly.

Dated this 20th day of July, 2005.

BY ORDER OF THE
STATE TAX APPEAL BOARD

(S E A L)

____
GREGORY A. THORNQUIST, Chairman

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JOE R. ROBERTS, Member

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SUE BARTLETT, Member

NOTICE: You are entitled to judicial review of this Order in accordance with Section 15-2-303(2), MCA. Judicial review may be obtained by filing a petition in district court within 60 days following the service of this Order.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this 20th day of July, 2005, the foregoing Order of the Board was served on the parties hereto by depositing a copy thereof in the U.S. Mails, postage prepaid, addressed to the parties as follows:

KMT Stores Limited Partnership
145 Rosemary Street, #18
Needham, Massachusetts 02494-3238

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DONNA EUBANK
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