

Summary

Based on a preponderance of the evidence, the Board modifies the decision of the Yellowstone County Tax Appeal Board.

Evidence Presented

The property at issue in this appeal is the Hedden-Empire building in downtown Billings. Built in 1929, the building is a two-story multi-use building located at 208 North 29th Street, Billings. It is a multi-tenant building with mixed retail and office space. DOR Exh. A; Taxpayer Brief to the Montana Tax Appeal Board.

The DOR initially appraised the subject property using standard rental information and expenses for Billings office space, and set the value at \$2,954,800. DOR Exh. A, p 12. During informal review with the DOR, the Taxpayer submitted income and expenses (I&E) for the building for years 2006, 2007 and 2008. Exhs. 1, 2 and 3.

After the informal review, the DOR used those taxpayer-specific figures to determine a value of \$1,705,550 using an income approach to value. The DOR used a net operating income (NOI) of \$131,661.00, based on the I&E presented. DOR Exh. C.

The DOR divided the NOI by a standard capitalization rate of 7.72% to determine the total valuation of \$1,705,500. The capitalization rate was derived using 106 sales of office buildings between January 2003 and June 2008. The sale price and NOI was verified for each sale, and a standard capitalization rate was calculated. DOR Test. p. 68-69, DOR supplement.

The Taxpayer filed an appeal of the value set by the DOR, and the Yellowstone CTAB held a hearing in the matter. The taxpayer presented a Market Analysis and Opinion of Value by Tom Emerling, setting the value of the subject property at \$1,035,00 (Exh. 11), as well as significant data about the costs and income of the

building. Exhs. 1-11. The DOR presented its income and capitalization data to the Board. Exhs. A and B.

In determining the market value, the CTAB made certain adjustments to the NOI. The CTAB began its review with the \$131,661, and adjusted the NOI to reflect an 8% vacancy and no cost adjustment (\$17,273) and subtracted an additional \$3,968 in expenses for HVAC repair to set a \$110,420 NOI. The CTAB also adjusted the capitalization rate (to 8.6%) to reflect a final value of \$1,283,953. CTAB decision, May 20, 2011.

After the County Tax Appeal Board hearing, the Taxpayer filed an appeal with this Board and requested a total value of \$877,400. Without opposition, the Board heard the matter on the record, and both parties provided additional submissions to the Board.

Principles of Law

1. The State Tax Appeal Board has jurisdiction over this matter. §15-2-301, MCA.
2. All taxable property must be assessed at 100% of its market value except as otherwise provided. §15-8-111, MCA.
3. 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. §15-8-111(2)(a), MCA.
4. When determining the market value of commercial properties, Department appraisers will consider, if the necessary information is available, an income approach valuation. If the Department is not able to develop an income model with a valid capitalization rate based on the stratified direct market analysis, the band-of-investment method, or another accepted method, or is not able to collect sound income and expense data, the final value chosen for ad valorem tax purposes will be

based on the cost approach or, if appropriate, the market approach to value. The final valuation is that which most accurately estimates market value. Section 42.20.107, ARM.

5. The income approach is based on the theory that the market value of income-producing property is related to the amount, duration, and certainty of its income-producing capacity. Section 42.20.108(1), ARM.

6. The Department periodically requests gross rental income and expense information from commercial property owners. Standard forms, developed by the Department, are used to collect the information statewide when income-producing properties are reported sold. Additional methods of obtaining income and expense information may consist of personal or telephone contacts with owners, tenants, renters or lessees, knowledgeable lending institution officials, real estate brokers, fee appraisers, or any other sources the appraiser deems appropriate including summarized data from recognized firms which collect income and expense information, and appeal or court actions. Section 42.20.108(3), ARM.

7. When using the income approach, the Department will develop overall capitalization rates which may vary according to use type, location, and age of improvements. Rates will be determined by dividing the net income of each property in the group by its corresponding valid sale price. The overall rate chosen for each group is the median of the rates in that group. The final overall rate must include an effective tax rate. Section 42.20.109(1), ARM.

9. The appraised value supported by the most defensible valuation information serves as the value for ad valorem tax purposes. Section 42.18.110(12) ARM.

10. The State Tax Appeal Board must give an administrative rule full effect unless the Board finds a rule arbitrary, capricious, or otherwise unlawful. §15-2-301(4), MCA.

Board Discussion and Conclusions of Law

The DOR used an income approach to value the subject property. When using an income approach, the DOR uses net operating income and a capitalization rate to determine the value of the subject property. The Taxpayer requests an adjustment to the DOR's NOI to reflect a 10% vacancy rate and collection loss. The Taxpayer also requests the NOI be adjusted for additional HVAC repairs of \$15,968 originally disallowed by DOR. With those adjustments, the Taxpayer argues this Board should adopt a \$93,264 NOI for valuation purposes, divided by a 10.63% capitalization rate for a final value of \$877,366.00.

The DOR contends that the valuation requested by the taxpayer underestimates the value of the building. The DOR now contends that the proper NOI is \$115,693 (allowing for the HVAC adjustment, but no adjustment to the vacancy rate) which the Department argues should be capitalized at the standard rate used by the DOR of 7.72%

We address the arguments below. We begin with a review the methodologies used in valuation.

DIRECT CAPITALIZATION

The direct capitalization method calculates a commercial entity's value by dividing the company's annual income by a "capitalization rate," that is, the average sale price divided by the average income earned by the asset. The direct capitalization rate is a standard method used in commercial property valuation, and is widely used when properties are already operating on a stabilized basis and there is an ample supply of comparable sales with similar risk levels, incomes, expenses, physical and locational characteristics, and future expectations. *See Appraisal of Real Estate*, 12th Ed, p. 529. The parties do not contest this valuation method, but rather the specific data used to derive the income and the capitalization rate.

Vacancy Rates

In mass appraisal, the DOR often uses standard income and expense information in valuing income producing property in Montana in order to equalize the tax treatment of all such properties. In this instance, however, after informal review of the property, the DOR used Taxpayer's actual rents and expenses to set the net operating income for valuation purposes. Those I&E calculations included a three year 2% vacancy rate. The Taxpayer requests that the CTAB value be further reduced by increasing the vacancy rate, which would lower the NOI. The Taxpayer claims that a 10% vacancy rate should be applied to his income and expenses to properly reflect vacancy rates for a typical building.

In response, the DOR notes when using the Taxpayer's actual income and expense information, it is proper to use the actual vacancy rate. We agree with the Department. While it is true that a typical building may be subjected to a higher vacancy rate than demonstrated by the subject property, such a property may also command a higher rental rate. In this instance, the DOR analyzed the actual expenses and incomes to determine valuation so that the vacancy rate was automatically included in the income. The CTAB however, adjusted the NOI to reflect a vacancy rate of 8%. Taxpayer's valuation expert Tom Emmerling argued that a 10% vacancy rate is appropriate. Exh. 11. We certainly agree that a 10% vacancy rate might be justified in certain situations, but we find no evidence in this case to indicate that a 10% vacancy rate adjustment is appropriate or necessary to market and sell the building, or what increased rental rates would match to a 10% vacancy rate. The only information that is given to the Board is that the rents *for the subject property* created a very low vacancy rate. We have no evidence regarding the market rents and corresponding vacancy rates for the area generally. Thus, while a 10% vacancy rate may be appropriate when market rents are charged, there is no evidence that the subject property is commanding market rents.

The only evidence presented to this Board is the rental income for the subject property, and the vacancy rate for the subject property. We cannot hypothesize as to the value which may be set if the property was valued using typical market rents or typical market vacancies, without such evidence being presented. Based on the evidence in the record, using the Taxpayer's income with an "average" or "standard" vacancy rate would be an inappropriate mismatch in determining a net operating income for valuation determination.

HVAC Expenses.

The Taxpayer argues it would be proper to remove \$15,968 worth of HVAC repairs from the expenses used to set the valuation. The county tax appeal board partially adjusted the HVAC repairs. Subsequent to the county hearing, the DOR concurred with the Taxpayer's request for expense deduction. Because the parties agree, we need not address this issue specifically.

NOI calculations

The above discussions highlight the differing figures used to calculate the NOI presented by the parties in this case. The taxpayer ultimately requests a NOI of \$93,264, the taxpayer's real estate professional used \$98,000 NOI, while the DOR requests an adjusted NOI of \$115,693. The CTAB used an adjusted NOI of \$110,402. The Taxpayer's calculations, however, require a significant discount based on unrealistic hypothetical vacancy rate (in comparison to his own income.) Again, we note that use of the property's actual rental income with a hypothetical vacancy rate creates an inconsistent valuation method, and thus the CTAB NOI also does not comport with proper methodology. The DOR presents the only NOI supported by a consistent methodology. In this instance, we find that the evidence supports the use of the DOR's NOI (as presented in their supplement to the record.)

Capitalization rate

The Department typically derives a capitalization rate for a specific commercial area from comparable sales of similar properties. An overall capitalization rate can be calculated by dividing a property's net operating income by its sale price. The DOR developed a standard capitalization rate (7.72%) for office buildings in the urban Billings area. The capitalization rate was calculated using 106 sales of office buildings from 2003 to 2008, comparing sales price to the actual NOI for those buildings, and is used in calculating value for the majority of urban office buildings in Billings. (*See* DOR supplemental brief, p. 3.) The DOR uses a capitalization rate which includes the effective property tax rate as part of the capitalization rate. Section 42.20.109(1), ARM.

Again, we weigh the evidence to determine which of the capitalization rates most effectively demonstrates the market. The Taxpayer argues that a 9% capitalization rate is more appropriate because that is what a buyer of property would want, with an additional 1.72% for the effective tax rate added onto that capitalization rate. Emmerling argues that, in general, the DOR capitalization rate is too low. We find he failed to provide sufficient evidence to support his contention. He also fails to provide argument as to why the capitalization rate is inappropriate as applied to this specific property. The CTAB adjusted the capitalization rate to 8.6%. There is insufficient evidence presented to determine that a 10.72% capitalization rate is proper in this instance, and in fact, we find the evidence demonstrates that such a capitalization rate undervalues the property for tax purposes. Further, we find there is insufficient evidence to demonstrate that any adjustment to the capitalization rate is warranted in this instance. Rather, the DOR presented significant evidence of sales to derive a standard capitalization rate. There is no evidence presented that the Department's capitalization rate, as applied to the subject property in this instance, is incorrect.

Taxpayer's evidence

The taxpayer presents a market analysis and opinion of value by Tom Emerling. *See* Taxpayer Exh. 11. Emerling valued the property at \$1,035,000 (significantly higher than the value requested by the Taxpayer). He derived this value by using a NOI of \$98,000, and a capitalization rate of 9%. We would note that while it is clear that Emerling has significant experience as a realtor and in setting valuation for sales purposes, he is not a certified appraiser. Thus, while we may give some credence to his determination of value, we do not give it the weight which we would give a certified appraisal. *See* Rule 42.20.455(1), ARM. Further, the Taxpayer submitted an affidavit of Charles Hamway to support the use of a higher vacancy rate and capitalization rate. Mr. Hamway fails to address the issue of using standard rents to calculate NOI, along with the vacancy rate, or the issue of the tax rate addition to the capitalization rate. We afford this evidence little weight as there is no comparison to the actual income generated, or a market analysis in the affidavit. The Taxpayer consistently demonstrates a desire to use differing figures for determining a lower value. While understandable that the Taxpayer is looking for the lowest possible valuation for tax purposes, we do not give the discounted value presented the same weight as a certified appraisal of value as of the lien date in question.

Summary

This Board has the authority to affirm, reverse or modify any decision made by a county tax appeal board. Section 15-2-301(4), MCA; *Lovaas v. DOR*, PT-2009-117. In this instance, the Board has closely examined the evidence presented, and as a trier of fact, this Board finds the market value of the subject property is properly set at \$1,498,600, and modifies the CTAB decision accordingly.

It is this Board's responsibility to determine if an appropriate value was assessed to the subject property. By law, all property must be appraised at 100% of market value using the most appropriate data. There is no controversy on the use of the income method to set the value for this property. The parties disagree, however, as to the net operating income and the capitalization rate.

In this instance, the CTAB lowered the market value and stated that they accepted an increased vacancy rate, and a higher capitalization rate than used by the DOR. While the CTAB generally has the expertise to determine market value, in this case, there is insufficient evidence to support their adjustment to the vacancy rate and capitalization rate. As discussed above, there is no evidence to support using a hypothetical vacancy rate when the DOR uses the taxpayer's actual income and expenses to calculate the NOI and no credible evidence to overcome the DOR's significant evidence supporting their capitalization rate.

We find that the evidence presented supports the modified value presented by the DOR, and set the value of the subject property at \$1,498,600.

Order

IT IS THEREFORE ORDERED by the State Tax Appeal Board of the State of Montana that the subject property value shall be entered on the tax rolls of Yellowstone County at a value of \$1,498,600.

DATED this 26th day of October, 2011.

BY ORDER OF THE
STATE TAX APPEAL BOARD

/s/ _____
KAREN E. POWELL, Chairwoman

(S E A L)

/s/ _____
DOUGLAS A. KAERCHER, Member

/s/ _____
SAMANTHA SANCHEZ, 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 t his Order.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this 26th day of October, 2011, 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:

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/s/ _____
DONNA J. EUBANK, Paralegal