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Assessment/Collection

Taxpayers challenging their real estate tax assessments in Virginia must overcome a presumption that the taxing authority's assessment is correct. In this article, Mr. Shane Smith of Williams Mullen discusses how it is not always enough to be prepared to show manifest error in the tax authority's assessment or that the taxing authority disregarded controlling evidence in making its assessment. Taxpayers should also be prepared to defend their own appraisals against this same attack, that is, the taxing authority's argument of manifest error or disregard of controlling evidence in the taxpayer's appraisal.

Taxpayers Beware: Appraisal and Court Education Errors Can Doom Your Real Estate Tax Appeal

BY SHANE L. SMITH

The Constitution of Virginia imposes a mandate on tax assessors to assess real property at its fair market value. The Virginia Supreme Court instructs assessors to determine a property's value using all three of the widely-recognized appraisal methodologies, that is, the cost approach, income approach, and comparable sales approach, "in order to maximize the likelihood that the valuation accurately reflects the property's fair market value." *Keswick Club v. County of Albemarle*, 273 Va. 128, 137, 639 S.E.2d 243, 248 (2007) (citation omitted). When an assessor appraises a property using only one of these three appraisal methodologies, the resulting determination of value is not afforded a presumption of correctness by Virginia courts unless the assessor considered and properly rejected the other valuation methods. *Id.* (citation omitted). Although directed at the appraisal methodology used by tax assessors, this principle can apply with equal – and devastating – force to appraisals taxpayers employ in challeng-

ing tax assessments in Virginia courts, particularly when court education factors come into play.

Taxpayer Lessons

Taxpayers considering challenges to real property assessments should glean two important lessons from the Norfolk Circuit Court's recent decision in *United Services Automobile Ass'n v. City of Norfolk*, No. CL10-6578 (April 2, 2012), striking appraisal evidence presented by United Services Automobile Association's ("USAA") and US Real Estate Limited Partnership ("USRE") (collectively the "Taxpayers") and dismissing their case.

First, a taxpayer should be prepared to educate a court thoroughly, as clearly and simply as possible, on the role of a "highest and best use" analysis in arriving at fair market value.¹ To aid this education process, the taxpayer's appraiser should include in the appraisal—and be prepared to testify on—the definition of highest

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¹ "Highest and best use" is defined as "[t]he reasonably probable and legal use of vacant land or an improved property, that is physically possible, appropriately supported, financially feasible, and that results in the highest value." The Dictionary of Real Estate Appraisal, at 93. In the case of improved property, an appraiser must determine both highest and best use, as vacant, and highest and best use, as improved. This is necessary as land is always appraised as if it were vacant.

and best use, a detailed explanation of the reasons appraisers must arrive at a highest and best use conclusion, a thorough analysis of the legally permissible, physically possible, financially feasible, and maximally productive uses of the parcel and its improvements, and the rationale for eliminating all but the highest and best use as vacant and as improved before reaching a fair market value conclusion.

In *United Services Automobile Ass'n*, it appears the Taxpayers did not succeed in helping the court understand that a proper highest and best use analysis “must reflect the [future] expenditures and improvements necessary to allow the property to achieve its maximum potential,” *Arlington County Board v. Ginsberg*, 228 Va. 633, 641-42, 325 S.E.2d 348, 353 (1985), and that the deductions the appraiser made to arrive at a fair market value as of the dates of the assessments were the same offer price deductions a prudent, knowledgeable buyer would make for the costs that would be incurred or the losses that would have to be absorbed in buying the property and bringing it to its maximum potential. As a result, the Norfolk court appears to have concluded incorrectly that a property’s current use reflects its highest and best use unless credible evidence shows the property “cannot continue to function” in its current use.

Second, a taxpayer should be prepared to educate a court thoroughly on the correct definition of fair market value. To aid this education process, the taxpayer’s appraiser should include in the appraisal—and be prepared to testify on—a thorough explanation of each valuation method and the criteria that make each method appropriate (or not) for use, a thorough consideration of the use of each method for the subject property, and a thorough analysis of the reasons for eliminating any method. Moreover, the appraisal should include all three valuation methods to the extent each is capable of producing a credible result, within the Uniform Standards of Professional Appraisal Practice.

United Services Automobile Ass’n v. City of Norfolk

The Norfolk Circuit Court’s opinion in *United Services Automobile Ass’n* illustrates the importance of these lessons. At issue were the City of Norfolk’s (the “City’s”) assessments of two parcels that made up USAA’s Mid-Atlantic Regional Office. The main parcel consisted of 18.963 acres with a 269,246 square-foot office building, five-level parking deck, one-story building housing a child day-care center, and paved driveways, parking areas, and walkways (collectively the “Office Building”).

In February 2009, USAA announced plans to scale down its Mid-Atlantic Regional operation and vacate a majority of the Office Building. As of the July 1, 2009, effective date of the 2009 assessment, USAA was the sole owner and occupant of the Office Building but was actively transitioning the company’s operations to other offices. Three months later, USAA transferred fee simple title to the Office Building to its affiliate, US Real Estate Limited Partnership (“USRE”), at a transfer value of \$15.2 million, and executed a lease with USRE for 73,254 square feet of the Office Building. The USAA lease left 195,992 square feet of the Office Building vacant and available for USRE to lease to others. As of the July 1, 2010, effective date of the 2010 assessment,

USAA remained the sole tenant in the Office Building and occupied only the portion of the Office Building that it leased. None of the vacated space had been relet to others.

Taxpayers should educate a court thoroughly, as clearly and simply as possible, on the concepts of highest and best use and fair market value.

The City assessed the Office Building at \$38.5 million for the 2009 tax year. The City’s commercial real estate appraiser testified during depositions that the 2009 assessment was based on sales of three comparable office buildings from July 1, 2007, through Dec. 31, 2008. USAA appealed the 2009 assessment to the local Board of Equalization which, without explanation, reduced the improvements portion of the assessment by approximately \$3 million, lowering the overall 2009 assessment to \$35.5 million. The City’s 2010 assessment equaled the lowered 2009 assessment of \$35.5 million. During depositions, the City’s appraiser testified that she “backed into” the 2010 assessment using an income model that began with projected potential gross income, then made deductions for assumed vacancy and expense percentages to arrive at projected net operating income, and multiplied the projected net operating income by a loaded capitalization rate of 10.11% (9.0% cap rate plus 1.11% tax rate) to arrive at the assessment.

The Taxpayers had the Office Building appraised using the income and cost approaches and arrived at a value of \$18.0 million as of July 1, 2009, and \$19.0 million as of July 1, 2010, “with all emphasis” on the income approach. The Taxpayers’ appraiser did not use the sales approach citing, in part, a lack of comparable sales, but he did rely on eight recent sales of other office buildings in developing a capitalization rate for his income approach. The appraiser opined that the Office Building’s highest and best use “is to remain an office building” and that it “will most likely house several tenants, instead of a single owner-occupant.” The appraiser based his highest and best use conclusion on his findings that “[t]here are very few organizations in Hampton Roads large enough to need a building of nearly 300,000 square feet” and “such an organization . . . would likely want to build to suit its needs rather than to take an existing building.” The Taxpayers’ appraiser did not differ materially with the City regarding income, expenses, or capitalization rate but differed sharply “over the appropriateness of deductions to reflect costs necessary to bring the property to full stabilization,” based on the appraiser’s highest and best use analysis. Specifically, the Taxpayers’ appraiser opined that the City should have made deductions for: (1) rent loss during an estimated three-year lease-up period; (2) a tenant improvements allowance; (3) leasing commissions; (4) USAA’s lease at below-market rent; and (5) capital expenditures for ground floor corridor, mechanical, plumbing, and electrical improvements essential to convert the Office Building to use by multiple tenants.

At trial, the City moved to strike the Taxpayers’ evidence on grounds that the Taxpayers failed as a matter of law to establish the Office Building’s fair market

value. The City argued that the Taxpayers' appraisals applied "extraordinary assumptions to the valuation of the property that are unsupported by the applicable law or evidence of the relevant market" and failed "to present any evidence of what a willing seller would accept for the subject property."

The City argued that an appraisal lacking a comparable sales analysis is fundamentally defective.

In its post-trial brief in support of its motion to strike, the City made fallacious arguments regarding fair market value. The City argued that the Taxpayers defined fair market value as "what an investor would pay for the building with the expectation of converting the building into a multi-tenant office building and achieving stabilized occupancy within a short period of time," but left out "a critical part of the legal definition of the fair market value [which] is what a willing seller would accept for the building." The Taxpayers' approach to fair market value, the City argued, was "fundamentally defective" because it ignored "the willing seller side of the . . . definition of fair market value by failing to conduct a necessary sales comparison analysis of value or consider any other evidence of what a willing seller would accept to consummate a sale of the building." According to the City, "to meet the definition of fair market value, it is necessary to require the sales analysis as a part of the valuation of the" Office Building. The City argued that, as a result, the Taxpayers' "case as presented to the Court is completely devoid of a single shred of evidence as to what a seller of the building would have accepted on the assessment dates in question and as such falls far short of constituting fair market value."

The court found the Taxpayers' appraisals were "not persuasive,"² and granted the City's motion to strike the Taxpayers' evidence, dismissing the Taxpayers' case for two reasons. First, the court found that the appraiser's conclusion regarding the Office Building's highest and best use, that is, "to remain an office building" but "most likely hous[ing] several tenants, instead of a single-owner occupant," was not supported by law or evidence because the appraiser's highest and best use "theory" resulted in a "prospective or speculative value based on possible future improvements or expenditures" rather than the Office Building's "present actual value." The court noted that it heard "no evidence that this building *cannot continue to function* as an owner-occupied commercial office building," and agreed with the City that the Taxpayers' appraisals "failed to consider full or even partial owner occupancy, or sale and leaseback by the owner, in their valu-

² The court recognized that the standard of review for deciding a motion to strike required it "to accept as true all evidence favorable to the plaintiff" and "not to judge the weight and credibility of the evidence." Notwithstanding its recitation of the rule, the court's comments regarding the persuasiveness and sufficiency of the Taxpayers' evidence indicate the court weighed the evidence in reaching its decision.

ation of the property." The court concluded that the Taxpayers' decision to advance a "single," "speculative" theory of highest and best use violated Virginia's definition of fair market value by not reflecting what a willing seller would accept for the Office Building.

The court rejected the Taxpayers' reliance on *Arlington County Board v. Ginsberg*, 228 Va. 633, 325 S.E.2d 348 (1985), to support the appraiser's deduction of renovation and leasing expenses, because the property at issue in *Ginsberg* "demonstrated major rehabilitation was necessary *before* the property could yield economic rents," while the Office Building was "*presently suitable* to accommodate a large organization and *can be used 'as is,'* without any significant additional improvements or adjustments." Because the Office Building was "*presently suitable to accommodate a large organization . . . 'as is,'*" the court concluded that the "probability that the highest and best use of the office building is to convert the building to multi-tenant space, which would require extensive leasing and renovation costs, is speculative." In short, the Taxpayers did not "present persuasive³ evidence that the highest and best use of the Office Building, based on market or external factors, is simply to convert the building to multi-tenant space."

Second, the court appears to have been led astray by the City's convoluted argument about fair market value and comparable sales and, also, appears to conflate "comparable building" with "comparable sale." The court stated in its decision: (A) "there is sufficient market data to perform the sales comparison analysis" because the "Office Building is comparable to other buildings in the Hampton Roads area" (emphasis in original); and (B) "[e]ven though the building was built to accommodate one specific organization, this does not prevent the development of a comparable sales analysis of similar Class A office properties" because the Office Building "is not unique." Viewing the Taxpayers' appraisals through this lens, the court rejected the appraiser's testimony that the "sales approach would not lead to credible results" because the Office Building was "a custom built property, and it would be difficult to find another owner-user 'capable and interested in all or most of the space.'" The court also pointed to the eight sales⁴ that the appraiser used to develop his capitalization rate in finding "comparable sales data was readily available," and thus, concluded that Taxpayers' appraisal "should have contained the sales comparison approach to accurately reflect the [Office Building's] fair market value." As a result, the court concluded that the Taxpayers "did not produce sufficient⁵ evidence that the sales approach was unnecessary and that the omission would not lead to unreliable results."

Conclusion

Appraisal deficiencies or a failure to adequately educate the court can sink a credible tax assessment challenge. Other taxpayers considering real estate tax appeals would be well served to learn from the Taxpayers'

³ *Id.*

⁴ The Taxpayers may have unintentionally conceded the proverbial nail in their appraisal's coffin, stating in their filed proposed findings of fact that the eight sales the appraiser used to calculate his capitalization rate were "comparables."

⁵ See footnote 2, *supra*.

experience in this case. Be sure your appraisal's highest and best use and fair market value analyses are thorough, easy to understand, and well communicated

to the court. The appraisal and your appraisal expert's testimony may cost you more, but they will be dollars smartly spent.