

15-497
TAX TYPE: PROPERTY TAX
TAX YEAR: 2014
DATE SIGNED: 2-8-2016
COMMISSIONERS: M. CRAGUN, R. PERO, R. ROCKWELL
EXCUSED: J. VALENTINE
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

<p>PETITIONER,</p> <p style="text-align: center;">Petitioner,</p> <p>vs.</p> <p>BOARD OF EQUALIZATION OF (X) COUNTY, STATE OF UTAH,</p> <p style="text-align: center;">Respondent.</p>	<p style="text-align: center;">INITIAL HEARING ORDER</p> <p>Appeal No. 15-497</p> <p>Parcel No. #####</p> <p>Tax Type: Property Tax</p> <p>Tax Year: 2014</p> <p>Judge: Phan</p>
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This Order may contain confidential "commercial information" within the meaning of Utah Code Sec. 59-1-404, and is subject to disclosure restrictions as set out in that section and regulation pursuant to Utah Admin. Rule R861-1A-37. Subsection 6 of that rule, pursuant to Sec. 59-1-404(4)(b)(iii)(B), prohibits the parties from disclosing commercial information obtained from the opposing party to nonparties, outside of the hearing process. Pursuant to Utah Admin. Rule R861-1A-37(7), the Tax Commission may publish this decision, in its entirety, unless the property PETITIONER responds in writing to the Commission, within 30 days of this notice, specifying the commercial information that the PETITIONER wants protected. The PETITIONER must send the response via email to taxredact@utah.gov, or via mail to the address listed near the end of this decision.

Presiding:

Jane Phan, Administrative Law Judge

Appearances:

For Petitioner: REPRESENTATIVE FOR PETITIONER, Representative
PETITIONER, Owner, PETITIONER

For Respondent: RESPONDENT-1, Appraisal Supervisor, (X) COUNTY
RESPONDENT-2, Appraiser, (X) COUNTY

STATEMENT OF THE CASE

Petitioner ("Property Owner") brings this appeal from the decision of the (X) COUNTY Board of Equalization under Utah Code §59-2-1006. This matter was argued in an Initial Hearing on January 5, 2016, in accordance with Utah Code §59-1-502.5. The (X) COUNTY Assessor's Office had originally valued the subject property at \$\$\$\$ as of the January 1, 2014 lien date.

The County Board of Equalization (“County”) lowered the value to \$\$\$\$\$. At the hearing, the Property Owner requests a reduction in value to \$\$\$\$\$.

APPLICABLE LAW

Utah Code §59-2-103 provides for the assessment of property, as follows:

- (1) All tangible taxable property located within the state shall be assessed and taxed at a uniform and equal rate on the basis of its fair market value, as valued on January 1, unless otherwise provided by law.

For property tax purposes, “fair market value” is defined in Utah Code §59-2-102(12), as follows:

“Fair market value” means the amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. For purposes of taxation, “fair market value” shall be determined using the current zoning laws applicable to the property in question, except in cases where there is a reasonable probability of change in the zoning laws affecting that property in the tax year in question and the change would have an appreciable influence upon the value.

A person may appeal a decision of a county board of equalization, as provided in Utah Code §59-2-1006, in pertinent part, below:

- (1) Any person dissatisfied with the decision of the county board of equalization concerning the assessment and equalization of any property, or the determination of any exemption in which the person has an interest, may appeal that decision to the commission by filing a notice of appeal specifying the grounds for the appeal with the county auditor within 30 days after the final action of the county board.
- (5) In reviewing the county board’s decision, the commission shall adjust property valuations to reflect a value equalized with the assessed value of other comparable properties if:
 - (a) the issue of equalization of property values is raised; and
 - (b) the commission determines that the property that is the subject of the appeal deviates in value plus or minus 5% from the assessed value of comparable properties.

A party requesting a value other than that established by the County Board of Equalization has the burden of proof to establish that the market value of the subject property is different. To prevail, a party must 1) demonstrate that the value established by the County contains error; and 2) provide the Commission with a sound evidentiary basis for changing the value established by the county board of equalization to the amount proposed by the party. The Commission relies in part on *Nelson v. Bd. of Equalization of Salt Lake County*, 943 P.2d 1354 (Utah 1997); *Utah Power & Light Co. v. Utah State Tax Comm’n*, 590 P.2d 332 (Utah 1979);

Beaver County v. Utah State Tax Comm'n, 916 P.2d 344 (Utah 1996); and *Utah Railway Co. v. Utah State Tax Comm'n*, 5 P.3d 652 (Utah 2000).

DISCUSSION

The subject property is a single parcel of property located at SUBJECT PROPERTY, CITY-1, Utah. The subject is on the corner of ROAD and ##### North. It is #####-acres in size and is improved with three separate buildings. The improvements were constructed in 1988 originally as small industrial/flex spaces. However, Building 1 has been modified into retail spaces. Building 1 is an L-shaped building located at the front of the parcel and runs along the length of ROAD and the frontage on ##### North. Building 1 has #####-square feet and is divided into ##### retail units. The representative for the Property Owner stated that although modified with retail storefronts, these buildings retain much of the original design features and several of these units still have a considerable amount of warehouse space. Because of this he states they are only Class D retail buildings.

Building 2 is located in the middle of the parcel and would not be visible from the public roadways. The units in this building are used as office/warehouse spaces. Building 2 is divided into ##### units with #####-square feet in total. Building 3 is located along the back of the lot line and is an industrial/flex building. Building 3 has #####-square feet and is divided into ##### rental units.

REPRESENTATIVE FOR PETITIONER who represented the Property Owner stated that the mixed retail and industrial uses of these buildings created functional obsolescence because these two uses were incompatible. It was his contention that retail users preferred to be near other retail businesses that draw similar foot traffic. The industrial users, however, do not want the traffic associated with the retail spaces. It was also his opinion that there was functional obsolescence due to the fact that the retail spaces were not originally designed for that purpose and there was considerable physical deterioration on the property with deferred maintenance. Because of these negative factors, the buildings have had a considerable amount of vacancy over many years ranging from 21% to 32% with a historical average vacancy of 24.2%. The representative for the Property Owner also states that the buildings attract primarily low credit tenants and there is a high collection loss with the property. Another point made was that the Property Owner has never been able to lease these units on a "Triple Net" basis, asserting that superior properties could be leased on a triple net basis, but the subject property could not be leased in that manner. The Property Owner pays the insurance and taxes on this property,

although the tenants pay for common area maintenance or CAM charges. It was his contention that for an income approach, “triple net” leases should not be used as comparables.¹

The Property Owner requested a reduction of the assessed value for the subject property to \$\$\$\$\$. In reaching this conclusion, REPRESENTATIVE FOR PETITIONER had prepared a direct capitalization income approach, a discounted cash flow income approach and a comparable sales approach. For his direct capitalization approach, he stated that the actual lease rates for the subject were market rates and the actual income received was market income. The Property Owner had provided tax returns with profit and loss statements to support income and expense amounts. He provided that the average of the actual lease rates for the retail space was \$\$\$\$ per square foot. For the light industrial spaces the average lease rate was \$\$\$\$ per square foot and the flex spaces average rate was \$\$\$\$ per square foot. He derived from this a weighted average composite lease rate of \$\$\$\$ per square foot. This indicated a potential gross income of \$\$\$\$\$. He then applied a vacancy and collection loss factor of 24.2%, which was the historical average vacancy for this property. He subtracted out actual expenses of 21.99%² and 6% for reserves, which resulted in net operating income of \$\$\$\$\$. He had chosen a capitalization rate of 9%. He states that there are more risks with this property due to its age, poor condition, obsolescence and the mixed use. So although market rates indicated a base rate of 8%, he had added an additional 1% premium for the discount due to these negative factors. He also added the effective tax rate, which was 1.40% to the capitalization rate, rather than include the taxes as an expense. Capitalizing his net operating income of \$\$\$\$\$ by the 10.40% overall rate indicated a value for the property of \$\$\$\$\$.

To the \$\$\$\$\$ REPRESENTATIVE FOR PETITIONER subtracted \$\$\$\$\$ in deferred maintenance. He provided bids for asphalt and gutter way repairs, costs to paint exterior of the building and patch holes where signs were removed, a 10 year projected cost to replace the HVAC and an estimate to remove and replace the roofs on Building 1 and Building 2. However, the fact that he had already allowed a 6% reserve, which gets capitalized into perpetuity, appears to already account for these types of replacements or repairs.

¹ Neither party went into detail in explaining a triple net lease. From Wikipedia: “An NNN Lease is a net lease, structured as a turnkey investment property in which the tenant is responsible for paying the three major expenses associated with commercial real estate ownership "Triple Net" . . . represents the three most common, consequential real estate related expenses: N - Property Tax; N – Insurance; and N - Maintenance”

² REPRESENTATIVE FOR PETITIONER expense rate of 21.99% did not include property taxes because in his calculation he added the effective tax rate to the capitalization rate to account for taxes. He did indicate in his valuation information that if taxes were added as an expense, the expenses would be 36% of income.

REPRESENTATIVE FOR PETITIONER had also prepared a discounted cash flow analysis from which he concluded a value of \$\$\$\$\$. It was his position that investors would consider a DCF approach when determining whether or not to buy a property. An assumption in this approach was that the buildings would have a holding period of 10 years and there would be a 1.5% decline after 5 years. His discount rate in the DCF analysis was 8.5% to which he had added the effective tax rate of 1.40%, for an adjusted rate of 9.9%

The representative for the Property Owner did provide comparable sales, but he indicated he placed little weight on this approach because the subject property is so unique that there were no sales of similar properties that combined both retail spaces and industrial spaces in one property. Eleven comparable sales were provided and three listings. No appraisal adjustments were made for differences. These properties had sold for prices ranging from a low of \$\$\$\$\$ per square foot to a high of \$\$\$\$\$ per square foot. As a comparison, the subject's assessed value was \$\$\$\$\$ per square foot. From the sales, REPRESENTATIVE FOR PETITIONER concluded a value of \$\$\$\$\$ per square foot or \$\$\$\$\$ for the subject. He then subtracted the \$\$\$\$\$ deferred maintenance adjustment for a value rounded of \$\$\$\$\$.

The County had submitted an appraisal prepared by RESPONDENT-2, Certified General Appraiser. It was RESPONDENT-2's conclusion that as of the lien date January 1, 2014, the value of the subject property was \$\$\$\$\$. This was a higher value than that set by the County Board but the County did not request an increase to the appraisal value. RESPONDENT-2's conclusion appears to be based primarily on a direct capitalization income approach, although he also provided some comparable sales.

In his appraisal, for purposes of the income approach, RESPONDENT-2 looked at the buildings as if they were three separate properties. He prepared a separate income indicator for Building 1, Building 2, and Building 3 then added the three totals together. Instead of using actual rent, RESPONDENT-2's rent in the income approach was a higher rent, which he indicated in the appraisal was "market" rent. He did not include any rent comparables to support this as market rent, but had submitted some listings regarding the vacant spaces offered in the subject. The listing report showed current active listings and showed retail space advertised at \$\$\$\$\$ per square foot triple net, office space at \$\$\$\$\$ per square foot triple net, and warehouse space at \$\$\$\$\$ per square foot triple net. The Property Owner has maintained that he has never been able to lease spaces in these buildings on a triple net basis.

The approach used by RESPONDENT-2 to value the property as if it had three separate buildings ignores the functional obsolescence argued by Petitioner, due to a combination of retail and industrial properties which may be undesirable for both types of tenants. RESPONDENT-2

has basically valued a stand-alone retail building, a separate flex/office building and an industrial/warehouse building, and then has added the total together. Additionally, it is unclear where RESPONDENT-2's "market" rates are coming from as rent comparables were not included in the appraisal document and even he acknowledged that his "market" rents were higher than actual rents.

For Building 1, RESPONDENT-2 listed at page 9 of his appraisal the ##### retail spaces and their actual lease rates, which he listed as ranging from \$\$\$\$\$ to \$\$\$\$\$ per square foot. He indicated the total or average from the "actual" rates to be \$\$\$\$\$ per square foot, but used a "market" lease rate of \$\$\$\$\$. The representative for the Property Owner had stated that the Property Owner was not able to lease these buildings based on triple net. The rate RESPONDENT-2 used in his income approach of \$\$\$\$\$ was higher than the \$\$\$\$\$ of "actual" rates, but because it was a triple net rate this distinction is even greater and increased the value far more than the \$\$\$\$\$ difference in the rates. Because RESPONDENT-2 assumed that the lease rate was triple net, he allowed only 5% for expenses. As noted above in the Property Owner's income approach, the Property Owner paid much of the expenses including property taxes, about 36% of income went to expenses. This difference results in a substantially different value conclusion.

RESPONDENT-2 used the same approach on the other buildings. For Building 2, RESPONDENT-2 used a triple net "market" rate of \$\$\$\$\$ per square foot while the Property Owner maintained the rate was \$\$\$\$\$ per square foot with the owner paying most of the expenses. For Building 3, RESPONDENT-2 used a triple net "market" rate of \$\$\$\$\$ per square foot, while the Property Owner maintained the actual rate was \$\$\$\$\$ per square foot with the owner paying most of the expenses.

RESPONDENT-2's vacancy rates were different depending on the building. For Building 1, the retail spaces, he used a 20% vacancy rate. For Building 2, he had a 10% vacancy rate and for Building 3, which had a higher vacancy historically, he applied a 30% vacancy rate. Collectively this is similar to the Property Owner's approach in which a combined historical vacancy rate of 24.2% was applied to the property as a whole. Like REPRESENTATIVE FOR PETITIONER, in his income approach for all three buildings RESPONDENT-2's also used a capitalization rate of 9% which he noted in his appraisal was higher than the CRG rate. This would account for some of the risks inherent in this property. One difference, however, because RESPONDENT-2's lease rates were triple net, he did not deduct property tax as an expense, nor did he add the effective tax rate to the capitalization rate. This is appropriate if, in fact, the analysis is based on triple net leases, but without any lease comparables or market studies, there

was no support for lease rates as high based on triple net as RESPONDENT-2 had concluded in the appraisal.

RESPONDENT-2 provided five sales of flex-warehouse buildings from properties sold in (X) COUNTY, primarily in the southern end of (X) COUNTY and not in the same location as the subject. The comparables had sold for prices per square foot ranging from \$\$\$\$\$ to \$\$\$\$\$ and it appears that he used these as comparables only for Buildings 2 and 3. RESPONDENT-2 did not make appraisal adjustments for differences and concluded an average sales price per square foot of \$\$\$\$\$. All of these comparable sales were smaller than the combined size of Buildings 2 and 3. The comparables ranged from #####-square feet to #####-square feet. The combined total of Buildings 2 and 3 is #####-square feet. RESPONDENT-2 did not provide retail property comparables.

The County's representative RESPONDENT-1 had also prepared a spread sheet, which he indicated was an income approach based on the actual income and expenses as taken from information provided by the Property Owner. From this analysis he had concluded that the value of the subject was \$\$\$\$\$, which was just below the County BOE value of \$\$\$\$\$. In the spread sheet, he looked at actual income and expenses for the years 2009 through 2014 and he concluded that expenses were 32.50% of income. Comparing his spread sheet to the profit and loss information provided by the Property Owner, it appears that with the exception of 2011, this expense ratio was based on the actual income and expenses and included property tax. For the 2011 year, RESPONDENT-1 had concluded 31% of income went to expenses. This one calculation did not appear to include property tax. If the property tax expenses were added it would have increased this ratio to 44% for that year. That would increase the average from the years 2009 through 2013 to 34%. Increasing the expenses in this analysis would result in a value of \$\$\$\$\$ with the 8.48% capitalization rate that RESPONDENT-1 had used in this analysis. Both RESPONDENT-2 and the Property Owner's representative had used a 9% capitalization rate to account for risks in the subject property. Using a 9% capitalization rate would indicate a value of \$\$\$\$\$, which is similar to the value REPRESENTATIVE FOR PETITIONER had concluded in his income approach before he made the final adjustment for deferred maintenance.

After reviewing all of the evidence submitted in this matter, the value for the subject property should be lowered to \$\$\$\$\$. RESPONDENT-2 has not supported the much higher triple net "market" lease rates which he used in his appraisal. This was a significant difference from actual rates and there was no showing that the subject could be leased at those higher rates plus on a triple net basis. This Property Owner has been operating this property in a professional manner for many years and the rates he has obtained are likely market given the negative factors

with this building. Given the fact of the age, condition and the odd configuration that combines retail and industrial on one lot, the 9% capitalization rate used by RESPONDENT-2 and the representative for the Property Owner would be appropriate. However, making an additional adjustment for deferred maintenance as well as a relatively high 6% reserves adjustment is not warranted as the repairs or replacements noted would generally be paid out of the reserve or some as current maintenance expenses.

DECISION AND ORDER

Based on the foregoing, the Commission finds the value of the subject property was \$\$\$\$ as of the January 1, 2014 lien date. The (X) COUNTY Auditor is hereby ordered to adjust its records accordingly. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed, or emailed, to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission
Appeals Division
210 North 1950 West
Salt Lake City, Utah 84134

or emailed to:
taxappeals@utah.gov

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this _____ day of _____, 2016.

John L. Valentine
Commission Chair

Michael J. Cragun
Commissioner

Robert P. Pero
Commissioner

Rebecca L. Rockwell
Commissioner