Valuing Real Property For Taxation: Some Current Issues And Basic Principles

By James V. McGettrick

The past decade has seen a relatively large volume of litigation in Virginia challenging local real property tax assessments. Many issues were addressed, but others remain ripe for resolution or clarification. This article discusses three: the effect of actual rent in valuing commercial properties, whether a "business value" component should be extracted from a shopping mall valuation, and the reliance on cost approach to value "limited market" commercial properties. The latter two issues have yet to be addressed by the Virginia Supreme Court. In contrast, the Court repeatedly has addressed the first issue but it continues to cause confusion. Some basic principles of valuing real property for taxation are first discussed in order to aid in understanding these issues.[1]

Basic Principles

The Constitution of Virginia requires that all non-exempt property be taxed.[2] Since that is true, it follows that the estate in real property to be valued for taxation is the fee simple, which the Supreme Court has emphasized repeatedly.[3] Property tax assessments generally must be at fair market value[4] based on a property's highest and best use.[5]

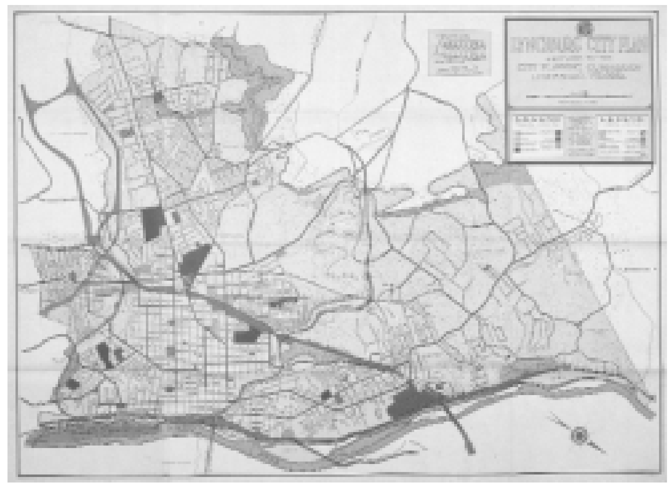
Real property usually is valued using one or more of three appraisal approaches. The sales comparison approach is based on recent sale prices of similar properties. The cost approach is based on the cost to acquire comparable land and construct improvements of similar utility. The income capitalization approach is based on the relationship between the income potential of a property and the rate of return sought by an investor purchasing the property.[6] The Supreme Court has recognized that all three approaches are accepted methods to determine fair market value.[7]

Ideally, an appraiser would like to employ all three approaches each time he or she valued a property.[8] However, one or another of the approaches often best reflects the value of a specific kind of property. In particular, commercial real estate typically purchased by investors and leased to tenants, such as office buildings, apartments, and retail space, usually is valued by income capitalization.

Current Issues

1. Consideration of Contract Rent in Income Capitalization

The most persistent valuation question to come before the Virginia Supreme Court is how the "contract rent" for a commercial property (i.e., the rent payable under any actual leases on the property) should be considered in using income capitalization. It is particularly significant and most commonly arises when contract rent is the product of a long-term lease and is significantly above- or below-market at the time of the assessment.



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The usual first step in a fee simple income capitalization is selecting the economic rent. The Supreme Court has said that "economic rent" means the amount a typical lessee should be willing to pay for the right to use and occupy the property for a stated period.[9] The appraisal profession generally defines "economic rent" and its synonym "market rent" as "the rental income that a property most probably would command in the open market; it is indicated by the current rents paid and asked for comparable space as of the date of the appraisal."[10]

Obviously, the contract rent specified in a particular lease may not necessarily be at market. One example might be in a lease between friends or close business associates.[11] But what of an older, long-term lease, especially one without rent "step ups" or "escalators" to adjust for changing economic conditions? Even if contract rent was at market when the lease was signed, why would it necessarily still reflect the market at the time of an assessment years later? Can contract rent from such a lease be ignored in assessing the property?

Courts across the country are sharply divided on this question. Some have held that contract rent should be ignored completely in valuing a fee simple.[12] A few have held that contract rent absolutely controls the selection of economic rent.[13] Many others, like the Supreme Court of Virginia, have ruled that while contract rent does not control the selection of economic rent, if known it must be "considered" by an assessor. However, our Supreme Court has never clearly indicated how assessors can and should "consider" contract rent in their calculations without violating the requirement to value the entire fee simple.

Appraisal theory provides that an income capitalization based on contract rent instead of market rent values not the fee simple but merely the partial interest in the property held by the landlord, usually called the "leased fee."[14] If contract rent is below market, the leased fee generally is worth less than the fee simple, because the landlord's income stream is less than if rent was at the higher market level. The difference can be considered to be the market value of the tenant's interest, i.e., the leasehold. In condemnation cases the Supreme Court has recognized this relationship, requiring fee simple awards to be split between landlords and tenants who prove the market value of their leaseholds.[15]

But it seems intuitively attractive to require an assessor to at least consider contract rent rather than ignore it completely. The assessor is going to consider rents for comparable properties, so why not also consider the actual rent on the subject property? But what can and should such consideration entail? Dictionary definitions of "consider"[16] suggest that it should be sufficient if an appraiser fairly and carefully evaluates whether contract rent provides a reliable indication of the current market. In other words, contract rent should go into the evidentiary "mix" of factors reviewed but does not necessarily affect the resulting value. This is how a requirement to consider contract rent is construed in many other states. For example, the Florida Supreme Court has held (based on a statute requiring consideration of certain listed factors, including actual income) that "[w]hen determining the fair market value of income-producing property which is encumbered by a long-term sub-market lease, the assessor must consider *but not necessarily use* each of the factors . . . . The ultimate method of valuation employed and the weight, if any, to be given each factor considered is within the discretion of the assessor."[17]

But while the Virginia Supreme Court clearly seems to require something more, in six decisions it has never set forth the mechanics of how it thinks an assessor should consider contract rent in the selection of economic rent. In 1982 in Board of Supervisors v. Nassif ("Nassif I"),[18] the Court ruled that while the assessor had erred in ignoring contract rent completely, the trial court also had erred in holding that contract rent must be inserted into the income capitalization formula, and so remanded the case. In Board of Supervisors v. Donatelli & Klein[19] and Arlington County Board v. Ginsberg,[20] decided in 1985, the Court simply affirmed the trial courts' decisions to set the assessments at the amount of a recent sale of the subject property in the former case and at the previous year's assessment in the latter.

In 1986 in Nassif v. Board of Supervisors ("Nassif II"),[21] on remand from Nassif I, the Court found error when the assessor testified that that he had considered contract rent but decided that he should not change the economic rent (and resulting assessment) because it did not reflect the current market. In contrast, the taxpayer's expert increased his Nassif I value estimate by $250,000, claiming that he had used economic rent instead of contract rent but had considered contract rent as relevant evidence of economic rent. The Court adopted his value but did not indicate how or why he had concluded that the effect of considering contract rent was a $250,000 change in value, thus giving assessors no guidance on how to employ contract rent in their calculations.

In Smith v. Board of Supervisors in 1987, the Court stated that actual rents (and expenses) cannot be ignored "or given only token consideration" by an assessor.[22] The Court adopted the values of the taxpayer's expert who had inserted the actual rents and expenses into his calculations, but the Court also cited evidence that those actual figures in fact were at market. The next year in Clarke Associates v. Arlington County,[23] the Court merely remanded when it again ruled that an assessor erred when he claimed to have considered contract rent but had rejected it as not reflecting the current market rate of rent. The Court explicitly rejected the argument "that any method of assessment which gives effect to a contract rental rate below the economic rental rate violates the constitutional mandate to tax the full market value of the fee simple interest"[24] but again provided no guidance as to what such method *would* be constitutional.

In 1992 in Tysons International Ltd. Partnership v. Board of Supervisors,[25] the trial court ruled it adequate that the assessors were aware of and considered contract rent in selecting their economic rents but had concluded that the contract rent was not at market based on contemporaneous leases of comparable properties. But the Supreme Court disagreed, again emphasizing that contract rent somehow must be factored into the income capitalization formula. However, as in Smith the Court concluded that there was sufficient evidence that the contract rents in fact were at market to adopt values based on them.

The result has been continuing confusion, illustrated by two 1996 circuit court decisions. In one, appraisers for both the locality and the taxpayer explicitly valued the leased fee instead of the fee simple and the assessment was affirmed.[26] In the other, the trial court ruled that even though contract rent had been ignored in making the assessments, the taxpayer's evidence of the value of the leased fee was legally insufficient to justify any revision.[27] The Supreme Court denied appeal petitions in both cases. Undoubtedly this issue will continue to bedevil assessors and taxpayers alike unless and until the Court clarifies its position.

2. Business Value and Shopping Malls

When a property is valued by income capitalization, should its entire earning potential be used to select economic rent, or should some portion be considered "non-realty" and excluded from the computation so as to reduce the resulting value? If the property is sold, should some portion of the price be allocated other than to realty in considering the sale price as evidence of value? In recent years, arguments have raged in the appraisal profession over whether there should be a non-realty deduction for "business enterprise value" (or "business value")[28] in an income capitalization or sales comparison valuation and, if so, then for what kinds of property, under what circumstances, to what extent, and how should it be calculated. The appraisal profession recognizes that the concept is "highly controversial."[29] Articles regularly appear in professional journals on both sides of the debate. Given the obvious appeal of any such deduction to a taxpayer seeking a lower assessment, this controversy has spilled over into the courts of other states.

An authoritative text defines "business enterprise value" as "a value enhancement that results from items of intangible personal property such as marketing and management skill, an assembled work force, working capital, trade names, franchises, patents, trademarks, non-realty related contracts or leases, and some operating agreements."[30] In 1990 in County Board v. Commonwealth,[31] the Supreme Court recognized that a valuation based on income from business operations can include non-realty elements and, if so, should not form the basis for a real property tax assessment. It held that Virginia's "unit method" of appraising railroad real estate, which instead of capitalizing rental income from real estate capitalized the operating income of the entire railroad, was invalid because the resulting value was influenced by many elements unrelated to the land and improvements. Whether the Court would extend this reasoning to more standard valuations of other kinds of real estate is problematic.

Much litigation in other states has concerned shopping malls. This is not surprising, for several reasons. First, the shopping mall industry has been instrumental in attempting to advance the business value theory.[32] Also, shopping malls are usually quite valuable and thus often have tax assessments high enough to warrant the litigation expense. However, to date mall owners have met with little success.

In State ex rel. N/S Associates v. Board of Review,[33] a Wisconsin court rejected a claim that a shopping mall assessment improperly included business value. The court distinguished cases cited by the taxpayer where some business value had been recognized (involving property of a cable television franchisee and a motel complex) principally on the ground that those cases had concerned property values "substantially influenced by the non-transferrable nature of the business conducted on the property,"[34] in contrast to the mall, whose "raison d'etre—namely, the leasing of space to tenants and related activities such as trash disposal, baby stroller rentals, etc.—is a transferrable value that is inextricably intertwined with the land and [improvements and appurtenant rights and privileges] . . . ."[35]

In Merle Hay Mall v. City of Des Moines Board of Review[36] in 1997, the Iowa Supreme Court, quoting the "raison d'etre" language from State ex rel. N/S Associates, rejected a business enterprise value theory in another shopping mall case. An extensive evidentiary record on the issue was made at trial. Significantly, the Court found that business enterprise value is not a generally recognized appraisal method. It noted that the concept "seems to be used almost exclusively in tax assessment cases; it is not used in all mall appraisals. . . . [O]ne appraiser who had used the theory several times in tax assessment cases testified that he had never used it when a mall requested an appraisal for the purpose of obtaining a mortgage loan."[37]

Other cases have claimed a business value component of one kind or another in shopping malls. Given the size of the stakes, it is likely that such challenges will continue and that the theories underlying them will continue to evolve as taxpayers try to make them more acceptable to courts.

3. The Cost Method and "Limited Market" Commercial Properties

Real estate assessments based on cost approaches have been ruled erroneous in several Virginia Supreme Court decisions. For example, in First & Merchants National Bank v. County of Amherst,[38] the Court ruled that assessments of two dams using a cost approach failed to properly consider the effect of deed restrictions limiting the use of the dams and thus affecting their market value. In Tuckahoe Woman's Club v. City of Richmond,[39] the Court ruled that assessments of a clubhouse based on a cost approach were excessive. The assessor testified that the property had no value as a clubhouse to anyone except the present owner, and all witnesses agreed that the property would not sell for the amount of the assessment in the open market. The Court held that "[d]epreciated reproduction cost may be an element for consideration in ascertaining fair market value, but it cannot of itself be the standard for assessment."[40]

But in 1998 in Tidewater Psychiatric Institute v. City of Virginia Beach,[41] the Court reaffirmed the vitality of the cost approach in certain circumstances when it held that an assessment of a psychiatric hospital was not erroneous merely because it was based solely on a cost approach. The Court explicitly limited the application of Tuckahoe Woman's Club and other prior decisions repudiating assessments based on cost to situations "where the taxing authority fails to consider other factors that plainly show such a method 'would patently lead to unfair and improper results.'"[42] The Court found that the assessor had properly considered and rejected other methods of valuation, due in part to a lack of reliable data, and cited Norfolk & Western Ry. Co. v. Commonwealth[43] for the proposition that "where a taxing authority considers and properly rejects other methods of calculating the value of property, an assessment based on depreciated reproduction cost is entitled to a presumption of validity where that method is the only one remaining."[44]

Certain properties, by their nature, are designed for a particular use and rarely trade in the market for real estate. Common examples might include churches or museums. Just as in Tidewater Psychiatric, a lack of data necessary to perform a sales comparison or income capitalization valuation often leads to such properties being valued based on a cost approach.

But what if a company has constructed a factory for its own use, specifically designed to perform a particular industrial task. Until they become obsolete, such facilities rarely are sold as real estate, separate from a sale of an entire business. The assessor, unable to find sales or rentals of similar specialized facilities, deems the property to be "special purpose" or "limited market" and values it using a cost approach. But the taxpayer objects, asserting that in the absence of evidence of a market for such a specialized facility, its highest and best use cannot be assumed to be its actual use. The taxpayer contends that therefore the property should be valued by using sales or leases of generic industrial property as comparables.

Cases similar to this fact pattern have occurred across the country, with inconsistent results. For example, STC Submarine, Inc. v. Department of Revenue[45] concerned a factory specifically designed and used to manufacture undersea fiber optic cable. The taxpayer claimed that the highest and best use was merely as general-purpose industrial property, principally because all three companies in the business recently had acquired or built their own plants. But the Court concluded that since there was an active market for the cable produced by the plant, its existing specialized use was highest and best, and that the plant's special design would be valuable to any purchaser planning to continue that use.

In Safran Printing Co. v. City of Detroit,[46] the Court held that the highest and best use of a printing plant was generic industrial because the building was ill-suited for use as a printing plant and so obsolete and inefficient that no one would buy it for that purpose. The Court thus ruled that it should be valued not by a cost method but by comparison to sale prices of warehouses. In Ford Motor Co. v. Township of Edison, the Court held that the highest and best use of an automobile assembly plant also included "kindred heavy-industrial-type purposes."[47] The Court found that limiting it to an auto assembly plant would have artificially narrowed the market so that it would have been necessary to rely on a cost approach.

This general issue has been litigated at least once to date in Virginia. In 1997 in Fairfax County, a taxpayer contended that a facility specifically designed and constructed as a newspaper printing plant and economically valuable for that purpose should be assessed not as a printing plant by a cost approach, but as generic industrial space based on sales and leases of warehouses. The trial court ruled that the county's failure to identify a specific prospective purchaser of the plant who might need or want a printing facility of its large capacity in the Washington metropolitan area was fatal to its claim that the existing use was the highest and best. The trial court determined that Tuckahoe Woman's Club compelled its ruling, and refused to rely upon Norfolk & Western because that case had concerned personal property and thus the court believed that it was not relevant in a real property case where highest and best use was at issue.[48]

Before the decision could be appealed, the case was settled. But in light of Tidewater Psychiatric a year later, it is interesting to speculate on what would have happened on appeal, especially considering that in Tidewater Psychiatric the Supreme Court limited its ruling in Tuckahoe Woman's Club and explicitly relied upon Norfolk & Western. Furthermore, should the trial court have distinguished Tuckahoe Woman's Club because the clubhouse in that case, like the printing plant in Safran Printing (but emphatically unlike the printing plant in Fairfax County), apparently had little or no economic value based on its existing use?

More broadly, is it unrealistic to value a type of property that by its very nature never sells in the real estate market by reference to its "fair market value?" In Clark Equipment Co. v. Township of Leoni a Michigan appellate court observed that "[t]he problem with valuing large industrial plants is a problem with the statutory standard itself,"[49] noting the essential futility of attempting to discern what would be the selling price of property that is so rarely bought and sold. Nonetheless, the fair market value standard is constitutionally mandated in Virginia, and so no matter how impractical in a particular case, it must be the basis for any tax valuation. ⚖

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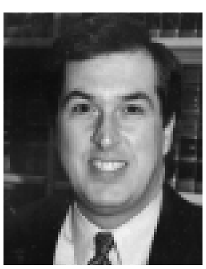

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Endnotes

1 Although this article focuses on valuation for tax purposes, principles accepted by the courts for valuing property for other purposes can be just as applicable. See, e.g., Fairfax County Park Authority v. Virginia Department of Transportation, 247 Va. 259, 440 S.E.2d 610 (1994) (principles governing fair market value in taxation cases can be applied in a condemnation case). Also, the Supreme Court has found cases concerning personal property valuation to be authoritative in real property assessment disputes. E.g., Tidewater Psychiatric Institute, Inc. v. City of Virginia Beach, 256 Va. 136, 142, 501 S.E.2d 761, 764 (1998) (relying upon Norfolk and Western Ry. Co. v. Commonwealth, 211 Va. 692, 179 S.E.2d 623 (1971)).

2 VA. CONST. art. X, § 1.

3 E.g., Clarke Associates v. Arlington County, 235 Va. 624, 626, 369 S.E.2d 414, 415-16 (1988); Arlington County Board v. Ginsberg, 228 Va. 633, 640, 325 S.E.2d 348, 352 (1985); Board of Supervisors v. Nassif, 223 Va. 400, 403-04, 290 S.E.2d 822, 824 (1982).

4 VA. CONST. art. X, § 2. "Fair market value" is "the price property will bring when offered for sale by a seller who desires but is not obliged to sell and bought by a buyer under no necessity of purchasing." Board of Supervisors v. Donatelli & Klein, 228 Va. 620, 628, 325 S.E.2d 342, 345 (1985).

5 E.g., County Board v. Commonwealth, 240 Va. 108, 112, 393 S.E.2d 194, 196 (1990). "Highest and best use" means "the most advantageous and valuable use of the [property] . . . having regard to the existing business demands of the community or such as may reasonably be expected in the immediate future." Appalachian Power Co. v. Anderson, 212 Va. 705, 708, 187 S.E.2d 148, 152 (1972). "Remote or speculative advantages or disadvantages, however, are not to be considered." Lynch v. Commonwealth Transp. Comm'r, 247 Va. 388, 391, 442 S.E.2d 388, 390 (1994).

6 See generally APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 90-93 (11th ed. 1996).

7 E.g., County Board, 240 Va. at 112, 393 S.E.2d at 196-97.

8 APPRAISAL INSTITUTE, supra note 6.

9 Nassif I, 223 Va. at 402 n.1, 290 S.E.2d at 823 n.1 (quoting Shaia v. City of Richmond, 207 Va. 885, 895, 153 S.E.2d 257, 265 (1967).

10 APPRAISAL INSTITUTE, supra note 6, at 478-79 (emphasis in original deleted).

11 See, e.g., Richmond, F. & P. R.R. v. Commonwealth, 203 Va. 294, 301, 124 S.E.2d 206, 211 (1962).

12 E.g., Oberstien v. Adair County Bd. of Review, 318 N.W.2d 817 (Iowa 1982); Donovan v. City of Haverhill, 141 N.E. 564 (Mass. 1923).

13 E.g., C.A.F. Investment Co. v. Township of Saganaw, 302 N.W.2d 164 (Mich. 1981).

14 See APPRAISAL INSTITUTE, supra note 6, at 137-42.

15 See, e.g., Exxon Corp. v. M & O Holding Corp., 221 Va. 274, 281-82, 269 S.E.2d 371, 376-77 (1980).

16 E.g., WEBSTER'S THIRD NEW INT'L DICTIONARY (UNABRIDGED) 483 (1971) ("to reflect on [or] think about with a degree of care or caution"); BLACK'S LAW DICTIONARY 306 (6th ed. 1990) ("[t]o fix the mind on, with a view to careful examination").

17 Schultz v. TM Florida-Ohio Realty Ltd. Partnership, 577 So.2d 573, 574 (Fla. 1991) (emphasis added).

18 223 Va. 400, 290 S.E.2d 822 (1982).

19 228 Va. 620, 325 S.E.2d 342 (1985).

20 228 Va. 633, 325 S.E.2d 348 (1985).

21 231 Va. 472, 345 S.E.2d 520 (1986).

22 234 Va. 250, 258, 361 S.E.2d 351, 355 (1987).

23 235 Va. 624, 369 S.E.2d 414 (1988).

24 235 Va. at 628, 369 S.E.2d at 416 (emphasis added).

25 241 Va. 5, 400 S.E.2d 151 (1991).

26 WNH L.P. v. Board of Supervisors, Law No. 32197 (Prince William County Cir. Ct.).

27 Hechinger Company v. Board of Supervisors, Law No. 133802 (Fairfax County Cir. Ct.)

28 Some commentators distinguish between business enterprise value and business value, positing that the former is merely a component of the latter. E.g., Robert W. Owens, "How Business Enterprise Value Applies in Nearly All Appraisals," The Appraisal Journal 117 (April 1998).

29 APPRAISAL INSTITUTE, supra note 6, at 579.

30 Id. at 578.

31 240 Va. 108, 393 S.E.2d 194 (1990).

32 See, e.g., Merle Hay Mall v. City of Des Moines Board of Review, 564 N.W.2d 419, 424 (Iowa 1997) ("It is undisputed that [the business enterprise value theory] was designed in the late 1980s by a group of shopping mall owners in cooperation with real estate appraisers and real estate professors in a group called 'SCAN' (shopping center assessment network)").

33 473 N.W.2d 554 (Wisc. App. 1991).

34 Id. at 563.

35 Id.

36 564 N.W.2d 419 (Iowa 1997).

37 Id. at 424.

38 204 Va. 584, 132 S.E.2d 721 (1963).

39 199 Va. 734, 101 S.E.2d 571 (1958).

40 199 Va. at 740, 101 S.E.2d at 575. See also Skyline Swannanoa v. Nelson County, 186 Va. 878, 44 S.E.2d 437 (1947).

41 256 Va. 136, 501 S.E.2d 761 (1998).

42 256 Va. at 142, 501 S.E.2d at 764 (quoting First & Merchants Nat'l Bank, 204 Va. at 588, 132 S.E.2d at 724).

43 211 Va. 692, 179 S.E.2d 623 (1971).

44 256 Va. at 142, 501 S.E.2d at 764..

45 890 P.2d 1370 (Ore. 1995).

46 276 N.W.2d 602 (Mich. App. 1979).

47 604 A.2d 580, 586 (N.J. 1992).

48 The Washington Post Co. v Board of Supervisors, Law No. 129013 (Fairfax County Cir. Ct.)

49 318 N.W.2d 586, 588-89 (Mich. App. 1982).