

STATE OF MINNESOTA
COUNTY OF HENNEPIN

TAX COURT
REGULAR DIVISION
FOURTH JUDICIAL DISTRICT

Macy's Retail Holdings, Inc.,

Petitioner,

v.

County of Hennepin,

Respondent.

**FINDINGS OF FACT,
CONCLUSIONS OF LAW AND
ORDER FOR JUDGMENT**

File Nos. 27-CV-09-15221
 27-CV-10-08453
 27-CV-11-07991
 27-CV-12-10082

Filed: November 6, 2014

This matter came on for trial before The Honorable Bradford S. Delapena, Chief Judge of the Minnesota Tax Court.

Thomas R. Wilhelmy and Christopher A. Stafford, Fredrikson & Byron, P.A., represented petitioner Macy's Retail Holdings, Inc.

John March and Lisa Hahn-Cordes, Assistant Hennepin County Attorneys, represented respondent Hennepin County.

These property tax cases concern the market value of the Macy's Home Store in Edina as of January 2, 2008, January 2, 2009, January 2, 2010, and January 2, 2011. We find that the assessed value of the subject property overstates its market value as of each valuation date.

The court, having heard and considered the evidence adduced at the hearings and the arguments of counsel, and upon all of the files, records, and proceedings herein, now makes the following:

FINDINGS OF FACT

1. Petitioner Macy's Retail Holdings, Inc., has sufficient interest in the property to maintain this petition; all statutory and jurisdictional requirements have been fulfilled; and the court has jurisdiction over the subject matter of the action and the parties thereto.

2. The subject property is a single owner-occupied parcel with 347,097 square feet of land and a street address of 7235 France Avenue South in Edina, Minnesota.

3. The land is improved with an 89,294 square foot freestanding furniture showroom facility which is currently a Macy's Home Store. The majority of the subject's improvements (a 53,377 square foot main floor and 35,917 square feet of additional space split between an upper and a lower level) were constructed in 1977. A modest addition of 7,507 square feet was built in 1997. The building's exterior is concrete block and finished brick, with earth berm sides.

4. The subject property is burdened by three easements. The first is an underground utility easement crossing the parcel's northeast corner.

5. The second easement is a perpetual vehicular access easement that serves both the subject property and the parcel lying immediately to the south. This easement runs east/west and occupies the southerly 85 feet of the westerly 360 feet of the subject parcel. It functions as the easterly portion of Gallagher Drive, which crosses France Avenue at a controlled intersection, thereby furnishing both northbound and southbound traffic access to the subject property. The easement is the subject property's sole curb cut on France Avenue.

6. The third easement is a transit easement that runs east/west just north of the subject property's southern boundary. It thus lies within the vehicular access easement for the westerly 360 feet of the parcel and occupies otherwise unburdened space for the remainder of its length along the easterly 250 feet of the parcel.

7. The property was zoned PCD-3, Planned Commercial District, on all valuation dates. The property's existing use as a furniture showroom was a conforming use.

8. The highest and best use of the subject property is for continued use of its existing retail improvements.

9. The Edina Assessor's estimated market value for the subject property was \$8,894,000 as of both January 2, 2008, and January 2, 2009, and was \$8,227,000 as of both January 2, 2010, and January 2, 2011.

10. Macy's appraiser, Rodger L. Skare, MAI, opined that the fee simple market value of the subject property was \$6,275,000 as of January 2, 2008; \$5,625,000 as of January 2, 2009; \$5,250,000 as of January 2, 2010; and \$5,275,000 as of January 2, 2011.

11. The County's appraiser, Shelagh Stoerzinger, opined that the fee simple market value of the subject property was \$12,755,100 as of January 2, 2008; \$11,089,000 as of January 2, 2009; \$10,811,300 as of January 2, 2010; and \$12,893,900 as of January 2, 2011.

12. The fee simple market value of the subject property as of January 2, 2008, was \$8,482,000.

13. The fee simple market value of the subject property as of January 2, 2009, was \$8,385,000.

14. The fee simple market value of the subject property as of January 2, 2010, was \$6,710,000.

15. The fee simple market value of the subject property as of January 2, 2011, was \$7,403,000.

CONCLUSIONS OF LAW

1. Petitioner submitted sufficient credible evidence to rebut the presumptive validity of the assessed value as of each valuation date.

2. The Edina Assessor's estimated market value for the subject property as of January 2, 2008, overstates its market value as of that date.

3. The Edina Assessor's estimated market value for the subject property as of January 2, 2009, overstates its market value as of that date.

4. The Edina Assessor's estimated market value for the subject property as of January 2, 2010, overstates its market value as of that date.

5. The Edina Assessor's estimated market value for the subject property as of January 2, 2011, overstates its market value as of that date.

ORDER FOR JUDGMENT

1. The assessed value of the subject property as of January 2, 2008, shall be decreased from \$8,894,000 to \$8,482,000.

2. The assessed value of the subject property as of January 2, 2009, shall be decreased from \$8,894,000 to \$8,385,000.

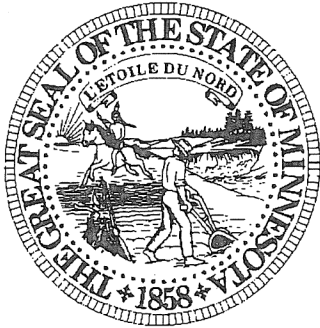
3. The assessed value of the subject property as of January 2, 2010, shall be decreased from \$8,227,000 to \$6,710,000.

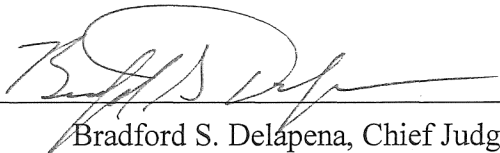
4. The assessed value of the subject property as of January 2, 2009, shall be decreased from \$8,227,000 to \$7,403,000.

5. Real estate taxes due and payable in 2009 and 2010, 2011, and 2012 shall be recomputed accordingly and refunds, if any, paid to petitioner as required by such computations, together with interest from the original date of payment.

IT IS SO ORDERED. THIS IS A FINAL ORDER. ENTRY OF JUDGMENT IS STAYED FOR 15 DAYS. LET JUDGMENT BE ENTERED ACCORDINGLY.

BY THE COURT,




Bradford S. Delapena, Chief Judge
MINNESOTA TAX COURT

November 6, 2014

MEMORANDUM

Petitioner Macy's Retail Holdings owns and operates the Macy's Southdale Home Store in Edina, Minnesota. Macy's filed petitions under Minn. Stat. ch. 278 (2012) challenging the Edina Assessor's estimated market values for the subject property as of the January 2, 2008, January 2, 2009, January 2, 2010, and January 2, 2011 assessment dates. We conclude that the assessed value of the subject property overstates its market value as of each valuation date.

I. THE SUBJECT PROPERTY

The subject property is a single owner-occupied parcel with 347,097 square feet of land and a street address of 7235 France Avenue South in Edina, Minnesota.¹ The land is improved with an 89,294 square foot freestanding furniture showroom facility which is currently a Macy's

¹ Ex. A1, at 4, 30, 33. Ms. Stoerzinger's figure of 347,092 square feet was based on Hennepin County's GIS system. Tr. 332. Mr. Skare estimated the land area at 352,982 square feet, Ex. 1, at 3, 6, relying on unspecified information supplied by Macy's and unspecified government records, Ex. 1, at 8. We rely on Stoerzinger's figure.

Home Store.² The majority of the subject's improvements (a 53,377 square foot main floor and 35,917 square feet of additional space split between an upper and a lower level) were constructed in 1977.³ A modest addition of 7,507 square feet was built in 1997.⁴ The building's exterior is concrete block and finished brick, with earth berm sides.⁵

The subject property is burdened by three easements. The first is an underground utility easement crossing the parcel's northeast corner.⁶ The second is a perpetual vehicular access easement that serves both the subject property and the parcel lying immediately to the south.⁷ This easement runs east/west and occupies the southerly 85 feet of the westerly 360 feet of the subject parcel.⁸ It functions as the easterly portion of Gallagher Drive, which crosses France Avenue at a controlled intersection, thereby furnishing both northbound and southbound traffic access to the subject property.⁹ The easement is the subject property's sole curb cut on France Avenue.¹⁰

The third easement is a transit easement that runs east/west just north of the subject property's southern boundary.¹¹ It thus lies within the vehicular access easement for the westerly

² Ex. 1, at 3. Mr. Skare's figure of 89,294 square feet, Ex. 1 at 3, 6, was based on architectural drawings supplied by Macy's and on a building sketch in the Hennepin County Assessor's records, Ex. 1, at 8, 32. Ms. Stoerzinger figure of 89,782 square feet was based on the assessor's field card and on building plans, Ex. A1, at 36. We rely on Skare's figure.

³ Ex. 1, at 3.

⁴ Ex. 1, at 3.

⁵ Ex. 1, at 3.

⁶ Ex. A1, at A43.

⁷ Ex. A1, at 31-32.

⁸ Ex. A1, at 31, A22-A35; Tr. 342-45.

⁹ Ex. 1, at 2; Tr. 343-44.

¹⁰ Ex. 1, at 1; Tr. 344.

¹¹ Ex. A1, at 32, A36-A42; Tr. 345-48.

360 feet of the parcel and occupies otherwise unburdened space for the remainder of its length along the easterly 250 feet of the parcel.¹²

The property was zoned PCD-3, Planned Commercial District, on all valuation dates.¹³ The property's existing use as a furniture showroom was a conforming use.¹⁴

The Edina Assessor's estimated market value for the subject property was \$8,894,000 as of both January 2, 2008, and January 2, 2009, and was \$8,227,000 as of both January 2, 2010, and January 2, 2011.¹⁵ Macy's appraiser, Rodger L. Skare, MAI, opined that the fee simple market value of the subject property was \$6,275,000 as of January 2, 2008; \$5,625,000 as of January 2, 2009; \$5,250,000 as of January 2, 2010; and \$5,275,000 as of January 2, 2011.¹⁶ The County's appraiser, Shelagh Stoerzinger, opined that the fee simple market value of the subject property was \$12,755,100 as of January 2, 2008; \$11,089,000 as of January 2, 2009; \$10,811,300 as of January 2, 2010; and \$12,893,900 as of January 2, 2011.¹⁷

II. BURDEN OF PROOF

An assessor's estimated market value is prima facie valid. *S. Minn. Beet Sugar Coop v. Cnty. of Renville*, 737 N.W.2d 545, 557 (Minn. 2007) (citing Minn. Stat. §§ 271.06, subd. 6 & 272.06 (2012)). A petitioner may overcome the presumption of validity by introducing evidence that the assessor's estimated market value is excessive. *Id.* at 558. We conclude that Macy's presented sufficient evidence, through the testimony of its valuation expert, to rebut the presumption. When the presumption of validity is overcome, we determine market value based

¹² Ex. A1, at A42.

¹³ Ex. A1, at 4, 35, 38.

¹⁴ Ex. A1, at 43.

¹⁵ Ex. 1, at 12-15; Ex. A1, at 12.

¹⁶ Ex. 1, at 174.

¹⁷ Ex. A1, at 88.

upon a preponderance of the evidence. *Macy's Retail Holdings, Inc. v. Cnty. of Hennepin*, No. 27-CV-07-07774 et al., 2011 WL 6117899, at *2 (Minn. T.C. Nov. 28, 2011) (citing *Pep Boys v. Cnty. of Anoka*, No. C2-01-2780 et al., 2004 WL 2436350, at *3 (Minn. T.C. Oct. 26, 2004)).

III. TAX VALUATION GENERALLY

We consider the three traditional approaches to valuation—cost, income, and sales comparison—in determining market value. See *Equitable Life Assur. Soc'y of the U.S. v. Cnty. of Ramsey*, 530 N.W.2d 544, 552 (Minn. 1995). We are not required, however, to give weight to all three valuation approaches, and we may place greater emphasis on a particular approach or approaches. *Id.* at 554. Because the approaches to value are applied in light of a property's highest and best use, see, e.g., Appraisal Institute, *The Appraisal of Real Estate* 42-43, 331, 362, 373, 379, 565 (14th ed. 2013) (so indicating), we turn to highest and best use.

IV. HIGHEST AND BEST USE

A property's highest and best use is “[t]he reasonably probable use of property that results in the highest value.” *Appraisal of Real Estate* 332. To be reasonably probable, a use must be physically possible, legally permissible, and financially feasible. *Id.* Uses that satisfy these three criteria are then tested under a fourth “for economic *productivity*, and the reasonably probable use with the highest value is the highest and best use.” *Id.* (emphasis in original).

A proper highest and best use analysis is undertaken “from two perspectives: [1] the use of a property based on the assumption that the parcel of land is vacant or can be made vacant by demolishing any improvements [and 2] the use that should be made of a property as it exists (i.e., considering the current improvements).” *Appraisal of Real Estate* 336. These two perspectives “are connected but [reflect] distinctly different concepts.” *Id.* An “as vacant” analysis “focuses [broadly] on alternative uses, with the appraiser testing each reasonably probable use for legal permissibility, physical possibility, financial feasibility, and maximum productivity.” *Id.* at 337.

An “as improved” analysis, in contrast, applies the four criteria more narrowly to alternative uses *of the existing improvements in particular*, evaluating whether to retain, modify, or demolish them. *Id.*

A. The Parties’ Highest and Best Use Conclusions

The parties’ appraisers agreed about the subject property’s highest and best use as vacant, but disagreed about its highest and best use as improved.

1. As Vacant

Mr. Skare concluded that the subject property’s highest and best use as vacant was “for some type of a fairly intense, larger destination-oriented commercial/retail development or a mixed-use commercial and residential development”¹⁸ Likewise, Ms. Stoerzinger concluded that “a retail or mixed use development ... would represent the highest and best use of the subject site as if vacant.”¹⁹

2. As Improved

Mr. Skare concluded that “the highest and best use of the subject property ‘as improved’ is for continued use of the existing improvements as a single-occupant, high-margin (i.e. big ticket) retail facility such as a furniture showroom.”²⁰ Ms. Stoerzinger, in contrast, concluded that “[t]he current improvements ... do not contribute to overall property value and thus the highest and best use of the site as improved is for redevelopment on the appraisal dates.”²¹

The appraisers’ directly contrary conclusions about highest and best use as improved mask two points of substantial agreement. First, although Skare concluded that the property’s

¹⁸ Ex. 1, at 72.

¹⁹ Ex. A1, at 42.

²⁰ Ex. 1, at 73.

²¹ Ex. A1, at 43.

existing improvements continued to contribute to its overall value on the four valuation dates, he recognized: (1) that “the property’s underlying land value is quite high compared to ... its overall value;”²² (2) that the existing structure suffered from “a significant amount of incurable function obsolescence;”²³ and, accordingly, (3) that within “a matter of five years, maybe seven, probably 10, this site would be redeveloped.”²⁴ The appraisers thus agreed that the subject’s disproportionately high land value would soon surpass its overall value, spurring redevelopment; they disagreed only about how soon this would occur.

Second, the appraisers agreed that to properly determine the subject property’s highest and best use as improved, its value for sale as a development site must be compared with its value assuming continued use of its existing retail improvements. Skare concluded, for example, that “both a land valuation and a total property valuation must be performed in order to test the highest and best use of the property in its current state.”²⁵ Stoerzinger reached a similar conclusion.²⁶

B. We Defer a Highest and Best Use Conclusion

We agree with the appraisers that a proper “as improved” analysis requires a comparison of the subject’s value for sale as a development site with its value assuming continued use of the existing improvements: “[A]n appraiser needs to *test* whether the existing improvements contribute value, rather than simply *assume* that the current use is the highest and best use

²² Ex. 1, at 4, 9, 160.

²³ Ex. 1, at 73.

²⁴ Tr. 182; *see also* Ex. 1, at 160.

²⁵ Ex. 1, at 73.

²⁶ Ex. A1, at 44 (“A sales comparison approach to value was used for the site.... [F]or the subject property as improved ... [a]n income approach was fully developed and a sales comparison approach was partially developed.”).

because the improvements are already in place.” *Appraisal of Real Estate* 346 (emphasis added). Indeed, “the most persuasive analysis of the highest and best use of the property as improved often first tests whether the existing improvements could be demolished and the site redeveloped to the highest and best use as though vacant” *Id.* “When the improvements no longer contribute to value, demolition and redevelopment of the ideal improvement would be economically supportable.” *Id.* On the other hand, “[i]f the value of the property as improved is greater than the value of the site as though vacant less demolition costs, the existing improvements contribute value to the property’s highest and best use, and the improvements should not be demolished at that time.” *Id.*

Specifically because the appraisers disagreed about whether the existing improvements continued to contribute value, we defer our highest and best use determination until after we consider application of the pertinent value approaches to the probable alternative land uses. Only then will we be able to determine which probable use is the property’s maximally productive use.

In many appraisal assignments, the final tests of financial feasibility and maximum productivity require information that is obtained from the application and development of the approaches. Therefore, ... the conclusion of highest and best use often can be finalized only after a preliminary analysis of alternative land uses has been performed.

Appraisal of Real Estate 358.

Mr. Skare used the following approaches to value the probable alternative uses of the subject property as of the four valuation dates, January 2 of each listed year:

	<u>Site Value</u>	<u>Value as Improved</u>	
	Sales Comp.	Sales Comp.	Income
2008	\$5,825,000	\$6,250,000	\$6,300,000
2009	\$4,725,000	\$5,675,000	\$5,550,000
2010	\$4,725,000	\$5,400,000	\$5,125,000
2011	\$4,725,000	\$5,400,000	\$5,200,000 ²⁷

Ms. Stoerzinger considered or used the same approaches:

	<u>Site Value</u>	<u>Value as Improved</u>	
	Sales Comp.	Sales Comp.	Income
2008	\$12,755,100	Not Completed	\$9,090,600
2009	\$11,089,000	Not Completed	\$8,134,100
2010	\$10,811,300	Not Completed	\$7,102,400
2011	\$12,893,900	Not Completed	\$8,413,000 ²⁸

These tables further illuminate the appraisers' disagreement. Skare concluded that the subject's highest and best use as improved was continued use of the existing improvements specifically because his as-improved values exceeded his site value. Conversely, Stoerzinger concluded that its highest and best use as improved was for redevelopment because her site values exceeded her as-improved values.

We note that both appraisers' as-improved values exceed Skare's site values. Accordingly, because only Stoerzinger's site values exceed the as-improved values, only Stoerzinger's site values suggest that the property's highest and best use as improved is for redevelopment rather than continued use. Therefore, after briefly discussing the cost approach, we will begin by evaluating Stoerzinger's site valuation using the sales comparison approach.

²⁷ Ex. 1, at 173; Tr. 263-64, 268.

²⁸ Ex. A1, at 4, 88.

V. COST APPROACH

The cost approach is based upon the proposition that “an informed buyer would pay no more for the property than the cost of constructing new property having the same utility.” *Equitable Life Assur. Soc’y*, 530 N.W.2d at 552. Neither party’s appraiser applied the cost approach to determine either a site value or an overall value.²⁹ We agree. First, “[s]ales comparison is usually the preferable methodology for developing an opinion of site value.” *Appraisal of Real Estate* 364. Second, given the significant age of the improvements and their substantial functional obsolescence,³⁰ the cost approach would not be reliable. *See, e.g., Sears, Roebuck & Co. v. Cnty. of Dakota*, No. C4-04-7619, 2007 WL 2481290, at *3 (Minn. T.C. Aug. 30, 2007) (“When older properties have experienced significant depreciation and obsolescence, the cost approach is not a reliable method to use to ascertain market value.”).

VI. SALES COMPARISON APPROACH

The sales comparison approach assumes, among other things, “that the value of property tends to be set by the cost of acquiring a substitute or alternative property of similar utility and desirability within a reasonable amount of time.” *Appraisal of Real Estate* 379; *see also Equitable Life Assur. Soc’y*, 530 N.W.2d at 552 (observing that the sales comparison approach “is based on prices paid in actual market transactions involving comparable properties”). Application of the sales comparison approach requires analysis of recent sales of other properties to determine the comparability of those properties to the subject property, and adjustment of their sales prices as necessary for such features as age, size, location, and condition to make those properties comparable to the subject property. *Appraisal of Real Estate* 381-82. The reliability

²⁹ Ex. 1, at 4; Ex. A1, at 4.

³⁰ Ex. 1, at 73.

of this approach depends on the availability of sales information for other properties, and on the comparability of those properties to the subject. *Id.* at 380.

A. Site Value

Both appraisers used the sales comparison approach to value the subject property as a redevelopment site.

1. County

Ms. Stoerzinger chose as comparables for her site valuation sales that involved either vacant land or property purchased for redevelopment.³¹ She generally rejected sales of properties smaller than 100,000 square feet, but relaxed this restriction for two sales involving smaller properties along the same commercial corridor on France Avenue.³² Stoerzinger considered only sales of properties “located on good transportation corridors, or in high demand infill location similar to the subject.”³³ Stoerzinger ultimately selected seven land comparables,³⁴ adjusting the actual sale price of each for factors such as location and date of sale.³⁵

In determining site value, Stoerzinger gave no weight to her land comparables 2, 4, or 6, which she concluded required excessive gross adjustments and thus were not sufficiently similar

³¹ Ex. A1, at 45.

³² Ex. A1, at 45, 62; Tr. 403-04.

³³ Ex. A1, at 45.

³⁴ Ex. A1, at 46-52, 62. Stoerzinger’s land comparable 1 was 6500 France Avenue South in Edina; comparable 2 was 6996 France Avenue South in Edina; comparable 3 was 6501 Lyndale Avenue South in Richfield; comparable 4 was 2810 Nicollet Avenue in Minneapolis; comparable 5 was 1710 Highway 7 in Hopkins; comparable 6 was 8100 26th Avenue & 2600 East 18th Street in Bloomington; and comparable 7 was 2812-28 Emerson Avenue South and 2820-28 Dupont Avenue South in Minneapolis. *Id.*

³⁵ Ex. A1, at 54-62.

to the subject property.³⁶ And, although Stoerzinger's site valuation focused on the January 2, 2008 valuation date (she indexed that value for the next three years³⁷), three of Stoerzinger's remaining land comparables sold approximately 4-5 years after that valuation date.³⁸ Given the economic uncertainty that prevailed between the 2008 valuation date and the much later dates of these three sales,³⁹ we cannot reasonably rely on Stoerzinger's land comparables 1, 3, or 7.

Minnesota law provides that a licensed appraiser "must act according to the standards of professional appraisal practice [USPAP]" Minn. Stat. § 82B.195, subd. 1 (2012). USPAP's "Statement on Appraisal Standards No. 3" cautions that "[a] retrospective appraisal is complicated by the fact that the appraiser already knows what occurred in the market after the effective date of the appraisal." The Appraisal Foundation, *Uniform Standards of Professional Appraisal Practice*, Statement 3, U-74 (2014-15 ed.). Under the Statement, "[d]ata subsequent to the effective date may be considered in developing a retrospective value as a confirmation of trends that would reasonably be considered by a buyer or seller as of that date." *Id.* Accordingly, the Statement counsels that "[i]n the absence of evidence in the market that data subsequent to the effective date were consistent with and confirmed market expectations as of the effective date, the effective date should be used as the cut-off date for data considered by the appraiser." *Id.*

In this case, Stoerzinger agreed during cross-examination that she had conducted a retrospective appraisal.⁴⁰ She then forthrightly acknowledged that she never determined that

³⁶ Ex. A1, at 62, 65; Tr. 300-01, 516-17.

³⁷ Ex. A1, at 65.

³⁸ Ex. A1, at 62. Land comparable 1 sold on December 20, 2012; comparable 3 on November 14, 2011; and comparable 7 on September 11, 2012.

³⁹ Ex. 1, at 37, 52, 56-58; Ex. A1, at 39-42.

⁴⁰ Tr. 464.

market information “as of April 2013 was a confirmation of trends that were expected as of January 2, 2008.”⁴¹ Likewise, there is no evidence that Stoerzinger determined that the market information represented by the three land comparables that sold on or after November 14, 2011, could properly be considered under USPAP’s Statement No. 3.

As we have repeatedly noted, this court is concerned with USPAP compliance only insofar as it affects the substantive accuracy and credibility of an appraisal. *See, e.g., Macy’s Retail Holdings, Inc. v. Cnty. of Hennepin*, No. 27-CV-09-15221 et al., 2014 WL 1379288, at *6 n.8 (Minn. T.C. Feb. 25, 2014); *Geneva Exch. Fund XXVII, LLC v. Cnty. of Hennepin*, No. 27-CV-06-08694, 2010 WL 532865, at *6 (Minn. T.C. Feb. 11, 2010). Here, we conclude that the use of comparable sales occurring 4-5 years after the January 2, 2008 valuation date—and separated from that date by a period of unusual economic uncertainty—raises substantial accuracy concerns. Accordingly, we find that Stoerzinger’s land comparables 1, 3, and 7 are entitled to no weight.

This leaves Stoerzinger’s site valuation with only land comparable 5 to support it. That sale occurred on June 26, 2007, approximately six months before the January 2, 2008 valuation date.⁴² Stoerzinger adjusted the actual sale price of \$22.72 per square foot downward by 4% for time-of-sale, and downward by 5% because it is approximately 50% smaller than the subject property.⁴³ Stoerzinger then adjusted the price upward by 29% for its inferior location (Hopkins).⁴⁴ This adjustment was based on seven sub-factors, only three of which were supported by objective criteria (traffic counts, number of households within three miles, median

⁴¹ Tr. 465-66.

⁴² Ex. A1, at 50, 62.

⁴³ Ex. A1, at 62.

⁴⁴ Ex. A1, at 62.

income within three miles).⁴⁵ Based on a net upward adjustment of 24%, Stoerzinger derived an adjusted sale price of \$26.99 per square foot.⁴⁶

We find that land comparable 5 alone cannot support Stoerzinger's site value conclusion under the sales comparison approach. First, Stoerzinger admitted during trial that her adjusted sale price for land comparable 5 improperly included \$2.21 per square foot for remediation costs not anticipated by either the buyer or the seller.⁴⁷ *Appraisal of Real Estate* 412 (noting that where sale price is increased by expenditures made immediately after purchase, "[t]he relevant figure is not the actual cost that was incurred but the cost that was anticipated by both the buyer and seller"). Second, whereas Stoerzinger concluded that the site was worth \$40.00 per square foot based on her consideration of land comparables 1, 3, 5, and 7, yielding a value (before reductions for demolition and site preparation costs) of \$13,883,900 as of January 2, 2008,⁴⁸ comparable 5's indication (recomputed without the excess \$2.21 per square foot) yields a preliminary site value on only \$8,474,582. Third, when we eliminate from Stoerzinger's location adjustment the effect of the four sub-factors *not* supported by objective criteria, we arrive at an upward location adjustment of only 8%, a net upward adjustment of only 3%, an adjusted sale price of \$20.28 per square foot, and a preliminary site value of only \$7,039,370 as of January 2, 2008.⁴⁹ Both of these figures, which must be further reduced by \$1,128,800 for

⁴⁵ Ex. A1, at 60, 62.

⁴⁶ Ex. A1, at 62.

⁴⁷ Tr. 437-38.

⁴⁸ Ex. A1, at 65.

⁴⁹ Although appraisers can, and sometimes must, make subjective adjustments not based on objective criteria and related empirical evidence, such adjustments are intrinsically less persuasive. See *Macy's Retail Holdings*, 2014 WL 1379288, at *8 & n.9 (collecting cases). Here, we segregate the subjective portion of Stoerzinger's location adjustment not because it lacked credibility, but simply to illustrate its significant effect on indicated site value.

demolition and other site preparation costs,⁵⁰ are well below Stoerzinger's own value conclusion for the overall property under the income approach as of January 2, 2008 (\$9,090,600).⁵¹ Finally, and most importantly, we are unwilling to give weight to a sales comparison analysis supported by only a single comparable sale.

2. Macy's

Macy's site values under the sales comparison approach fall well below both appraisers' values for the property overall.⁵² They therefore suggest that the property's highest and best use is as currently improved, and that its overall value must control. Consequently, we will not consider Macy's site valuation analysis unless we conclude that both appraisers have overestimated the property's overall value.

B. Overall Value

Mr. Skare completed a sales comparison analysis for the overall property as of each valuation date. Ms. Stoerzinger, in contrast, having already determined rather high site values, began a sales comparison analysis for the overall property, but concluded that the preliminary indicated value range (\$3,196,500 to \$9,107,200) verified her conclusion that the property's site value exceeded its overall value.⁵³ Accordingly, Stoerzinger did not complete her sales comparison analysis.⁵⁴ For this reason, we consider only Skare's sales comparison analysis for the property overall.

⁵⁰ Ex. A1, at 66.

⁵¹ Ex. A1, at 87-88.

⁵² Ex. 1, at 88.

⁵³ Ex. A1, at 67.

⁵⁴ Ex. A1, at 67.

Mr. Skare located nine building sales he considered sufficiently comparable to support a sales comparison analysis for the property overall.⁵⁵ Because the sale dates for Skare's building comparables ranged from August 30, 2004, to October 12, 2011,⁵⁶ Skare used for each valuation date only those sales he considered sufficiently contemporary.⁵⁷ Skare adjusted the actual sale price of each building comparable for factors such as location and date of sale.⁵⁸ Based on this procedure, Skare determined the following values for the property overall on the valuation dates:

	Value per sq.ft.	Total Value	Rounded
2008	\$70.00	\$6,250,580	\$6,250,000
2009	\$63.50	\$5,670,169	\$5,675,000
2010	\$60.50	\$5,402,287	\$5,400,000
2011	\$60.50	\$5,402,287	\$5,400,000 ⁵⁹

For several reasons, we find that Skare's sales comparison analysis of the property overall is flawed and is entitled to no weight.

First, Skare's analysis founders on a criticism Macy's directs toward Ms. Stoerzinger's. Macy's complains that Stoerzinger relied, at least in part, upon comparable sales with gross adjustments of 50% or more, and asserts that this court "has applied a litmus test that sales with

⁵⁵ Ex. 1, at 91 (selection criteria); *id.* at 94-104 (selected comparables); *id.* at 105 (rejected comparables). Skare's building sale comparable 1 was 8348 Tamarack Village in Woodbury; comparable 2 was 6725 York Avenue South in Edina; comparable 3 was 5419 Lakeland Avenue North in Crystal; comparable 4 was 1360 University Avenue West in St. Paul; comparable 5 was 3180 County Drive in Little Canada; comparable 6 was 14200 Ewing Avenue South in Burnsville; comparable 7 was 1605 County Road 101 North in Plymouth; comparable 8 was 1001 Plymouth Road in Minnetonka; and comparable 9 was 1390 University Avenue West in St. Paul. Ex. 1, at 94-103.

⁵⁶ Ex. 1, at 94-103.

⁵⁷ Ex. 1, at 113, 116, 119, 122 (separate adjustment grids). Specifically, Skare used comparables 1 through 5 for the January 2, 2008 valuation date, *id.* at 113; comparables 4 through 6 for the January 2, 2009 date, *id.* at 116; comparables 5 through 8 for the January 2, 2010 date, *id.* at 119; and comparables 6 through 9 for the January 2, 2011 date, *id.* at 122.

⁵⁸ Ex. 1, at 106-113, 116, 119, 122.

⁵⁹ Ex. 1, at 115, 118, 121, 124; Tr. 263-64, 268.

aggregate adjustments greater than 50% ... may be deemed not sufficiently comparable.”⁶⁰

Although we reject Macy’s assertion that we apply a “litmus test,” we acknowledge a reluctance to rely upon sales comparables with gross adjustments of 50% or more without good reason for doing so.⁶¹ Because both appraisers in this case appropriately valued the property overall under the income approach, for example, we perceive no good reason here to rely upon sales of marginally comparable properties to reach a dubious conclusion of value under the sales

⁶⁰ Macy’s Post-Trial Mem. at 14; *see also id.* at 25-26 (similar assertion, citing cases).

⁶¹ Although three of the four cases cited by Macy’s reflect a reluctance to use comparable sales with gross adjustments of 50% or more, they do not amount to a “litmus test.” *See, e.g., Johnson v. Cnty. of Chisago*, No. 13-CV-10-499, 2012 WL 516823, at *8 (Minn. T.C. Feb. 14, 2012) (noting that we have “consistently given little to no weight to sales comparables where the adjustments are excessive and gross adjustments exceeded 50%); *Bon Stores Realty Two LLC v. Cnty. of Ramsey*, Nos. 62-C0-07-4475, 62-CO-07-4475, 2011 WL 3621612, at *6 (Minn. T.C. Aug. 8, 2011) (giving no weight to comparable sales involving 50% and 65% gross adjustments); *Shoppes of Woodbury Vill. v. Cnty. of Washington*, No. CX-07-2880 et al., 2009 WL 3837267, at *4 (Minn. T.C. Nov. 12, 2009) (giving no weight to comparable sale involving 65% gross adjustment). The fourth case involves an income comparable rather than a sales comparable, and likewise belies Macy’s claim that we have applied a “litmus test.” *Kmart Corp. v. Cnty. of Martin*, No. C1-01-201 et al., 2006 WL 771935, at *6 (Minn. T.C. Mar. 13, 2006) (giving “less weight” to income comparables involving 50% and 55% adjustments on the ground that such an adjustment “makes [each comparable] less reliable”).

Real property appraisal is a practical endeavor in which the unavailability of data of a preferred quality (comparable sales with modest gross adjustments) can conceivably compel at least partial reliance on lower quality instances of that data (comparable sales with gross adjustments of 50% or more). Such circumstances require appraisers and courts to exercise reasoned judgment. Where a type of data relied upon by market participants and recognized as reliable by courts is available, but is of a lower quality than might be wished, the question of whether to rely upon or reject that data must be answered on a case-by-case basis, taking into account factors such as the centrality of the data to the value approach being applied and the availability and reliability of alternative value approaches. *See, e.g., Shoppes of Woodbury Vill. v. Cnty. of Washington*, Nos. CV-08-1506, CX-07-2880, 2010 WL 773915, at *2 (Minn. T.C. Mar. 5, 2010) (“The relative weight to be placed on each of the three traditional approaches to value depends on the nature of the property and the reliability of the data in the particular case.”); *Kmart Corp.*, 2006 WL 771935, at *6 (placing “minimal weight” on various classes of comparable sales where superior data was available in that “[w]ithin one year of the initial date of valuation, four nearly identical Kmart buildings ... sold”). “Litmus tests” are plainly incompatible with the exercise of practical judgment in such intrinsically circumstantial inquiries.

comparison approach. *See, e.g., Equitable Life Assur. Soc'y*, 530 N.W.2d at 549 (“Income-producing real estate ... is typically purchased as an investment, and from an investor’s point of view, earning power is a critical element affecting property value.”); *Nordlie v. Cnty. of Hennepin*, No. 23227, 1995 WL 758550, at *2 (Minn. T.C. Dec. 21, 1995) (“This property is owned and managed as an income-producing property and analyzing its income-producing potential reflects what a potential buyer would consider.”).

Eliminating from Skare’s analysis any building sale comparables with gross adjustments of 50% or more leaves three comparable sales for the 2008 valuation date; no comparables for the 2009 date; and two comparables each for the 2010 and 2011 dates.⁶² Although we might find sufficient data to support value conclusions for the 2008, 2010, and 2011 valuation dates if other approaches to value could not be developed, that is not the case here.

In any event, we reject Skare’s sales comparison analysis for a more fundamental reason: its lack of credibility. As we have noted, Skare adjusted his building sale comparables for, among other things, location and date of sale.⁶³ A “market conditions” adjustment takes into account market changes occurring over time and is used to adjust the actual sale prices of comparables to the valuation date. *Appraisal of Real Estate* 414 (“An adjustment for market conditions is made if general property values have increased or decreased since the transaction dates.”). Based on market evidence, for example, an appraiser might formulate sub-rules that between t_1 and t_2 , an X% adjustment is warranted; that between t_2 and t_3 , a –Y% adjustment is warranted; and between t_3 and t_4 , a Z% adjustment is warranted, and so on. *Id.* at 415; *id.* at 416 (“in volatile markets, an adjustment for market conditions may be needed to account for periods

⁶² *See* Ex. 1, at 114, 117, 120, 123.

⁶³ Ex. 1, at 108 (market conditions adjustment); *id.* at 109 (location adjustment).

of time in which sale prices go up and down”). The appraiser then applies the adjustment to his comparable sales.

Skare’s market condition adjustment is set forth on page 108 of his appraisal report.⁶⁴ During cross-examination, the County asked Skare to clarify the sub-rules embodied in his adjustment.⁶⁵ Skare’s responses were inconsistent with his report, and were both evasive and equivocal.⁶⁶ The County then asked Skare to acknowledge that the market conditions adjustment he used in the present case was different than one he had used in the appraisal of another property for some of the same valuation dates.⁶⁷ Again, Skare was evasive.⁶⁸

In an attempt to rehabilitate Skare, Macy’s counsel proposed to “talk just for a minute about your time adjustments.”⁶⁹ The next twelve pages of the trial transcript, however, are devoted to this discussion.⁷⁰ The redirect examination is extensive specifically because, even when interacting with Macy’s counsel, Skare’s responses were couched, qualified, baroque, and contradictory. In sum, we found them wholly unpersuasive, leaving us with no confidence in Skare’s time adjustment.

Skare’s explanation of his location adjustments went no better. Skare included in his overall location adjustment considerations such as visibility, access, demographics, and trade area.⁷¹ The objective demographic information upon which Skare relied was disclosed during

⁶⁴ Ex. 1, at 108.

⁶⁵ Tr. 103-08.

⁶⁶ *Compare* Ex. 1, at 108 *with* Tr. 103-08.

⁶⁷ Tr. 108-10.

⁶⁸ Tr. 108-10.

⁶⁹ Tr. 227.

⁷⁰ Tr. 227-39.

⁷¹ Tr. 65, 102-03; Ex. 1 at 109.

discovery and discussed during trial.⁷² In contrast, although Skare indicated that traffic counts were “factored in[to]” his location adjustment, he admitted during trial that his report included no objective information about traffic counts and that his workfile contained no notes on the subject.⁷³ Skare testified that his overall location adjustment was based on his judgment, and that he “did not split it out and give certain percentages to each [sub-factor].”⁷⁴ For this reason, we cannot determine the extent to which Skare’s location adjustment was supported by objective evidence rather than subjective inference (as we could with Stoerzinger’s location adjustment).

In any event, Skare’s trial testimony suggested that his location adjustments were largely ad hoc and unreliable. Skare testified that he adjusted building comparable 1 downward because its 10-minute drive area had “less than half in households” as compared with the subject property.⁷⁵ When the County observed that comparable 4 had a *higher* 10-minute household count than the subject, Skare responded, “[t]hen that in and of itself would warrant a downward adjustment.”⁷⁶ Likewise, Skare testified that he adjusted building comparable 1 downward in part because “it’s *a very heavily retailed area*, ... and so it’s not as good a location.”⁷⁷ When asked why he adjusted comparable 3 downward, however, he replied, “*it’s not a retail location like the subject is*, not near as good a retail location.”⁷⁸ Again, we find Skare’s testimony unpersuasive.

⁷² Ex. A11.

⁷³ Ex. 1, at 109; Tr. 116-17.

⁷⁴ Ex. 1 at 109; Tr. 119.

⁷⁵ Tr. 117-18.

⁷⁶ Tr. 120; *see also* Tr. 121 (same).

⁷⁷ Tr. 118 (emphasis added).

⁷⁸ Tr. 119 (emphasis added).

Skare's sales comparison analysis for the property overall was supported by only marginally acceptable comparable sales data. More importantly, however, we are unable to rely on Skare's adjustments because we find that they were not credibly explained or consistently applied. Under the circumstances, we give the analysis no weight.

VII. INCOME APPROACH

Under the income capitalization approach, the anticipated income stream of an income-producing property is reduced to a present value by applying a suitable discount rate. *Equitable Life Assur. Soc'y*, 530 N.W.2d at 549. When valuing a fee simple interest in property, the amount to be capitalized is the "anticipated market level of rent less the market level of expenses." *Macy's Retail Holdings*, 2011 WL 6117909, at *9; *see also Eden Prairie Mall, LLC v. Cnty. of Hennepin*, 797 N.W.2d 186, 195 (Minn. 2011) ("*EPM I*") ("In valuing a fee simple interest in property, the value of rentable space is estimated using market rent levels."). Here, the parties' appraisers used materially similar values for most of the factors affecting the income capitalization approach (vacancy, expenses, replacement reserves, capitalization rates, and effective tax rates).⁷⁹ Their primary disagreement concerned a proper market rent for the subject property.

A. Market Rent

Rent is typically the most significant component of an income-producing property's potential gross income, *Appraisal of Real Estate* 478, which is "the total potential income attributable to the real property at full occupancy before vacancy and operating expenses are deducted," *id.* at 451. Market rent is "the rent that a property should bring in a competitive open market." *EPM I*, 797 N.W.2d at 195. Where a property is owner-occupied, market rent must be

⁷⁹ Macy's Post-trial Br. 35-36; County's Post-trial Br. 13.

derived from market evidence. *Id.* (“Typically, an appraiser conducts extensive market research to determine market rents.”).

To estimate market rent in this case, both appraisers located and analyzed leases for comparable properties.⁸⁰ Mr. Skare also used the so-called percentage-of-retail-sales technique, which estimates the market rent for a particular retail property by applying a market-derived percentage rate to a retail sales figure for the property.⁸¹ See, e.g., *Carson Pirie Scott (Ridgedale) v. Cnty. of Hennepin*, 576 N.W.2d 445, 449 (Minn. 1998) (applying percentage rate to market-derived projected retail sales for the particular retail property); *Montgomery Ward & Co., Inc. v. Cnty. of Hennepin*, 450 N.W.2d 299, 303 (Minn. 1990) (applying percentage rate to the current retail tenant’s actual retail sales).

1. The Parties’ Comparable Lease Analyses

“When a market rent estimate for the subject property is required, the appraiser gathers, compares, and adjusts comparable rental data.” *Appraisal of Real Estate* 466. Mr. Skare located ten leases he considered sufficiently similar to support an analysis of market rent.⁸² Skare adjusted his lease comparables for factors such as location and date of execution.⁸³ Where a lease involved tenant improvements or rent concessions, Skare deducted these amounts from

⁸⁰ Ex. 1, at 129-43; Ex. A1, at 74-77.

⁸¹ Ex. 1, at 143-51.

⁸² Ex. 1, at 130-38. Skare’s lease comparable 1 was 6725 York Avenue South in Edina; comparable 2 was 14308 Burnhaven Drive in Burnsville; comparable 3 was 4900 County Road 101 in Minnetonka; comparable 4 was 1475 Queens Drive in Woodbury; comparable 5 was 9450 Dunkirk Lane North in Maple Grove; comparable 6 was 1655 County Road B2 West in Roseville; comparable 7 was 2100 Snelling Avenue North in Roseville; comparable 8 was 700 78th Street West in Richfield; comparable 9 was 5300 Robert Trail in Inver Grove Heights; and comparable 10 was 1350 West County Road 42 in Burnsville. *Id.*

⁸³ Ex. 1, at 130-32.

base rent and thereby computed for that comparable an *effective* net rent.⁸⁴ Because the execution dates for Skare's lease comparables ranged from April 2003 to December 2011,⁸⁵ Skare used for each valuation date only those leases he considered sufficiently contemporary.⁸⁶ Based on this procedure, Skare determined the following effective market rents: \$6.00 per square foot for the January 2, 2008 valuation date, and \$5.75 per square foot for the remaining dates.⁸⁷

Ms. Stoerzinger considered five lease comparables,⁸⁸ which she likewise adjusted for factors such as location and date of execution.⁸⁹ In contrast to Skare, Stoerzinger did *not* reduce base rents by tenant improvements to derive effective net rents.⁹⁰ Giving weight only to her lease comparables 1 through 3, Stoerzinger determined a market rent of \$9.00 per square foot for the January 2, 2008 valuation date.⁹¹ She indexed that figure for the remaining years as follows: \$8.64 per square foot for the January 2, 2009 valuation date; \$8.44 per square foot for the January 2, 2010 date; and \$8.89 per square foot for the January 2, 2011 date.⁹²

⁸⁴ Ex. 1, at 133-37.

⁸⁵ Ex. 1, at 133-37.

⁸⁶ Ex. 1, at 130-32 (separate adjustment grids). Specifically, Skare used comparables 1 through 5 for the January 2, 2008 valuation date, *id.* at 130; comparables 3 through 7 for the January 2, 2009 date, *id.* at 131; comparables 6 through 10 for the January 2, 2010 and January 2, 2011 dates, *id.* at 132.

⁸⁷ Ex. 1, at 140-43.

⁸⁸ Ex. A1, at 76. Stoerzinger's lease comparable 1 was 13900 Aldrich Avenue in Burnsville; comparable 2 was 300 Southdale Center in Edina; comparable 3 was 8264 Tamarack Village in Woodbury; comparable 4 was 4200 78th Street West in Bloomington; and comparable 5 was 4210 78th Street West in Bloomington. *Id.*

⁸⁹ Ex. A1, at 74-76.

⁹⁰ Ex. A1, at 76; Tr. 512.

⁹¹ Ex. A1, at 75.

⁹² Ex. A1, at 75.

2. The Court's Comparable Lease Analysis

As we have already noted, the appraisers largely agreed on the vacancy loss by which market rent must be reduced to arrive at effective gross income, on the expenses to be deducted therefrom to determine net operating income, and on the applicable capitalization rates. Consequently, their differing value conclusions under the income approach turned almost entirely on their differing views of market rent.

The County argues that we should give no weight to three of Mr. Skare's ten lease comparables,⁹³ and we agree. Comparable 1 is a lease renewal;⁹⁴ comparable 5 an unconsummated letter of intent;⁹⁵ and comparable 8 "a very short term lease" covering only 75 days.⁹⁶ Skare placed significant reliance on lease comparable 1, modest reliance on comparable 5, and some reliance on comparable 8.⁹⁷ Given the availability of other leases that furnish a more reliable indication of market rent, we give these lease comparables no weight. *See Silgan Containers Mfg. Corp. v. Cnty. of Scott*, No. 70-CV-07-9396 et al., 2014 WL 470820, at *17-18 (Minn. T.C. Jan. 30, 2014) (noting that lease renewals must be used with caution).

Stoerzinger gave no weight to her lease comparables 4 and 5 because she concluded that they required excessive adjustments.⁹⁸ We agree. Macy's urges us to give no weight to Stoerzinger's lease comparable 1 because (like Skare's lease comparable 1), it involved the renewal of an existing lease.⁹⁹ Again we agree.

⁹³ County's Post-Trial Br. 18-19.

⁹⁴ Ex. 1, at 130, 133.

⁹⁵ Ex. 1, at 130-31, 135, 140.

⁹⁶ Ex. 1, at 132, 136.

⁹⁷ Ex. 1, at 140-42.

⁹⁸ Ex. A1, at 75.

⁹⁹ Macy's Post-Trial Br. 15.

Having concluded that we can rely on seven of Skare's lease comparables and two of Stoerzinger's, we now address the issue that caused the appraisers to arrive at such different conclusions concerning market rent: the proper treatment of tenant improvements when determining the market rent that will—after reduction by market expenses—constitute the net operating income capitalized to arrive at a value indication. As relevant here, that issue turns on two considerations: the magnitude of the tenant improvements in question, and the compatibility of available capitalization rate data.

Market rent is a measure of income that reflects, among other things, “tenant improvement allowances.” *EPM I*, 797 N.W.2d at 195. As the supreme court has cautioned, however:

Where market conditions require rent concessions, an appraiser must further determine a property's effective rent. Effective rent is an analytical tool used to compare leases and develop effective market rents. Generally, effective market rent is “the total of base rent ... over the specified lease term minus rent concessions—e.g., free rent [and] *excessive* tenant improvements ... Therefore, in determining effective market rent as part of valuation under the income capitalization approach, the court must adjust for rent concessions that affect future rent receipts.

Id. at 195-96 (citations omitted) (emphasis added).

As the foregoing passage makes plain, not all tenant improvements are deducted from base rent when determining effective market rent: a deduction is warranted only where the tenant improvement allowance is “excessive.” *See id.* at 196 (in rejecting the trial court's conclusion “that reducing effective rents by tenant improvement allowances was inappropriate,” the supreme court noted that the trial court “did not indicate whether the tenant improvement allowances were excessive or atypical”). Accordingly, “[w]hether tenant improvement allowances should be deducted from market rents to arrive at effective market rents ‘must be determined on a case-by-case basis’ as part of the overall determination of market rents.” *Eden*

Prairie Mall, LLC v. Cnty. of Hennepin, 830 N.W.2d 16, 21 (Minn. 2013) (“*EPM II*”) (quoting *EPMI*, 797 N.W.2d at 196).

The correct treatment of tenant improvements, then, must be determined on a case-by-case basis, and depends in part on the magnitude of the tenant improvements in question. Deductions need be made only for tenant improvements that are “excessive or atypical.”

If an adjustment for tenant improvements is appropriate, the next question is how that adjustment should be accomplished. As the supreme court has explained, tenant improvement allowances can be considered in two different ways:

When an appraiser determines it is appropriate to deduct tenant improvement allowances, the appraiser must decide whether those allowances should be considered an “above-the-line expense” or a “below-the-line expense.” An “above-the-line expense” is recorded “above” the net operating income line and is considered part of the total operating expenses for the property. In contrast, a “below-the-line expense” is recorded “below” the net operating income line and is not considered part of the total operating expenses for the property. Generally, tenant improvement allowances “are the most common line items recorded below the net operating income line.”

EPM II, 830 N.W.2d at 21 (citations omitted) (quoting Appraisal Institute, *The Appraisal of Real Estate* 480 (13th ed. 2008)).

If tenant improvements are considered as above-the-line expenses, they are subtracted from market rents to determine effective market rents. *Id.* (noting that the petitioner’s appraiser “subtracted tenant improvement allowances from market rents as an above-the-line expense to arrive at effective market rents”). If, on the other hand, tenant improvements are considered as below-the-line expenses, they are addressed through the selection of the appropriate capitalization rate. *Id.* (noting that the county’s appraiser “opted to consider tenant improvement allowances as a below-the-line expense by reflecting that expense in his determination of the capitalization rates”).

The choice of how to consider, and adjust for, tenant improvements may, as a practical matter, be influenced by the compatibility of available capitalization rate data. If available capitalization rates were computed with net operating incomes *not* adjusted for tenant improvements, then considering tenant improvements as above-the-line expenses that reduce the subject property's anticipated net operating income produces an internal inconsistency: a net operating income *reduced by tenant improvements* is capitalized using a rate derived from net operating incomes *not reduced by tenant improvements*. This configuration of internal inconsistency produces artificially *lowered* value indications.¹⁰⁰ The converse inconsistency produces artificially *inflated* values.¹⁰¹ We have long stressed the need for internal consistency:

It is well settled that a capitalization rate derived from the sale of a comparable property is valid only if it is applied to the subject property on the same basis. The Appraisal Institute, *The Appraisal of Real Estate* 496, 514 (11th ed. 1996). Either deducting the expenses or not deducting the expenses is

¹⁰⁰ Tr. 512-13.

¹⁰¹ Assume that all sales used to derive a capitalization rate involve properties with net operating incomes of \$100, TI allowances of \$10, and sale prices of \$1,000. The sales can generate two different capitalization rates, one adjusted for TIs, the other not adjusted for TIs:

<u>Rate Type</u>	<u>Derivation</u>	<u>Indicated Rate</u>
Adjusted for TIs	$\$90 \div \$1,000$	0.09
Not Adjusted for TIs	$\$100 \div \$1,000$	0.10

If the subject property has the same anticipated net operating income of \$100 and TI allowance of \$10, the subject property's indicated value will be \$1,000 so long as there is internal consistency:

<u>Subject's NOI</u>	<u>Rate Type</u>	<u>Derivation</u>	<u>Indicated Value</u>
Adjusted for TIs	Adjusted for TIs	$\$90 \div 0.09$	\$1,000
Not Adjusted for TIs	Not Adjusted for TIs	$\$100 \div 0.10$	\$1,000

The absence of internal consistency, on the other hand, produces distorted value indications:

<u>Subject's NOI</u>	<u>Rate Type</u>	<u>Derivation</u>	<u>Indicated Value</u>
Adjusted for TIs	Not Adjusted for TIs	$\$90 \div 0.10$	\$900
Not Adjusted for TIs	Adjusted for TIs	$\$100 \div 0.09$	\$1,111

acceptable as long as net operating income for the subject property is derived in the same manner as net operating income was derived for calculating the capitalization rate on the sold property. Consequently, if tenant improvements and leasing commissions are not deducted from net operating income in deriving the capitalization rate from market data, then they must not be deducted before capitalizing net operating income for the subject.

St. Louis Park Corp. v. Cnty. of Hennepin, Nos. TC-24719, TC-25694, 1998 WL 46355, at *3 (Minn. T.C. Feb. 2, 1998); *see also Geneva Exch. Fund XVII, LLC v. Cnty. of Dakota*, Nos. 19-C6-07-8009, 19HA-CV-08-931, 2009 WL 4017075, at *15 (Minn. T.C. Nov. 19, 2009) (noting that “it is important to know the actual NOI for each comparable as well as the cap rate to verify that the NOI for each comparable is calculated in the same way as for the Subject Property”).

In this case, Mr. Skare deducted tenant improvements and rent concessions when computing the effective net rent of his lease comparables¹⁰² and, therefore, when computing the anticipated net operating income of the subject property. Skare acknowledged, however, that his capitalization rates were derived from sales in which net operating incomes had *not* been adjusted for tenant improvements or rent concessions.¹⁰³ As previously indicated, this internal

¹⁰² Ex. 1, at 133-37.

¹⁰³ Tr. 174 (noting that Skare’s market-derived capitalization rates “were based upon the income in place”); Tr. 286 (noting with respect to Skare’s capitalization rate comparables that “[t]enant improvements are not considered as a line item deducted to get to the NOI estimate”); Tr. 176-77 (noting that capitalization rates reported by the *RERC Real Estate Report* and the *Korpacz Real Estate Investor’s Survey* are based “[o]n income in place for as-is properties”).

inconsistency produces artificially low value indications.¹⁰⁴ Consequently, we reject Skare's income approach to the extent it incorporated this internal inconsistency.¹⁰⁵

The inconsistency, however, is easily remedied by using Skare's base rent figures rather than the "average net rent" figures he derived by subtracting tenant improvement and rent concessions.¹⁰⁶ Using Skare lease comparables 2, 3, 4, 6, 7, 9, and 10, along with Stoerzinger's lease comparables 2 and 3, we have nine comparable leases with execution dates ranging from April 2005 to December 2011.¹⁰⁷ Like Skare, we use for each valuation date only those leases we consider sufficiently contemporary. Although we expressed reservations about the location and time adjustments used by one or both of the appraisers in their sales comparison approaches, we adopt each appraiser's adjustments of their own lease comparables, a procedure rendered fair by our use of comparable leases supplied by both appraisers. We use the following comparable leases for the indicated valuation dates:

¹⁰⁴ We reject Macy's argument that failing to adjust the net rents of lease comparables for tenant improvements generates a leased-fee analysis. *See* Macy's Post-Trial Br. 39. This would be so only if the tenant improvements were excessive or atypical, thus rendering the actual net rents paid above true market rent. There is no evidence that any of the lease comparables involved excessive or atypical tenant improvements, however.

¹⁰⁵ Ms. Stoerzinger was consistent in her analysis. She testified that—specifically because the net operating incomes of the sales underlying her capitalization rates had *not* been adjusted for tenant improvement—she did not deduct tenant improvements from the net operating incomes of her lease comparables in determining market rent. Tr. 512-13.

¹⁰⁶ Ex. 1, at 130-32.

¹⁰⁷ Ex. 1, at 130-37; Ex. A1, at 76.

	Skare 2 ¹⁰⁸	Skare 3 ¹⁰⁹	Skare 4 ¹¹⁰	Skare 6 ¹¹¹	Skare 7 ¹¹²	Stoer 3 ¹¹³	Stoer 2 ¹¹⁴	Skare 9 ¹¹⁵	Skare 10 ¹¹⁶
	Apr-05	Dec-07	Jan-08	Oct-09	Nov-09	Jul-10	Apr-11	Dec-11	Dec-11
Jan. 2, 2008	\$8.47	\$7.20	\$9.60						
Jan. 2, 2009		\$6.84	\$9.12	\$10.50	\$9.00				
Jan. 2, 2010				\$10.50	\$9.00	\$9.98	\$6.00	\$5.25	\$4.95
Jan. 2, 2011				\$10.50	\$9.00	\$9.98	\$6.00	\$5.25	\$4.95

For the January 2, 2008 valuation date, we give equal weight to Skare's lease comparables 2 through 4, and derive a market rent of \$8.42 per square foot. For the January 2, 2009 valuation date, we give equal weight to Skare's lease comparables 3, 4, 6, and 7, and derive a market rent of \$8.87 per square foot. For the January 2, 2010 and January 2, 2011 valuation dates, we give preferential weight (20% each) to Skare's lease comparables 6 and 7, and to Stoerzinger's lease comparable 2; and we give secondary weight (approximately 13% each) to Skare's lease comparables 9 and 10, and to Stoerzinger's lease comparable 3, deriving a market

¹⁰⁸ 14308 Burnhaven Drive in Burnsville. Ex. 1, at 130.

¹⁰⁹ 4900 County Road 101 in Minnetonka. Ex. 1, at 130-31.

¹¹⁰ 1475 Queens Drive in Woodbury. Ex. 1, at 130-31.

¹¹¹ 1655 County Road B2 West in Roseville. Ex. 1, at 131-32.

¹¹² 2100 Snelling Avenue North in Roseville. Ex. 1, at 131-32.

¹¹³ 8264 Tamarack Village in Woodbury. Ex. A1, at 76. Ms. Stoerzinger made a market conditions adjustment to many of her comparable leases, including her comparable 3, to adjust them to the January 2, 2008 assessment date. *See* Ex. A1, at 74-76. She then indexed the subject property's indicated 2008 market rent for the remaining valuation dates. *Id.* at 74-75. Because we use Stoerzinger's comparable 3 solely for the January 2, 2010 and January 2, 2011 assessment dates, we find that no market conditions adjustment is necessary.

¹¹⁴ 300 Southdale Center in Edina. Ex. A1, at 76. Ms. Stoerzinger made a market conditions adjustment to lease comparable 2 to adjust it to the January 2, 2008 assessment date. *See* Ex. A1, at 74-76. Because we use Stoerzinger's comparable 2 solely for the January 2, 2010 and January 2, 2011 assessment dates, we find that no market conditions adjustment is necessary.

¹¹⁵ 5300 Robert Trail in Inver Grove Heights. Ex. 1, at 132.

¹¹⁶ 1350 West County Road 42 in Burnsville. Ex. 1, at 132.

rent of \$7.79 per square foot for both valuation dates. These weightings are roughly consistent with those used by the appraisers themselves.¹¹⁷

3. Percentage of Retail Sales Evidence

Although the court has approved the percentage-of-retail-sales technique, *see Allied Cent. Stores (Rosedale) v. State of Minnesota & Cnty. of Ramsey*, Nos. TA-176, TA-302, 1984 WL 2060, at *3 (Minn. T.C. Sept. 12, 1984), we have long expressed reservations about its use. *See J.C. Penney Properties, Inc. v. Cnty. of Hennepin*, Nos. 27-CV-10-07609, 27-CV-11-08714, 2013 WL 6043899, at *2-5 (Minn. T.C. Aug. 21, 2013) (collecting cases); *Montgomery Ward & Co., Inc. v. Cnty. of Hennepin*, No. TC-7428, 1991 WL 96258, at *1-2 (Minn. T.C. May 31, 1991). The technique can be inaccurate and is subject to manipulation. *See, e.g., Montgomery Ward & Co., Inc. v. Cnty. of Hennepin*, 482 N.W.2d 785, 789-90 (Minn. 1992); *Allied Cent. Stores v. Cnty. of Hennepin*, Nos. TC-4720, TC-5542, 1988 WL 21105, at *4 (Minn. T.C. Feb. 11, 1988). Consequently, we have long preferred that market rent be estimated by the use of leases for directly comparable properties. *Allied Cent. Stores (Hennepin)*, 1988 WL 21105, at *5 (“Actual rental data of comparable anchor stores would be a better indicator of rental value, but this is apparently not available.”).

We conclude that Macy’s presented insufficient foundation to support its expert’s resort to the percentage-of-retail-sales technique. *See J.C. Penney Properties, Inc. v. Cnty. of Hennepin*, Nos. 27-CV-10-07609, 27-CV-11-08714, 2013 WL 6043899, at *1 (Minn. T.C. Aug. 21, 2013) (reaching similar conclusion). Mr. Skare’s location of seven acceptable lease comparables amply demonstrates that the subject property’s market rent can be estimated by the use of leases for directly comparable properties. Although Skare used the percentage-of-retail-

¹¹⁷ Ex. 1, at 139-43; Ex. A1, at 75.

sales technique only as a check on his lease-derived market rent,¹¹⁸ we give it no weight even for that purpose.

B. Vacancy and Collection Loss

We reduce potential gross income by “losses expected to be incurred due to unoccupied space, turnover, and nonpayment of rent by tenants,” to arrive at effective gross income.

Appraisal of Real Estate 451. The parties’ appraisers used the following vacancy rates:

<u>Date</u>	<u>Skare</u>	<u>Stoerzinger</u>
January 2, 2008	5.00%	7.50%
January 2, 2009	6.00%	7.50%
January 2, 2010	7.00%	7.50%
January 2, 2011	7.50%	7.50% ¹¹⁹

We find that a vacancy rate of 7.5% is proper for all valuation dates.

C. Operating Expenses

We reduce effective gross income by “the periodic expenditures necessary to maintain the real property and continue the production of revenue.” *Appraisal of Real Estate* 453. Operating expenses include fixed expenses such as property insurance; variable expenses such as management, utilities, building maintenance, and owner expense on vacant space; and reserves for replacement. *Appraisal of Real Estate* 479-86. The parties’ appraisers used the following per square foot estimates for total fixed and variable expenses:

¹¹⁸ Ex. 1, at 151.

¹¹⁹ Ex. 1, at 151-52; Ex. A1, at 78.

<u>Date</u>	<u>Skare</u> ¹²⁰	<u>Stoerzinger</u>
January 2, 2008	\$2.03	\$3.31
January 2, 2009	\$2.10	\$3.81
January 2, 2010	\$2.03	\$3.30
January 2, 2011	\$2.09	\$3.11 ¹²¹

We give equal weight to each party's estimates and therefore use the following expense figures: \$2.67 per square foot for the January 2, 2008 assessment date; \$2.96 per square foot for the January 2, 2009 assessment date; \$2.67 per square foot for the January 2, 2010 assessment date; and \$2.60 per square foot for the January 2, 2011 assessment date.

The appraisers used the following per square foot estimates for replacement reserves:

<u>Date</u>	<u>Skare</u>	<u>Stoerzinger</u>
January 2, 2008	\$0.20	\$0.25
January 2, 2009	\$0.21	\$0.25
January 2, 2010	\$0.21	\$0.25
January 2, 2011	\$0.22	\$0.25 ¹²²

We find that a replacement reserve of \$0.25 per square foot of total building area is proper for all valuation dates.

Based on the foregoing, we derive the following net operating income figures for the indicated valuation dates:

¹²⁰ Specifically, Skare estimated fixed and variable expenses of \$1.25 per square foot for the January 2, 2008 assessment date, \$1.28 per square foot for the January 2, 2009 date, \$1.31 per square foot for the January 2, 2010 date, and \$1.34 per square foot for the January 2, 2011 date. Ex. 1, at 154. He also estimated additional, miscellaneous expenses of 0.75% of effective net income. *Id.* Here, we combine Skare's separate estimates into a single figure.

¹²¹ Ex. 1, at 153-54; Ex. A1, at 78-83.

¹²² Ex. 1, at 154, 156-59; Ex. A1, at 79.

<u>Date</u>	<u>Net Operating Income</u>
January 2, 2008	\$655,636
January 2, 2009	\$690,109
January 2, 2010	\$603,218
January 2, 2011	\$621,067

D. Capitalization Rates

Direct capitalization converts a single year's expected income into an indication of value for the subject property by dividing estimated net operating income by an appropriate discount rate. *Appraisal of Real Estate* 491. The appropriate capitalization rate can be estimated using a variety of techniques. *Id.* at 492.

1. Base Rates

Mr. Skare relied on three techniques—band of investment, market extraction, and market surveys—to arrive at his opinion of capitalization rates.¹²³ Ms. Stoerzinger relied on market extraction and market surveys.¹²⁴ The parties' appraisers determined that the following capitalization rates were applicable:

<u>Date</u>	<u>Skare</u>	<u>Stoerzinger</u>
January 2, 2008	7.50%	7.50%
January 2, 2009	8.00%	8.00%
January 2, 2010	8.50%	9.00%
January 2, 2011	8.25%	8.00% ¹²⁵

We give equal weight to each party's estimates and therefore use the following capitalization rates: 7.50% for the January 2, 2008 assessment date; 8.00% for the January 2, 2009 assessment

¹²³ Ex. 1, at 160-68.

¹²⁴ Ex. A1, at 84-87.

¹²⁵ Ex. 1, at 168; Ex. A1, at 87.

date; 8.75% for the January 2, 2010 assessment date; and 8.13% for the January 2, 2011 assessment date.

2. Loading for Effective Tax Rates

The experts agreed that the appropriate capitalization rates should be adjusted upward (loaded) to account for effective tax rates. In addition, both appraisers calculated the effective tax rate for each valuation date by dividing taxes payable during the year of valuation by the assessed value of the subject property as of the preceding valuation date.¹²⁶ Skare, however, opined that a prospective purchaser would have forecast increases in the effective tax rates on each of the valuation dates, citing increases in the effective rates actually applicable to the subject property over the four valuation dates.¹²⁷ Because Skare's opinion was based on the assumption that taxing district levies would remain constant, we find this possibility unduly speculative and refuse to adopt it.

We load our capitalization rates by the product of the effective tax rate and the vacancy rate as of each valuation date in question (reflecting the portion of property taxes expected to be borne by the property owner), as follows:

<u>Date</u>	<u>Cap. Rate</u>	<u>Eff. Tax Rate x Vacancy Rate</u> <u>(rounded)</u>	<u>Loaded Cap. Rate</u>
January 2, 2008	7.50%	3.01% x 7.5% = .23%	7.73%
January 2, 2009	8.00%	3.07% x 7.5% = .23%	8.23%
January 2, 2010	8.75%	3.19% x 7.5% = .24%	8.99%
January 2, 2011	8.13%	3.44% x 7.5% = .26%	8.39%

¹²⁶ Ex. 1, at 11-12; Ex. A1, at 12.

¹²⁷ Ex. 1, at 168-70.

E. Values Per Income Approach

Dividing net operating income by the applicable capitalization rate, we arrive at the following values for the subject property under the income approach to value:

January 2, 2008	\$8,481,700
January 2, 2009	\$8,385,300
January 2, 2010	\$6,709,900
January 2, 2011	\$7,402,500

VIII. HIGHEST AND BEST USE CONCLUSION AND FINAL VALUES

These indicated values for the property overall substantially exceed Mr. Skare's estimated site values under the sales comparison approach. Consequently, we agree with Skare's conclusion that "the highest and best use of the subject property 'as improved' is for continued use of the existing [retail] improvements" ¹²⁸ Accordingly, our final values for the subject property are those we reached for the property overall applying the income approach, rounded as follows:

January 2, 2008	\$8,482,000
January 2, 2009	\$8,385,000
January 2, 2010	\$6,710,000
January 2, 2011	\$7,403,000

B.S.D.

¹²⁸ Ex. 1, at 73.