BEFORE THE BOARD OF TAX APPEALS OF THE STATE OF KANSAS

IN THE MATTER OF THE EQUALIZATION
APPEAL OF PRIEB PROPERTIES, L.L.C.
FOR THE YEAR 2004 FROM SHAWNEE
COUNTY, KANSAS

Docket No. 2004-3806-EQ

O R D E R

Now the above-captioned matter comes on for consideration and decision by the Board of Tax Appeals of the State of Kansas.

The tax year in issue is 2004, and the effective appraisal date for this appeal is January 1, 2004. The taxpayer, Prieb Properties, L.L.C, appeared by and through its attorney of record, Linda A. Terrill. Shawnee County appeared by and through its attorney of record, Shawn S. Leisinger. The Board conducted a hearing of this matter on February 15, 2006. The taxpayer and county filed post-hearing briefs on June 22, 2006 and June 23, 2006, respectively.

Having exercised jurisdiction pursuant to K.S.A. 79-1609, and after fully considering all of the evidence presented, the Board finds and concludes as follows.

I.
Subject Property

The subject matter of this tax equalization appeal is described as follows:

> Real estate and improvements commonly known as
> 1600 SW Wanamaker Road in Topeka, Shawnee County, Kansas,
> also known as Parcel ID# 089-142-04-0-20-06-005.00-0.

The subject property is a single-tenant discount store situated on approximately 4.02 acres. The store was built in 1989 with 30,378 square feet, and an addition comprising 15,436 square feet was built in 1996. The total square footage of the facility as of the appraisal date was 45,814. The structure's exterior walls are masonry over metal framing with windows of double-paned glass. The property currently is leased and operated by Best Buy in an area called the West Market Area of Topeka, Kansas, as designated by the Office of the Shawnee County Appraiser. The subject property is zoned to allow for a wide variety of commercial uses.

II.
County Valuation Evidence

In making its determination of value, the county collected data within the local market concerning actual sales, sales offerings, and rates of return on investments and real estate. The county developed values based on this data for both the land and improvements. The county valued the land as vacant and available for development at its highest and best use. Using a paired sales analysis, the county arrived at a base value for the land at $3.75 per square foot and then applied an influence factor of 175 percent based on the desirability of the subject property's location. The county arrived at a land value estimate of $1,149,170, or $6.56 per square foot.

The county appraised the subject property with the aid of the Computer Assisted Mass Appraisal (CAMA) system, utilizing both the income and cost approaches to value. The county's expert witness, David Meyer, testified that the county failed to complete a formal sales comparison approach because there was a scarcity of sales of comparable properties in the relevant valuation area and investment class. The county did however review relevant sales to determine whether they fell within the range for the subject's designated investment class (class A).

The county prepared, but did not rely upon, a cost approach to value. The cost approach provides an estimate of value based on the current replacement cost of the improvements as new. The county estimated the improvement's replacement cost using a cost system developed by a national mass appraisal vendor and made modifications for local market factors. This replacement cost estimate was then adjusted to reflect depreciation resulting from physical deterioration as well as functional and economic obsolescence. The county added the depreciated replacement cost new to the estimated land value to arrive at a final cost approach value determination of $3,347,860.

The county relied most heavily on the income approach to value. Under the income approach, the county initially arrived at a valuation of $5,032,200 for the subject property. Prior to the final hearing, however, the county reduced its valuation recommendation after re-evaluating the rental income information. Under the income approach, the county estimated the fair market value of the subject property by capitalizing anticipated net operating income into its present market worth. Through this methodology the county estimated the property's economic potential gross income at $435,233 using a gross rental rate of $9.50 per square foot. Allowing for a vacancy and collection loss of 5 percent, the county arrived at an effective gross income of $413,471.

The county estimated normal management and operating expenses at 5.54 percent ($0.50 per square foot) and deducted total expenses from the estimated effective gross income calculation to arrive at a net operating income of $390,564. The net operating income calculation was capitalized into a value indication using a capitalization rate of

9.1 percent. The county's final value recommendation for tax year 2004, based on the income approach, is $4,291,916.

The county's income approach utilized income, vacancy and expense rates from the 2004 *Benchmark Study* performed by Daniel W. Craig for Shawnee County. For single-tenant retail properties of 20,000 square feet or greater, the study indicates a rental rate for class A properties to be between $7.50 and $10.00 per square foot, a vacancy rate range of between 5 and 10 percent, and an expense range of $.41 to $1.05 per square foot. The county's capitalization rate was derived from the 2003 *Capitalization Rate Study* performed by Daniel W. Craig for Shawnee County. The capitalization rate study shows a prevailing rate of 9.4 percent for class A properties. Meyer testified that he considered the subject property to be a class A+ property and thus determined that the subject property's rental rate should be at the high end of the range and that its vacancy and expense rates should be at the low end of the range for investment class A properties. Meyer also determined that a capitalization rate of 9.1 percent was appropriate for the property because of its class A+ designation, instead of the 9.4 percent capitalization rate for typical class A properties. The data contained in the two Craig studies were derived from various types of leases, including leases of facilities that were built to suit the existing tenant's operational purposes.

The county noted that the subject property was sold in December 1996 for $4,441,086 and then again in September 2001 to its current owner for $5,049,000. Both sales occurred with the existing Best Buy lease in place. Meyer testified that the county's recommended value is below the 1996 and 2001 sale prices because those sale prices included the excess value of the build-to-suit Best Buy lease.

III.
Taxpayer Valuation Evidence

The taxpayer's valuation witness, Gerald Maier, applied all three accepted approaches to value – the cost, income and sales comparison approaches. Maier reached essentially the same conclusion concerning the value of the subject land as the county. Maier and the county also reached substantially similar conclusions of value under the cost approach, except that Maier deducted a considerably higher amount for functional obsolescence. Maier's final value estimate under the cost approach was approximately $2,300,000.

Maier relied extensively upon the sales comparison and income approaches to value. In his testimony and appraisal report, Maier provided an explanation of the economics of big box sales. According to Maier, big box sales generally fall within one of three categories: (1) sales of build-to-suit properties, (2) sales of second-generation properties, or (3) sales of vacant properties.

The first category, sales of build-to-suit properties, are sales of facilities constructed to match the particular operational needs of the occupying tenant. Big box retailers typically sign long-term lease agreements with terms that capture the actual construction costs of the facility plus a developer profit. These build-to-suit lease arrangements are then assigned to investors to finance construction of the facility. Maier testified that build-to-suit sales reflect not only the value of the real estate but also the intangible value of the right to receive rent payments, which, depending on the lease term and creditworthiness of the tenant, can be significantly higher than the value of the fee simple estate.

Maier testified that the second category of big box sales are sales of properties that have been leased to "second generation" tenants. The majority of such sales are of buildings that were originally constructed for a specific tenant and then later released to one or more new tenants. Like build-to-suit sales, sales of second-generation properties also are driven by existing lease rates and the creditworthiness of the occupying tenant.

The third category of big box sales identified by Maier are sales involving vacant big box properties. The purchaser of a vacant big box facility may be another retailer (typically of lower quality) that plans to occupy the space "as is" or with limited renovation. Many properties of this type are purchased by speculators planning to subdivide the space for multiple tenants or uses. These speculators purchase the property hoping to turn it into a second-generation sale.

Maier identified and compared nine properties in Kansas: three in Topeka, two in Wichita, and one in Lawrence, Overland Park, Bonner Springs and Shawnee. All of the comparison sales were of big box properties ranging in size from 33,500 to 90,465 square feet. The sales Maier selected included only second-generation and vacant sales. Maier testified that he ignored build-to-suit sales because such sales were not indicative of the market value of the subject property's fee simple estate. Maier adjusted the comparison sales he selected based on time and market conditions, property age and condition, location and lot size, improvement size, and construction quality. After making adjustments to the nine comparison properties, the indicated value range for the subject property was from $42.31 to $74.84 per square foot, with an average per square foot price of $57.43. Excluding the high and low extremes, Maier narrowed the range to include a low value of $51.08 per square foot and a high value of $65.41 per square foot. From this narrowed range, Maier selected a $57.50 per square foot value, which resulted in a $2,630,000 total rounded value for the subject property.

Maier also presented an income approach analysis of the subject property. Maier chose not to rely heavily upon income from the actual lease in place; doing so, Maier explained, would have made the appraisal a "leased fee" appraisal, not a "fee simple" appraisal.[1] Maier also chose not to consider build-to-suit lease rates from other properties. He explained that instead of reflecting market factors, such rates generally are based on construction costs, the cost of land, and a reasonable developer profit. Maier explained that build-to-suit rates reflect an above-market rate for a turnkey lease that provides a prototype building for a first-generation tenant.

In his income approach analysis, Maier considered two types of leases: (1) leases from second-generation tenants in big box structures that were originally designed for a different tenant and later renovated at the owner's expense and (2) leases from second-generation tenants in big box structures that were taken by the tenants on an "as is" basis or with minimal renovations. Maier testified that the second-generation "as is" leases provide a better indication of fair market rent for the subject property under a fee simple appraisal.

Maier selected a total of nine comparison leases in his income analysis and determined that a market rental rate for the subject was approximately $6.50 per square foot on a net basis. Maier arrived at a potential gross income of $396,291, a vacancy and credit loss of 12.5 percent, expenses of $0.26 per square foot and a capitalization rate of 10.5 percent. Under the income approach, Maier estimated the market value of the subject property to be approximately $2,180,000.

Correlating the three approaches to value, Maier accorded only moderate consideration to the cost approach because there were significant depreciation adjustments undermining the approach's reliability. Maier accorded the sales comparison and income approaches considerable weight. Overall, Maier estimated the subject property's value as of the appraisal date to be $2,500,000.

IV.
Findings of Fact and Conclusions of Law

USPAP Compliance

The taxpayer argues extensively that the county's written appraisal report does not conform to the Uniform Standards of Professional Appraisal Practice (USPAP). Property valuation in Kansas is governed by K.S.A. 79-501 *et seq*. By statute, the appraisal process utilized in the valuation of all real and tangible personal property for *ad valorem* tax purposes shall conform to generally accepted appraisal procedures which are adaptable to mass appraisal and consistent with the definition of fair market value, unless otherwise specified by law. K.S.A. 79-503a.

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[1] The existing lease encumbering the property is a long-term (20-year) lease that was negotiated at the time of construction. The current actual lease rate is $10.45 per square foot.

The director of property valuation is required to adopt rules and regulations prescribing appropriate standards for performing appraisals that are in accordance with generally accepted appraisal standards as evidenced by the standards promulgated by the appraisal standards board. K.S.A. 79-505. The Appraisal Standards Board publishes the Uniform Standards of Professional Appraisal Practice. In November 1992, the director of property valuation adopted Directive #92-006, requiring county appraisers to perform all appraisal functions in conformity with Standards 2 and 6 of the 1992 USPAP.

It is the duty of the director of property valuation to regulate and monitor the professional standards and practice of county appraisers, and it is the duty of the Board to hear and weigh competent valuation evidence in accordance with the Kansas Administrative Procedures Act (KAPA) and the Kansas rules of civil procedure. The Board's responsibility as a quasi-judicial agency is to determine the fair market value of the subject property based on substantial evidence in light of the record as a whole. *See* K.S.A. 77-621(c).

In *Board of County Comm'rs v. Jensen*, 32 Kan. App. 2d 730, 88 P.3d 242 (2004), the Kansas Court of Appeals held that the Board may not rely on an approach to value that is expressly prohibited by USPAP. Nevertheless, USPAP violations in a county appraiser's written materials that are not materially detrimental to the county's overall opinion of value are not fatal to the county's case. *See In re Amoco Production Co.*, 33 Kan. App. 2d 329, 337, 102 P.3d 1176 (2004), *rev. denied* June 9, 2005. Based on the entire record – the written documents and the testimony of the county appraisal witness – the Board concludes that the county has come forward with substantial competent evidence to meet its burden of production. Any deviations from USPAP requirements in the county's written exhibit are not materially detrimental to the overall opinion rendered by the county's expert. The USPAP violations contained in the county's presentation go to the weight of the evidence, not its admissibility.[2]

Fair Market Value of the Subject Property

It is the county appraiser's duty to determine the fair market value of the subject property in accordance with K.S.A. 79-503a, which provides in pertinent part as follows:

> "Fair market value" means the amount in terms of money that a well informed buyer is justified in paying and a well informed seller is justified

[2] The USPAP was established in response to the perception of appraisal abuses during the savings and loan crisis of the late 1980s. The overriding purpose of the USPAP is to promote and maintain a high level of public trust in professional appraisal practice. The standards and rules contained in the USPAP promote credibility, professionalism and consistency in appraisal practice. Thus, when evidence presented by either party at a tax appeal hearing falls short of full USPAP conformity, the credibility and weight of that evidence naturally suffers as a result.

> in accepting for property in an open and competitive market, assuming that the parties are acting without undue compulsion.
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> Sales in and of themselves shall not be the sole criteria of fair market value but shall be used in connection with cost, income and other factors including but not by way of exclusion:
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> (a) The proper classification of lands and improvements;
> (b) the size thereof;
> (c) the effect of location on value;
> (d) depreciation, including physical deterioration or functional, economic or social obsolescence;
> (e) cost of reproduction of improvements;
> (f) productivity;
> (g) earning capacity as indicated by lease price, by capitalization of net income or by absorption or sell-out period;
> (h) rental or reasonable rental values;
> (i) sale value on open market with due allowances to abnormal inflationary factors influencing such values;
> (j) restrictions imposed upon the use of the real estate by local governing bodies, including zoning and planning boards or commissions; and
> (k) comparison with values of other property of known or recognized value. The assessment –sales ration study shall not be used as an appraisal for appraisal purposes.

The county bears the burden of initiating the production of evidence to prove by a preponderance of the evidence the validity and correctness of its valuation. K.S.A. 79-1609. No presumption exists in favor of the county appraiser with respect to the validity and correctness of its determination. *Id*.

Both parties acknowledge that the realities of the real estate market for build-to-suit big box facilities present unique appraisal challenges. These challenges arise because big box facilities typically are built for the special business requirements of a particular retailer and because construction costs of such facilities often are financed through build-to-suit lease arrangements. When big box properties sell, they typically sell based on the intangible investment value of an existing build-to-suit lease. If vacant, such properties sell at a significant discount because the existing improvements do not fit the specific requirements of a new occupant, resulting in considerable functional obsolescence. The question in this appeal thus becomes whether the county's or the taxpayer's valuation evidence better addresses these unique appraisal challenges.

For purposes of *ad valorem* taxation, the terms "real property," "real estate," and "land" are broadly defined to include "not only the land itself, but all buildings, fixtures, improvements, mines, minerals, quarries, mineral springs and wells, *rights and privileges appertaining thereto*." K.S.A. 79-102 (emphasis provided.) Both the county and the taxpayer agree that the interest that must be appraised for purposes of *ad valorem* taxation is the fee simple interest. The term "fee simple interest" denotes absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat. *See* APPRAISAL INSTITUTE, THE APPRAISAL OF REAL Estate (12th Ed.) at 68.

Valuation of the subject property's fee simple estate must take into account all rights and interests – including the landlord's and the tenant's interests – as if merged into a single estate. Thus, regardless of how the rights and interests in the subject property were negotiated and separated by deed or by contract, this Board is charged with determining the property's value to a hypothetical buyer purchasing all rights and interests in the property free of encumbrance or restriction. When valuing a commercial property for purposes of *ad valorem* taxation, the proper inquiry is what a hypothetical buyer could expect to generate in rents when offering the property on the market anew.[3] *See* id. at 480.

In the instant appeal, the county properly ignored the existing build-to-suit Best Buy lease. Yet the county incorporated into its appraisal of the subject property data from two market studies that were based in part on build-to-suit leases. In fact, the county's expert witness admitted on cross-examination that the rental rate the county used in its appraisal to arrive at a valuation of the subject property was a "market rate for a build-to-suit" lease.

The county's witness opined that it was proper to apply a build-to-suit lease rental rate in its appraisal of the subject property because, after a hypothetical sale, the existing

[3] This appeal exemplifies the importance of appraising real estate for purposes of *ad valorem* taxation based on the value of the unencumbered fee simple interest, not the value of the landlord's interest in the existing lease (the leased fee interest). The Board finds the evidence of the taxpayer's expert witness concerning the economics of big box sales persuasive. According to the evidence, a big box facility subject to a build-to-suit lease generally attracts a substantially higher sale price than an identical owner-occupied facility. This phenomenon can be explained based on the fact that investors who purchase leased big box facilities purchase the landlord's right to receive rents under a build-to-suit lease contract while, in contrast, when an owner-occupied facility is sold, the buyer purchases the unrestricted right to offer the property for lease at current market rental rates. According to the evidence, sale prices for owner-occupied big box facilities necessarily reflect the low contributory value of the existing improvements because the improvements must be reconstructed to meet the particular business needs of the new occupant. Article 11, Section 1 of the Kansas Constitution would prohibit assessments of identical commercial properties at significantly different levels based solely on the fact that one property is leased and the other property is owner occupied.

tenant, Best Buy, would be among the tenants seeking to lease the space. The Board agrees that Best Buy should be included among potential tenants after a hypothetical sale; however, it does not follow that Best Buy would pay full build-to-suit rental rates to lease the subject property. As a matter of economics, after a hypothetical sale of the subject property, Best Buy would pay no more than the next competitor. And, according to the uncontroverted testimony, a competitor would not be willing to pay full build-to-suit rental rates for a big box facility that might have to be reconstructed to meet the competitor's own special business needs.

Based on the expert opinion evidence presented, the Board concludes that build-to-suit leases are financing arrangements for new construction and generally do not provide a reliable indication of value for big box facilities that are resold on the secondary market. There is no indication that the county made any adjustment in its appraisal to account for the functional obsolescence that arises when a big box property that was built to suit the particular purposes of one retailer is sold in a hypothetical sale for use by another retailer (or, for that matter, by the same retailer, who would pay no higher rental rates than the next competitor).

Moreover, the Board notes that the county failed to perform a sales comparison approach in its appraisal. Counties are required to use sales to arrive at a fair market value under Kansas law. *See* K.S.A. 79-503a ("*Sales* in and of themselves shall not be the sole criteria of fair market value but *shall be used* in connection with cost, income and other factors….) (emphasis provided). The county's failure to perform a sales comparison approach is particularly egregious in view of the fact that the two approaches the county did report (the cost and income approaches) yielded vastly disparate values.

Based on all the evidence, the Board concludes that the taxpayer's appraisal evidence provides a better estimate of the fair market value of the subject property than the county's appraisal. The taxpayer performed and reconciled all three recognized approaches to value and presented its appraisal in substantial compliance with USPAP. The taxpayer also properly ignored build-to-suit leases and sales in its appraisal, a method designed to distill the value of the fee simple estate.

IT IS THEREFORE ORDERED BY THE BOARD OF TAX APPEALS OF THE STATE OF KANSAS that, for the reasons stated above, the appraised value of the subject property for tax year 2004 is $2,500,000. IT IS FURTHER ORDERED that the appropriate officials are directed to correct the County's records accordingly, re-compute the taxes owed by the Taxpayer and issue a refund for any overpayment.

Any party to this appeal who is aggrieved by this decision may file a written petition for reconsideration with this Board as provided in K.S.A. 77-529, and amendments thereto. The written petition for reconsideration shall set forth specifically and in adequate detail the particular and specific respects in which it is alleged that the Board's order is unlawful, unreasonable, capricious, improper or unfair. Any petition for reconsideration shall be mailed to: Secretary, Board of Tax Appeals, DSOB Suite 451, 915 SW Harrison St., Topeka, KS 66612-1505. *A copy of the petition, together with all accompanying documents submitted, shall be mailed to all parties at the same time the petition is mailed to the Board. Failure to notify the opposing party shall render any subsequent order voidable.* The written petition must be received by the Board within fifteen (15) days of the certification date of this order (allowing an additional three days for mailing pursuant to statute if the Board serves the order by mail). If at 5:00 pm on the last day of the specified period the Board has not received a written petition for reconsideration, this order will become a final order from which no further appeal is available.

IT IS SO ORDERED THE BOARD OF TAX APPEALS