

A05-1069

No. A0

STATE OF MINNESOTA
IN SUPREME COURT

Kmart Corporation,

Relator,

vs.

County of Becker,

Respondent.

BRIEF AND APPENDIX OF RELATOR KMART CORPORATION

Thomas R. Wilhelmy (#117134)
Laurie J. Miller (#135264)
FREDRIKSON & BYRON, P.A.
200 South Sixth Street, Suite 4000
Minneapolis, MN 55402
Phone: (612) 492-7000
Facsimile: (612) 492-7077

*Attorneys for Relator
Kmart Corporation*

Gretchen D. Thilmony (#288573)
Assistant Becker County Attorney
910 Lincoln Avenue
P.O. Box 746
Detroit Lakes, MN 56502
Phone: (218) 847-6590

*Attorneys for Respondent
County of Becker*

TABLE OF CONTENTS

	<u>Page</u>
TABLE OF AUTHORITIES	ii
LEGAL ISSUES	1
STATEMENT OF THE CASE	2
STATEMENT OF THE FACTS	3
STANDARD OF REVIEW	6
ARGUMENT	7
I. In Calculating the Indication of Value Under the Income Approach, the Tax Court did not Apply the Capitalization Rate It Identified as Proper.....	8
II. The Tax Court Erred When Calculating the Adjusted Sales Price per Square Foot Under the Sales Comparison Approach to Value.....	12
A. To Arrive at Fair Market Value, Leased Fee Sales Must be Adjusted to Account for Any Differences Between Actual Rent and Market Rent.	12
B. Despite Recognizing that Adjustment Was Necessary, the Tax Court Relied on Unadjusted Figures in Its Sales Comparison Approach.	15
CONCLUSION	20
CERTIFICATE OF COMPLIANCE	21
APPENDIX AND ITS INDEX	22

TABLE OF AUTHORITIES

STATE CASES

Page(s)

A&H Vending Co. v. Comm'r of Revenue, 608 N.W.2d 544 (Minn. 2000).....	1, 6
American Express Fin. Advisors v. County of Carver, 573 N.W.2d 651 (Minn. 1998).....	1, 7, 11, 19
Bond v. Comm'r of Revenue, 691 N.W.2d 831 (Minn. 2005).....	6
Crossroads Center (Rochester), Inc. v. Commissioner of Tax'n, 286 Minn. 440, 176 N.W.2d 530 (1970).....	1, 12
Equitable Life Assurance Soc'y v. County of Ramsey, 530 N.W.2d 544 (Minn. 1995).....	1, 7, 9, 11
Federal Reserve Bank of Minneapolis v. County of Hennepin, 372 N.W.2d 699 (Minn. 1985).....	8
Ferche Acquisitions, Inc. v. County of Benton, 550 N.W.2d 631 (Minn. 1996).....	7
Halla v. County of Hennepin, 306 Minn., 533, 237 N.W.2d 348 (1975)	9, 11
Harold Chevrolet, Inc. v. County of Hennepin, 526 N.W.2d 54 (Minn. 1995).....	6, 8
Jefferson v. Comm'r of Revenue, 631 N.W.2d 391 (Minn. 2001).....	6
Lewis v. County of Hennepin, 623 N.W.2d 258 (Minn. 2001).....	7
Marquette Bank Nat'l Ass'n v. County of Hennepin, 589 N.W.2d 301 (Minn. 1999).....	7
Montgomery Ward v. County of Hennepin, 450 N.W.2d 299 (Minn. 1990).....	8
Northerly Centre Corp. v. County of Ramsey, 311 Minn. 335, 248 N.W.2d 923 (1976).....	11

TMG Life Ins. Co. v. County of Goodhue,
540 N.W.2d 848 (Minn. 1995).....1, 8, 12

STATE STATUTES

Minn. Stat. § 272.03.....7
Minn. Stat. § 273.11.....1, 7
Minn. Stat. § 278.04.....3

LEGAL ISSUES

I. Did the tax court err in calculating the indication of value under the income approach, by expressly crediting the capitalization rate derived by Appellant's expert but then, without explanation, using a different capitalization rate?

The tax court held that expert Alan Leirness' analysis of the capitalization rate was "persuasive," and went on to state that it used "his capitalization rate of 10.25%," despite in the same paragraph twice properly recognizing that the capitalization rate testified to and relied on by Mr. Leirness was 10.5%, not 10.25%.

Most apposite cases and statute:

TMG Life Ins. Co. v. County of Goodhue, 540 N.W.2d 848 (Minn. 1995)
Equitable Life Assurance Soc'y v. County of Ramsey, 530 N.W.2d 544 (Minn. 1995)
American Express Fin. Advisors v. County of Carver, 573 N.W.2d 651 (Minn. 1998)
Minn. Stat. § 273.11, subd. 1 (1996)

II. Did the tax court err when calculating the adjusted sales price per square foot under the sales comparison approach to value?

The tax court rejected the sales comparison approach of Respondent's expert, Dwight Dahlen, based upon its finding that Mr. Dahlen improperly failed to adjust his comparable sales to account for the leased fee nature of those sales; but then went on to rely on Mr. Dahlen's discredited sales comparison values as the upper bracket to reach the ultimate determination of the subject property's fair market value.

Most apposite cases and statute:

TMG Life Ins. Co. v. County of Goodhue, 540 N.W.2d 848 (Minn. 1995)
Crossroads Center (Rochester), Inc. v. Commissioner of Tax'n, 286 Minn. 440, 176 N.W.2d 530 (1970)
Equitable Life Assurance Soc'y v. County of Ramsey, 530 N.W.2d 544 (Minn. 1995)
American Express Fin. Advisors v. County of Carver, 573 N.W.2d 651 (Minn. 1998)
Minn. Stat. § 273.11, subd. 1

STATEMENT OF THE CASE

Relator Kmart Corporation (“Kmart”) brings this appeal from the Findings of Fact, Conclusions of Law, and Order for Judgment of the Minnesota Tax Court (Hon. Sheryl A. Ramstad) dated December 1, 2004 (“12-1-04 Order”), and the Order Denying Motion for Amended Findings of Fact, Conclusions of Law or New Trial dated April 1, 2005 (“4-1-05 Order”). App. 15, 37.¹

Kmart timely filed property tax petitions to contest the assessed value as of January 2, 2001, January 2, 2002, and January 2, 2003, for taxes payable in the years 2002, 2003, 2004, with respect to its store located in Detroit Lakes, Minnesota (“the subject property”). App. 1, 7, 11. Kmart both owns and occupies the subject property. App. 5–6.

Kmart’s three petitions were consolidated for trial, which took place on August 31, September 1 and 2, 2004. Kmart’s expert appraiser, Alan Leirness, opined that the fair market value of the subject property was \$2,350,000, and Respondent’s expert appraiser, Dwight Dahlen, opined that it was \$3,300,000, on each of the three assessment dates of January 2, 2001, 2002, and 2003. App. 45, 67. (Excerpts from Leirness and Dahlen appraisal reports). Both experts agreed that the subject property’s value was unchanged during the three tax years at issue. On December 1, 2004, the tax court issued its Findings of Fact, Conclusions of Law, and Order for Judgment, holding that the fair

¹ References in this brief in the form “App. ___” are to specified pages of Relator Kmart’s Appendix. References in the form “Tr. ___” are to specified pages of the Transcript of the August 31, September 1 and 2, 2004 trial proceedings, and “Tr. II ___” are to specified pages of the Transcript of the January 19, 2005 hearing on the motion for amended findings.

market value of the subject property was \$2,720,380² on each of the three assessment dates. App. 18.

Kmart moved for amended findings, seeking to correct inconsistencies between the tax court's findings of fact and its memorandum explaining how it arrived at its opinion of value. App. 32. On April 1, 2005, the tax court denied Kmart's post-trial motion. App. 37-38. This appeal followed. App. 42.

STATEMENT OF THE FACTS

The subject property is a single user, retail store located on Highway 10 in Detroit Lakes Minnesota, which was constructed in 1990-91. Kmart Corporation has occupied the building continuously since construction, initially as a tenant, and later as the owner. In October of 1999 Kmart exercised its right of first refusal under the lease to purchase the site (including the neighboring Fashion Bug parcel) from its landlord. The proceedings heard by the Court, however, addressed solely the Kmart parcel, and did not include the Fashion Bug parcel. The Kmart store's gross building area is approximately 86,879 square feet, plus an additional 2,500 square footage used for a garden center. The land area is approximately 588,723 square feet, or 13.505 acres.

Kmart purchased the subject property from its landlord in 1999 as part of a portfolio of three out-state Minnesota Kmart stores. Of the total \$11,000,000 purchase price for the three stores, the parties allocated \$3,696,000 to the subject property. Tr.

² The 2003 assessment was further adjusted downward, to provide the equalization relief mandated by Minn. Stat. § 278.04, subd. 4, based upon the applicable sales ratio study showing that the level of assessment for commercial property in Becker County was 82.8% of market value in that year. App. 19 (12-1-04 Order at 16).

212-14; Exhibit 21. A third party had offered to purchase all three Kmart stores, which were generating a rental stream well in excess of the then-current market rents each of for those three locations. App. 130-32. Kmart made use of its right of first refusal to purchase the three stores in order to buy its way out of what had become, over time, financially disadvantageous leases. Id.

In 2001 a 163,300 square foot Wal-Mart Superstore opened just west of the Kmart on Highway 10 in Detroit Lakes. The pending addition of Wal-Mart to the Detroit Lakes retail market was widely known at the first assessment date, January 2, 2001, because Wal-Mart had already acquired the site and its development plans were common knowledge. Tr. 217. The additional competing retail square footage of the new Wal-Mart has had a radical impact on the Kmart site. Since 2001, when the Wal-Mart opened, the sales per square foot at the Kmart store, which had been increasing in 1999 and 2000, plummeted to less than half of their previous level. Tr. 142-48; Exhibits 9, 10.

At the trial, the two sides' experts presented differing appraisal opinions. Both experts relied on two of the standard approaches to value: the sales comparison and income approaches.³ On critical valuation issues, one in each of the two approaches, the tax court specifically found that Mr. Dahlen's analysis and conclusions were not credible, and instead endorsed Mr. Leirness' approach. Nevertheless, in determining the subject property's value, the tax court went on to use figures directly contrary to its explanation of what valuation testimony it found to be credible.

³ The tax court expressly placed no weight on the third approach, the cost approach, which only Mr. Dahlen had included in his appraisal. App. 24 (12-1-04 Order at 10).

First, with respect to the sales comparison approach, the tax court focused on three comparable sales which appeared in both experts' reports: the sales of the Kmart stores in Dundas, New Ulm, and Marshall, Minnesota. App. 24-25 (12-1-04 Order at 10-11), App. 21-30 (Leirness' appraisal report), App. 70-72 (Dahlen's appraisal report). The tax court found that in all three cases, "the purchaser was obtaining a leased fee interest rather than fee simple." App. 25 (12-1-04 Order at 11). The tax court disagreed with Mr. Dahlen's unsupported assertion that the leases on these comparable sales were at market rent at the time of sale, and instead agreed with Mr. Leirness that "the leases were higher than the market rent" and accordingly, to find the value of the fee simple interest, one must "make adjustments for the leased fee nature of the comparable sales . . . to reflect the market rent for aging stores which was less per square foot than the contract rent when the stores were new." App. 26-27 (12-1-04 Order at 12-13). Having discredited Mr. Dahlen's sales comparison figures, however, the tax court went on inexplicably to apply Mr. Dahlen's very same figures in arriving at its determination of the subject property's value. App. 27 (12-1-04 Order at 13; tax court bracketed its conclusion of value in sales comparison approach midway between the two expert's figures, without any downward adjustment to Mr. Dahlen's figures to comport with the tax court's own findings on the variance between the leased fee and fee simple values of the comparable sales).

Second, in determining the capitalization rate to be applied in the income approach to value, the tax court held that Mr. Dahlen's 9.5% rate was too low, because it relied on the same leased fee sales used in the sales comparison approach, which as before, Mr.

Dahlen failed to adjust to arrive at a fee simple capitalization rate. App. 29 (12-1-04 Order at 15). The tax court instead found “Mr. Leirness’ analysis persuasive,” and decided to “use his capitalization rate of 10.25%.” Id. As the tax court had earlier twice noted, however, in the very same paragraph of its December 1, 2004 Order, Mr. Leirness used a capitalization rate of 10.5%. Id. The tax court did not find any flaws in Mr. Leirness’ calculation of the capitalization rate, and gave no explanation for its decision to use a different rate from the one supported by Mr. Leirness’ expert analysis, even though it expressly found his analysis to be persuasive and represented that it was using his rate.

Kmart presented both of these inconsistencies in its motion for amended findings, and requested the tax court to correct them, in order to make its valuation findings consistent with the fact findings and reasoning expressed in its memorandum. The tax court denied Kmart’s motion, without further explaining or reconciling either inconsistency.

STANDARD OF REVIEW

This Court reviews tax court decisions to determine whether the court lacked jurisdiction, whether the court’s decision is supported by the evidence and is in conformity with the law, and whether the court committed any other error of law. Jefferson v. Comm’r of Revenue, 631 N.W.2d 391, 394-95 (Minn. 2001). While this Court will not disturb the tax court’s valuation of property for tax purposes unless the tax court’s decision is clearly erroneous, Harold Chevrolet, Inc. v. County of Hennepin, 526 N.W.2d 54, 57 (Minn. 1995), this Court is not bound by decisions of the tax court. Bond v. Comm’r of Revenue, 691 N.W.2d 831, 835 (Minn. 2005); A&H Vending Co. v.

Comm'r of Revenue, 608 N.W.2d 544, 546 (Minn. 2000). This Court will overrule the tax court, if it concludes that the evidence as a whole does not reasonably support the tax court's decision. Lewis v. County of Hennepin, 623 N.W.2d 258, 261 (Minn. 2001). Thus, reversal is appropriate if this Court is left with a definite and firm conviction that a mistake has been made, or if the tax court completely failed to explain its reasoning in valuing property. Marquette Bank Nat'l Ass'n v. County of Hennepin, 589 N.W.2d 301, 305, 306 (Minn. 1999). Where the tax court uses illogical reasoning to reject an expert appraiser's valuation, this Court will reverse the tax court's valuation as clearly erroneous. American Express Fin. Advisors v. County of Carver, 573 N.W.2d 651, 654, 658 (Minn. 1998) (invalidating the tax court's valuation under the clearly erroneous standard, where "the reasoning the court presented . . . was illogical").

ARGUMENT

Minnesota law requires that real property be assessed at its fair market value. Minn. Stat. § 273.11, subd. 1 (2004). Fair market value for property assessment purposes is the consideration which a willing purchaser not required to buy the property would pay to an owner willing but not required to sell it, taking into consideration the highest and best use of the property. Ferche Acquisitions, Inc. v. County of Benton, 550 N.W.2d 631, 634 (Minn. 1996); see also Minn. Stat. § 272.03, subd. 8 (2004). This Court recognizes the three traditional approaches to determining the market value of real property, consisting of the cost, market comparison, and income approaches. See Equitable Life Assurance Soc'y v. County of Ramsey, 530 N.W.2d 544, 552 (Minn. 1995). The tax court relied upon two of the three approaches, but in each approach

improperly deviated, without explanation, from its own findings and stated explanation of the expert analysis it relied upon and used as the basis for its determination of value.

I. In Calculating the Indication of Value Under the Income Approach, the Tax Court did not Apply the Capitalization Rate It Identified as Proper.

Under the income approach to value, an appraiser is required to determine the rental income the property should generate, to subtract expenses to arrive at the net operating income attributable to the property, and then to divide the net income by a capitalization rate to obtain the price an informed investor would reasonably expect to pay for the property. See TMG Life Ins. Co. v. County of Goodhue, 540 N.W.2d 848, 852 (Minn. 1995). Thus, the income approach “is predicated on the capitalization of the income the property is expected to generate.” Harold Chevrolet, 526 N.W.2d at 57 (Minn. 1995), citing Lewis & Harris v. County of Hennepin, 516 N.W.2d 177, 178 (Minn. 1994); Montgomery Ward v. County of Hennepin, 450 N.W.2d 299, 302 (Minn. 1990); Federal Reserve Bank of Minneapolis v. County of Hennepin, 372 N.W.2d 699, 700 (Minn. 1985).

The two expert appraisers who testified at trial used widely different capitalization rates in their opinions of value. In its decision, the tax court rejected Respondent’s expert Dwight Dahlen’s capitalization rate of 9.5%. The tax court noted that Mr. Dahlen based his capitalization rate on the same leased fee sales used in his sales comparison approach, but failed to make the adjustments necessary to arrive at a fee simple valuation. “Based upon the long term nature of the leases in place for the sales Mr. Dahlen used as comparables, as well as Kmart’s creditworthiness at the time the leases were negotiated,

we find that the fee simple capitalization rate would be higher than those derived from the leased fee sales.” App. 29 (12-1-04 Order at 15). The tax court went on to state that it found the selection of a capitalization rate by Relator’s expert Alan Leirness to be “persuasive,” and identified no flaws or defects in Mr. Leirness’ calculation of the capitalization rate. Id. In two places on page 15 of the December 1, 2004 Order, namely, lines 7 to 8, and then again lines 13 to 14, the tax court properly stated that Mr. Leirness used a capitalization rate of 10.5%. Inexplicably, however, in the penultimate line on that same page, the Court stated that in determining the fair market value of the subject property, it would “use his [Mr. Leirness’] capitalization rate of 10.25%.” Id.

In reality, Mr. Leirness unquestionably used a capitalization rate of 10.5% in his analysis. Tr. 90, 101-02. Thus, the tax court’s opinion – indeed, the same paragraph cited above – contains an internal inconsistency, unsupported by any evidence in the record. The tax court’s use of 10.25% constitutes a compromise between the expert opinions which is unsupported by the evidence credited by the tax court, and is, moreover, contradicted by the tax court’s own findings and reasoning as explained in its decision. “When the tax court reconciles conflicting opinions of value and arrives at a compromise valuation, that compromise must have evidentiary support.” Equitable, 530 N.W.2d at 558, citing Northerly Centre Corp. v. County of Ramsey, 311 Minn. 335, 342, 248 N.W.2d 923, 927 (1976), and Halla v. County of Hennepin, 306 Minn. 533, 534, 237 N.W.2d 348, 349 (1975).

In its motion for amended findings, Relator asked the tax court to clarify this facial inconsistency, but the tax court declined to do so. App. 39 (4-1-05 Order at 3). The tax

court instead sought to justify its conclusion by stating that Mr. Leirness “also used the band of investment method, which reflected a capitalization rate of 10.25%.” Id. Contrary to the tax court’s implication that Mr. Leirness simultaneously used two contradictory capitalization rates, he only used one: 10.5%. App. 63, 64 (Leirness appraisal). In his testimony at trial, he explained that he reviewed a variety of information, including information on market conditions, information from a comparable sale, the band of investment analysis, and survey information from Korpacz and from other sources. Tr. 101. Based upon all of the available information, he relied upon his experience and expertise to try “to replicate the way a buyer would look at the property given the income estimates and the expenses and the vacancy rates estimated.” Id. He concluded that the subject property came in at the high side of the possible range of capitalization rates because of its age, location, and size. Tr. 90. He used the 10.25% band of investment information merely as a check on his conclusion, but did not use or adopt that figure in his income approach, because he testified that all of the factors taken together warranted a higher capitalization rate. App. 64 (Leirness’ appraisal at 42).

The tax court’s statement that it adopted Mr. Leirness’ capitalization rate, followed by its unexplained usage of a different, lower capitalization rate, represents a clearly erroneous finding which this Court can and should correct on appeal. The tax court expressly rejected Mr. Dahlen’s capitalization rate and adopted Mr. Leirness’ capitalization rate. Its explanation of its decision offered no basis for compromising downward from Mr. Leirness’ rate, which the tax court concurrently and specifically called “persuasive.” In denying Kmart’s motion for amended findings, the tax court

intimated that its selection of 10.25% was based, in part, on “compar[ing] it to Respondent’s suggested capitalization rate of 9.5%.” App. 39 (4-1-05 Order at 3). However, the tax court’s original findings rejected Mr. Dahlen’s analysis and accepted Mr. Leirness’ analysis unequivocally. The tax court has provided no explanation or justification for adopting a compromise rate between the expert’s two different capitalization rates.

“When the tax court reconciles conflicting opinions of value and arrives at a compromise valuation, that compromise must have evidentiary support.” Equitable, 530 N.W.2d at 558, citing Northerly Centre Corp. v. County of Ramsey, 311 Minn. 335, 342, 248 N.W.2d 923, 927 (1976), and Halla v. County of Hennepin, 306 Minn. 533, 534, 237 N.W.2d 348, 349 (1975). Here, as in American Express, while the tax court may not have been bound to accept either expert’s analysis, it was reversible error for the tax court to come up with its own analysis based upon illogical reasoning. 573 N.W.2d at 658. When the tax court makes findings which expressly reject one expert’s analysis and credit the other expert’s, the tax court may not then choose a compromise rate between the two experts without explaining its basis for doing so. The tax court’s failure here to provide an explanation for the inconsistency on its face within the same paragraph of its decision leaves a definite impression that a mistake has been made. Because it identified no basis for a downward adjustment to Mr. Leirness expert calculation of the appropriate capitalization rate, while expressly endorsing his analysis, the tax court should have applied the 10.5% rate used by Mr. Leirness and to which he testified.

II. The Tax Court Erred When Calculating the Adjusted Sales Price per Square Foot Under the Sales Comparison Approach to Value.

In addition to divergent capitalization rates under the income approach, the tax court was also faced with contradictory expert analyses of the same comparable sales for purposes of the sales comparison approach to valuing the subject property. Here, as in the selection of the appropriate capitalization rate, the tax court found Mr. Leirness' adjustment of the comparable sales to be credible, and rejected Mr. Dahlen's approach.

A. To Arrive at Fair Market Value, Leased Fee Sales Must be Adjusted to Account for Any Differences Between Actual Rent and Market Rent.

When determining the fair market value of an income-producing property for property tax purposes, the court must determine the fee simple value, not the leased fee value. See TMG, 540 N.W.2d at 853 (assessor and court must value the property based upon the fair rental value, not the actual rent paid under a below-market lease), citing Crossroads Center (Rochester), Inc. v. Commissioner of Tax'n, 286 Minn. 440, 447, 176 N.W.2d 530, 535 (1970). In TMG, as in Crossroads, the property owner sought to reduce its valuation for tax purposes, arguing that because the property was subject to an unprofitable long-term lease at a below-market rental rate, the property generated less income and was therefore worth less than a comparable property that was not so encumbered. This Court rejected that argument, holding that fair market valuation must be calculated by applying market rents, and not actual rents that differ from market rents.

Based upon TMG and Crossroads, the tax court correctly recognized that when evaluating a leased fee sales comparable, an appraiser must determine whether an adjustment is necessary to arrive at the fee simple value of the sale. This in turn requires

determining whether on the date of sale the comparable sale was leased at a rate that was at, above, or below then-current market rents. The tax court found that Mr. Dahlen failed to take into account the decline in market rental rates for the subject property from the time it opened as a new, build-to-suit store in 1991 to the three valuation dates before the tax court starting a decade later, when the store was no longer new, and market conditions had changed substantially. “The problem is that Mr. Dahlen’s analysis only reflects what a tenant would pay to rent a brand new build-to-suit building in 1990.” App. 26 (12-1-04 Order at 12). Accordingly, the tax court rejected Mr. Dahlen’s unsupported and unsubstantiated testimony that he believed the market rental rates for the subject property would be unchanged from 1991 to the assessment dates in 2001, 2002, and 2003. Id. The tax court, instead, “accept[ed] Mr. Leirness’ testimony that the leases were higher than the market rent.” App. 27 (Id. at 13).

Mr. Dahlen’s appraisal report establishes that he made no adjustment to account for the leased fee nature of the comparable sales, and his testimony confirmed that fact. His appraisal report contains a chart listing all of the adjustments he made to the sales he identified as comparable. App. 82 (Dahlen report at 48). The chart includes a line item entitled “Property Rights Conveyed,” which Mr. Dahlen explained was intended to make any necessary adjustment between the leased fee and fee simple value of the property. App. 74 (Dahlen report at 44). In the chart, Mr. Dahlen identified the adjustment factor for “Property Rights Conveyed” as “1.00” for each of the comparable sales, meaning that he made no adjustment whatsoever for that factor. App. 82 (Dahlen report at 48). In his report and his testimony at trial, he stated that he made no adjustment, because he

believed the comparable sale properties “were leased at market rent at time of sale.”

App. 74 (Dahlen report at 44); Tr. 293-95.

In contrast, the tax court specifically relied on Mr. Leirness’ analysis that a downward adjustment was required to each of the leased fee sales. App. 27 (12-1-04 Order at 13). “[W]e accept Mr. Leirness’ testimony that the leases were higher than the market rent and make adjustments for the leased fee nature of the comparable sales . . . to reflect the market rent for aging stores which was less per square foot than the contract rent when the stores were new.” Id. Accordingly, based on its finding that the comparable sale properties were subject to above-market leases at the time of sale, the tax court found that Mr. Dahlen erred when he made no downward adjustment to the any of the leased fee sales comparables.

Notwithstanding its express acceptance of Mr. Leirness’ leased fee adjustments, and its express rejection of Mr. Dahlen’s decision not to make such adjustments, the calculations cited by the tax court to arrive at its conclusion of value under the sales comparison approach cited and relied upon Mr. Dahlen’s unadjusted (and therefore incorrect) figures. The tax court arrived at a sales comparison value by bracketing it between the two competing experts’ figures, *without adjusting Mr. Dahlen’s figures at all*. The conclusion reached by the tax court is actually closer to Mr. Dahlen’s figures than to Mr. Leirness’ correctly adjusted figures, indicating that the tax court relied even more heavily on Mr. Dahlen’s discredited analysis than on the analysis of Mr. Leirness which the tax court had expressly accepted. Significantly, if Mr. Dahlen’s figures are adjusted to account for market rents as the tax court said they must be, and if his

arithmetical errors (as shown below, he miscalculated the square footage of one of the comparable sales) are corrected as they also must be, the resulting adjusted Dahlen indication of value is actually lower than the figure adopted by the tax court as the indicated compromise value under the sales comparison approach.

B. Despite Recognizing that Adjustment Was Necessary, the Tax Court Relied on Unadjusted Figures in Its Sales Comparison Approach.

The tax court chose to rely on three comparable sales in the sales comparison approach, concluding that they were the closest in time and most similar to the subject property.⁴ The three sales were identified as comparables ## 1, 2, and 3 in Mr. Dahlen's report, and they were the same as the sales identified as comparables ## 14, 15, and 16 in Mr. Leirness' report. App. 24 (12-1-04 Order at 10). All three were sales of Kmart stores, subject to long-term leases, which Kmart purchased by exercising its right of first refusal when the owner proposed to sell them to another buyer. Dahlen #1/Leirness #14 was the February 1998 sale of the Kmart store in Dundas. Dahlen #2/Leirness #16 was the October 1999 sale of the Kmart store in Marshall. Dahlen #3/Leirness #15 was the October 1999 sale of the Kmart store in New Ulm. App. 55, 70-72. (The latter two sales were part of the same package transaction which included the subject property, but neither expert considered the subject property's own sale as a comparable sale in his analysis.)

Each expert began his analysis of these three comparable sales by dividing the property's square footage by its allocated sale price to arrive at a gross sales price per

⁴ Kmart does not contest, for the limited purposes of this appeal, the tax court's decision not to rely on any of the other comparables identified by Mr. Leirness.

square foot. App. 53. Although in theory the experts should have arrived at the same price per square foot for each of the three sales as a matter of simple arithmetical calculation, Mr. Dahlen first recognized but then omitted the square footage of the Fashion Bug store that was included in the sales price for his comparable sale #1, thus leading him to arrive at an erroneously higher sales price per square foot for that sale. Compare App. 70 (Dahlen report at p. 38, listing square footage of comparable sale #1 as 94,479 square feet, including 86,479 square foot Kmart store and 8,000 square foot Fashion Bug store, and calculating sales price as \$40.88/square foot, based upon total gross building area) with App. 82 (Dahlen report at p. 48, listing total square footage of comparable sale #1 as 86,479, and calculating sales price per square foot as \$44.67). See also App. 53 (Leirness report at p. 23, calculating sales price per square foot for comparable #14, which is the same property as Dahlen's comparable #1, as \$40.88 per square foot). For the other two shared comparables, Dahlen #2/Leirness #16 and Dahlen #3/Leirness #15, both experts included in the property's square footage both the Kmart store and the Fashion Bug store included in each sale, and calculated virtually identical sales prices per square foot, of \$39.59 and \$36.71/\$36.77, respectively. Mr. Dahlen did not explain why he first included and then omitted the Fashion Bug store from his calculation of the sales price for his comparable sale #1, while leaving it in for #2 and #3; indeed, at trial he admitted that dividing the sales price by the overall square footage for #1 yielded a figure of \$40.88, not \$44.67. Tr. 437-39.

Each expert then made various adjustments to the actual sales prices for each comparable to arrive at an indicated value for each sale. In direct contradiction to the tax

court's decision that the sales prices must be adjusted downward to account for the above-market nature of the actual rents, Mr. Dahlen only adjusted his figures upward. His appraisal report confirms that he made no adjustment for the leased fee nature of the sales, because he applied a factor of 1.0 in his adjustment grid for "Property Rights Conveyed." App. 82 (Dahlen's Report at p. 48). As a result, he arrived at an indicated value range of \$46.78 to \$36.71 for the three comparable sales. *Id.* Mr. Leirness, in contrast, made a 15% downward adjustment to each sale, to account for the leased fee nature of the sales, and after making other adjustments for factors such as age, condition, land to building ratio, and location, he arrived at an indicated value range of \$28.68 to \$29.84. App. 59 (Leirness' Report at p. 29).

The tax court, after detailing how Mr. Dahlen improperly failed to make the required leased fee adjustment to his indicated values, then relied upon his indicated values *without making any adjustments* to arrive at an indicated value of \$35.00 per square foot under the sales comparison approach. The contradictory and illogical nature of this reversal of the tax court's express findings of credibility is emphasized by the observation that the tax court concluded to an indication of value under the sales comparison approach which is actually closer to Mr. Dahlen's discredited approach than to Mr. Leirness' approved approach. "The three comparables provide a range of adjusted sales prices of \$28.68 to \$46.78 per square foot. Mr. Leirness chose \$27.00 per square foot, and Mr. Dahlen chose \$39.00 per square foot. We find \$35.00 per square foot to be reasonable *based on the adjustments discussed above.*" App. 27 (12-1-04 Order at 13) (emphasis added). \$35.00 is only \$4.00 lower than Mr. Dahlen's indicated value of

\$39.00, while it is \$8.00 higher than Mr. Leirness' indicated value of \$27.00. Thus, the tax court inexplicably selected a figure that is twice as close to the expert whose approach was rejected as it is to the expert whose approach was accepted.

To be consistent with its own express findings that a downward adjustment was required due to the leased fee nature of the three comparable sales, and the below-market rents found to be present in all three sales, logically the tax court should have adjusted Mr. Dahlen's figures before relying on them to bracket a conclusion as to value under the leased fee approach. The only testimony on the record as to the appropriate amount of reduction was Mr. Leirness' testimony that a 15% reduction was required. Tr. 152-53. Given that Mr. Dahlen testified that no reduction should be made because he assumed the comparable sales were at market rents, and given the tax court's express rejection of Mr. Dahlen's testimony, Mr. Leirness' testimony was the only evidence in the record to support the amount of downward adjustment that should be made.⁵ When Mr. Dahlen's \$39.00 indicated value is reduced by 15%, in accordance with the tax court's ruling that an adjustment must be made to account for the leased fee nature of the sales from which it was derived, it is lowered to \$33.15, a figure nearly \$2.00 lower than the compromise indicated value of \$35.00 selected by the tax court.

⁵ At the hearing on the motion for amended findings, the tax court asked Respondent's counsel to address whether Mr. Dahlen had in fact made any adjustment to account for the leased fee sales. Respondent replied that Mr. Dahlen had made such an adjustment in reaching his range of values, and argued that it was therefore proper for the tax court to rely on his indicated values in setting the range relied on by the tax court in the sales comparison approach to value. See Tr. II at 26-27. Contrary to Respondent's argument, Mr. Dahlen's appraisal report and his testimony confirm that he chose *not* to make any such adjustment. App. 74, 82 (Dahlen's report at pp. 44, 48); Tr. 293-95.

Likewise, if Mr. Dahlen's individual comparable sales figures are adjusted, both to correct his unexplained failure to include all of the square footage purchased in his comparable sale #1, and to include a 15% downward adjustment for the leased fee nature of all three of his comparable sales, then his indicated values would become \$36.39, \$34.65, and \$31.20, which confirm the downward adjustment of his correlated value from \$39.00 to \$33.15, as noted above. The tax court then would have had a range of \$27 (Mr. Leirness) to \$33 (Mr. Dahlen, as adjusted), as brackets within which to consider the appropriate indicated value under the sales comparison approach.

The tax court's decision to adopt a sales comparison valuation of \$35 per square foot, a figure which is well outside the expert testimony found credible by the tax court, when calculated according to the tax court's own rationale, leaves the definite impression that a mistake has been made. The tax court's \$35 per square foot valuation is not supported by the evidence as found by the tax court itself. It is the result of an illogical bracketing, based upon Mr. Dahlen's discredited and excessive expert testimony. To follow its own logic, the tax court was required to reduce Mr. Dahlen's figures before relying on them. When given an opportunity to make the correction required by its own logic, the tax court declined to do so, but without explanation or reasoning to justify why it relied on figures which it had, itself, discredited. Here, as in American Express, the reasoning the tax court presented was "illogical." Its failure to correct its figures to correspond to its findings represents clear error.

CONCLUSION

Relator Kmart Corporation respectfully requests that this Court reverse the tax court's April 1, 2005 Order denying Kmart's post-trial motions and remand with directions to amend the tax court's December 1, 2004 findings of fact and conclusions of law to correct the errors outlined above by applying the tax court's own reasoning to use a 10.5% capitalization rate in the income approach to value, to adjust downward Mr. Dahlen's sales comparison figures before using them to bracket the final valuation decision, and to rely primarily upon the income approach as opposed to the sales comparison approach to value.

Respectfully submitted,



Dated: June 27, 2005

Thomas R. Wilhelmy (#117134)
Laurie J. Miller (#135264)
FREDRIKSON & BYRON, P.A.
200 South Sixth Street, Suite 4000
Minneapolis, MN 55402-3397
Telephone: (612) 492-7000
Facsimile: (612) 492-7077

ATTORNEYS FOR RELATOR
KMART CORPORATION

#3135388\1

CERTIFICATE OF COMPLIANCE
WITH MINN. R. APP. P 132.01, Subd. 3

The undersigned certifies that Relator's Brief submitted herein contains 6,024 words and complies with the type/volume limitations of the Minnesota Rules of Appellate Procedure 132. This Brief was prepared using a proportional spaced font size of 13 pt. The word count is stated in reliance on Microsoft Office Word 2000, the word processing system used to prepare this Brief.

Laurie J. Miller

The appendix to this brief is not available for online viewing as specified in the *Minnesota Rules of Public Access to the Records of the Judicial Branch*, Rule 8, Subd. 2(e)(2) (with amendments effective July 1, 2007).