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STATE OF MINNESOTA  
IN SUPREME COURT

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444 Lafayette, LLC  
and  
Meritex Enterprises, Inc.,  
  
Relators,

v.

County of Ramsey,  
  
Respondent.

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BRIEF AND ADDENDUM  
OF  
RELATORS 444 LAFAYETTE, LLC  
AND MERITEX ENTERPRISES, INC.

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FREDRIKSON & BYRON, P.A.  
Thomas R. Wilhelmy  
Atty. Reg. No. 0117134  
Jennifer A. Kitchak  
Atty. Reg. No. 0317056  
200 South Sixth Street, Suite 4000  
Minneapolis, MN 55402  
(612) 492-7000

*Attorneys for Relators 444 Lafayette, LLC  
and Meritex Enterprises, Inc.*

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).

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## LEGAL ISSUES

- I. Is the Tax Court's decision clearly erroneous because its findings regarding tenant improvements are not reasonably supported by the evidence as a whole and are contrary to law, including the Tax Court's own analysis and findings involving highly similar legal and factual issues in a decision relating to the value of the same property as of a date just two years earlier?**

The Tax Court determined that no adjustment to the subject property's income or value should be made to account for tenant improvement expenses because the amounts had already been spent and the renovations completed. This conclusion is contrary to Tax Court precedent, is inconsistent with the Tax Court's treatment of highly similar issues for the same property in an earlier decision, and contradicts the evidence of record. Moreover, the Tax Court made no finding whether the tenant improvement costs at issue were excessive or atypical, or why it is appropriate to deduct those allowances in the years before those costs were spent.

Preservation of Issue: Substantive questions of law that were properly raised below are preserved for review on appeal. Alpha Real Estate Co. v. Delta Dental Plan of Minnesota, 664 N.W.2d 303, 310 (Minn. 2003).

Most Apposite Cases: Eden Prairie Mall, LLC v. Cnty. of Hennepin, 2011 Minn. LEXIS 236 (Minn. 2011); Meritex Enters., Inc. v. Cnty. of Ramsey, 2009 Minn. Tax LEXIS 14 (Minn. Tax Ct. July 24, 2009).

- II. Did the Tax Court err in adopting verbatim the valuation analysis and conclusions of value for the subject property found only in the County's post-trial briefs, where the analysis and conclusions were not adequately explained and not reasonably supported by the record as a whole?**

The Minnesota Tax Court rejected the appraisal testimony of both of the experts and adopted verbatim the analysis and conclusions of value for the subject property found only in the County's post-trial briefs. The reasoning for those conclusions was not adequately explained, and the conclusions were not reasonably supported by the evidence as a whole. The decision is therefore clearly erroneous.

Preservation of Issue: Evidentiary support in the record for the Tax Court's decision is an issue that is automatically preserved for review on appeal. Gruenhagen v. Larson, 246 N.W.2d 565, 569 (Minn. 1976).

Most Apposite Case: Eden Prairie Mall, LLC v. Cnty. of Hennepin, 2011 Minn. LEXIS 236 (Minn. 2011).

## STATEMENT OF THE CASE

This is a review by certiorari of the Order of the Minnesota Tax Court determining the fair market value for property tax purposes of an office building located at 444 Lafayette Road in Saint Paul, Minnesota. (Add-5).<sup>1</sup> The Ramsey County Assessor's estimated market value for the property was \$22,500,000 as of the January 2 assessment dates in 2008, 2009 and 2010. (Add-5). Meritex Enterprises, Inc. and 444 Lafayette, LLC (hereinafter "Meritex") challenged these valuations by timely petitions to the district court under Minnesota Statutes Section 278.01, subdivision 1, claiming that the property had been assessed at a value greater than its actual market value and had been unfairly and unequally assessed as of the assessment dates.

At trial, Meritex introduced the expert appraisal testimony of Michael F. Amundson, MAI (Member of the Appraisal Institute). (See Trial Exhibit 1 (hereafter "Ex. \_\_")). Meritex appraiser Amundson opined that the fair market value of the taxable real property was \$16,600,000 on January 2, 2007; \$16,300,000 on January 2, 2008; and \$13,800,000 on January 2, 2009. (Ex. 1, p. 1). Amundson's appraisal analysis and testimony referenced and agreed with critical findings and valuation analysis in a recent decision of the Tax Court when it valued the same Meritex property at \$13,200,000 as of the January 2, 2005 assessment date. (See, e.g., Ex. 1, pp. 36, 37).

The County introduced the expert testimony of Jason L. Messner, MAI. County appraiser Messner testified that the value of the Meritex property was higher than the assessor's value as of the first two assessment dates: he opined to values of \$23,900,000;

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<sup>1</sup> Citations in the form "Add-\_\_" refer to pages of Relators' Addendum.

\$25,000,000 and \$20,100,000 as of January 2, in 2007, 2008 and 2009, respectively. (Ex. I, pp. vi, vii).

The Assessor's estimated market values and the final value opinions of the appraisal experts at trial were therefore as follows:

	<u>Assessment</u>	<u>Meritex Appraiser</u>	<u>County Appraiser</u>
January 2, 2007	\$22,500,000	\$16,600,000	\$23,900,000
January 2, 2008	\$22,500,000	\$16,300,000	\$25,000,000
January 2, 2009	\$22,500,000	\$13,800,000	\$20,100,000

After trial, the County submitted briefs in which it argued that the fair market value of the Meritex property was even higher than the values to which County appraiser Messner testified at trial. In so doing, the County argued that the income approach of Meritex appraiser Amundson used inappropriate assumptions concerning income, expenses and in the selection of the appropriate capitalization rate. (A07 to 14) (County's Post Trial Brief, filed 2/14/11).<sup>2</sup> The County then presented proposed valuations that "modified" County appraiser Messner's value determinations by substituting what the County deemed to be "more reasonable" assumptions about the anticipated levels of parking income (which was wholly absent in Messner's analysis) and operating expenses. Those assumptions differed from the assumptions to which any expert or other witness testified. (A07 to 14).

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<sup>2</sup> Citations in the form "A\_\_" refer to pages of Relators' Appendix.

The effect of the new assumptions, first proposed by the County in post-trial briefs, was to substantially increase the County's calculation of Meritex's net operating income for all three assessment years. (A28 to 29; Ex. I, pp. 93 to 94). By applying the same capitalization rates used by the County's appraiser to these differing assumptions and corresponding increased levels of net operating income, the County argued that County appraiser Messner's values for the Meritex property should be increased from \$23,900,000 to \$26,164,000 for 2007; from \$25,000,000 to \$27,420,000 for 2008; and from \$20,100,000 to \$22,094,000 for 2009. (A28 to 29; Ex. I, pp. 93 to 94). Thus, the County argued that the assessment value for the Meritex property should be increased from \$22,500,000 to \$26,164,000 as of January 2, 2007, from \$22,500,000 to \$27,420,000 as of January 2, 2008, and decreased modestly from \$22,500,000 to \$22,094,000 as of January 2, 2009.

The Tax Court adopted verbatim the County's recalculated but unsupported higher value analysis and determinations. (Add-5; A33). As a result, the Tax Court increased the value of the Meritex property by 16% over the County's original assessed value in 2007 and 22% over the county's original assessed value in 2008. The Tax Court did lower the 2009 assessed value, but it still concluded to a higher value than either appraiser testified was appropriate. The Tax Court's concluded values were an average of \$1,926,000 per year higher than the appraisal testimony of the County's expert.

Even more significantly, the Tax Court's concluded values were, on average, 91% higher than the value the court found for the same property in its order determining the same Meritex property's market value as of January 2, 2005 under largely unchanged

facts and circumstances. See Meritex Enters., Inc. v. Cty. of Ramsey, 2009 Minn. Tax LEXIS 14, \*4 (Minn. Tax Ct. July 24, 2009).

The Relators appealed to this Court with a petition for writ of certiorari.

### STATEMENT OF FACTS

The property at issue is a six-story, single-tenant office building located at 444 Lafayette Road in Saint Paul, Minnesota. (Ex. 1, pp. 2, 14). It was constructed in the early 1900's as two warehouse properties that were later joined and renovated for office use in the 1980's. (Ex. 1, p. 2). There are no parking spaces located on the subject property's tax parcel, so parking for employees and visitors is provided by operation of a reciprocal easement agreement over parking lots in the vicinity which also serve other neighboring office properties. See Meritex Enters., Inc., 2009 Minn. Tax LEXIS 14 at \*7; Ex. 60. Pursuant to that agreement, parking spaces are available for lease by employees of the subject office building's tenant. (Ex. 1, pp. 1; Trial Transcript 23:6-20, 213:6-214:12 (hereafter "TT")). A portion of the net parking income generated in connection with these parking lots is allocated to the subject property by operation of the reciprocal easement agreement. (Ex. 60, pp. 12-13).

On the relevant assessment dates, the property was leased to the State of Minnesota and housed the Department of Human Services ("DHS"). (Ex. 1, p. 3; Ex. 15, p. 16). The lease to DHS, in place on the assessment dates, was negotiated in the fall of 2004, signed on January 21, 2005 and commenced on January 1, 2006 ("DHS Lease"). DHS's prior lease of the subject property was terminated early, with the DHS Lease

replacing the last two years of the prior lease at lower rental rates. Meritex Enters., Inc., 2009 Minn. Tax LEXIS 14 at \*5, \*15. (See Add-26 (Ex. 8)).

In the DHS Lease, the parties agreed to the payment of gross rent,<sup>3</sup> with the initial level of gross rent at \$16.50 per useable square foot of area.<sup>4</sup> (Ex. 3 at “Exhibit B”). The DHS Lease required the property owner to extensively remodel and renovate the property to DHS’s detailed specifications, which, when originally budgeted, were expected to cost around \$15,000,000. (TT, 299:1-301:6; Ex. 29). The gross rental rate under the lease was scheduled to increase by approximately \$.50 per square foot each year, an amount negotiated to offset anticipated increases in occupancy expenses to the landlord (including common area expenses, repairs, and real estate taxes); the net rent to the landlord under the DHS Lease therefore was expected to remain essentially flat, and at a lower rate than the predecessor lease. (TT, 43:23-44:13).

The Minnesota Tax Court had recently determined that the fair market value of the Meritex property was \$13,200,000 as of January 2, 2005. Meritex Enters., Inc., 2009 Minn. Tax LEXIS 14 at \*3. The Tax Court relied primarily on the income approach to value, determining that the appropriate level of market rent was indicated by the DHS

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<sup>3</sup> A gross lease is one in which the tenant pays only rent to the landlord and the landlord pays all occupancy expenses (including common area expenses, repairs, real estate taxes). See Appraisal Institute, The Appraisal of Real Estate, 451 (13th ed. 2008). Under a gross lease, the landlord assumes the risk of all increases in occupancy expenses, foreseen or unforeseen.

<sup>4</sup> The State of Minnesota leases properties on a “useable area” basis, which is a measurement defined in the lease. (TT, 324:15-325:4). As defined in this lease, useable area is the floor area actually available to be occupied by the tenant, and does not include space used by interior columns. This measurement results in a smaller number of square feet leased, as compared to the more common measurement of “rentable” area.

Lease. Id. at \*14-16. In that case, the Tax Court agreed with the taxpayer's expert that the provisions of the DHS Lease which required the property owner to spend approximately \$14 million (or \$45 per square foot) to renovate the subject property to DHS's specifications (the "Total Tenant Improvement Costs") were not typical "market" levels of tenant improvements. Id. at \*22-24. The Tax Court recognized that a market level of tenant improvements was only \$15 per square foot, or roughly \$4 million ("Market Tenant Improvement Costs"), an amount significantly less than the entire amount of Total Tenant Improvement Costs that the landlord was obligated to spend under the DHS Lease.

The Tax Court held that the Market Tenant Improvement Costs of \$15 per square foot could not be deducted from the Meritex property's income when estimating market value as of January 2, 2005 under the direct capitalization approach. Rather, the Tax Court held that even the Market Tenant Improvement Costs should be amortized over five or ten years, with one year's amortized amount deducted as a "below the line" expense in determining the property's value in 2005. Id. at \*22-24. The Tax Court determined that deducting the entire amount of Market Tenant Improvement Costs in one year would skew the direct capitalization approach to value, and that the equivalent of only one year's amortization should properly be deducted from the estimated value under the direct capitalization approach for 2005. Id. at \*24.

In December 2007, the Meritex property was sold in a package of property interests, subject to and together with the DHS Lease and along with seven nearby parcels of land containing parking lots. (Ex. 1, p. 3). This transaction was a leased-fee

transaction in which the buyer paid for not only the taxable fee simple interest in the real estate itself, but also paid for the contractual rights to collect the rents under the DHS Lease and the net parking income generated DHS employee parkers, as well as a partial guarantee regarding future property tax expenses secured by a \$1.5 million letter of credit. (Ex. 1, p. E2; Ex. 15; TT, 127:3-10).

The value of the subject property came before the Tax Court again for the assessment dates in 2007, 2008 and 2009, the result of which prompted the current appeal. The Tax Court determined that, based on the same DHS Lease, the value of the subject property had increased significantly between 2005 and 2007, nearly doubling the taxable value of the Meritex property, from \$13,200,000 in 2005 to \$26,164,000 in 2007, even though the net rent under the DHS Lease was virtually unchanged. The resulting value increased the taxable fee simple market value by an amount equivalent to the Total Tenant Improvement Costs, or the entire amount Meritex spent to renovate the property, not merely the amount which the Tax Court found to be real property related in the previous decision.<sup>5</sup>

## ARGUMENT

### I. STANDARD OF REVIEW

This Court is deferential to the Tax Court's valuation determinations on appeal unless such determinations are clearly erroneous. Eden Prairie Mall, LLC v. Cnty. of Hennepin, 2011 Minn. LEXIS 236, \*15-16 (Minn. 2011); Montgomery Ward & Co. v.

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<sup>5</sup> Meritex actually spent \$12,945,075.25 in 2005, 2006 and 2007 to renovate the property to DHS's specifications. (Ex. 30).

Cnty. of Hennepin, 450 N.W.2d 299, 308 (Minn. 1990). The Tax Court's decision is erroneous, and this Court does not defer, where the decision is not reasonably supported by the evidence as a whole, where the Tax Court has clearly misvalued the property, or where the Tax Court has failed to adequately explain its reasoning. Eden Prairie Mall, 2011 Minn. LEXIS at \*21, \*28-29, \*37; Montgomery Ward, 450 N.W.2d at 308; Northwestern Nat'l Life Ins. Co. v. Cnty. of Hennepin, 572 N.W.2d 51, 52 (Minn. 1997).

**II. The Tax Court Erred, as a Matter of Law, By Refusing to Include Any Adjustment For Tenant Improvements in its Valuation Analysis, Contrary to Settled Law, the Evidence in the Record, and its Own Analysis and Findings in an Earlier Decision Valuing the Same Property.**

The Tax Court erred by disregarding tenant improvement expenses when it determined the fair market value of the Meritex property. The Tax Court is required to value all property at its market value. Minn. Stat. Sec. 273.11, subd. 1 (2010). Fair market value for property assessment purposes is the compensation which a willing purchaser not required to buy the property would pay to an owner willing but not required to sell it. See McNeilus Truck & Mfg., Inc. v. Cnty. of Dodge, 705 N.W.2d 410, 413 (Minn. 2005). See also Equitable Life Assurance Soc'y v. Cnty. of Ramsey, 530 N.W.2d 544, 555 (Minn. 1995) ("market value" defined as "the price for which property would sell upon the market at private sale"); Marquette Bank Nat'l Ass'n v. Cnty. of Hennepin, 589 N.W.2d 301, 304 (Minn. 1999) (relevant consideration is "the property's value to buyers in the marketplace").

The fair market value of a property is determined on a fee simple basis, rather than a leased-fee basis. TMG Life Ins. Co. v. Cnty. of Ramsey, 540 N.W.2d 848, 853 (Minn.

1995). The value of rentable space is estimated using market rent levels. Eden Prairie Mall, 2011 Minn. LEXIS 236, \*24. As a matter of black letter law, this requirement of fee simple valuation under generally accepted appraisal principles is because

[a] lease of the property never increases the market value of real property rights to the fee simple estate. Any potential value increment in excess of a fee simple estate is attributable to the particular lease contract, and even though the rights may legally “run with the land,” they constitute contract rather than real estate rights.

The Appraisal Institute, The Appraisal of Real Estate, 447 (13th ed. 2008).

Under these principles, and to value a property as the market would, the Tax Court must treat elements of potential value in the same way buyers and sellers treat them, so that the property is not valued higher (or lower) than the price a willing buyer would pay. In this case, the Tax Court failed to treat tenant improvement expenses in the same way the marketplace would.

Tenant improvements are a rent concession commonly negotiated by the parties in connection with commercial leases. Landlords offer such concessions in order to attract or retain existing tenants. The property owner will negotiate arrangements by which they either make improvements in a tenant’s space to meet their unique needs at their own expense, or pay for an allowance for the tenant to pay for such improvements. See Appraisal Institute, The Dictionary of Real Estate Appraisal, 289-90 (4th ed. 2002); Appraisal Institute, The Appraisal of Real Estate, 480. Regardless of how these improvements are financed, they reduce the net income that the owner receives from the tenant over the term of the lease. Accordingly, a property’s stabilized net operating income should recognize the tenant improvements expectations regarding a property that

are appropriate for the market. Id. This Court has held that when valuing a property under the income approach, the court must adjust for rent concessions, like tenant improvements, that affect future receipts. Eden Prairie Mall, 2011 Minn. LEXIS 236, \*25.

In this case, Meritex appraiser Amundson testified that, in a fee simple analysis, a purchaser of the Meritex property would factor into the price it would be willing to pay for the property an amount based on the fact that it, too, would likely have to pay for tenant improvements when the current lease ended. (See TT, 132:19-133:11). Accordingly, the fee simple purchase price would be adjusted to reflect the buyer's anticipation of the market requirement that such expenses will be incurred on a continuing basis after the purchase. Mr. Amundson determined that a market level of tenant improvements was \$15 per square foot, but that \$5 of that amount would have continued use, and therefore value, after the expiration of the term of the lease. Accordingly, he amortized the tenant improvement expenses that are consumed during the lease (i.e., \$15 per square foot less \$5 per square foot, or \$10 per square foot) over the life of a ten-year lease, and deducted one year's amortized amount as an expense from the operating income projected for the Meritex property. (TT, 103:20-106:8).

Meritex appraiser Amundson's selection of market gross rent as revenue while subtracting tenant improvement expenses from the property's income is effectively consistent with and economically equivalent to a determination of the property's "effective rent." As this Court has explained,

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, or minimum rent stipulated in a lease, over the specified lease term minus rent concessions--e.g., free rent, excessive tenant improvements, moving allowances, lease buyouts, cash allowances, and other leasing incentives.” 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.

Eden Prairie Mall, 2011 Minn. LEXIS 236 at \*24 (citations omitted).

Mr. Amundson’s income capitalization approach properly adjusted for rent concessions, namely tenant improvements, that affect future rent receipts. By starting with a market level of gross rent, less expenses and taxes, a market net rent was essentially determined. After deducting \$10.00 per square foot of tenant improvements, amortized over ten years, the result was the property’s effective income after consideration of rent concessions. This is equivalent to determining the Meritex property’s effective rent, an analysis approved by this Court in determining market levels of rent that take into account the cost of tenant improvements and other concessions. See Eden Prairie Mall, 2011 Minn. LEXIS 236 at \*23-24.

Critically, County appraiser Messner also opined that tenant improvement expenses are present in the market and therefore must be taken into account in the income approach. His shortcoming was the failure to ever estimate what amount of tenant improvements constituted the market level for the subject. Despite full awareness that the nearly \$13 million had been fully spent on the Total Tenant Improvements Costs to the subject property before the assessment dates, Mr. Messner clearly opined that the

subject's value must, in some way, be adjusted to account for periodic replacement of tenant improvements, stating that:

The subject will also incur periodic re-leasing costs in the form of tenant improvements and leasing commissions. Such leasing costs can be deducted as an expense when calculating net operating income. . . . Alternatively, leasing costs can be deducted after NOI has been calculated, in a further estimate of cash flow. . . . Both methods are employed by investors and property managers.

(Ex. I, p. 87). Mr. Messner's statement validates Mr. Amundson's analysis and essentially agrees with the Tax Court's treatment of tenant improvement expenses in its decision valuing the Meritex property as of January 2, 2005. See discussion at pages 14 to 16, *infra*, and on pages 10 to 11, *supra*.

The analysis that adjustments must be made for tenant improvements is consistent with previous holdings of the Tax Court. As the Tax Court explained in Space Center Enterprises, Inc. v. County of Ramsey:

"In a market value appraisal, [forecasts of replacement costs including tenant improvements] must be applied in a manner that reflects the thinking of market participants." The Appraisal Institute, *The Appraisal of Real Estate* 502 (11th ed. 1996). "Direct capitalization is market oriented. The appraiser analyzes market evidence and values property by inferring the assumptions of typical investors." *Id.* at 461. The tenant improvement figure, under standard appraisal practices, represents the amount an owner would have to spend to keep an existing tenant or attract a new tenant. The figure represents the market level of tenant improvements a potential buyer of the property could expect and would factor into his income analysis in deciding whether to buy the property.

1999 WL 1018098 (Minn. Tax Ct., Nov. 4, 1999) at \*5.

Here, the Tax Court failed to follow the analysis of either appraisal expert in this case. The Tax Court also failed to follow generally accepted appraisal practices

incorporated into its own decisions that instruct how tenant improvements must be taken into account in determining the Meritex property's market value. In so doing, the Tax Court's decision also directly contradicts this Court's decision in Eden Prairie Mall. The Tax Court rejected the analysis of Meritex appraiser Amundson, who testified that the cost of tenant improvements should be amortized over the term of a typical lease. It also rejected the testimony of County appraiser Messner, who ultimately opined that tenant improvement costs must be considered by means of an addition to the capitalization rate selected to capitalize anticipated income into value.<sup>6</sup> The Tax Court stated that an adjustment for tenant improvements was improper because "the work was completed and the expenditures made." (Add-18). Both experts directly contradicted such treatment.

If, as the Tax Court ruled here, tenant improvements may no longer be amortized over the term of the lease once they have been completed and the monies spent, then presumably it would have been proper to deduct the full amount of Market Tenant Improvement Costs prior to the years they were actually incurred. But the Tax Court

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<sup>6</sup> Mr. Messner's methodology of accounting for tenant improvement costs by adding basis points to the base capitalization rate is unorthodox, but if it is performed properly, this method can be used to determine an appropriate capitalization rate that takes into account a market level of reserves and tenant improvements. (TT, 147:14-148:17). Mr. Messner did not perform this analysis properly because he made no attempt to even determine an appropriate level of market tenant improvements or reserves when choosing the number of basis points to add to his capitalization rate. (TT, 613:15-616:19, 630:5-12). The testimony of Meritex appraiser Amundson demonstrated how the alternate analysis -- loading the capitalization rate for reserves and tenant improvement expenses -- could be performed more accurately. (Ex. 16; TT, 148:18-155:25). Mr. Amundson's calculations show that a much greater addition to the capitalization rate must be made to account for market levels of reserves and tenant improvements in accordance with Mr. Messner's testimony. (See Add-27 (Ex. 16)).

rejected precisely that approach in its previous decision determining the value of this very property as of January 2, 2005. Rejecting the taxpayer expert's analysis that a little more than \$4 million should be deducted from income to account for a market level of tenant improvements needed to retain a tenant, the court stated that:

[A] lump sum deduction for a tenant improvement which occurs only once in five or ten years skews the direct capitalization method. The issue thus becomes how these tenant improvement expenses should be handled. Since they occur infrequently, it is reasonable to amortize them over a five- or ten- year period of time, with one year's expense being used as a deduction.

Meritex Enters., Inc., 2009 Minn. Tax LEXIS 14, \*24.

The Tax Court's refusal to make any adjustment for tenant improvements after they were completed and paid for is contrary to Tax Court precedent and generally accepted principles of appraisal practice. As this Court noted in Eden Prairie Mall, the Tax Court itself has long recognized that tenant improvements are like other short-lived capital expenses that require replacement from time to time during the economic life of a property. This is accounted for under generally accepted appraisal practices by a "reserve for replacements." Calhoun Square Assoc. LP v. Cnty. of Hennepin, 1990 Minn. Tax LEXIS 101 at \*11 (Minn. Tax Ct. May 9, 1990). In an income-based analysis of market value, such expenses are accounted for, not by deducting the full amount actually expended in the particular tax year, but by determining the amount of all such expenses that have been or are likely to be incurred over the entire useful life of the relevant items (whether or not those expenses have actually been incurred at the time), and deducting one year's amortized share of the total in each year for which market value is being

determined. See generally, Int'l Ass'n of Assessing Officers, Property Assessment Valuation 217-18, 220-24 (2d ed. 1996).

Amortizing tenant improvement expenses also is consistent with the way buyers and sellers of rental real estate treat such expenses. If a potential buyer were considering buying the Meritex property as of any one of the assessment dates in this case, it would not ignore the economic investment in tenant improvements necessary to secure and maintain the existing rental streams. Nor would it rely on only one year's income and expenses as indicative of future cash flows or ignore the cost of tenant improvements anticipated to be incurred in the future.

A potential buyer would consider the amount of time that had passed since the last tenant improvements were completed, the expected life and salvage value of those items, and the amount of time that would pass before a tenant would require new improvements. It would view the cost of those tenant improvements, whenever required, as reducing the effective stream of economic income that it can derive during its ownership from annual income or eventual sale of the subject property, regardless of exactly when during its ownership the tenant improvement expenses will be incurred. The prospective purchaser would not regard the value of the property as being higher or lower in the first year of its potential ownership if the timing of the existing leases deferred the need to incur tenant improvement costs until the second year. Nor would the prospective purchaser regard the property's fee simple value as suddenly increasing in the second year if those costs were paid in the first year, even though the leased fee value likely would increase as a result of tenant improvements being completed and paid.

By ignoring these realities of fee simple interests and the marketplace, the Tax Court failed to value the Meritex property at the “market value” of the fee simple interest as required by Minnesota statutes and the decisions of the Tax Court and this Court. The Tax Court should have adopted Meritex appraiser Amundson’s tenant improvements analysis, which analysis was conceptually validated by Mr. Messner, and which is consistent with Minnesota statutes and the decisions of the Tax Court in other cases, including the Tax Court’s decision determining the 2005 value of the Meritex property. Mr. Messner at no time determined the market level of tenant improvements, but unquestionably confirms that tenant improvements are a reality in the market and must be reasonably adjusted for in the valuation analysis. The Tax Court erred in failing to adjust for tenant improvement expenses in any manner whatsoever in its analysis.

**III. THE TAX COURT ERRED WHEN IT ADOPTED VERBATIM THE VALUATION ANALYSIS AND CONCLUSIONS FOUND ONLY IN THE COUNTY’S POST-TRIAL BRIEFS, WHICH CONCLUSIONS WERE NOT ADEQUATELY EXPLAINED OR REASONABLY SUPPORTED BY THE RECORD AS A WHOLE.**

The Tax Court erred when it adopted verbatim its appraisal analysis and market values for the subject property based on the County’s post-trial modifications to the actual appraisal testimony in the record. Absent an adequate explanation and reasonable factual support in the record, a finding of value is clearly erroneous. Eden Prairie Mall, 2011 Minn. LEXIS 236 at \*37.

In the Eden Prairie Mall case, the Tax Court similarly adopted the analysis and value conclusions, almost verbatim, that were presented only after trial in briefs filed by Hennepin County. Eden Prairie Mall, 2011 Minn. LEXIS 236 at \*15. The Hennepin

County analysis and value conclusions similarly rejected the appraisal analysis of all of the experts who testified at trial and instead substituted Hennepin County's new analysis. Id. This Court determined that the Tax Court erred because it did not adequately explain its reasoning for rejecting the appraisal testimony or the grounds for adopting different assumptions and calculations than had been presented at trial. This Court further found that the Tax Court's conclusions were not reasonably supported by the evidence as a whole. This court accordingly held that the Tax Court erred and the case should be remanded for findings consistent with and reasonably supported by the evidence in the record and any new evidence introduced at remand hearings. Id. at \*37.

The Tax Court's value conclusions in this case, with unsubstantiated increases not reasonably supported by the evidence as a whole, which are parallel to Eden Prairie Mall and determined by the same judicial officer in that case, are clearly erroneous under the standard set forth in Eden Prairie Mall. It was error to adopt verbatim unsupported appraisal analysis and recalculated new values argued after trial by the County containing similar errors and inconsistencies, suggesting that the Tax Court failed to exercise its own skill and independent judgment. More significantly, the appraisal analysis and recalculations argued by the County were not reasonably supported by the evidence of record and resulted in value conclusions significantly higher than the appraisal testimony of the experts. Because the Tax Court failed to adequately explain its reasoning and the evidentiary grounds for rejecting the appraiser testimony, and instead adopted the County's modifications and recalculations without reasonable support in the evidentiary record, the Tax Court's decision is clearly erroneous.

**A. The Tax Court Erred When it Accepted a Parking Income Analysis With No Reasonable Evidentiary Basis.**

The Tax Court relied primarily on the income approach to value in determining the value of the subject property. (Add-24). The Tax Court considered whether net income should be attributed to the subject property for parking revenues collected in connection with parking provided to the subject property by an easement agreement. (Add-15 to 16). While it properly determined that parking income should be attributed to the Meritex property by virtue of the easement, the Tax Court erred in its analysis of how much revenue to add. The amounts the Tax Court determined to be appropriate were wholly unsupported by the evidence.

The Tax Court rejected both appraisers' analysis and opinions about parking income. As a result, the Tax Court's findings about parking income were not adequately explained and supported by the evidence of record. See Eden Prairie Mall, 2011 Minn. LEXIS 236, \*22. Here, the only evidence of record about parking income was the testimony of Meritex appraiser Amundson. County appraiser Messner did not include any analysis of parking income in his appraisal report. (Ex. I, pp. 75 to 82). Nor did he give any testimony concerning whether or in what amount parking income should be included. The income approach in County appraiser Messner's written appraisal report did not include any parking income. (Ex. I, pp. 75-82).

Meritex appraiser Amundson opined that the historical levels of actual parking income and amounts budgeted to be received as a benefit of the easement agreement – information a potential purchaser could actually know when determining what to pay for

the property on January 2 of the assessment year – were the best evidence of the amount of parking income a purchaser would anticipate. (Ex. 1, pp. 35, 42, 44, 46; TT, 214:23-216:15). He projected parking income of \$200,000 in 2007, based upon actual parking income of \$197,719 in 2006. (Ex. 1, p. 42; TT, 215:19-216:9). He determined that an appropriate projection of parking income for 2008 was \$250,000, based upon actual parking income of \$249,973 in 2007. (TT, 214:23-216:15; Ex. 1, p. 44). Using the same reasoning, Amundson opined that a potential purchaser of the property, as of January 2, 2009, would project parking income of \$260,000 for 2009 based upon actual 2008 parking income of \$259,335. (Ex. 1, p. 46).<sup>7</sup>

After trial, the County agreed with Meritex appraiser Amundson that parking income should be included in an income approach to value for the subject property, but argued that the amounts he included were inadequate. (A08 to 09 and A27). Despite a complete lack of evidence to support any parking income projection other than that opined to by Meritex appraiser Amundson, including the identified basis for his anticipated parking income, the County argued that a higher level of parking income, \$264,600 should be attributed to the property for 2007 and both successive years. (A08

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<sup>7</sup> The Tax Court adopted wholesale the County's analysis that incorrectly recited Meritex appraiser Amundson's parking income analysis. That analysis stated, in error, that Amundson calculated parking income by multiplying \$25.00 or \$30.00 by 882 parking spaces, and then applying a 10% vacancy rate. (Add-10). This is squarely incorrect. Had Mr. Amundson used this method, the resulting parking income would have been \$238,140 for 2007 and 2008, and \$285,768 for 2009 (\$25 per month for 882 spaces, less 10% vacancy for 2007 and 2008; and \$30 per month for 2009). In describing Mr. Amundson's analysis, the Tax Court again adopted verbatim the arguments made in the County's post-trial brief rather than correctly identifying the analysis which Mr. Amundson actually used. (See A08 to 09).

to 09). The only evidence of record for parking income is Mr. Amundson's testimony who testified to \$200,000, \$250,000 and \$260,000, respectively.

The County's proposed level of parking income assumes several facts not in evidence. First the County assumed that in each year, all 882 non-visitor parking spaces<sup>8</sup> would be leased each every month. (A08). Then the County assumed that each of those parking spaces would generate \$25.00 that would actually be collected each month, resulting in a projected annual parking income of \$264,600 before vacancy. (A08 to 09).

There is no evidentiary support for either of these assumptions in the trial record. The evidence upon which Meritex appraiser Amundson relied, the actual historical parking income for the property in recent years, shows that \$264,600 in parking income was an excessive, unrealistic and unsupported projection for every assessment year at issue, since the amount of parking income actually collected in 2006, 2007 and 2008 (the years preceding the assessment dates in the present controversy) never reached that level. (See Ex. 1, p. 46). The only support for the County's re-calculation of parking income are unsubstantiated statements in the County's post-trial brief that such amounts "seem[] reasonable" to Hennepin County, a view not expressed by any witness. (A09).

In its written decision, the Tax Court addressed the issue of parking income, but failed to make a specific finding as to the appropriate amount to include when valuing the Meritex property. (Add-15 to 16). The Tax Court's conclusion, however, indicates that

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<sup>8</sup> 882 is the total number of parking spaces required to be made available for lease to tenants and agencies, but does not include spaces required to be provided for visitors to the office building. (Ex. 1, p. 35).

it adopted the entire analysis suggested by the County, including the suggested levels of assumed parking income, when it adopted verbatim the values derived from the modifications to and recalculations of the evidence in the County's post-trial brief. (Add-25; A33). Because the Tax Court failed to adequately explain its own determination about the appropriate amount of parking income, failed to adequately explain its reasoning for departing from the expert testimony of all of the witnesses, identified no evidence in the record to reasonably support the level of parking income urged by the County in its post-trial briefing and there is no such evidence, it was error for the Tax Court to adopt the County's parking income analysis in reaching values for the subject property. See Eden Prairie Mall, 2011 LEXIS 236, \*37.

**B. The Tax Court Erred When it Adopted the Operating Expense Contentions in the County's Post-Trial Brief.**

The Tax Court erred on at least two grounds when it determined the market level of operating expenses for the subject property. First, the Tax Court erred when it adopted expense figures argued only in the County's post-trial briefs and not reasonably supported by the evidence. The Tax Court erred a second time when it adopted, without explanation, the County's ultimate value calculations, which applied another totally different level of operating expenses than even the unsupported expense figures which the Tax Court had earlier and erroneously concluded were correct.

**1. The Tax Court Accepted the County's Market Expense Contentions Which Lack Evidentiary Support.**

The Tax Court erred in its determination of the proper market level of operating expenses for the subject property when it disregarded the experts' opinions about the

appropriate amount of operating expenses, and instead adopted expense amounts found only in the County's post-trial briefing for which there is no reasonable evidentiary support in the record. Furthermore, the Tax Court did not explain why it departed from the experts' opinions or identify any reasonable factual support in the record for its conclusions on this issue. Absent an adequate explanation and reasonable factual support in the record, a finding is clearly erroneous. Eden Prairie Mall, 2011 LEXIS 236, \*37.

In determining the appropriate market level of operating expenses per square foot of rentable area for the subject property, the Tax Court stated that it accepted the "expense figures suggested by Respondent," described as "Mr. Messner's figures of \$5.80 for 2006, \$5.97 for 2007 and \$6.15 for 2008." (Add-17). This is obviously in error because Mr. Messner did not ever testify to these amounts, or to figures even reasonably close to these amounts. These amounts were not the opinion of any witness; the only time that they were proposed was by the County in briefing after trial. Mr. Messner, in fact, testified that the appropriate level of operating expenses for the subject property, measured per square foot of rentable area, was \$5.10 in 2007 and \$5.33 per square foot in 2008 and 2009. (TT, 483:18-4847:7 and 595:19-596:14). The figures the Tax Court refers to (\$5.80, \$5.97 and \$6.15 per square foot) are copied directly from the County's post-trial brief at pages 11 to 12, where the County argues that "it would be reasonable to reduce [Meritex appraiser Amundson's] \$6.00 per square foot figure by 3.3% " to reach

the value of \$5.80 for 2007.<sup>9</sup> The County then extrapolated values for 2008 and 2009 from its recalculated figure for 2007. (A14).

Rather than adopting the actual figures to which Mr. Messner or Mr. Amundson opined at trial, the Tax Court adopted the expense figures suggested by the County in its post-trial brief as the level of market expenses for the subject property on the assessment dates. (Add-17). In so doing, the Tax Court did not explain why it departed from both of the experts to agree with the figures first presented by the County in its post-trial briefing, nor did it point to any evidentiary support for its conclusion. (Add-17). It was error to adopt the County's suggested expense figures because there is no evidence in the record to support them.

**2. The Tax Court Did Not Apply the Expense Figures That It Found Were Appropriate.**

After concluding that the County's unsupported post-trial suggestions for levels of market operating expenses for the subject property were appropriate, the Tax Court then failed to consistently apply those operating expenses. The Tax Court departed from its own stated expense conclusions by adopting the ultimate conclusions of value found in the Pro Forma Operating Statements in the County's post-trial brief, and by unmistakable implication, the operating expense figures contained therein. Those expense figures are

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<sup>9</sup> There is also no reasonable support in the record for the determination that "it would be reasonable to reduce" Mr. Amundson's market supported expenses by 3%. (See A14).

different than the figures the County had argued earlier in its post-trial brief, and which Tax Court held were appropriate for 2007,<sup>10</sup> 2008<sup>11</sup> or 2009.<sup>12</sup>

The Tax Court did not explain why it adopted the County's ultimate calculations of value for the property, particularly when those calculations used different operating expense assumptions than those the Tax Court had determined were appropriate. Nor did the Tax Court explain the factual basis for its conclusions that \$5.80, \$5.97 and \$6.15 were appropriate expense figures. In adopting verbatim the County's proposed analysis and values, the Tax Court failed to exercise its own skill and judgment, and failed to apply the expense findings that it had previously determined were correct. Absent an adequate explanation for the expenses adopted, or for the departure from the findings regarding expenses, and without any evidentiary support for the Tax Court's analysis and determinations, the Tax Court's value conclusions are clearly erroneous. Eden Prairie Mall, 2011 LEXIS 236, \*37.

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<sup>10</sup> The County argued at page 17 of its post-trial brief, that 2007 operating expenses should be \$1,551,158 ( $\$5.80 \times 267,441$  square feet) and the Tax Court agreed with this figure. (A19; Add-17). But in the Pro Forma Operating Statement for January 2, 2007, the results of which the Tax Court adopted verbatim as its ultimate value conclusion for 2007, a different amount was used for operating expenses: \$1,540,946. (A28; Add-25).

<sup>11</sup> At page 18 of its brief, the County argued that 2008 operating expenses should be \$5.97 per square foot or equivalent to \$1,596,623 ( $\$5.97 \times 267,441 = \$1,596,623$ ), and the Tax Court agreed. (A20; Add-17). But in the Pro Forma Operating Statement for January 2, 2008, the results of which the Tax Court again adopted verbatim as its value conclusion, the County used a different figure: \$1,610,898. (A29; Add-17).

<sup>12</sup> For 2009, the County argued at page 18 of its post-trial brief, that operating expenses should be \$6.15 per square foot, or \$1,644,762 ( $\$6.15 \times 267,441 = \$1,644,762$ ). The Tax Court agreed the \$6.15 was the appropriate figure. (A20; Add-17). But in the Pro Forma Operating Statement for January 2, 2009, the results of which the Tax Court adopted as its value conclusion, the County used a lower figure: \$1,610,989. (A29).

**C. The Tax Court's Attempt to Distinguish its 2005 Valuation of the Same Meritex Property at \$13,200,000 Is Not Reasonably Supported by the Evidence.**

At the close of its decision, the Tax Court addressed Meritex's argument that the Tax Court should not adopt the values argued by the County after trial, which were nearly double the Tax Court's determined value as of January 2005, because such a result would be inconsistent with not only the court's prior decision, but would also be inconsistent with the evidence actually found in the record and contrary to generally accepted appraisal principles. (See Add-24 to 25). The section of the Tax Court's decision titled "Prior Property Tax Decision" is a nearly word-for-word reproduction of the opening paragraph of the County's Post-trial Reply Brief. (See Add-24 to 25; A34 to 35). In this section echoing the County's brief, the Tax Court attempted to justify its near-doubling of the property's value from its recent decision by reference to three facts: a sale of the property in 2007, a "new" lease and its required tenant improvements, and the "strengthening" of the office market in the Twin Cities from 2005 to 2008. (Add-24 to 25). The justifications identified by the Tax Court, and which were derived directly from the County's post-trial brief, do not withstand scrutiny when compared with the evidence of record.

**1. The Tax Court Improperly Relied Upon the Unadjusted Sales Price From a Leased-Fee Package Sale of Property Interests, Including the Subject Property, Contrary to the Evidence as A Whole.**

In holding that a December 2007 sale of the Meritex property supports the concluded values for the subject property, the Tax Court disregarded all of the evidence in the record about this sale.

Meritex appraiser Amundson performed a detailed analysis of this sale of the property, which was a sale of the leased-fee interest in the subject property (together with a portfolio of other properties as well), which is significantly different from and much more valuable than the fee simple interest in the subject property alone which the Tax Court is legally required to value under Chapter 278. (See Ex. 1, p. 50). After adjusting the \$36,000,000 sales price to account for numerous factors, including the date of the sale, above-market tenant improvements purchased, parking revenue, operating expense savings, capitalization rate differences, above-market vacancy figures, and the letter of credit as security for the property tax guarantee, Amundson concluded that the sales price from the December 2007 leased fee transaction indicated a fair market value for the fee simple interest in the subject property in an amount between \$10,385,603 and \$17,381,208. (Ex. 1, p. 50).

On the other hand, County appraiser Messner testified that he could not even attempt to reconcile the December 2007 sales price with the fair market value of the subject property as of any of the assessment dates, despite the fact that the Uniform Standards of Appraisal Practice require such a reconciliation. (TT, 249:1-14). Messner

concluded that this sale was not a “market transaction,” and that appropriate adjustments to this sales price could not be made to indicate a fair market value for the fee simple interest in the subject property. (Ex. I, p. 5; TT, 400:10-401:1).

The Tax Court rejected the analysis of both experts about this December 2007 leased fee transaction. Even though Mr. Messner concluded that it could not be used to indicate a fee simple value for the Meritex property, and even though Mr. Amundson performed a detailed analysis in accordance with generally accepted appraisal practices that showed the sale supported a much lower market value on a fee simple basis, the Tax Court adopted the argument from the County’s brief and held that the unadjusted \$36,000,000 sales price supported its concluded values. Because the Tax Court provided no explanation of how a leased-fee sale of the property (in a package sale with other properties and non-taxable interests included) could support the concluded market values, and disregarded the only evidence of record adjusting this sales price to indicate a much lower market value, this finding is clearly erroneous.

**2. The Tax Court’s Reliance on the “New” DHS Lease and the Total Tenant Improvements Required Thereunder to Justify an Increase in the Fee Simple Value Does Not Find Reasonable Support in the Evidentiary Record and Contradicts its Previous Decision Valuing the Same Meritex Property Just Two Years Earlier.**

The Tax Court’s reliance on the Meritex property being “subject to a new 10-year lease on January 1, 2006” (Add-26) is not reasonably supported by the evidence in the record and is highly inconsistent with the Tax Court’s earlier decision valuing the property. The Tax Court relied on the very same DHS Lease when determining the

appropriate level of market rent for the subject property as of January 2, 2005. Meritex Enters., 2009 Minn. Tax. LEXIS 14, \*14 to \*16. This same lease required, as a condition of the rents agreed to be paid, that Meritex commit to spend nearly \$14 million for Total Tenant Improvement Costs to renovate and improve the property to DHS's specifications. Id. at \*6. The amount of those anticipated Total Tenant Improvement Costs was taken into account in the negotiated rental rates in the DHS Lease, and the Tax Court was fully aware of the impact of those negotiated rental rates and anticipated Total Tenant Improvement Costs when it valued the Meritex property at \$13,200,000 as of January 2, 2005. Since the existence of the same DHS Lease, the rental rates agreed to be paid pursuant to it, and the nearly \$14 million in Total Tenant Improvement Costs required under the DHS Lease were all known and considered when the Tax Court valued the property as of 2005, for the Tax Court to refer to these identical factors as "new" and as justifying a near doubling of the \$13,200,000 fee simple value, finds no reasonable support in the evidentiary record and is erroneous in light of the Tax Court's earlier decision.

In the previous decision the Tax Court determined that approximately \$4 million of the \$14 million<sup>13</sup> Total Tenant Improvement Costs were appropriately considered when determining the fee simple real estate value; the remaining \$9 million spent was of value to the tenant (DHS), but not related to the fee simple value of the real estate.

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<sup>13</sup> The Tax Court found that the Total Tenant Improvement Costs would exceed \$14 million in its decision valuing the Meritex property as of January 2, 2005. Meritex, 2009 Minn. Tax LEXIS 14, \*6.

Consequently, if the \$4 million in real estate related Market Tenant Improvements were added to the Court's value of \$13.2 million as of January 2, 2005, and resulting adjustments made for the additional two years' age of those improvements, the resulting value closely approximates and affirms Mr. Amundson's value of \$16.6 million as of January 2, 2007.

**3. The Tax Court's Reliance on a "Strengthening Office Market" To Nearly Double the Meritex Property's Value Is Not Reasonably Supported by the Evidence.**

As part of its justification of the near-doubling of the Meritex property's taxable value reached in its prior decision, the Tax Court stated that the tenant improvements, the leased-fee sale and the new lease, ". . . coupled with a strengthening of the office market in the Twin Cities area between 2005 and the second half of 2008, support our valuations of the Subject Property." (Add-24 to 25). This rationalization, here too, taken verbatim from the County's post-trial reply brief (see A35), does not have reasonable support in the record.

First, in its findings of fact the Tax Court determined that the Meritex property's competitive market included Saint Paul's Lafayette Park neighborhood and the Saint Paul CBD, not the entire "Twin Cities area" identified in this section of the Court's written decision. (See Add-7). The Meritex property's competitive market was not on the upswing from 2005 to 2008. In fact, both net rents and gross rents for competitive Class B office properties in Saint Paul decreased during that time period. (See Ex. 6 at p. 11). Even more tellingly, the rental rates achieved in Lafayette Park itself were declining. Between 2002 and 2009, a number of leases renewed in Lafayette Park at rates

significantly lower than the rates agreed to in earlier leases for the same property. (See TT, 34:7-37:2; Add-26 (Ex. 8)). Any nominal improvement in occupancy rates in Saint Paul was largely attributable to two properties being removed from the universe of the office market in 2008, not from an increase in occupied office space or a strengthening of demand in the Saint Paul office market. (See Ex. 7 at p. 8). The undisputed evidence of decreasing rents and steadily high vacancy in the Saint Paul office market does not support the Tax Court's conclusion that the Meritex property's market was strengthening.

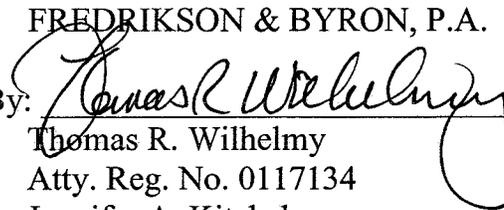
### CONCLUSION

The Tax Court's near doubling of the taxable value of the Meritex property, as compared with the Tax Court's recent decision valuing it just two years earlier, is clear error and without reasonable support in the evidentiary record. By adopting verbatim post-trial arguments without explanation or reasonable basis in the record, the Tax Court erred, and its decision should be reversed.

Respectfully submitted,

FREDRIKSON & BYRON, P.A.

Dated: July 7, 2011

By: 

Thomas R. Wilhelmy

Atty. Reg. No. 0117134

Jennifer A. Kitchak

Atty. Reg. No. 0317056

200 South Sixth Street, Suite 4000

Minneapolis, MN 55402-1425

Telephone: (612) 492-7000

Facsimile: (612) 492-7077

ATTORNEYS FOR 444 LAFAYETTE, LLC  
AND MERITEX ENTERPRISES, INC.

STATE OF MINNESOTA

IN SUPREME COURT

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444 Lafayette, LLC and  
Meritex Enterprises, Inc.

**CERTIFICATION OF BRIEF LENGTH**

Relators,

v.

Supreme Court No. A11-1014

County of Ramsey,

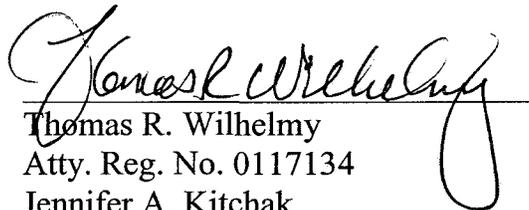
Respondent.

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I hereby certify that this brief conforms to the requirements of Minn. R. Civ. App. P. 132.01, subs. 1 and 3, for a brief produced with a proportional font. The length of this brief is 8,912 words. This brief was prepared using Microsoft Word 2003.

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FREDRIKSON & BYRON, P.A.



Thomas R. Wilhelmy  
Atty. Reg. No. 0117134

Jennifer A. Kitchak  
Atty. Reg. No. 0317056

300 South Sixth Street, Suite 4000  
Minneapolis, MN 55402  
(612) 492-7000

Attorneys for Relators 444 Lafayette, LLC  
and Meritex Enterprises, Inc.