

A12-0963

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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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**RESPONDENT'S BRIEF**

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## LEGAL ISSUE

**Did the Tax Court, on remand, explain the reasons for its findings and state the factual basis in the record for its determination of the market value of the Subject Property and were its findings based on the evidence presented by the experts?**

**Result below:** The evidence presented to Tax Court included an appraisal report and testimony from Relators' appraiser, Mr. Amundson, and from Respondent's appraiser, Mr. Messner. Both appraisers relied primarily on the income approach to value. The Tax Court evaluated the evidence and determined that Mr. Messner's appraisal was more persuasive on most aspects of the income approach to value. The Tax Court adopted those aspects of the income approach from Mr. Messner's appraisal and testimony, including selection of capitalization rates and allowance for tenant improvements as part of the capitalization rate rather than as an above the line expense. The Tax Court found Mr. Amundson's vacancy rate to be more appropriate and used that vacancy rate in its calculation of value under the income approach. In addition, the Tax Court agreed with Mr. Amundson that income attributable to the property by virtue of an easement for parking on adjacent property should be added to the property's income. Taking these components of the income approach directly from both appraisers' appraisals and testimony, the Tax Court's calculation under the direct capitalization approach concluded to a value that was higher than either appraiser had concluded to at trial. Throughout its Order, the Tax Court identified which appraisal report it was using in its calculations, and it explained why it chose elements of one report over another.

Relators have preserved this issue for appeal by petitioning the Supreme Court for certiorari pursuant to Minn. Stat. § 271.10, subd. 1 (2010).

**The most apposite cases:** Eden Prairie Mall v. County of Hennepin, 797 N.W.2d 186 (Minn. 2011); Janssen v. Best & Flanagan, LLP, 704 N.W.2d 759 (Minn. 2005).

## STATEMENT OF THE CASE

Meritex Enterprises, Inc. and 444 Lafayette, LLC (“Relators”) brought this litigation jointly to contest the assessed values for January 2, 2007, January 2, 2008 and January 2, 2009 for property tax purposes for the office building located at 444 Lafayette Road in Saint Paul, Minnesota (“Subject Property”).

Trial commenced before the Honorable Judge Sheryl A. Ramstad at the Minnesota Tax Court on December 6, 2010 and concluded on December 22, 2010. Both Relators and Respondent presented expert appraisals regarding the valuation of the Subject Property. Relators’ expert, Michael F. Amundson, MAI, testified that the fair market value of the Subject Property was \$16,600,000 as of January 2, 2007; \$16,300,000 as of January 2, 2008; and \$13,800,000 as of January 2, 2009. Respondent’s expert, Jason L. Messner, MAI, testified that the fair market value of the Subject Property was \$23,900,000 as of January 2, 2007; \$25,000,000 as of January 2, 2008; and \$21,000,000 as of January 2, 2009. The parties filed post-trial briefs as scheduled at the close of trial.

In its Findings of Fact, Conclusions of Law, and Order for Judgment dated April 7, 2011, the Tax Court increased the assessor’s estimated market value of the Subject Property from \$22,500,000 to \$26,164,000 as of January

2, 2007, and from \$22,500,000 to \$27,420,000 as of January 2, 2008; and reduced the assessor's estimated market value from \$22,500,000 to \$22,094,000 as of January 2, 2009. Relators appealed the decision of the Tax Court to this Court. On January 25, 2012 this Court issued its reversal, finding that the Tax Court's "findings and conclusions fail to meet the standard we articulated in *Eden Prairie Mall.*" 444 Lafayette v. County of Ramsey, 811 N.W.2d 106, 108 (Minn. 2012). This Court remanded the case to the Tax Court to hold further proceedings and to give that court the opportunity to explain its reasoning and to point out the factual basis in the record for its determination of value. This Court deferred to the Tax Court to determine whether to reopen the record on remand.

Upon remand, on February 1, 2012 the Tax Court issued an Order requiring both parties to answer specific questions with regard to 1) any typographical errors<sup>1</sup> there may have been in the original Order, 2) any findings in the original Order that were outside the range of the testimony of the appraisers, and the position of the parties with regard to 3) parking income, 4) net operating income and 5) the calculation of value using that net operating income. After further briefing by both parties, the Tax Court

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<sup>1</sup>Contrary to this Court's statement (444 Lafayette, LLC v. County of Ramsey, 811 N.W.2d 106 at 107), neither party found any typographical errors in the April 7, 2011 opinion related to the County's post-trial arguments.

concluded that the value of the property was \$25,100,000 as of January 2, 2007, \$26,000,000 as of January 2, 2008 and \$22,500,000 as of January 2, 2009.

In its decision on remand the Tax Court relied primarily on the income approach, as had both appraisal witnesses. However, the Tax Court did not accept either expert's methodology in its entirety. The Tax Court found Mr. Messner's testimony more persuasive on most issues and drew significantly from his appraisal, but modified it by using Mr. Amundson's vacancy rates and by attributing additional income from a parking easement based on the parking easement information in Mr. Messner's appraisal and testimony from Mr. Amundson regarding market rates for parking contracts. As a result of this composite analysis, the Tax Court concluded to market values that were higher than either expert's value conclusions, although all of the elements of the Tax Court's valuation of the Subject Property were taken from evidence presented by the appraisers in the record.

On April 5, 2012 the Tax Court issued its Order on Remand, and on April 10, 2012 an Amended Order on Remand was issued to correct an error in the April 5 Order. A Writ of Certiorari was obtained for review of the Order and Amended Order on June 4, 2012.

## STATEMENT OF FACTS

This case addresses the value of an office property built in the early 1900s and located at 444 Lafayette Road in St. Paul, Minnesota. Relators' Addendum at 29 (hereinafter "Rel. Add. \_\_"). The Subject Property has a gross building area of 329,711 square feet. Rel. Add. 33.

The Subject Property has been used as office space since its renovation in 1986 and, during that entire time, has been leased to the State of Minnesota without any vacancy. Rel. Add. 30. In 2005, Meritex Enterprises, Inc. ("Meritex") executed a ten-year lease with the Department of Human Services. Rel. Add. 34. As part of the negotiation over this lease, Meritex agreed to remodel the Subject Property at a cost of almost \$13,000,000 over the course of 2005, 2006, and 2007. Rel. Add. 29; 34. In December 2007, Meritex sold the Subject Property, along with several parking parcels, to 444 Lafayette, LLC for \$36,000,000. Rel. Add. 34. There are no parking spaces located on the Subject Property, but a Reciprocal Easement Agreement provides 966 employee parking spaces and 13 visitor/delivery parking spaces to the Subject Property from an adjoining parcel. Rel. Add. 30; Respondent Exhibit I at 113 (hereinafter "Resp't. Ex. I at \_\_") (Oct. 27, 2010); Trial Transcript pp. 324:6-7, Dec. 7, 2010 (hereinafter "Tr. \_\_: \_\_").

To determine the taxes payable in 2008, 2009, and 2010 the Ramsey County Assessor estimated the Subject Property's value to be \$22,500,000 for

the 2007, 2008, and 2009 assessments. Rel. Add. 30; 33. On December 6, 7, 15, and 22, 2010, the Minnesota Tax Court held a trial wherein Relators and Respondent presented appraisals and testimony from their appraisers regarding the value of the Subject Property. Rel. Add. 28; 32.

Though the appraisers used various appraisal methods, both appraisers and the Tax Court relied primarily on the income capitalization method as the most accurate method for determining the value of the Subject Property. Rel. Add. 58. This method involves determining the net operating income of a given property and then dividing it by the appropriate capitalization rate. Rel. Add. 36. The appraisers differed in their calculations of the Subject Property's net operating income as well as the applicable capitalization rates. Rel. Add. 37; 50-52.

In determining the net operating income of the Property, Mr. Amundson and Mr. Messner differed in their calculations of market rent, market vacancies, and market expenses. Rel. Add. 37-41; 43-47. Also, Mr. Amundson included parking income derived from the Subject Property's 882 leased parking spaces. Rel. Add. 41. Mr. Messner recognized the presence of the parking spaces, but failed to include the parking income they could generate in his net operating income calculation. Rel. Add. 41-42; Tr. 361:23-62:1; Tr. 364:25-65:4.

The appraisers also differed in their treatment of tenant improvements and replacement reserves. Rel. Add. 48-49. Mr. Amundson subtracted these costs as expenses each year. Rel. Add. 48. In contrast, Mr. Messner did not treat tenant improvements as an appropriate operating expense in determining net operating income because the sales from which he derived his capitalization rate similarly did not subtract tenant improvements from the property's operating income to arrive at net operating income. Rel. Add. 48-49.

The appraisers also differed in their estimates of the appropriate capitalization rates. Rel. Add. 50. Mr. Amundson used capitalization rates of 8.00% for 2007 and 2008, and 9.00% for 2009. Rel. Add. 51. Mr. Messner used a capitalization rate of 7.00% for 2007. Rel. Add. 52. He increased this by 50 basis points to account for tenant improvements and other leasing costs because he had excluded these costs from his calculation of net operating income, thus resulting in a capitalization rate of 7.50% for 2007. Rel. Add. 52. Applying the trends found within the Korpacz survey, he determined that the appropriate capitalization rates were 7.25% for 2008 and 8.25% for 2009. Rel. Add. 52. When adjusted for taxation, these amounts became 10.74%, 10.42%, and 11.50% respectively. (Rel. Add. 53-54). Further, because the roof was repaired in 2010 at a cost of \$213,389, and a potential buyer in 2007, 2008,

and 2009 would have anticipated this cost, Mr. Messner deducted \$215,000 from his estimates of final value for all three years. Rel. Add. 49.

In its Order on Remand, the Tax Court began its income approach with a determination of market rents. Rel. Add. 36. The Tax Court found Mr. Messner's indication of market rents to be more supported by the record. Rel. Add. 40-41. To those rents, the Tax Court added the market level of parking income per parking space, based on Mr. Amundson's testimony, for the number of parking spaces allocated to the property by a Reciprocal Easement Agreement, as documented in Mr. Messner's Appraisal Report. Rel. Add. 42-43; Resp't. Ex. I at 113. The Tax Court changed its earlier finding regarding the vacancy rates and on remand adopted Mr. Amundson's vacancy rates. Rel. Add. 45; 53-54. The Tax Court found Mr. Messner's operating expenses to be more persuasive, based on analysis of the evidence presented. Rel. Add. 47. The Tax Court found the testimony of Mr. Messner more persuasive with regard to treating tenant improvement allowances and reserves for replacements as below-the-line expenses, and found that approach was consistent with the studies used by both appraisers in determining the appropriate capitalization rate. Rel. Add. 49. As a result, the Tax Court computed Net Operating Income for the assessment years at issue based on the factors noted above. Rel. Add. 50.

The Tax Court found Mr. Messner's selection of real estate tax loaded capitalization rates to be more persuasive, based on analysis of the evidence presented. Rel. Add. 52. Capitalizing the Net Operating Income as determined above by these rates, and then deducting for a roof replacement expense based on Mr. Messner's methodology, the Tax Court concluded on remand to values that were higher than either appraiser had individually reached at trial. Rel. Add. 53-54. However, the support for the Tax Court's conclusions on remand was taken directly from the appraisers' facts and opinions presented at trial and those facts and opinions were referenced in the Tax Court's Memorandum.

The Tax Court examined the reports of both appraisers and listened to trial testimony regarding their appraisals. The Tax Court, relying primarily on the income approach to value, concluded that the Subject Property had a market value of \$25,100,000 on January 2, 2007, \$26,000,000 on January 2, 2008, and \$22,500,000 on January 2, 2009. (Rel. Add. 61).

## ARGUMENT

### I. Standard of Review

This Court reviews a final order of the Tax Court to determine whether the Tax Court lacked jurisdiction, whether the order is supported by the evidence and is in conformity with the law, and whether the Tax Court committed any other error of law. Southern Minnesota Beet Sugar Coop v.

County of Renville, (“SMBSC”) 737 N.W.2d 545, 551 (Minn. 2007), *citing* Hutchinson Tech., Inc. v. Comm’r of Revenue, 698 N.W.2d 1, 6 (Minn. 2005); Jefferson v. Comm’r of Revenue, 631 N.W.2d 391, 394 (Minn. 2001). Legal determinations are subject to de novo review while factual findings are subject to a “clearly erroneous” standard. SMBSC, 737 N.W.2d at 551, *citing* Hutchinson Tech., 698 N.W.2d at 6; 200 Levee Drive Ass’n v. County of Scott, 532 N.W.2d 574, 576 (Minn. 1995).

In Equitable Life Assurance Society of the United States v. County of Ramsey, 530 N.W.2d 544, 552 (Minn. 1995), this Court set forth the clearly erroneous standard as occurring when the Tax Court’s decision is “not reasonably supported by the evidence as a whole.” In State v. Evans, 756 N.W.2d 854, 870 (Minn. 2008), *citing* Fletcher v. St. Paul Pioneer Press, 589 N.W.2d 96, 101 (Minn. 1999), this Court held that it “give[s] great deference to a district court’s findings of fact and will not set them aside unless clearly erroneous.” In other words, if there is “reasonable evidence to support the [district] court’s findings of fact,’ we will not disturb those findings.” Id., *quoting* Fletcher, 589 N.W.2d at 101. Additionally, this Court has held that it defers to the decision of the Tax Court, due to the “inexact nature of property assessment,” unless the Tax Court either clearly overvalued or undervalued the subject property, or completely failed to explain its

reasoning. Equitable Life, 530 N.W.2d at 552, *citing* Harold Chevrolet v. County of Hennepin, 526 N.W.2d 54, 58 (Minn. 1995).

In Janssen v. Best & Flanagan, LLP, 704 N.W.2d 759, 763 (Minn. 2005), *citing* John Wright & Assocs. v. City of Red Wing, 97 N.W.2d 432, 434 (Minn. 1959), this Court held that “district courts are given broad discretion to determine how to proceed on remand, as they may act in any way not inconsistent with the remand instructions provided.” Additionally, in considering a trial court’s compliance with remand instructions, this Court applies the deferential abuse of discretion standard. *Id.*, *citing* Halverson v. Village of Deerwood, 322 N.W.2d 761, 766-67 (Minn. 1982).

**II. The Tax Court’s decision on remand regarding the value of the Subject Property is “reasonably supported by the evidence as a whole” and the Tax Court explained its reasoning.**

The Tax Court properly exercised its discretion when on each element of its analysis it found one appraisal more persuasive than the other. *See* Weed v. County of Fillmore, 630 N.W.2d 419 (Minn.) at 425. When coming to a conclusion about the value of a property, the Tax Court is not bound by the estimations of either appraiser. Eden Prairie Mall, 797 N.W.2d at 193. Instead, the court may draw its own conclusions after evaluating the evidence presented at trial. Equitable Life, 530 N.W.2d at 558. *See also* Kmart Corp. v. County of Becker, 709 N.W.2d 238, 243 (Minn. 2006) (holding that the Tax Court did not err when it arrived at a different valuation than

that expressed by either appraiser). The Tax Court may even come to a valuation higher than the submitted appraisals, as long as it “adequately explains its reasoning and its determination is supported by the factual record.” Eden Prairie Mall, 797 N.W.2d at 194.

The method of determining value given the most weight by both appraisers in this case was the direct capitalization approach. Relators’ Exhibit 1 at 28-47 (hereinafter “Rel. Ex. 1 at \_\_\_”); Resp’t. Ex. I at 75-94. Determining the value of a building from direct capitalization involves dividing the net operating income of the property by its capitalization rate. Appraisal Institute, The Appraisal of Real Estate at 501 (13th ed. 2008).<sup>2</sup> Net operating income is the “actual or anticipated net income that remains after all operating expenses are deducted from gross income, but before debt service and book depreciation are deducted.” Eden Prairie Mall, 797 N.W.2d at 195 (citing The Appraisal of Real Estate at 457). When the court is presented with differing expert testimony regarding sources of income, it must reconcile those differences using the evidence presented. Equitable Life, 530 N.W.2d at 558.

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<sup>2</sup> Though this edition was published in 2008, this authoritative reference work is a compilation of developing appraisal techniques and would encompass best practice appraisal methods that were in use in 2007. See Appraisal Institute, The Appraisal of Real Estate Foreword. This is the edition referenced by the Tax Court in its Order on Remand. See Rel. Add. 35; 44; 48; 57.

The expert opinions differed regarding the market rent, the use of income derived from parking, the level of market expenses, the vacancy rate, whether tenant improvements should be included when calculating net operating income, and, finally, the appropriate capitalization rate to use to derive an estimate of value. The Tax Court reconciled all of these disputes by examining the facts presented in the record, assessing the credibility of the expert appraisers and explaining its reasoning.

The Tax Court found Respondent's appraiser to be more persuasive on numerous issues. *See* Rel. Add. 40 (regarding market rent); Rel. Add. 47 (regarding operating expenses); Rel. Add. 48-49 (regarding replacement reserves and tenant improvements); Rel. Add. 52 (regarding capitalization rate selection). That conclusion was drawn after the court had an opportunity to review the appraisals submitted and to hear and observe the expert appraisers as they testified. This Court has recognized that the Tax Court "is in the best position to evaluate the credibility of witnesses." Dreyling v. Comm'r of Revenue, 711 N.W.2d 491, 494 (Minn. 2006) (*citing* Manthey v. Comm'r of Revenue, 468 N.W.2d 548, 550 (Minn. 1991)); (Lewis v. County of Hennepin, 623 N.W.2d 258, 262 (Minn. 2001) (*citing* F-D Oil Co. v. Comm'r of Revenue, 560 N.W.2d 701, 706 (Minn. 1997)). Because the value conclusions of the Tax Court are based on the record and the Tax Court adequately explained how it arrived at those conclusions in a manner consistent with

accepted appraisal methodology, the Tax Court's valuations were not clearly erroneous and should be affirmed.

**1. The Tax Court's finding of market rent is supported by the record and the court explained its reasoning.**

Income from rent must be derived from the market, taking into account the conditions and restrictions of the typical lease agreement. Eden Prairie Mall, 797 N.W.2d at 195. Here, the Tax Court was presented with two different opinions of what constituted market rent for the Subject Property. (Rel. Add. 38-39). The Tax Court explained that it adopted Mr. Messner's estimations of market rent because rents of the Subject Property and comparable properties in Lafayette Park, as well as statistics regarding rents provided in Mr. Amundson's appraisal, "more closely support Mr. Messner's determinations of market rent for office space." Rel. Add. 38-40. The Tax Court cited to the appraisal reports and the transcript to support the data it reviewed and relied on to arrive at its conclusion. Rel. Add. 38-40.

The Tax Court analyzed the appraisal and testimony of both appraisers and found Mr. Messner's use of \$6.00 per square foot rent for storage space to be reasonable. Rel. Add. 40. It cited to the appraisal report and transcript to support that conclusion. Rel. Add. 40. Further, the Tax Court found that Mr. Amundson had failed to account for the rising cost of storage space in the Subject Property's neighborhood. Rel. Add. 40-41.

**2. The Tax Court's finding of parking income is supported by the record and the court explained its reasoning.**

The Tax Court correctly determined that, as a matter of law, when a subject property is benefited by a parking easement, the value of the parking spaces on the burdened property “should be added to the Subject Property.” Rel. Add. 42; Alvin v. Johnson, 63 N.W.2d 22, 25 (Minn. 1954) (stating that “in assessing the plaintiff’s property, it was the assessor’s duty to take into consideration the additional value the property had by reason of the easement appurtenant.”). That conclusion is supported by Mr. Amundson’s testimony that it is the parking *easement* that “transfers value from those sites [with the parking lots] to this parcel.” Tr. 23:15-20.

The value transferred pursuant to that easement agreement is measured by the Subject Property’s right to the potential income from 979 parking spaces. Resp’t. Ex. I at 113; Tr. 324: 6-7. That right exists if the owner of the Subject Property chooses to lease those spaces to employees or to tenants of other buildings in the area, or even if it chooses to retain the parking spaces for use by the Subject Property’s tenants without compensation. The right to income is not transferred by a lease agreement. When the owner of the Subject Property leases parking spaces from another owner in addition to those to which it is entitled by the easement agreement, it does not obtain additional property rights. The Subject Property’s right to income from the

parking spaces is not increased or decreased if, for a given year, the owner negotiates to have the right to receive income from parking spaces assigned to another building by the easement agreement. For example, Mr. Amundson's appraisal notes that the Subject Property had 1,042 parking spaces under its control, presumably due to lease agreements with the neighboring buildings. Rel. Ex. 1 at 35. Mr. Amundson based his projection of income from parking on the recent history of rent collected under those lease agreements. Tr. 56:2-4; Rel. Ex. 1 at 35, 42, 44, & 46. But the Subject Property's potential income from parking spaces under the income approach to value is defined as the income that could be generated by the rights in the Subject Property's bundle of rights, including the parking rights transferred to the Subject Property by the easement. That is the starting point for the value calculation of both appraisers, *i.e. potential* gross income. Appraisal of Real Estate at 457; Rel. Ex. 1 at 42, 44 & 46; Resp't. Ex. I at 76-82. Potential market income is not necessarily the same as actual income generated by any given lease. As Mr. Amundson testified "There are two agreements. The reciprocal easement, burdens those parcels regardless to what the negotiated rent is for parking." Tr. 214:10-22. Thus, Mr. Amundson erred when he used actual collected revenue from 1,042 parking spaces that were leased for the most recent year. The Tax Court correctly followed the law and proper appraisal methodology, and is supported by the record, when it imputed

potential income from the 979 parking spaces provided by the easement agreement.

The imputed rent attributable to the Subject Property is to be determined at market levels. Eden Prairie Mall, 797 N.W.2d 186, 195 (Minn. 2011), *citing Appraisal of Real Estate* at 453. The Tax Court adopted Mr. Amundson’s testimony that the market rents were \$25 per space as the only evidence in the record regarding market levels for parking income and applied it to the 979 parking spaces allocated to the subject property under the easement agreement.<sup>3</sup> Rel. Add. – 42-43; *See also*, Tr. 64:25 – 65:1; *See Kmart*, 709 N.W.2d at 242-3 (holding that the Tax Court did not err when it used evidence presented by Kmart’s appraiser to arrive at a final value higher than that reached by the same appraiser).

Because the Tax Court added the imputed parking income to the Subject Property’s market rents as part of its total potential gross income, the parking income was also subject to the vacancy/credit loss adjustment made by the Tax Court in its income approach analysis. The result is to arrive at a potential *net* income derived from both the building and the parking lot. Had

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<sup>3</sup> While the Tax Court incorrectly describes the 979 parking spaces allocated to the Subject Property as “contracts in place” in footnote 30 of its April 5 Order on Remand (Rel. Add. 16), it correctly used income from all parking spaces allocated to the Subject Property by the easement agreement as income from *potential* contracts. That is the correct methodology under Alvin v. Johnson and The Appraisal of Real Estate.

the Tax Court subtracted a vacancy/credit loss allowance from the potential gross parking income and then added that net amount to the building potential gross income, the subsequent deduction for vacancy in the income analysis would have been making a *double* deduction with regard to the parking income. That is precisely the error Mr. Amundson made, and the reason the Tax Court rejected his treatment of parking income. Rel. Add. 42 (stating that “[Mr. Amundson] applied a 10% vacancy factor to the parking income despite the fact he used actual parking income which would have already accounted for the actual vacancy factor. In other words, he applied vacancies twice to the parking income”); See Rel. Ex. 1 at 42, 44, & 46 (The *actual* revenue collected is used to project Potential *Gross* Parking Income); Tr. 215:8-12; Tr. 217:9-19.

Because the Tax Court’s treatment of parking income is supported by the law and the evidence, the Tax Court did not err by including it in its analysis of the Subject Property’s income. Had Mr. Messner properly included parking income in his analysis, his indicated values would have been higher than what the Tax Court ultimately determined, because the Tax Court used a higher vacancy rate than Mr. Messner used in the income approach to value.

**3. The Tax Court’s treatment of operating expenses is supported by the record and the court explained its reasoning.**

The Tax Court found Mr. Messner's operating expenses to be most persuasive. Rel. Add. 47. Mr. Messner had analyzed the Subject Property's actual expenses and compared them to other buildings (excluding Class A space) in the same market area to arrive at an estimate of market level expenses for the Subject Property. Resp't. Ex. I at 85-87; Tr. 362:4-365:11.

The Tax Court discredited the NorthMarq statistics in Mr. Amundson's appraisal and chose to not adopt Mr. Amundson's estimates of operating expenses and gave the reasons for that decision. Rel. Add. 47. Because Mr. Amundson had calculated his operating expenses per square foot using an incorrect number of square feet, much discussion and recalculation took place to attempt to arrive at corrected numbers. See Tr. 98:11-103:8. The Tax Court ultimately found that the testimony did not sufficiently explain how the change of square footage affected all of his calculations. Rel. Add. 46. The Tax Court then showed how the change of net rentable area to the correct square footage *would* change the reported actual expenses of the Subject Property as reported in Mr. Amundson's appraisal at pages 42, 44 and 46 on a per square foot basis, and that the resulting numbers (\$5.46 for 2007 and \$5.84 for 2008) are close to the numbers used by Mr. Messner (\$5.50 for 2007, \$5.75 for 2008 and 2009). It is these numbers that the Tax Court references when it refers to "the corrected rentable area in square feet...used to recomputed [*sic*] Mr. Amundson's operating expenses." Rel. Add. 47. The court would have been

more accurate if it had referred to these as the Subject Property's actual operating expenses as reported by Mr. Amundson. But, the support in the record for the Tax Court's adopting Mr. Messner's operating expenses is not affected by the mischaracterization of these numbers as "Mr. Amundson's operating expenses." Resp't. Ex. I at 85-87; Tr. 362:4-365:11.

The record is also clear that the actual expenses of the property (Resp't. Ex. I at 86 ("Non-Recoverable Expenses)), the operating expenses used in Mr. Messner's income approach (Resp't. Ex. I at 86-87; Tr. 365:5-11), and the operating expenses used in Mr. Amundson's income approach (Rel. Ex. 1 at 42, 44 & 46), all included the expenses associated with the costs of the parking lots, the shuttle service and the cafeteria. Mr. Messner compared the actual expenses, including these items, with reported data from the market to derive the operating expenses he used. Resp't. Ex. I at 81, 87. The Tax Court's finding that Mr. Messner's operating expenses were more persuasive is firmly supported by the record.

**4. The Tax Court's treatment of tenant improvements and reserves for replacements is supported by the record and the court explained its reasoning.**

Both appraisers found that the market indicated that tenant improvement expenses should be accounted for in their income approach to value. Rel. Ex. 1 at 38; Resp't. Ex. I at 87; *See also* Eden Prairie Mall, 797 N.W.2d at 196 (stating that appraisers must conduct market research to determine if tenant

improvement allowances are typical for that market). Tenant improvements can be taken into account in the income approach either by a deduction from base rent to obtain effective market rent, or by selection of a capitalization rate from capitalization rates that were determined prior to any deduction from rent for tenant improvements, and then making an appropriate addition to the capitalization rate to account for this factor. The Appraisal of Real Estate at 480; Resp't. Ex. I at 87. "[I]t is imperative that the appraiser analyze comparable sales and derive their capitalization rates in the same manner used to analyze the subject property and capitalize its income." The Appraisal of Real Estate at 503. The Tax Court has recognized and applied this principle. See Space Ctr. Enters., Inc. v. County of Ramsey, File Nos. C4-97-3360, C4-98-3241 (Minn. Tax Ct. Nov. 4, 1999) 1999 WL 1018098 at \*5, citing St. Louis Park Corp. v. County of Hennepin, File Nos. TC-24719, TC-25694 (Minn. Tax Ct. Apr. 12, 1998) 1998 WL 46355 at \*2.

While tenant improvements may be considered above-the-line expenses that affect net operating income and effective market rents, "[m]ore often, they are treated as below-the-line expenses" and dealt with in the selection of a capitalization rate. The Appraisal of Real Estate at 480. Whether to deduct tenant improvement allowances to arrive at effective rent, *i.e.* by treating tenant improvements as an above-the-line expense, or whether to account for

tenant improvements by an adjustment to the capitalization rate is to be determined on a case-by-case basis. Eden Prairie Mall, 797 N.W.2d at 196.

The appraisers here differed on whether to factor tenant improvements into the calculation of net operating income as an above-the-line expense or to take it into account in the capitalization rate as a below-the-line expense. Mr. Amundson estimated the tenant improvements for the Subject Property at \$10.00 per square foot of useable area and deducted an amortized amount each year as an operating expense taken from effective gross income to determine net operating income. Rel. Ex. 1 at 38. Mr. Messner left tenant improvements out of his net operating income calculation. Resp't. Ex. I at 87. In doing so, he explained that from his research and knowledge of investor surveys and the comparable properties used to develop his capitalization rates, tenant improvements were usually excluded from the net operating income calculation. Resp't. Ex. I at 87. Leasing costs were similarly excluded from Mr. Messner's net operating income calculation. Resp't. Ex. I at 87. Instead of a direct expense in the computation of net operating income, Mr. Messner added 50 basis points to the capitalization rate to account for leasing costs and tenant improvements. Resp't. Ex. I at 90; Tr. 365:1-70:25. Mr. Messner based that adjustment on his review of capitalization rate studies: first, on his review of capitalization rates with and without tenant improvements that were included in the Korpacz reports, which data

indicated a 60 basis point differential in capitalization rates (Resp't. Ex. I at 89-90; Tr. 368:22-69:19), and second, on his analysis of capitalization rates extracted from the market, which is supportive of his use of a 50 basis point upward adjustment to a 7% capitalization rate for the 2007 valuation date at issue. Resp't. Ex. I at 91; Tr. 371:9-73:19. This methodology is consistent with the imperative that "the appraiser analyze comparable sales and derive their capitalization rates in the same manner used to analyze the subject property and capitalize its income." The Appraisal of Real Estate at 503.

The Tax Court found Mr. Messner's methodology to be more persuasive based on the market studies used by both appraisers to determine their capitalization rates and the fact that the below-the-line approach is noted as the more frequently used methodology by The Appraisal of Real Estate. Rel. Add. 49-50. The Tax Court cited to the record to support that finding. Rel. Add. 49-50. The Tax Court thus chose a method of treating tenant improvements based on the evidence presented. Given its explanation of its reasoning along with its use of modern appraisal techniques as described in the latest edition of The Appraisal of Real Estate, the Tax Court did not err when it excluded tenant improvements from its estimation of the Subject Property's net operating income and included them in the capitalization rate.

Contrary to Relators' assertion, the Tax Court did not change its treatment of tenant improvements and replacement reserves from its original

Order to its Order on Remand. In its original Order the Tax Court did not specifically make a finding as to how it was treating tenant improvements, but it did reject deduction of tenant improvements as an above-the-line expense. Rel. Add. 17-19. By its adoption of Mr. Messner’s capitalization rates, the Tax Court accounted for tenant improvements, leasing commissions and replacement reserves in the capitalization rate. Rel. Add. 20 (stating “[s]pecifically, Mr. Messner added 50 basis points to his capitalization rate to account for those expenses which were not deducted as expenses in the surveys upon which he relied.”); Rel. Add. 21 (deciding “[b]ased upon the evidence presented, we find Mr. Messner’s determination of cap rates to be more persuasive”). Upon remand, and in compliance with this Court’s direction, the Tax Court explicitly explained that it was adopting Mr. Messner’s approach to tenant improvements and replacement reserves and gave its reasons for doing so. Rel. Add. 49.

There was no need for the Tax Court to analyze effective market rents in this case because the Tax Court adopted the below-the-line methodology. By rejecting the use of above-the-line treatment of tenant improvements, the Tax Court was rejecting the need for an analysis of “effective market rents” in this valuation. The Tax Court based its adoption of the below-the-line methodology in part on the fact that studies used by both appraisers in determining the appropriate capitalization rate were based on treating

tenant improvements as below-the-line expenses. Rel. Add. 49. That consistency with the studies in the appraisals is the reason the Tax Court gives for finding “Mr. Messner’s approach to treating the tenant improvements and replacement costs as below-the-line items to be more persuasive.” Rel. Add. 49. In selecting the level of tenant improvements to allow, the Tax Court deferred to and adopted Mr. Messner’s judgment that 50 basis points was the appropriate level of adjustment to the capitalization rate. Rel. Add. 49. The Tax Court explained the reasons it found Mr. Messner’s approach to handling tenant improvements and replacement reserves more persuasive. Those reasons are supported by the facts in the record and the court’s finding should be affirmed.

**5. The Tax Court’s determination of capitalization rates is supported by the record and the court explained its reasoning.**

Deriving capitalization rates from comparable sales is the preferred technique when such data is available. The Appraisal of Real Estate at 501. The overall level of risk associated with each comparable should be similar, and appraisers should examine the credit rating of the tenants, the market conditions of the particular property, the stability of the property’s income stream, the level of investment in the property by the tenant, and the property’s upside or downside potential. The Appraisal of Real Estate at 502.

The Tax Court followed those principles in its selection of capitalization rates to apply to the Subject Property for the years at issue.

The Tax Court cites several reasons for adopting the capitalization rates used by Mr. Messner in his appraisal. Most importantly, “Mr. Messner’s analysis included comparable market sale cap rate studies.” Rel. Add. 53; Tr. 371:1-73:25. That is the preferred technique. The Appraisal of Real Estate at 501. Furthermore, the Tax Court recognized that the “unique features” affecting the overall level of risk of the Subject Property had been considered by Mr. Messner and accounted for in his selection of capitalization rates. Rel. Add. 53; Resp’t. Ex. I at 90. That is important because the Subject Property does not fit neatly into a central business district or suburban category as found in the surveys referenced by both appraisers. *See* Rel. Ex. 1 at 39-41 (IRR-Viewpoint, Korpacz with national data for central business district and suburban sectors; RERC with Minneapolis and Midwest data for central business district and suburban sectors); Resp’t. Ex. I at 88-89 (Korpacz with national data for central business district and suburban sectors). Mr. Messner considered “the strength of the Subject Property’s neighborhood, including its proximity to the State Capitol and the roadway infrastructure.” Rel. Add. 52; Tr. at 370:5-13. Thus, the Tax Court used Mr. Messner’s capitalization rates because they more closely matched the evidence

presented regarding the unique features of the Subject Property. Rel. Add. 52; Tr. at 370:1-73:25.

Relators try to discredit the Tax Court's choice of capitalization rates by meaningless criticisms. First, Relators take issue with the Tax Court's characterization of the capitalization rates indicated "when [Mr. Amundson] determined cap rates using the sale of the Subject Property" as being "in line with" Mr. Messner's capitalization rates. There is merely a one-line mention of this observation without any discussion of whether the leased fee and the fee simple are the same in this case. Rel. Add. 52. That comment by the court is inconsequential and it was not a significant factor in its selection of capitalization rates.

Second, Relators take issue with the Tax Court's comments about Mr. Messner's capitalization rates being "consistent with" studies Mr. Amundson relied on. In making this comment the Tax Court is reviewing and reciting evidence from the record. But Relators misstate the very statements they criticize. For example, the court does not say there were nine studies; it mentions "nine figures reported in these studies" relevant to the 2007 capitalization rate. The nomenclature used is not significant. What is significant is that the data reviewed is taken directly from evidence in the record.

The nine numbers the Tax Court gives as examples for the 2007 capitalization rate are found in Mr. Amundson's appraisal report at page 39 in a summary of IRR-Viewpoint, Korpacz and ACLI surveys, and at page 41 in the RERC Survey for the CBD (4<sup>th</sup> Quarter 2006), and the RERC study in Exhibit 21. The numbers in the exhibits are what they are, and the court's survey of them and its characterization of them as "consistent with" Mr. Messner's capitalization rates is not unreasonable. Many of the stated capitalization rates taken from these exhibits are close to the rates used by Mr. Messner. Relators try to dissociate Mr. Amundson from the RERC Estimates for 2007 of 6.9% and 7.4% by saying he "never indicated that he relied on" these rates. Relators' Brief at 38 (July 3, 2012) (hereinafter "Rel.Br. \_\_\_"). But Mr. Amundson testified with regard to Exhibits 21, 22 and 23 "Q. Mr. Amundson, are these the RERC reports that you used and relied upon in your Appraisal Analysis? A. Yes, they are." Tr. 111:24-112:2.

But, one of the most important facts the court is noting is that based on the numbers in these surveys, there was a downward trend in capitalization rates from 2007 to 2008 that Mr. Amundson's selection of capitalization rates ignored. The Tax Court explains that is one of the reasons it adopted Mr. Messner's capitalization rates rather than Mr. Amundson's. Rel. Add. 53.

Finally, Relators are correct in pointing out that the Tax Court incorrectly referred to information in the Korpacz survey as "properties" but the

incorrect reference is without consequence. Rel. Add. 49. That error occurred in the discussion of treatment of tenant improvements. The proposition for which the court was referencing the survey is true, that the majority of the participants in the survey did not include tenant improvements and replacement reserves as above-the-line expenses. That position is summarized in the quote the court uses from Mr. Messner earlier in the same paragraph, so the error in choice of words is of no significance in the court's findings.

In summary, the Tax Court found Mr. Messner's use of capitalization rate studies based on comparable market sales, taking into account the unique features of the Subject Property and the market trends to be most persuasive. It bases that finding on the evidence presented, to which it cites in its Order. The Tax Court's selection of applicable capitalization rates should be affirmed.

### **III. The Tax Court reviewed other approaches to value as a check on the Income Approach.**

Although both appraisal witnesses and the Tax Court gave most consideration and weight to the Income Approach to Value, the Tax Court on remand also reviewed the Sales Comparison Approach to Value and the Cost Approach to Value as a check on value, consistent with the direction of this

Court in Equitable Life, 530 N.W.2d at 555. *See also* Rel. Add. 57; The Appraisal of Real Estate at 141.

The Tax Court examined Mr. Amundson's analysis first, but found it unpersuasive because his comparable sale properties involved large vacancies at the time of sale that were not market levels of vacancy. Rel. Add. 56; Tr. 167:15-168:8. Second, Mr. Amundson did not include specific numerical adjustments in his grid to account for market conditions, location, or effective age. Rel. Add. 56; Rel. Ex. 1 at 26. Finally, Mr. Amundson failed to give a narrative explanation of his adjustments, a requirement for using the sales comparison approach effectively. Rel. Add. 56; *See also* The Appraisal of Real Estate at 304 (stating that "[i]t is imperative that the appraiser identify and analyze the strengths and weaknesses of the quantity and quality of the data compiled").

Instead, the Tax Court chose to give more weight to Mr. Messner's analysis, but with adjustment for the fact that his comparable sales had no basement space. (Rel. Add. 56-57). In the end, this approach was given little weight, but only served as a "check" on the reasonableness of the income approach to value. (Rel. Add. 57). Similarly, the Cost Approach was reviewed by the Tax Court, but it was not relied upon in the Tax Court's conclusions of value. Rel. Add. 57-58.

The record clearly shows that the Tax Court considered all three approaches to value in reaching its conclusions of value. Those conclusions of value are supported by the record as a whole and should be affirmed.

**IV. The Tax Court's prior adjudication of value was not part of the Tax Court's consideration on Remand and the Tax Court correctly gave no weight or discussion to the prior adjudication of value.**

Relators make many statements and assumptions about the Tax Court's reference in its initial Order to a previous court decision and the subsequent sale of the Subject Property that are not relevant to the issue before this Court. Rel. Br. 6-12. Prior Tax Court valuations of the property are not necessarily determinative when estimating market values for subsequent years, especially when, as in this case, the property has subsequently undergone substantial changes, including extensive renovations. SLC TB Acquisition v. County of Murray, File Nos. C2-03-121, C4-03-248 (Minn. Tax Ct. June 15, 2004) 2004 WL 1459339, at \*8, *citing* The Appraisal of Real Estate, 53 (12<sup>th</sup> ed. 2001).

The Tax Court in its Order on Remand did not address the order valuing the Subject Property in earlier years. On remand, the specific directive to the Tax Court was to explain its reasoning for adopting a higher value than either appraiser had concluded to in this case, and to describe the factual support in the record for the court's determination. 811 N.W.2d at 108. If the

Tax Court did not rely on either the prior sale or the adjudicated value in prior years for the appraisal assignment at hand, there was no need to address those issues on remand.

What the Tax court did rely on in determining value was the appraisals and the testimony at trial, giving most credence to Mr. Messner's appraisal and testimony. Relators' submission of argument on the prior adjudication upon remand was unsolicited and was rightly ignored by the Tax Court.

### CONCLUSION

Even though the Tax Court's final conclusions of value were higher than the estimates of either appraiser, it was well within the Tax Court's discretion, exercising its independent judgment, to come to its own conclusions regarding the Subject Property's value. See Eden Prairie Mall, 797 N.W.2d at 194. The issue is not whether anyone could disagree with the Tax Court's exact valuations. The issue is whether the court adequately explained its reasoning and whether its determination of value is supported by the factual record. *Id.* Clearly the Tax Court has met that standard in this case.

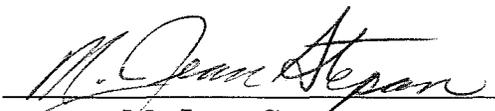
As it explained throughout its order, the Tax Court based its conclusions of value on the evidence presented and upon proper application of the law and accepted appraisal practice. Because the appraisers and the Tax Court based the value primarily on the Income Approach to Value, it was proper for

the Tax Court to focus on that approach on remand. In its Order on Remand the Tax Court clearly stated its reasons for its adoption of each element of the Income Approach, and the evidence from the record that supported that element: The fact that the ultimate indication of value was higher than either appraiser had opined at trial was a result of a combination of the elements of the income approach that the Tax Court found most persuasive. Once those elements were determined, the indicated value was merely a matter of mathematical computation. Because the conclusions regarding the elements of value are supported by the court's stated reasons and the evidence as a whole, the Tax Court did not clearly err in determining the value of the Subject Property. The Tax Court's decision should be affirmed in its entirety.

Respectfully submitted,

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Dated: July 30, 2012

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STATE OF MINNESOTA  
IN SUPREME COURT

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444 Lafayette, LLC and  
Meritex Enterprises, Inc.

Relators,

**CERTIFICATION OF BRIEF LENGTH**

v.

County of Ramsey,

Supreme Court No. A12-0963

Respondent.

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I hereby certify that this brief conforms to the requirements of Minn. R. Civ. App. P. 132.01, subds. 1 and 3, for a brief produced with a proportional font. The length of this brief is 7,811 words. This brief was prepared using Microsoft Word 2007.

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