No. A09-2229

STATE OF MINNESOTA
IN SUPREME COURT

Eden Prairie Mall, LLC,

Relator,

vs.

County of Hennepin,

Respondent.

BRIEF OF AMICUS CURIAE MINNESOTA SHOPPING CENTER ASSOCIATION AND APPENDIX OF UNPUBLISHED OPINIONS

Thomas R. Wilhelmy (#0117134)
Judy S. Engel (#267442)
FREDRIKSON & BYRON, P.A.
200 South Sixth Street, Suite 4000
Minneapolis, MN 55402
Telephone: (612) 492-7000

Attorneys for Relator
Eden Prairie Mall, LLC

Lisa Hahn-Cordes (#238545)
Beth A. Stack (#387967)
Hennepin County Attorney's Office
2000A Government Center
Minneapolis, MN 55487
Telephone: (612) 543-1357

Attorneys for Respondent
County of Hennepin

Mark D. Savin (#178007)
John F. Beukema (#8023)
FAEGRE & BENSON LLP
2200 Wells Fargo Center
90 South Seventh Street
Minneapolis, MN 55402
Telephone: (612) 766-8832

Attorneys for Amicus Curiae
Minnesota Shopping Center Association

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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On behalf of its more than 700 members, including shopping center owners, developers, brokers, property managers, retailers, attorneys, architects, contractors, and other professionals who serve the Minnesota retail real estate industry, the Minnesota Shopping Center Association ("the MSCA") submits this amicus brief[1] to point out two major errors of analysis in the Tax Court's opinion in this case – errors that, unless corrected, will have major harmful consequences to the MSCA's members and all owners of business property in the State. The MSCA has no interest in the ultimate result of this case—the proper assessed value of the subject property—but it has a strong interest in insuring that the result is reached according to sound principles and correct interpretation of the applicable statutes. As is more fully discussed below, the Tax Court's opinion in this case falls far short of those goals, and the judgment below should therefore be reversed and the case remanded for further proceedings that apply proper standards of analysis.

ARGUMENT

I. The Tax Court's Valuation of a Property Should Be Limited to the Range Established by the Expert Appraisal Testimony.

The MSCA submits, first, that the Tax Court committed legal error by finding that the market value of the Eden Prairie Mall (excluding the Von Maur property) was

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[1] In accordance with Minn. R. Civ. App. P. 129.03, the MSCA states (1) that no counsel for any party in this action authored this brief in whole or in part and (2) that no person or entity other than the MSCA, its members, and its counsel made any monetary contribution to the preparation or submission of the brief. Relator Eden Prairie Mall, LLC, is a member of the MSCA.

significantly greater than the value to which any of the expert appraisers testified—11.7% higher than the highest value testified to by the county's expert as of January 1, 2005, and 9.9% higher than the value of the county's expert as of January 1, 2006. The MSCA acknowledges that Minnesota law does not require the Tax Court to pick the value offered by one or another trial expert. On the contrary, the Tax Court often finds that the correct value of the subject property lies somewhere between the amounts to which the experts testified. This Court has approved such a result, saying:

> Real estate appraisal is at best an imprecise art, and a tax court proceeding is not high-low arbitration where the decision must choose the figure submitted by one or the other party. The Tax Court brings its own expertise and judgment to the hearing, and its valuation need not be the same as that of any particular expert *as long as it is within permissible limits and has meaningful and adequate evidentiary support.*"

Montgomery Ward & Co. v. County of Hennepin, 482 N.W.2d 785, 791 (Minn. 1995) (emphasis added).

But this Court has never approved what the Tax Court did in this case—value the subject property at a figure that was 10% or more above the highest level to which any witness testified.[2] Nor has it clarified what it meant by the emphasized language in the

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[2] The only case of which the MSCA is aware in which the Tax Court's valuation exceeded the highest expert appraisal is *EOP-Nicollet Mall, LLC v. County of Hennepin,* 723 N.W.2d 270 (Minn. 2006), but this Court's affirmance of that valuation did not discuss the issue. Moreover, the Tax Court's valuation in that case, while higher than any of the expert appraisals, at least was lower than the assessed value that the property owner was challenging. That is not true here. The fact that this has occurred at least twice in relatively recent times suggests the desirability of the Court's addressing the problem now to avoid its continuing recurrence.

passage from *Montgomery Ward* quoted above. The MSCA urges the Court to take this opportunity to do so and to hold that the "permissible limits" within which the Tax Court's finding of market value must fall are established by the expert appraisal testimony at trial.

Setting such limits on Tax Court fact-finding would flow directly from the proposition that the Tax Court's valuation must have "meaningful and adequate evidentiary support." No such support exists when, as it did in this case, the Tax Court picks and chooses line items from the various expert reports, mixes them together, and arrives at a number significantly higher than anyone has testified to. The various pieces of an expert appraiser's valuation are often interrelated. In attempting to assess a property's market value, an appraiser must evaluate the likely market relevance and impact of many different factors. If an appraiser gives substantial consideration and weight to one factor, he or she may decide that less consideration and weight should be given to another, related factor. This balancing of all relevant factors leads to the appraiser's ultimate opinion as to the property's value. But that opinion might be quite different if his or her assessment of one of the factors were changed. Perhaps for this very reason, the appraisal report of Hennepin County's expert in this case cautions that his appraisal "cannot be completely understood without reading the 'Contingent and Limiting Conditions' section of this report, which should be thoroughly read and understood before relying on any information or analysis presented herein" (Exhibit 101, p. iii) and then states, as a "Limiting Condition," that the report may be used "only in its entirety." (*Id.*, p. 102.) In short, unless the witness has testified on the question, there is no evidence permitting a court to assume that each relevant factor exists in a vacuum so that all other factors will remain the same if the court changes one assumption underlying the witness's opinion.

A homey, but perhaps instructive, analogy may be found in the realm of cooking. There are many different recipes for pie crust. One may call for more salt, another more flour. A few include some sugar. Some use butter, some lard, some vegetable shortening or oil, some a mixture of shortenings. Each of these recipes no doubt produces a perfectly serviceable—maybe even an excellent—crust, as long as the recipe's internal integrity is not altered. But if a cook decides to use the amount of salt from one recipe, the amount of sugar from another, and the amount of flour from the third, or decides to use one recipe's quantity of the shortening specified in another, the mix of ingredients may be something that no knowledgeable chef would endorse, and the crust produced by the hybrid recipe may be inedible.

Likewise, if the Tax Court selects individual elements of various valuation opinions without considering the interrelationship between those elements, it runs the risk of arriving at a valuation that none of the experts from whose opinions it drew the individual elements would agree with and that the evidence as a whole therefore does not support. That risk is particularly great where, as apparently occurred here, the basis on which the Court decided that the market value substantially exceeded the highest amount supported by expert testimony was proffered by counsel in its post-trial brief, when there was no longer an opportunity to submit rebuttal evidence. In such a situation, there is no evidentiary basis for believing that any knowledgeable appraiser would have approved the particular mix of elements that the lawyers proposed and the Tax Court adopted.

Given the imprecision of the art of real estate appraisal noted in *Montgomery Ward,* the risk that a mix-and-match court will arrive at an erroneous valuation may be tolerable so long as the court's valuation lies within the range of reasonableness established by the competing experts' testimony. But the risk is unacceptably great where, as in this case, the result exceeds by 10% or more the highest valuation that has internal integrity.

There are also compelling practical considerations that support a rule that the expert appraisal testimony sets the permissible limits for the Tax Court's valuation finding. Property owners such as the members of the MSCA base their decision whether to appeal the tax assessment of their property on their evaluation of the likely economic consequences of such a challenge. They need to have a reliable sense of how much their assessed valuation may change if they win or lose. With the assistance of its own expert appraiser and its lawyers , an owner can intelligently assess its litigation risks as long as it knows that the opposing expert's opinion represents the "worst case scenario"—the most that the assessed value of the property will increase if it loses. If the owner thinks there is a strong possibility that the appraisal by the county's expert will be adopted by the court, so that it will incur a larger increase in its valuation than it is prepared to endure, it can make an informed decision to dismiss its appeal before trial, so that the original assessed valuation remains unchanged.

But an informed judgment about litigation risks becomes impossible if the Tax Court is allowed, as occurred here, to set the property's market value at a figure significantly higher than the highest value that any witness at trial has supported. The possibility of such a result cannot be assessed, making a tax appeal a true "roll of the dice." Inevitably, the result will be to chill property owners' exercise of their statutory right to seek judicial review of taxing authorities' assessed valuations and complicate the possible settlement of tax challenges without trial.

In a case in district court, if a jury "goes off the rails" by awarding damages beyond what the plaintiff requested or the evidence supports, the defendant can ask the trial judge to set the verdict aside as excessive, with review by the court of appeals as a further judicial backstop against an ungrounded result; such issues rarely reach the level of the Supreme Court. In the system of Tax Court appeals, however, this Court is the sole source of appellate review, and it therefore must perform the function of correcting errors in a particular case as well as its usual function of establishing broad principles applicable to all cases. Here, the Court has the opportunity to combine both of these functions. Relator's Brief offers various arguments about why the Tax Court's findings were erroneous in light of the evidence in the case; as an *amicus curiae,* the MSCA expresses no opinion on most of those arguments. Rather, the MSCA urges the Court not merely to correct whatever specific errors led to a market-value finding more than 10% above the highest amount to which any witness testified, but to promulgate a rule of general applicability that will prevent such an erroneous finding from happening again. Based on the broad principles articulated in *Montgomery Ward*, the Court should hold that the "permissible limits" within which the Tax Court's finding of market value must fall are established by the expert testimony, and that the Tax Court errs as a matter of law when, as it did in this case, it sets a value outside those limits.[3]

II. The Tax Court Erred as a Matter of Law by Refusing to Include an Allowance for Tenant Improvements in its Valuation.

As this Court has stated, the Tax Court

> is required to follow Minn. Stat. § 273.11, subd. 1 (2004), which provides that "all property shall be valued at its market value." 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, taking into consideration the highest and best use of the property.

McNeilus Truck & Mfg., Inc. v. County of Dodge, 705 N.W.2d 410, 413 (Minn. 2005). *See also Equitable Life Assurance Soc'y v. County 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. County of Hennepin,* 589 N.W.2d 301, 304 (Minn. 1999) (relevant consideration is "the property's value to buyers in the marketplace").

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[3] As Relator's Brief notes (p. 9), such a rule is followed by some other states in eminent domain cases. This Court has recognized the appropriateness of relying on appraisal principles from the eminent domain context in tax assessment cases, and *vice versa. See, e.g., Hansen v. County of Hennepin,* 527 N.W.2d 89, 93-94 (Minn. 1995); *Southview Country Club v. City of Inver Grove Heights,* 263 N.W.2d 385, 388 n.4 (Minn. 1978). In both contexts the goal is to determine the market value of the affected property, and "market value" is defined in both as the price at which the property would sell in a transaction between a willing buyer and a willing seller. *Compare, e.g., McNeilus Truck & Mfg., Inc. v. County of Dodge,* 705 N.W.2d 410, 413 (Minn. 2005), *with Ramsey County v. Miller,* 316 N.W.2d 917, 919 (Minn. 1982).

If, as these cases instruct, a property must be assessed according to its value in the market in which property of the type is bought and sold, then it is critically important that the Tax Court's analysis treat elements of potential value in the same way as the marketplace would treat them, so that no element is ascribed greater (or lesser) value for purposes of a property's tax valuation than it would be given by a willing buyer of the property. In the present case, the Tax Court failed to follow this basic principle in its treatment of the tenant improvements that Eden Prairie Mall made to accommodate specific tenants when the Mall reopened in 2002 after its extensive reconstruction.

Tenant improvements are a common feature of most leased commercial properties. To attract new tenants, or to retain existing tenants who have the option to vacate and relocate at the end of their lease, owners of such properties often negotiate arrangements by which they either make at their own expense improvements in a tenant's leased space to meet the tenant's unique needs or provide an allowance to the tenant to pay for such improvements; such an allowance may take the form of a lump-sum payment or a reduction in the rent that the tenant would otherwise pay. *See generally* Appraisal Institute, *The Dictionary of Real Estate Appraisal* 289-90 (4th ed. 2002); Appraisal Institute, *The Appraisal of Real Estate* 480 (13th ed. 2008). 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.

More importantly for present purposes, a prospective purchaser of a commercial rental property must factor into the price that it would be willing to pay both the fact that it, too, will probably have to pay for tenant improvements as existing leases end, either to retain the existing tenants or to attract new tenants to fill vacancies. In either case, the purchase price will usually be adjusted to reflect the buyer's anticipated need to incur such expenses on a continuing basis after the purchase. As the Tax Court explained in *Space Center Enterprises, Inc. v. County of Ramsey,* 1999 WL 1018098 (Minn. Tax Ct., Nov. 4, 1999) (Apdx.94):

> "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.

Id. at *5 (court's bracketed alteration).

Although this Court has never addressed the proper treatment of tenant improvements in a property tax case,[4] a long line of Tax Court decisions recognize that such improvements must be taken into account in determining the market value of a rental property such as a shopping center. *See, e.g., Paddock Props., LLC v. County of Hennepin,* 2002 WL 31108684 at *8 (Minn. Tax Ct., Sept. 12, 2002) (Apdx.85) (owner's expert deducted for tenant improvements, county's expert did not; court agreed with

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[4] In *Equitable Life, supra,* the Court affirmed a Tax Court decision, 1993 WL 377210 at *9 (Minn. Tax Ct., Sept. 24, 1993) (Apdx.11), which held that an allowance for tenant improvements, amortized over the term of the affected leases, should be deducted from the property's gross rent before calculating net income, but it did not discuss the point.

owner's expert); *Northwestern Nat'l Life Ins. Co. v. County of Hennepin,* 1995 WL 377079 at *3 (Minn. Tax Ct., June 21, 1995) (Apdx.79) (rejecting failure of county's expert to deduct for tenant improvements in last year of DCF analysis, based on argument that improvements added value to property, saying the increased value, if any, "is reflected in increased rents"); *Northland Co. v. County of Hennepin,* 1990 WL 73454 at *7 (Minn. Tax Ct., May 4, 1990) (Apdx.71), (rejecting approach of county's expert because, among other things, it took no account of tenant improvements). In short, as Judge Ramstad, who decided the present case, observed several years earlier in another case, "Because we find that tenant improvements . . . are real in the market, . . . they must be accounted for in a direct capitalization income approach to value." *IRET Props. v. County of Hennepin,* 2005 WL 2076409 at *8 (Minn. Tax Ct., Aug. 25, 2005) (Apdx.45).

Unfortunately, in the present case, Judge Ramstad failed to follow her own teachings and take the tenant improvements at Eden Prairie Mall into account in determining the property's market value. Rejecting the analysis of relator's expert, who testified that the cost of the improvements should be amortized over the term of the affected leases, the court stated that such an adjustment "is improper because the allowances had already been spent prior to the dates of the valuations." (Relator's Appendix at A25.)

If, as Judge Ramstad ruled here, tenant improvements may not be amortized over the term of the lease, then presumably it would have been proper to deduct their full amount in the year in which they were incurred. Yet Judge Ramstad rejected precisely that approach in another case decided less than two months before her decision in this case, saying:

> [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 Enterprises, Inc. v. County of Ramsey, 2009 WL 2366285 at *8 (Minn. Tax Ct., July 24, 2009) (Apdx.60).

The ruling in *Meritex*, not the ruling in this case, is consistent with Tax Court precedent concerning the proper treatment of tenant improvements.[5] For example, in *Space Center, supra,* after discussing the reasons why tenant improvements must be considered in an income-based analysis of market value, the court observed that the amount taken into account "may be a different amount than the amount actually spent in a given year in the middle of a lease." *Space Center,* 1999 WL 1018098 at *5 (Apdx.94). It also concluded that the county's appraiser misstated standard appraisal practice by arguing that tenant improvements should not be deducted in multiple years, noting that "each year of an appraisal is a separate analysis of value distinct from previous or subsequent years" and that a tenant improvement adjustment therefore was proper in each of the two years

[5] The Tax Court regards its own previous decisions as precedential. *See, e.g., SPX Corp. v. County of Steele,* 2002 WL 1988180 at *3 (Minn. Tax Ct., Aug. 19, 2002) (Apdx.101); *Lucero v. Comm'r of Revenue,* 2002 WL 1732987 at *5 (Minn. Tax Ct., July 24, 2002) (Apdx.54).

at issue in the case. "The amounts of those adjustments are independent of each other and not cumulative." *Id.*

Similarly, in *Dolan, Sexton & Heim Realty Co. v. County of Hennepin*, 1992 WL 114634 at *3-4 (Minn. Tax Ct., Apr. 29, 1992) (Apdx.6), the evidence indicated that the property owner had incurred significant tenant improvement expenses, which varied from year to year as leases were renewed or new tenants moved in. The leases varied in length. The Tax Court rejected the approach of the county's expert, who based his tenant improvement deduction on the amount actually expended in the year at issue, and instead used an average of the expenses incurred over a number of years. And in *In re Petition of Gamble Devel. Co.*, 1981 WL 1227 (Minn. Tax Ct., July 20, 1981) (Apdx.21), the court held that it would be improper to add the tenant-improvement expenses incurred by the property owner back into income before applying a capitalization rate to determine market value, saying:

> It is undisputed that the leasehold improvements were made by the petitioner as additional, extraordinary inducements to bring tenants into the subject property. Normal practice would be that the tenants themselves pay for those improvements but because the petitioner had many vacancies the petitioner offered to make the improvements as an inducement to get tenants. In arriving at net income [petitioner's expert] included an amortization of the leasehold improvements over the term of the lease. The Court is of the opinion that that treatment best reflects net income.

Id. at *16.

Deducting the entire amount of tenant improvements in the year in which they were paid, as the court apparently thought should be done in the present case, is contrary not only to Tax Court precedent but also to basic principles of appraisal practice. As the

Tax Court has recognized, tenant improvements are like other short-lived property expenses that require replacement from time to time during the economic life of a property, which are accounted for by a "reserve for replacements." *Calhoun Square Assoc. LP v. County of Hennepin,* 1990 WL 73455 at *4 (Minn. Tax Ct., May 9, 1990) (Apdx.1). In an income-based analysis of market value, such expenses are accounted for, not by deducting the 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).

Amortization of recurring expenses having a limited useful life avoids the wide swings that would inevitably result if valuation were based on the amount actually expended for such items in a particular year. In the instant case, for example, the approach apparently favored by the Tax Court's decision would have meant that the value of the subject property would have jumped by $19,580,000—the amount of the tenant improvements, *see* Relator's Appendix A8—in a single year; in 2002, the year in which the improvements were made and paid for, the value would have been reduced (if the logic of the decision in this case, rather than that of *Meritex,* were followed) by the full amount of the improvements, but in 2003 no deduction would have been allowed. Such a roller-coaster of value would be undesirable for both property owners and taxing authorities, all of whom need a measure of predictability for their expenses and their tax receipts, respectively.

Amortizing tenant improvement expenses also is consistent—and the Tax Court's approach in this case is inconsistent—with the way buyers and sellers of rental real estate, like the members of the MSCA, treat such expenses in the marketplace. If a potential buyer were considering buying the Eden Prairie Mall today, it would not regard the operator's profit-and-loss experience in a single year as representative, and ignore the 2002 tenant improvements, as the Tax Court did, because they have already been paid. On the contrary, it would regard the length of time that has passed since the improvements were made as an indication that the leases to which they related are likely to be expiring soon and that the need to extend new tenant improvement inducements to retain existing tenants or to attract replacement tenants is that much more imminent. It would view the cost of those improvements, whenever they will be required, as reducing the stream of income that it can derive from its ownership, regardless of exactly when during its ownership the expenses will be incurred. The prospective purchaser would not regard the value of the property as being higher 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 it regard the property's value as suddenly increasing in the second year if those costs were paid in the first year.

Rather, a buyer of commercial rental property attempts to assess all revenue that the property will produce during a reasonable period of anticipated ownership and all expenses that will be incurred during the same period, and it will capitalize the revenue net of expenses to determine how much it thinks the property is worth and how much it is willing to pay. This is how value is determined in the marketplace for shopping centers and other commercial rental property. And it is also how taxable "market value" under Minn. Stat. § 273.11, subd. 1, should be determined, in light of this Court's repeated instruction that taxable "market value" is "the property's value to buyers in the marketplace." *Marquette Bank, supra,* 589 N.W.2d at 304.

CONCLUSION

As was noted at the outset, it is not MSCA's purpose, in filing this *amicus* brief, to suggest the correct valuation of the Eden Prairie Mall. But the MSCA believes that the Tax Court's decision in this case has lost sight of two basic principles that govern the determination of the market value of real estate for tax purposes and that those errors, if allowed to stand, will distort the law in future cases to the detriment of MSCA members and owners of commercial property generally.

First, by valuing the Eden Prairie Mall property at an amount more than 10% higher than the highest figure that has any support in the expert testimony, the Tax Court has exceeded the permissible limits on its authority to evaluate the evidence and, indeed, has made findings that have no evidentiary support. Second, by refusing to include in its valuation an allowance for the substantial market-driven tenant improvement expenses that the property owner extended to attract tenants, the court ignored both clear Tax Court precedent governing the treatment of tenant improvements and this Court's repeated instruction that the market value of real estate for tax purposes is supposed to be the value that would be placed on that property in the market in which it is bought and sold.

As both an error-correcting court and a doctrinal court in the field of property taxation, this Court, however it rules on the other specific errors asserted in Relator's Brief, should make clear: 1. that the testimony of the parties' expert appraisers establish the limits within which the Tax Court's finding of market value must fall; and 2. that a proper appraisal of commercial rental property must account for the owner's expenses for tenant improvements and that such expenses may not be disregarded because they were paid in a year other than the tax year at issue.

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Respectfully submitted,

John F. Beukema

Mark D. Savin (#178007)
John F. Beukema (#8023)
FAEGRE & BENSON LLP
2200 Wells Fargo Center
90 South Seventh Street
Minneapolis, Minnesota 55402
Telephone: (612) 766-7000

Attorneys for Amicus Curiae
Minnesota Shopping Center Association

fb.us.4755114.03