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A12-0963

STATE OF MINNESOTA
IN SUPREME COURT

444 Lafayette, LLC
and
Meritex Enterprises, Inc.,

Relators,

v.

County of Ramsey,

Respondent.

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

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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. **Did the Tax Court Err When it Failed to Follow the Guidance and Directions of the Minnesota Supreme Court on Remand?**
 - A. **Did the Tax Court Err When it Failed to Comply with the Guidance, Directions and Mandate of this Court Regarding Parking Income Net of Expenses and Where its Analysis is Not Reasonably Supported by the Evidence in the Record Taken as a Whole?**
 - B. **Did the Tax Court Err When it Failed to Follow the Guidance and Directions of this Court in *444 Lafayette I* and *Eden Prairie Mall I* In Its Tenant Improvements Analysis, and Where its Analysis is Not Reasonably Supported by the Evidentiary Record Taken as a Whole?**
 - C. **Did the Tax Court Err Where its Analysis of Capitalization Rates is Not Reasonably Supported by the Evidentiary Record Taken as a Whole?**
 - D. **Did the Tax Court Err in its Analysis of Operating Expenses Where its Analysis is Not Reasonably Supported by the Evidentiary Record Taken as a Whole?**

How Issue Was Raised Below: This issue was raised through the directions of the Minnesota Supreme Court in its earlier decision in this case. *444 Lafayette, LLC v. County of Ramsey*, 811 N.W.2d 106, 108 (Minn. 2012), citing *Eden Prairie Mall v. County of Hennepin*, 797 N.W.2d 186 (Minn. 2011).

Trial Court's Ruling: The Tax Court failed to comply with this Court's instructions on remand by: (1) failing to adequately explain the reasons for its value determinations, and the grounds for reaching a conclusion of value higher than either of the experts, based upon the evidence in the record taken as a whole; (2) failing to describe in detail the evidence in the record to support its value determinations; (3) failing to make any findings on the issue of effective market rent; (4) failing to determine whether or not tenant improvement allowances are atypical; (5) failing to adjust for rent concessions that affect future rent receipts; (6) failing to adequately explain the reasons for rejecting the uncontroverted appraisal testimony of Relators' expert on the issues related to parking income; and (7) adopting once again on remand verbatim arguments from Respondent's briefing which had no support in the evidentiary record as a whole.

Preservation of Issue: This issue was created by the Tax Court in its April 5 and 10, 2012 Remand Orders and, therefore, is automatically preserved for appeal. Evidentiary support in the record for the Tax Court's decision is also an issue that is automatically preserved for review on appeal. *Gruenhagen v. Larson*, 246 N.W.2d 565, 569 (Minn. 1976).

STATEMENT OF THE CASE

This is a review by certiorari of the Orders of the Minnesota Tax Court dated April 5, 2012 and April 10, 2012 (the “Remand Orders”), which Orders were issued after reversal and remand from this Court to determine the fair market value for property tax purposes of an office building located at 444 Lafayette Road in Saint Paul, Minnesota.

The trial of these proceedings took place on December 6, 7, 15 and 22 in 2010. At trial, the Tax Court heard expert testimony from Relators’ appraiser, Mr. Amundson, and Respondent Ramsey County’s appraiser, Mr. Messner. After trial, the County submitted a post-trial brief that argued for higher property valuations than the market values assigned to the property by either appraiser. The Tax Court adopted, verbatim, the County’s proposed market valuations on the three assessment dates.

In its Findings of Fact, Conclusions of Law and Order for Judgment Dated April 7, 2011 (the “Original Decision”), the Tax Court had adopted verbatim certain arguments found not in any expert appraisal report or testimony, or in any other evidence in the trial record, but only in arguments excerpted from the County’s post-trial brief. These arguments lacked any support in the evidentiary record at trial and advocated for values over and above the testimony of the expert appraisers at trial. The range of evidence and the Court’s Original Decision are set forth below.

	Assessed Value	Taxpayer’s Expert	Ramsey County’s Expert	Tax Court Original Decision
1/2/07	\$22,500,000	\$16,600,000	\$23,900,000	\$26,164,000
1/2/08	\$22,500,000	\$16,300,000	\$25,000,000	\$27,420,000
1/2/09	\$22,500,000	\$13,800,000	\$21,000,000	\$22,094,000

(Add - 03-04 (Original Decision))¹.

Relators appealed the Tax Court's Original Decision to this Court on several grounds, including the grounds that the Tax Court's conclusions regarding the fair market value of the Subject Property were unsupported by the evidence at trial and therefore were erroneous as a matter of law. In its decision on Relators' first appeal, this Court held that the Tax Court failed to present an adequate explanation or identify factual support in the record for its findings on individual valuation factors that fell outside of the range of testimony presented by either of the parties' appraisers. This Court determined that:

The tax court's verbatim adoption of the County's proposed value determinations and nearly verbatim adoption of the County's arguments suggest that the court "failed to exercise its own skill and independent judgment" in valuing the subject property.

444 Lafayette, LLC v. County of Ramsey, 811 N.W.2d 106, 108 (Minn. 2012), citing *Eden Prairie Mall v. County of Hennepin*, 797 N.W.2d 186, 192 (Minn. 2011) (hereafter referred to as "*444 Lafayette I*" and "*Eden Prairie Mall I*," respectively).²

This Court concluded that the Tax Court's findings and conclusions in its Original Decision failed to meet the standards articulated in *Eden Prairie Mall I*.³ The standards

¹ References to pages in Relators' Addendum are hereafter noted as "Add - ___".

² *Eden Prairie Mall I* is on appeal to this Court after the Tax Court, with the same judicial officer presiding as in the present appeal, issued its decision after remand from this Court (Supreme Court No. A12-0542).

³ This Court specifically noted that the Tax Court issued its Original Decision five weeks before this Court issued its decision in *Eden Prairie Mall I*. *444 Lafayette, LLC*, 811 N.W.2d at 107, n.1. Because of this timing, the Tax Court did not have the benefit of the guidance and directions found in *Eden Prairie Mall I* when it issued its Original Decision

identified in *Eden Prairie Mall I* applicable to this matter include: (i) the requirement that value conclusions outside the range of the experts at trial be explained carefully and with reasonable support in the evidentiary record; (ii) the admonition that adopting verbatim arguments, calculations and proposed findings found only in a party's brief calls into question whether the Tax Court exercised its own independent judgment; (iii) the requirement that effective market rent be determined, including the effect of rent concessions, such as tenant improvement expenses, that affect future rent receipts; and (iv) that the Tax Court should select capitalization rates that are appropriate for the subject property's type, class, location and degree of perceived risk as an investment, and that capitalization rates might require reconsideration based on the evidence regarding income approach factors considered on remand.

This Court reversed the Original Decision and remanded the matter for further proceedings before the Tax Court, specifying that the Tax Court could reopen the record in order to obtain additional evidence so that it could make any additional factual findings necessary for the proper resolution of this case. *444 Lafayette, LLC*, 811 N.W.2d at 108. This Court gave the Tax Court a specific mandate that, if its value determinations on remand fell outside the range of the appraisal experts at trial, the Tax Court "should carefully explain its reasoning for rejecting the appraisal testimony and the grounds for adopting a lower or higher value, and must adequately describe the factual support in the record for its determination." *Id.*, citing *Eden Prairie Mall*, 797 N.W.2d at 194.

in these proceedings. The Tax Court did, however, have the benefit of the guidance and directions in *Eden Prairie Mall I* when it issued its Remand Order.

On remand, the Tax Court declined to reopen the factual record despite the offer of Relators and this Court's permission to do so, and instead ordered the parties to submit additional briefing of the evidence in the trial record only on a series of specific questions. (*See* Add - 26-27 (Order dated February 1, 2012)). The Tax Court then issued an Order on Remand on April 5, 2012, and an Amended Order on Remand on April 10, 2012, the latter of which only corrected an inconsistency in the final value conclusion as of January 2, 2009.⁴ In its Remand Orders, the Tax Court again rejected the appraisal testimony of the appraisers and determined values for the Subject Property that fell outside of and higher than the range of the appraisal testimony at trial. (Add - 04, 31, 61 (Remand Orders)). In so doing, the Tax Court once again adopted new arguments of counsel that were without factual support in the evidentiary record and again failed to adequately explain why it rejected the appraisers' opinions of value. The range of evidence and the Court's Remand Orders are set forth below:

	Assessed Value	Taxpayer's Expert	Ramsey County's Expert	Original Decision	Tax Court Order on Remand 4/5/12	Tax Court Amended Order on Remand 4/10/12
1/2/07	\$22,500,000	\$16,600,000	\$23,900,000	\$26,164,000	\$25,100,000	\$25,100,000
1/2/08	\$22,500,000	\$16,300,000	\$25,000,000	\$27,420,000	\$26,000,000	\$26,000,000
1/2/09	\$22,500,000	\$13,800,000	\$21,000,000	\$22,094,000	\$22,500,000 <u>and/or</u> \$23,000,000	\$22,500,000

⁴ The remand order dated April 5, 2012 stated two different values for the Subject Property as of January 2, 2009: \$22,500,000 in the conclusions of law and then \$23,000,000 in the memorandum. (Add – 4 and 31, respectively (Remand Orders)).

The Relators appealed to this Court with a petition for writ of certiorari under Minnesota Statutes Section 271.10, subdivision 2.

STATEMENT OF FACTS

The property at issue is a six-story, single-tenant office building located at 444 Lafayette Road in Saint Paul, Minnesota. (Trial Exhibit 1, pp. 2, 14 (hereafter “Ex. __”).) 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 Ex. 60). Pursuant to that reciprocal easement agreement, parking is available for parking contracts with individual employees of the tenant at the subject office building. (Ex. 1, p. 1; Trial Transcript 23:6-20, 213:6-214:12 (hereafter “Tr.”)). The parking income and expenses related to these parking lots are allocated to the Subject Property by operation of the reciprocal easement agreement. (Ex. 60, pp. 12-13).

On the relevant assessment dates, the building 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 pertinent assessment dates was negotiated in the fall of 2004, signed on January 21, 2005 and commenced on January 1, 2006 (“DHS 2005 Lease”). DHS had a previous lease in place at the Subject Property that was terminated prematurely by the DHS 2005 Lease, with the DHS 2005 Lease replacing the last two years of the prior lease at lower rental rates.

	Gross Rental Rate scheduled to be paid under previous DHS Lease	Gross Rental Rate scheduled to be paid under DHS 2005 Lease
2006	\$21.68 per square foot	\$16.50 per square foot
2007	\$22.48 per square foot	\$17.00 per square foot

(See Add - 62 (Ex. 8)). The DHS 2005 Lease further required the property owner to remodel and renovate the property to DHS’s detailed specifications, which, when originally budgeted, were projected to cost around \$15,000,000, but ultimately cost approximately \$13 million.⁵ (Tr., 299:1-301:6; Ex. 29; Ex. 30).

The previous Tax Court decision determined that the fair market value of the fee simple interest in the Subject Property was \$13,200,000 as of January 2, 2005. *Meritex Enters., Inc. v. County of Ramsey*, Minn. Tax Ct. File No. CX-06-4506 (July 24, 2009) (“Tax Court 2005 Decision”) at p. 3 (Appendix p. 133).⁶ The Tax Court relied primarily on the income approach to value, determining that the appropriate level of market rent was indicated by the DHS 2005 Lease. *Id.* at pp. 11-12 (A141-2). In that decision, the Tax Court apparently agreed with the taxpayer’s expert that the provisions of the DHS Lease which required the property owner to spend approximately \$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 pp. 17-18 (A147-8). The Tax Court therefore apparently recognized that a market level of tenant

⁵ The evidence in the record at trial is that the actual cost of remodeling and renovating the Subject Property to these specifications was \$12,945,075.25. (Ex. 30).

⁶ References to Relators’ Appendix are hereafter noted as “A__.”

improvements was actually \$15 per square foot, or roughly \$4.2 million (“Market Tenant Improvement Costs”). *Id.* The Tax Court also apparently ruled that the amount of Total Tenant Improvement Costs under the DHS 2005 Lease in excess of \$15 per square foot, or \$30 per square foot, were of benefit to the tenant, DHS, but not to any other tenant or user. *Id.*

Hence, the Tax Court 2005 Decision apparently found that the additional amounts spent for Total Tenant Improvement Costs were well above market levels and based upon atypical motivations inappropriate to a fee simple market analysis, thereby concluding that the Total Tenant Improvement Costs were not of benefit to the value of the taxable real property. *Meritex Enters., Inc.*, File No. CX-06-4506 at pp. 17-18 (A147-8). The Tax Court ultimately held that only the Market Tenant Improvement Costs of \$15 per square foot should be taken into account by amortizing them over five or ten years, with one year’s amortized amount deducted as a “below the line” expense in determining the property’s value as of January 2, 2005. *Id.*

In December 2007, the Subject Property was sold in a package of property interests, subject to and together with the DHS 2005 Lease and also together with seven nearby parcels of land containing parking lots. (Ex. 1, p. 3). This transaction was a leased-fee transaction of a portfolio of real property interests in which the buyer acquired not only (i) the taxable fee simple interest in the real estate itself, but also paid for (ii) the contractual rights to collect the rents under the DHS 2005 Lease, and (iii) the allocated net parking income generated by DHS employees with parking contracts who paid individually for parking, as well as (iv) a partial guaranty limiting future property tax

expenses secured by a \$1.5 million letter of credit. (Ex. 1, p. E2; Ex. 15; Tr., 127:3-10). As such, the transaction represented the sale of far more than the fee simple interest in the Subject Property.

In the present proceedings, the value of the Subject Property came before the Tax Court for the assessment dates in 2007, 2008 and 2009, the result of which prompted the first appeal of this matter heard by this Court.⁷ In its Original Decision determining the fair market value of the property in 2007, 2008 and 2009, the Tax Court adopted value conclusions far greater than the \$13,200,000 value it had determined as of January 2, 2005: \$26,164,000 as of January 2, 2007; \$27,420,000 as of January 2, 2008; and \$22,094,000 as of January 2, 2009. In the Original Decision, the Tax Court concluded that the same tenant improvement costs considered under the same DHS 2005 Lease should not be considered at all, but then increased the taxable value of the Subject Property by almost exactly the amount of the nearly \$13 million in Total Tenant Improvement Costs spent pursuant to the DHS 2005 Lease. The Tax Court's concluded value for the Subject Property as of January 2, 2005 was \$13,200,000. When the Total Tenant Improvement Costs of \$12,945,075.25 (*see* Ex. 30) are added to that value, the

⁷ The Tax Court 2005 Decision resulted in a value of \$13.2 million as of January 2, 2005. *Meritex Enters., Inc.*, Minn. Tax Ct. File No. CX-06-4506 at p. 3 (A133). Ramsey County agreed to a corrected assessment of the Subject Property at that same \$13.2 million value as of January 2, 2006. (*See* Ex. 1, p. 18).

total is \$26,145,075, a value strikingly similar to the \$26,164,000 value determined by the Tax Court as of January 2, 2007 in its Original Decision.⁸

In support of its Original Decision increasing the value of the Subject Property by approximately 80% over and above its January 2, 2005 concluded value, the Tax Court presented a series of three facts which purportedly supported its value determinations. The Tax Court claimed that the vast increase in value from January 2, 2005 to January 2, 2007 was supported by: (i) the \$36,000,000 sale of the Subject Property in 2007 (the above-referenced leased-fee portfolio transaction in which the buyer purchased the Subject Property, the DHS 2005 Lease, seven separate parking lot properties, and the partial guaranty regarding property taxes), (ii) the so-called “new” DHS lease and its required tenant improvements, and (iii) the “strengthening” of the office market in the Twin Cities from 2006 to 2008. (Add – 24-25 (Original Decision)).

On remand, Petitioner effectively showed how each of these purported validating facts recited by the Tax Court was demonstrably false. First, the 2007 sale of the Subject Property, when the many non-fee simple factors (namely the leased-fee price paid for the property, the parking lots and related net income, the above-market tenant improvements,

⁸ The Total Tenant Improvement Costs were of key significance in the Tax Court’s Original Decision: “Petitioner argues that Respondent’s appraiser is seeking an increase of more than 80% from the 2005 assessment we addressed in Meritex Enterprises, Inc. v. County of Ramsey to the 2007 assessment. However, the facts had changed significantly between the 2005 assessment and the 2007, 2008, and 2009 assessments. Most significantly, Meritex spent \$12,945,075 on renovating the Subject Property between 2005 and 2007, demolishing the building to its structural skeleton and rebuilding it to be compatible with the recently constructed Elmer L. Anderson building.” (Add - 24 (Original Decision)).

and the guaranty) are adjusted to fee simple, a fee simple value for the Subject Property of \$16,862,772 as of January 2, 2007 is indicated, a reconciliation very similar to Amundson's value conclusion as of that date -- \$16,600,000. (Ex. 1 at p. 50). Second, the DHS 2005 Lease, with its required tenant improvements, was not "new," and in fact it was the same lease described as one of the primary bases for the Tax Court's 2005 Decision. *See Meritex Enters., Inc.*, Minn. Tax Ct. File No. CX-06-4506 at pp. 5-6, 11-12 (A132-33, A148-149). Third, the supposed "strengthening" of the office market was shown to be fictitious because rents were demonstrably decreasing and vacancy was steadily high in the Subject Property's neighborhood during that period of time. (Add - 62 (Ex. 8)). *See also* Ex. 8 and page 6, *supra*, regarding the rent for the first two years under the DHS 2005 Lease.

In the Remand Orders, the Tax Court apparently acknowledged that each of the facts cited as validating the value conclusions in its Original Decision was disproven in the remand proceedings by the evidence in the record as a whole. The Tax Court's Remand Orders are suspiciously devoid of any discussion of these purportedly validating facts. Rather than addressing any of these supposed facts, the Tax Court simply deleted that entire section of the Original Decision without comment. (*See* A211-12 ("Redlined" Order)).

Since the Tax Court implicitly recognized that the evidence in the trial record refutes the facts cited by the Tax Court as validating its Original Decision, the Remand Orders should have reflected not merely a superficial deletion of the arguments based on those erroneous factual assertions, but instead a reconsideration of the Tax Court's

valuation analysis which was purported supported by these deleted facts. The result should have been a profound reconsideration of the Tax Court's concluded values to reach a value, in conjunction with the guidance and direction of this Court in *444 Lafayette I* and *Eden Prairie Mall I*, more closely aligned with the evidence in the record taken as a whole.

Instead, the Remand Orders again concluded to values outside of and above the range of the appraisal experts' concluded values. The Remand Orders differed from the Original Decision in three substantive respects: the Tax Court (i) increased the amount of parking income attributed to the Subject Property, (ii) increased slightly its conclusion of market vacancy levels, and (iii) stated that tenant improvement expenses should now be considered. (Add – 15-16, 16, 17-19 (Original Decision), Add – 41-43, 43-45, 21-26 (Orders on Remand); A192-94, A194-95, A198-202 (“Redlined” Order)).

The Tax Court made no discernible adjustment to its valuation analysis to account for tenant improvements, however, in order to be consistent with the guidance and direction of this Court in *444 Lafayette I* and *Eden Prairie Mall I*. The Tax Court merely re-characterized the County expert's same analysis, now stating that Mr. Messner actually took into account tenant improvement expenses -- even though Mr. Messner made no determination of the market level of tenant improvement expenses, no determination of effective market rents, and made no effort to empirically support or quantify the fifty basis point⁹ adjustment to the capitalization rate which he used to

⁹ A basis point is one one-hundredth of one percentage point. Basis points are used to express figures that must be expressed in fractions of a percent, such as changes in

purportedly account for tenant improvement expenses. Consequently, the testimony of the County's expert provides no basis upon which to refute the detailed calculations offered by Relators' expert showing how many hundreds of basis points were actually necessary to account for the un rebutted market level of tenant improvements found by Relators' expert and similar to the analysis in the Tax Court 2005 Decision. (See Ex. 16).

ARGUMENT

I. Standard of Review

"It is elementary law that it is the duty of the trial court on remand to execute the mandate of this court strictly according to its terms." *Jallen v. Agre*, 122 N.W.2d 207, 208 (Minn. 1963). The trial court has no power to alter, amend, or modify this Court's mandates. *Halverson v. Village of Deerwood*, 322 N.W.2d 761, 766 (Minn. 1982), citing *Tanker Gas, Inc. v. Lumbermen's Mutual Casualty Co.*, 9 N.W.2d 754, 758 (Minn. 1943). The Tax Court's compliance with remand instructions is reviewed based on an abuse of discretion. *Janssen v. Best & Flanagan, LLP*, 704 N.W.2d 759, 763 (Minn. 2005); citing *Halverson v. Vill. of Deerwood*, 322 N.W.2d 761, 766-767 (Minn. 1982). While the trial court has some discretion in the manner in which it follows this Court's remand instructions, the trial court must not act inconsistently with those instructions. *Id.*

Few published decisions address the standard of review upon remand for proceedings in the procedural posture of the present appeal. The Tax Court received guidance and directions from this Court with multiple express citations and references to

interest rates, or here, capitalization rates. See Appraisal Institute, *The Dictionary of Real Estate Appraisal* (5th ed., 2010) at p. 17 (A216).

the further detailed guidance and directions from this Court in *Eden Prairie Mall I*. The dearth of such case law on appeal after remand confirms that it is a rare circumstance where the trial court does not exercise its discretion to fairly interpret and fully comport with the guidance, directions and mandate of this Court on remand.

To permit a trial court to disobey in the slightest degree the mandate of this tribunal would inevitably disrupt the harmonious operation of our entire judicial system and produce disorganization and incalculable confusion.

Tankar Gas, Inc., 9 N.W.2d at 758.

II. The Tax Court Erred When it Failed to Carefully Explain its Reasoning for Rejecting the Appraisal Testimony and the Grounds for Adopting Higher Values, and Failed to Adequately Describe and Base its Determinations on Factual Support in the Record.

This Court reversed the Tax Court's Original Decision valuing the Subject Property and remanded this matter for further proceedings. This Court's instructions on remand were clear:

If the tax court concludes that the market value of the subject property is lower or higher than the appraisal testimony, the court should "carefully explain its reasoning for rejecting the appraisal testimony and the grounds for adopting a lower or higher value, and adequately describe the factual support in the record for its determination."

444 Lafayette, LLC, 811 N.W.2d at 108, citing and quoting from *Eden Prairie Mall I*.

The Tax Court abused its discretion when it adopted values higher than the appraisal testimony and failed to carefully explain its reasoning or the grounds for rejecting the appraisal testimony, and when it failed to adequately describe or base its determinations on the factual support in the evidentiary record.

A. The Tax Court Erred When it Determined Values Outside the Range of the Expert Appraisal Testimony Based in Part on Parking Income Without Adequately Explaining the Support for its Findings in the Evidentiary Record Taken as a Whole.

In its opinion reversing and remanding the Tax Court's Original Decision, this Court found that the Tax Court failed to present an adequate explanation or identify factual support in the record for its decision to adopt estimated parking income values above the testimony of the appraisers other than arguments raised by the County in its post-trial brief. *444 Lafayette, LLC*, 811 N.W.2d at 108. The Tax Court's Remand Orders again committed this error.

1. The Tax Court Erred Again When it Adopted From Respondent's Briefing a New Argument Regarding Parking Income that Is Not Supported by any Evidence in the Record.

In *444 Lafayette I*, this Court found that, in concluding to market values above the testimony of the appraisers, the Tax Court adopted a nearly verbatim recital of the County's post-trial arguments regarding estimated parking income. This Court also found in *444 Lafayette I* that the Tax Court provided no explanation for this conclusion, other than arguments raised by the County in its post-trial brief. On remand, the Tax Court repeated this very same error.

The Tax Court erred in its treatment of parking income in several respects. First, the Tax Court rejected Mr. Amundson's parking analysis, mistakenly claiming that his analysis was unpersuasive because he accounted for market vacancy twice. (Add - 42 (Orders on Remand)). Second, the Tax Court again concluded to estimated parking income above the testimony of the appraisers without adequate explanation based in the

factual record. The Tax Court found estimated parking income on remand even higher than the parking income it determined in the Original Decision by increasing the parking revenue figures from \$264,600 per year to \$293,700 per year, again adopting verbatim the County's new analysis, this time in the County's post-remand brief. Third, the Tax Court erred by failing to give adequate consideration to, or deduction for, parking expenses. The Tax Court apparently concluded erroneously that parking expenses need not be determined or subtracted from parking revenue to determine parking income net of expenses, because "Mr. Messner indicated that his [office building] expenses included expenses related to parking." (Add- 47 (Orders on Remand)). The Tax Court cited to no evidence in the record to support its conclusion in this respect. *Id.*

In sum, the Tax Court found an erroneously high level of parking income not supported by the evidence when adopted the County's unsupported argument regarding the number of parking contracts, and then compounded that error it failed to take into account the uncontroverted expenses associated with providing parking spaces for the Subject Property. It thereby effectively attributed parking income to the Subject Property that equated parking revenues with parking net income, a conclusion which grossly inflated the actual net parking income and resulting market values above the testimony of the experts without adequate explanation or factual support in the record taken as a whole. This is clear error.¹⁰

¹⁰ Respondent's Statement of the Case at page 4 incorrectly states that on remand the Tax Court attributed "additional income from a parking easement based on the parking easement information in Mr. Amundson's appraisal." On remand the Tax Court erroneously estimated parking income in a manner significantly inconsistent with the

2. Mr. Amundson's Analysis Appropriately Applied a Market Level of Vacancy to Projected Parking Revenues.

The Tax Court's explanation for rejecting Mr. Amundson's parking income analysis is not supported, and is instead directly contradicted by the evidence in the trial record taken as a whole. The Tax Court criticized Mr. Amundson for estimating parking income based on historical amounts actually achieved, stating that this may or may not reflect market rental rates. (Add – 42 (Remand Orders)). Then, ironically, the Tax Court adopted Mr. Amundson's monthly parking rate as the market rental rate since it was the only evidence in the record. *Id.* The Court next stated, “[m]oreover, he 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.” (Add - 42 (Remand Orders)).

This explanation finds no support in the evidentiary record at trial. The Tax Court found that there had been no vacancy at the *office building* comprising the Subject Property for at least twenty years. (Add - 30 (Remand Orders)). Accordingly, Mr. Amundson based his parking revenue projections on historical amounts of actual parking revenue at an office building property that was fully occupied. Even with a building that was fully occupied, not every parking space is under contract every day. The undisputed evidence is that the historical total parking revenue is significantly less than the product of the number of parking spaces multiplied by \$25 per month. This

parking easement information found only in Mr. Amundson's appraisal, assuming a number of parking contracts found only in Respondent's briefs and ignoring parking expenses, thereby effectively equating unprecedented levels of parking revenue with net parking income.

undisputed evidence conclusively demonstrates that not every parking space was under contract every day, even though the subject office building was 100% leased. *See also* discussion at page 18, *infra*, and footnote 12.

It is imminently consistent with this undisputed factual record to estimate, as Mr. Amundson did, that an office building property with 90% occupancy (i.e., at the Tax Court's concluded level of ten percent market vacancy) would generate proportionately less parking revenue from its proportionately fewer employee parkers than the 100% leased office building represented by the historical parking revenues. It was therefore wholly consistent with the evidentiary record taken as a whole to deduct a market level of vacancy from parking revenue projections that were based on an office building with 100% occupancy. In fact, this is precisely the methodology that both expert appraisers applied to their office and storage rental revenue projections in this case. (*See, e.g.* Ex. 1, p. 42 (Projection 2007, applying Vacancy & Collection Loss to all Income); Ex. I, p. 83 (noting that a deduction is generally made from the 100% rent schedule for anticipated vacancy and collection loss) and at p. 85 (applying vacancy and collection loss to total estimated Potential Gross Income)).

Ironically, despite the Tax Court finding Mr. Amundson less persuasive because he applied a vacancy deduction to parking revenues, that same methodology is precisely what Ramsey County proposed in its post-remand brief, and is exactly what the Tax Court did when it adopted Ramsey County's analysis verbatim. (*See* A087 (Respondent's Memorandum on Remand, applying market vacancy to Potential Gross

Income); Add – 53-54 (Remand Orders, similarly applying vacancy to Potential Gross Income, including parking revenue)).

The evidentiary record taken as a whole fails to support the reasons cited by the Tax Court in the Remand Orders for finding Mr. Amundson counted vacancy twice in his parking income analysis.

3. The Tax Court’s Estimate of Parking Revenue Finds No Support in the Evidence at Trial.

In its Remand Orders, Tax Court concluded to an even higher level of parking income for the Subject Property – \$293,700, rather than the \$264,600 in its Original Decision.¹¹ The Tax Court employed exactly the same method of determining parking income as it did in the Original Decision. It explained its determination by stating that “because the only evidence in the record as to the market rate for the parking spaces is \$25, as testified to by Mr. Amundson,” and because the Subject Property benefits from an easement granting it access to 979 parking spaces, we determine the market level of annual income of parking to be \$293,700,” a figure reached by multiplying “the 979 *contracts in place* by the monthly market rate of parking (\$25) by the number of months in a year (979 spaces x \$25 x 12 = \$293,700).” (Add - 15-16 and fn. 30 (Remand Orders))

¹¹ The actual historical level of parking revenue from a 100% leased Subject Property office building was \$197,719 in 2006, \$249,973 in 2007 and \$259,335 in 2008. In the Original Decision, the Tax Court accepted verbatim Ramsey County’s argument that \$264,600 in annual estimated parking income should be attributed to the Subject Property, which figure was apparently determined by multiplying \$25 per space per month by 882 parking spaces, as argued in Ramsey County’s post-trial brief. (See Add – 13 (Original Decision); A008-009 (Post-Trial Brief of Respondent)).

(emphasis added)). The factual basis for this determination based on “contracts in place” is not found anywhere in the evidence in the record and is error.

The Tax Court’s multiplication exercise to project parking income is methodologically the same exercise it applied in the Original Decision, and is in error because it was not the testimony or analysis of any expert at trial and is not supported by the evidence. In fact, just as was the case with its original Decision on this issue, the level of estimated parking revenue adopted by the Tax Court on remand assumes several facts not found in the evidence. First, the County’s post-remand arguments assumed, and the Tax Court accepted verbatim, the unsupported argument that there are “979 [parking] contracts in place.” This presumes that there were 979 parking spaces available to the Subject Property pursuant to the parking easement agreement (increased from 882 without explanation or evidentiary support) that would be fully-leased each and every month. The actual historical level of parking revenue conclusively refutes this unsupported assumption by the Tax Court. On the basis of this unsupported assumption, the County argued, and the Tax Court again adopted the argument verbatim, that \$25.00 per month would be received for each of those parking spaces and would actually be collected each month, resulting in a projected annual parking income of \$293,700 before vacancy and collection loss.

Relator’s appraiser Amundson was the only expert who studied and testified regarding the historical level of parking revenue or the appropriate level of parking revenues that should be attributed to the Subject Property. He testified that the historical levels of parking revenues were \$197,719 in 2006, \$249,973 in 2007 and \$259,335 in

2008.¹² Specifically, he opined that the historical levels of actual parking income and amounts budgeted to be received as a result 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 – was the best empirical data about the amount of parking revenue a purchaser would anticipate. (Ex. 1, pp. 35, 42, 44, 46; Tr. 214:23-216:15). He projected parking revenue of \$200,000 in 2007, based upon actual parking income of \$197,719 in 2006. (Ex. 1, p. 42; Tr. 215:19-216:9). He determined that an appropriate projection of parking revenue for 2008 was \$250,000, based upon actual parking income of \$249,973 in 2007. (Tr. 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 revenue of \$260,000 for 2009 based upon actual 2008 parking income of \$259,335. (Ex. 1, p. 46).

The evidence upon which Amundson relied, the actual historical parking revenue for the property in recent years, shows two things. First, that 979 parking contracts could not have been in place for any of the years in issue (*see* footnote 12); and second, that \$293,700 in parking revenue was an unrealistic and unsupported projection for every assessment year at issue, since the amount of parking revenue actually collected in 2006,

¹² These totals indicate that, based on an assumed monthly rent of \$25 per space per month in 2006 and 2007, and \$30 per space per month in 2008, the indicated number of parking contracts was 659 in 2006, 831 in 2007, and 720 in 2008, not 979 as the Court assumed (i.e., \$197,719 divided by 12 months per year and by \$25 per month equals 659).

2007 and 2008 (the years preceding the assessment dates in the present controversy) never reached that level. (*See* Ex. 1, p. 46).

4. The Tax Court Ignored the Guidance and Directions of this Court Regarding Parking Income.

This Court has already rejected the notion that the evidence in the record supports a parking income conclusion reached by simple multiplication of a market rental rate by a number of total potential parking contracts. In its opening brief to this Court in *444 Lafayette, LLC I*, Respondent had argued that this very same method of determining parking income (albeit based on a smaller number of parking contracts) was supported by some unidentified and unknown factual basis in the record. (A111-115 (Brief of Respondent in Supreme Court Matter No. A11-1014)). This Court rejected that argument, finding that there was no factual support for his analysis in the record, but the analysis was found only in arguments raised by the County in its post-trial brief. *444 Lafayette, LLC*, 811 N.W.2d at 107-8.

The only basis for the County's re-calculation of parking income on remand is the County's own slightly revised but again unsubstantiated argument in its post-remand brief. The County's analysis was not testified to or supported by any witness at trial. Just as it did in its Original Decision, the Tax Court again determined estimated parking revenue to the Subject Property over and above the testimony of the experts. And just as it did in its Original Decision, the Tax Court again provided no empirical support in the record, other than arguments raised by the County in its post-remand brief. This "reworking" of the very same evidence by Respondent to argue for an even higher level

of parking revenue, and the Tax Court's verbatim acceptance again of the same argument on remand, is wholly unsupported by the evidence of record and is in sheer disregard of the mandate of this Court on remand.

5. The Tax Court Disregarded the Only Competent Evidence in the Record Regarding Parking Expenses.

The Tax Court also erred in its determination regarding parking-related expenses. The Remand Orders effectively held that parking-related expenses need not be separately determined or subtracted from parking revenue, stating that "Mr. Messner indicated that his expenses included expenses related to parking." (Add - 47 (Remand Orders)). The Tax Court did not include a citation to any testimony in the record for this conclusion. *Id.* Mr. Messner's written report failed to address whether parking, shuttle and cafeteria expenses were included in his net operating income calculations.¹³

A review of the record shows that the only evidence about appropriate levels of parking-related expenses which should be deducted from parking revenue to reach "net parking income" is the analysis and testimony of Mr. Amundson. His analysis and testimony is not disputed or contradicted. Mr. Amundson projected parking-related expenses for each year based on historical levels of those expenses at the Subject Property.

¹³ If in fact it were the case that Mr. Messner's building operating expenses were intended to also include parking-related expenses, then his operating expense projections for the office building itself, already significantly lower than market data, would actually be even further below the average operating expenses reported in the market data. *See* discussion in Section II.C., *infra*. Mr. Messner's estimated building expenses are already inconsistent with his market data even without reducing the building expenses for supposed inclusion of parking lot expenses.

Mr. Amundson's analysis is summarized in the following chart:

	Parking Revenue	<i>Citation</i>	Combined Parking and Shuttle Expenses	<i>Citation</i>	Net Parking Income
1/2/2007	\$200,000	Tr. 55:25-57:2	\$200,000	Tr. 56:9-17	\$0
1/2/2008	\$250,000	Tr. 59:10-16	\$206,000	Tr. 63:18-64:3	\$44,000
1/2/2009	\$260,000	Tr. 62:11-23	\$212,180	Tr. 63:18-64:3	\$47,820

Mr. Messner made no such analysis of net parking income, as he testified he did not analyze the issue of parking income at all. Rather, he testified that “there is no additional income ability in here for parking.” (Tr. 361:14-16). He further testified that “it was my opinion that income being generated from parking for off-site parking would be income to the parking lots, not necessarily income to this office building.” (Tr. 361:23-362:1).

Ultimately, Mr. Messner's appraisal report is silent on parking income and parking expenses. The only evidence of record on this issue is the testimony and analysis of Mr. Amundson. In the Remand Orders, the Tax Court *again* rejected the only expert testimony on this issue of parking income net of parking expenses, without adequate explanation or identifiable evidentiary support despite this Court's express guidance and direction in *444 Lafayette I* and *Eden Prairie Mall I*. The Tax Court failed to follow this Court's mandate that it explain deviations from the expert testimony regarding parking income. The Remand Orders are in error.

B. On Remand, the Tax Court Reversed Course, Now Stating that Tenant Improvements Must Be Considered, but Erred by Failing to Adjust its Analysis to Properly Analyze and Consider Market Levels of Tenant Improvements or Effective Market Rents.

In the earlier Tax Court 2005 Decision involving the same Subject Property, the Tax Court concluded that tenant improvements must be deducted when valuing the Subject Property as of January 2, 2005. *Meritex Enters., Inc.*, Minn. Tax Ct. File No. CX-06-4506 at pp. 17-18 (A170-71). But when it considered the value of the Subject Property as of January 2 in 2007, 2008 and 2009, the Tax Court concluded that tenant improvement expenses for the same property -- subject to the same lease requiring the same tenant improvements -- should not be considered in determining the fee simple income to the landlord under the income approach to value when valuing the Subject Property. The Tax Court reasoned that, because nearly \$13 million had been spent to renovate the property just prior to the first assessment date at issue, no deductions to fee simple value should be made. (Add – 18-19 (Original Decision)).

On remand, the Tax Court once again reversed its analysis involving tenant improvements. The statement in the Remand Orders conforms to the opinions of both parties' experts,¹⁴ effectively determining that tenant improvements are a reality in the Subject Property's market and must be taken into account when valuing the Subject Property. The Tax Court did not specifically identify that it had reached a changed

¹⁴ Mr. Amundson testified that a tenant improvement allowance was a reality in the Subject Property's marketplace – that without expending tenant improvements, the rents achievable for the Subject Property would be lower. (Tr. 103:2-11). Mr. Messner stated that the Subject Property will incur periodic re-leasing costs in the form of tenant improvements and leasing commissions. (Ex. I, p. 87).

conclusion that tenant improvements should indeed be considered for the Subject Property, but rather made cursory statements indicating that it “adopt[ed] Mr. Messner’s approach to handling tenant improvements and replacement reserves” and that it found “Mr. Messner’s approach to treating the tenant improvements and replacement costs as below-the-line items to be more persuasive.” (*See Add - 22 (Orders on Remand)*).¹⁵ The Remand Orders include no correction or reconciliation of the statements in the Original Decision that: (i) “no reduction in sale price for future tenant improvements should be made after spending \$13 million for tenant improvements” or (ii) “[b]ecause the actual condition of the building on the assessment dates reflected \$13 million in renovations recently made, it is inappropriate to add renovation costs to expenses and further subtract them from effective gross income to arrive at NOI.” (*Add – 18-19 (Original Decision)*).

Despite having changed this key factual and legal determination regarding consideration of tenant improvements, however, the Remand Orders made absolutely zero adjustments to the income approach analysis from the Original Decision in order to actually analyze or account for tenant improvement expenses. The Tax Court did not analyze effective market rents or determine the appropriate level of tenant improvements for the Subject Property’s market. It made no findings about whether the market levels of

¹⁵ Respondent’s Statement of the Case at page 5 states that “Mr. Messner’s treatment of tenant improvements and reserves for replacement was also consistent with modern appraisal techniques,” citing *The Appraisal of Real Estate*, 13th edition. This Court thoroughly discussed modern appraisal techniques in *Eden Prairie Mall I*, wherein this Court provided guidance and directions regarding modern appraisal techniques involving investigation of leases, tenant improvements and effective market rents – all of which are wholly disregarded by Mr. Messner and in the Remand Orders.

tenant improvements for the Subject Property were excessive. It made no changes to its Original Decision to account for the conclusion and opinion of both parties' experts that tenant improvements affect the Subject Property's future rent receipts.

1. The Tax Court Failed to Analyze Tenant Improvements in Accordance with the Guidance and Directions of this Court in *444 Lafayette I* and *Eden Prairie Mall I*.

Instead of adhering to the guidance and directions of this Court in *444 Lafayette I* citing *Eden Prairie Mall I*, the Tax Court casually concluded in its Remand Orders, without explanation, that the same capitalization rates it used in its original decision (Mr. Messner's concluded rates) already took into account the economic effects of accounting for tenant improvement expenses. The Tax Court then concluded to and applied the very same capitalization rates as it did in its Original Decision, even though it had concluded in its Original Decision that tenant improvements ought not to be considered at all. (*See Add - 53 (Remand Orders); Add - 21 (Original Decision); A199 ("Redlined" Order)*). The Tax Court did not reconcile, or even attempt to explain, how the same capitalization rates could be appropriate in such disparate situations – the first where the Court concluded that tenant improvement expenses should not be considered, and the second where the Tax Court acknowledged that they should be.

Rather than explain how the same capitalization rates could apply in both situations, the Tax Court simply re-characterized the evidence without explanation. In its Original Decision, the Tax Court found that Mr. Messner's capitalization rates were

adjusted upward by fifty basis points to account for replacement reserves (for capital items like roof, HVAC, elevators and the like)¹⁶:

Respondent's appraiser, however, did not include reserves for replacement as a separate expense because he adjusted his cap rate up 50 basis points to account for the reserves. The value of 50 basis points is \$.43 per square foot of useable space even though those reserves were not a separate line item expressed as an expense.

(Add - 19 (Original Decision)).

On remand, however, the Tax Court abruptly concluded to a *different* interpretation of Mr. Messner's same capitalization rates, finding that the added fifty basis points were for more than just replacement reserves. The Tax Court now found that, "[t]o account for *tenant improvements and* replacement reserves, Mr. Messner added 50 basis points to his base cap rate" (Add - 52 (Remand Orders) (emphasis added)). Thus the Tax Court now finds on remand that a market level of tenant improvements and replacement reserves could both be accounted for by an income adjustment of \$.43 per square foot.¹⁷ (See Add - 52 (Remand Orders); cf. Add - 19

¹⁶ Replacement reserves, also referred to as "reserves" or as a "replacement allowance," provide for the periodic replacement of building components that wear out more rapidly than the building itself and must be replaced during the building's economic life. Appraisal Institute, *The Dictionary of Real Estate Appraisal* (5th ed., 2010) at p. 168 (A215).

¹⁷ As of January 2, 2005, the Tax Court found that a market level of replacement reserves for the Subject Property was \$.20 per square foot, and that a market level of tenant improvements was approximately \$15.00 per square foot. *Meritex Enters., Inc.*, Minn. Tax Ct. File No. CX-06-4506 at pp. 17-18 (A147-148). Even assuming that only one-fifth or one-tenth of \$15.00 per square foot would be deducted in one year, the total market level of tenant improvement expenses and replacement reserve expenses would be at least \$1.70 per square foot, an amount nearly four times larger than the \$.43 per square foot used by Mr. Messner. For the Tax Court to now conclude that market tenant improvements and replacements for reserves could both be accounted for by a \$.43 per

(Original Decision) (fifty basis points equates to \$.43 per square foot)). This re-characterization of the evidence is to be contrasted with this Court's instructions that the Tax Court explain the factual basis in the evidentiary record and the reasons for its conclusions on remand. *444 Lafayette, LLC*, 811 N.W.2d 106 at 5-6.

Additionally, after re-characterizing Mr. Messner's fifty basis points as accounting for both reserves and tenant improvements, the Tax Court once again contradicted this finding later in its decision. Later in the same Remand Orders, the Court stated that the same fifty basis points added to Mr. Messner's base capitalization rate accounted only for replacement reserves, stating: "Thus, Mr. Messner did not include reserves for replacement as a separate expense, but rather, he adjusted his cap rate up 50 basis points to account for the reserves." (Add - 49 (Remand Orders)).

These two findings in the Remand Orders are contradictory and irreconcilable. Moreover, where the Tax Court has determined that tenant improvements and replacement reserves can be accounted for in the capitalization rate instead of as a deduction from projected income, then the same capitalization rate cannot be correct where tenant improvements are not considered, and then also correct where tenant improvements are taken into account. The Tax Court's casual and vacillating treatment of tenant improvements without identifying any appraisal analysis to quantify or account

square foot adjustment is inconsistent with the evidence in the record here and the decision valuing the same property just two years earlier. This finding confirms the inconsistency in the Tax Court's analysis of the same building under the same lease, and the lack evidentiary support in the record for the Tax Court's findings.

for them, and while disregarding the guidance and directions of this Court in 444 *Lafayette I* and *Eden Prairie Mall I*, is unsupportable and erroneous.

2. **The Tax Court Erred When it Failed to Follow this Court's Guidance and Directions in *Eden Prairie Mall I* Regarding Market Effective Rents and Rent Concessions that Affect Future Rental Receipts.**

Even if one could reconcile the Tax Court's inconsistent findings about tenant improvements and the role the fifty basis points added to the capitalization rate played in its appraisal analysis, the Tax Court's purported analysis for accounting for tenant improvements does not comport with this Court's guidance and directions in *Eden Prairie Mall I* specifying how to properly analyze and account for tenant improvements.

In *Eden Prairie Mall I* this Court explained that, under the income capitalization approach to value, an appraiser determines the value of the subject real property by dividing the net operating income of the property by the capitalization rate attributable to the property. *Eden Prairie Mall*, 797 N.W.2d at 192. This Court further explained that because the income generated by investment properties consists primarily of rents, the value of rentable space is estimated using market rent levels.

Typically, an appraiser conducts extensive market research to determine market rents: the rent that a property should bring in a competitive open market "reflecting all conditions and restrictions of the typical lease agreement," including among other things, use restrictions, expense obligations, term of the lease, renewal and purchase options, **and tenant improvement allowances**.

Where market conditions require rent concessions, an appraiser **must** further determine a property's effective rent. Effective rent is an analytical tool used to compare leases and develop effective market rents. *Id.* 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.

Id. (citations omitted and emphasis added).

In the Remand Orders, the Tax Court adopted an altogether contrary analysis whereby it simply agreed with the conclusory and unsupported testimony of Mr. Messner that tenant improvement expenses could be accounted for by increasing the capitalization rate without analyzing effective market rents. Mr. Messner agreed that tenant improvements were a factor in the market for the Subject Property. (Ex. I, p. 87). However, Mr. Messner did not perform any of the analysis under generally accepted appraisal practices required by *Eden Prairie Mall I* to determine effective market rents, an analysis that requires the determination of market levels of rent concessions including tenant improvements. Mr. Messner did not research the market conditions that drive tenant concessions for the Subject Property’s market, nor did he determine a market level of tenant improvement allowance, as demonstrated in the following questions by Relators’ counsel and Mr. Messner’s answers:

- Q. What is the market level of tenant improvements for the market of the subject property as of January 2, 2007? Do you have an opinion?
- A. No.
- Q. As I look at page 111, what is the average or typical level of tenant improvements for the seven comparables on page 111?
- A. I don't know.

Q. Have you analyzed that issue at all, Mr. Messner?

A. No.

(Tr. 630:5-19). Further, Mr. Messner failed to analyze effective rent for the Subject Property under generally accepted appraisal practices, and also failed to do any analysis of the rent concessions that affect future rent receipts for the Subject Property.

Mr. Messner's fifty basis point adjustment for tenant improvements and capital reserves was an arbitrary adjustment which lacked any empirical support or quantification based on the amount of tenant improvements required in the market. By adopting Mr. Messner's incomplete tenant improvement analysis, in violation of generally accepted appraisal practices, the Tax Court failed to comply with the guidance and directions of this Court in *444 Lafayette I* and *Eden Prairie Mall I* to properly analyze effective market rents for the Subject Property.

Ironically, the Tax Court had all of the evidence in the trial record that it needed to perform exactly the analysis under the guidance and directions of this Court regarding effective market rents and how they affect future rent receipts. The Tax Court had ample evidence to support an analysis under either of the two alternate methods of analyzing effective market rents and the impact of rent concessions on future rental receipts. The first method was demonstrated in Mr. Amundson's income capitalization approach, which adjusted for rent concessions that affect future rent receipts, namely tenant improvements, where he deducted an amortized one-tenth of a market level of \$10.00 per

square foot¹⁸ of tenant improvements from the Subject Property's projected income.¹⁹ This is equivalent to determining the Subject Property's effective market 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*, 797 N.W.2d at 192.

The record also contained detailed empirical evidence by which the Court could have analyzed tenant improvement expenses pursuant to a second method where market levels of tenant improvement expenses may be accounted for not as a line-item expense, but instead by loading the capitalization rate to account for future expenditures for tenant improvements. Mr. Amundson provided the only genuine analysis of how to apply this method to the Subject Property, complete with the facts, calculations and analysis necessary to determine the number of additional basis points one would need to add to a base capitalization rate to account for tenant improvement expenses. (*See Ex. 16.*)

Trial Exhibit 16, along with the supporting testimony found in the trial transcript at pages 148, line 18 through page 155, line 25, demonstrates precisely how such an analysis can be performed accurately, taking into consideration market rent concessions

¹⁸ Mr. Amundson estimated the market level of tenant improvement allowance for a ten-year lease to be \$15.00 per square foot. He estimated the "residual value" of the tenant improvements after a ten-year period is \$5.00 per square foot, as some short-lived items that are part of the tenant improvement package may have a salvage value at the end of ten years. He concluded that \$10.00 per square foot of tenant improvements should be amortized over a ten-year lease. (Ex. 1, p.38; Tr. 104:2-22).

¹⁹ The County's expert, Mr. Messner, agreed that leasing costs, including tenant improvements, may be deducted as an expense when calculating net operating income, and that this method is commonly employed by investors and property managers. (Ex. I, p. 87; Tr. 365:12-366:2).

and how they affect rent receipts. Notably, the Tax Court made no mention of this evidence or analysis in the Original Decision or in its Remand Orders, despite the fact that this was the only evidence and analysis of record that completely and empirically opined to this method for determining the effect of rental concessions (here, tenant improvements) on the Subject Property through a capitalization rate adjustment.

Mr. Amundson's carefully crafted opinions, backed by specific facts and detailed appraisal analysis, show that a greater than fifty basis point addition to the capitalization rate, indeed more than 280 basis points in each year, must be made to account for market levels of reserves and tenant improvements in accordance with Mr. Messner's method. (*See Add - 63 (Ex. 16)*). The Tax Court utterly disregarded the only evidence about how Mr. Messner's chosen method for analyzing and accounting for tenant improvements should be carried out in a way that truly analyzed and specifically determined the market level of tenant improvements. In so doing, Mr. Messner and the Remand Orders failed to meet the standard for analyzing effective market rents, including the effect of tenant improvements, which is substantively required by this Court in *Eden Prairie Mall I*. Accordingly, the Tax Court's findings on tenant improvements are erroneous and should be reversed.

a) The Tax Court Selected Capitalization Rates Which Are Not Supported by the Evidence, Nor Are its Explanations Based on the Evidence in the Record Taken as a Whole.

In its Remand Orders, the Tax Court rejected Mr. Amundson's capitalization rate analysis and instead adopted the capitalization rate selections of Mr. Messner. The Tax Court's explanation of its reasons for rejecting Mr. Amundson's analysis is not supported

by the evidence of record, misstates the evidence, and erroneously equates leased-fee and fee-simple capitalization rates.

The Tax Court's explanation of its reasons for rejecting Amundson and adopting Messner's rates as more persuasive are summarized as follows:

- i) The capitalization rate Mr. Amundson extracted from the December 2007 leased-fee sale of the Subject Property purportedly supported Mr. Messner's capitalization rates, rather than those Mr. Amundson selected (Add – 50-51 (Remand Orders));
- ii) The nine capitalization rate surveys considered by Mr. Amundson purportedly better supported Mr. Messner's selected rates, especially the 2007 RERC surveys (Add – 52-53 (Remand Orders)); and
- iii) The Korpacz study, in which the majority of the "properties" included in the survey used net operating income before deductions for reserves and tenant improvements, purportedly substantiated Mr. Messner's overall capitalization rate analysis (Add – 48-49 (Remand Orders)).

i) The Tax Court Erroneously Compared a Leased-Fee Capitalization Rate from a Portfolio Transaction to a Fee Simple Rate to Which 50 Basis Points Had Been Added.

The Remand Orders made erroneous comparisons of dissimilar data when finding that Mr. Messner's capitalization rates were "in line" with the rates found by Mr. Amundson when he determined the capitalization rate based upon the December 2007 sale of the Subject Property. (Add - 52 (Remand Orders)). This explanation, however, is not supported by the evidence in the record taken as a whole. The Tax Court's Remand Order, at page 24, discusses the "actual," i.e., leased-fee, capitalization rates that Mr. Amundson extracted from the 2007 leased-fee sale of the Subject

Property.²⁰ This rate, 7.55%, is set forth at page 50 of his appraisal report, Trial Exhibit 1. However, as Mr. Amundson explained, leased-fee capitalization rates derived from leased-fee sales transactions are typically lower than fee simple capitalization rates because the risks of vacancy and leasing are removed for a property that is fully-leased for a long term. (Tr. 119:17-23, 126:6-9). The Tax Court has itself explicitly recognized this difference between leased-fee and fee-simple capitalization rates. *See, e.g., IRET v. County of Hennepin*, Minn. Tax Court File No. 30776 at 18-19 (August 25, 2005) (Ramstad, J. presiding) (A171-72) (“Based upon the long-term nature of the leases in place for the sales that [the expert] used as comparables, we find that the fee simple Cap Rates would be higher than those derived from the leased fee sales.”)

In light of this well-recognized gap between leased-fee and fee simple capitalization rates, Mr. Amundson’s 7.55% capitalization rate derived from the leased-fee sale of the Subject Property in December 2007 compares well to the 8% fee simple rate he selected for January 2, 2008. (*See* Tr. 129:9-12). Mr. Messner’s base capitalization rate was actually 6.75% (i.e., 7.25% less the 50 basis points which he added for capital reserves and/or tenant improvements), and is not, in fact, “in line” with the 7.55% rate indicated by the sale of the Subject Property. The Tax Court’s explanation erroneously compared a leased-fee (or lower) capitalization rate to Mr. Messner’s fee simple capitalization rate without consideration of the added fifty basis

²⁰ The sale including the Subject Property was a portfolio sale which also included the rights under the DHS 2005 Lease, seven parking lot parcels, parking rights, as well as a partial guaranty limiting property taxes by virtue of a letter of credit. (*See* Ex. 1, pp. 3, E2-E21).

points for reserves and/or tenant improvements. Consequently, the Tax Court’s analysis is not supported by generally accepted appraisal practices or by the evidence taken as a whole. This is error.

ii) The Tax Court Erroneously Analyzed the Capitalization Rate Studies Considered by Mr. Amundson When it Adopted, Nearly Verbatim, Arguments Found in the County’s Post-Trial Brief.

Next, the Tax Court found that Mr. Messner’s capitalization rates were consistent with the “nine” studies Mr. Amundson reviewed in his appraisal report, placing weight on the sheer number of those nine studies that reported capitalization rates in certain ranges. This explanation is not supported by the evidence and is incorrect. Mr. Amundson considered four (or including subparts, possibly seven) studies: The IRR-Viewpoint study (CBD and Suburban office), the Korpacz study (CBD and Suburban office), the ACLI study (National office), and the RERC study (CBD and Suburban office). *See* Ex. 1 at 39-40. However, Mr. Amundson testified that he gave very strong consideration to the capitalization rates reported for *Minneapolis and the Midwest* in the RERC study when he concluded to a base capitalization rate of 8% in 2007 because those studies included investor data local to the Subject Property’s market. (Tr. 110:11-21; *see* also Ex. 1, p. 41 (reporting Minneapolis and Midwest rates)).

In analyzing this issue, the Tax Court appears to have copied its erroneous arguments almost verbatim from the County’s opening post-trial brief. The Tax Court’s decision states:

We find that Mr. Messner’s cap rates were more persuasive. . . . They are also consistent with the studies Mr. Amundson used in his own cap rates.

For 2007, of the nine figures reported in these studies, only two were 8% or higher, while six were in the 7% range, and one was in the 6% range. With regard to 2008, using the same survey, the cap rates were even lower, with only one of the studies reporting 8.1%, six studies reporting rates in the 7% range, and two studies reporting rates in the 6% range. For 2009, five surveys remained in the 7% range, one was in the 6% range, and three were in the 8% range. None of these rates is close to the 9% rate that Petitioners' expert used. While Petitioners' expert indicated that he relied heavily upon RERC's, CBD and Suburban cap rates, which were 6.9% for CBD and 7.4% for suburban in 2007, he chose a cap rate for the Subject Property of 8%. Moreover, he chose cap rates that ignored the downward trend from 2007 to 2008.

(Add – 52-53 (Remand Orders)). The Tax Court's findings are readily traced to the County's original post-trial brief as the direct source of the Court's findings above. The County's brief reads in relevant part:

For 2007, of the nine figures reported in these studies only two were 8% or higher. Six were in the 7% range and one was in the 6% range. With regard to the 2008 assessment using the same nine surveys only for one year later, the capitalization rates were even lower. Only one of the studies reported 8.1%. Six studies reported rates in the 7% range and two studies reported rates in the 6% range. . . . Petitioner's appraiser ignored those downward trends in capitalization rates in maintaining his capitalization rate the same for 2008 as he had determined for 2007. Finally, for the 2009 assessment, the surveys show an increase in capitalization rates. However, five remained in the 7% range, one in the 6% range and three were in the 8% range. . . . None of these rates are even close to the 9% rate that Petitioner's appraiser used. The Capitalization Rates that should have been used are 7.5% for 2007, 7.25% for 2008 and 8.25% for 2009.

(A17-18 (Post-Trial Brief of Respondent)). This Court cautioned the Tax Court against adopting verbatim arguments from briefs instead of marshaling the evidence in the record as a whole, but the Tax Court, on remand, continued this practice. *See 444 Lafayette, LLC*, 811 N.W.2d at 107, citing and quoting *Eden Prairie Mall*, 797 N.W.2d at 194.

Additionally, the Tax Court further compounded its misstatement of the evidence with respect to the RERC study, stating:

While Petitioner's expert indicated that he relied heavily upon RERC's, CBD and Suburban cap rates, which were 6.9% for CBD and 7.4% for suburban in 2007, he chose a cap rate for the Subject Property of 8%.

(Add - 53 (Remand Orders)). This conclusion is not supported by the evidence: Mr. Amundson never indicated that he relied on capitalization rates of 6.9% or 7.4% for 2007; those are the "RERC Estimates,"²¹ not the Minneapolis and Midwest survey results he specifically testified were the most relevant and what he considered.

The capitalization rates Mr. Amundson considered from the 4th Quarter 2007 RERC survey were 7.8% for Minneapolis CBD and 7.8% for Minneapolis Suburban. (Ex. 1 at 41 in chart titled "RERC Capitalization Rate Survey"; Ex. 22 under Minneapolis Survey, Going-in-Cap Rate for CBD and Suburban). Mr. Amundson testified explicitly that he relied on the *Minneapolis* and *Midwest* surveyed rates from RERC because it is done on a "market-by-market basis" and "because they included, or surveyed both Minneapolis and Midwest region, it's a very relevant survey." (Tr. 110:14-21). The Minneapolis and Midwest survey results were the results shown in his expert appraisal report at page 41. Mr. Amundson never referenced or relied upon the "RERC Estimates" of 6.9% or 7.4%, nor did any other witness. Nothing in the record supports the Court's finding that the relevant RERC data from 2007 indicated capitalization rates as low as 6.9% or 7.4%, or that the applicable market survey rates were lower than

²¹ RERC Estimates are estimates which are not the survey results. The survey results here, which reflect investor expectations, contradict the estimates. See Ex. 22.

Mr. Amundson's concluded rate of 8.0%. The Tax Court's purported explanation is without factual basis in the record, is based on a misreading of the RERC report, and is therefore in error.

iii) The Tax Court Erred in its Interpretation and Reliance on the Korpacz Capitalization Rate Surveys.

Lastly, the Remand Orders misstate the Korpacz capitalization rate survey, referring to it as a study of properties sold, and concluding that because a majority of the "properties" in the study treated tenant improvement expenses and replacement reserves as below-the-line expenses, the Tax Court should adopt Mr. Messner's hybrid capitalization rate and tenant improvement analysis. The Tax Court adopted this argument nearly verbatim from arguments in the County's briefing. This argument was presented Ramsey County's post-remand brief follows:

Both appraisers used the Korpacz study to determine cap rates. . . . But as Messner indicated, **four of the six properties in the study factored TIs and RRs as below-the-line expenses.** This Court should thus adopt, as it did in its April 7, 2011, opinion, **Messner's approach to handling TIS and RRs because these expenses were, for the most part, treated as below-the-line expenses** in the studies used by both appraisers in determining the appropriate cap rate.

(A83 (Respondent's Memorandum on Remand at 9) (emphasis added)). The Court adopted this argument and its incorrect facts nearly verbatim:

In the Korpacz study used by both appraisers to determine cap rates, **four of the six properties factored tenant improvements and replacement reserves as below-the-line expenses.** . . . Here, we adopt Mr. Messner's approach to handling tenant improvements and replacement reserves because it is consistent with the studies used by both appraisers in determining the appropriate cap rate, as well as the more frequently used methodology. **Further, the cap rates for buildings in the Korpacz**

survey incorporated tenant improvements and replacement reserves as below-the-line expenses. Consequently, we find Mr. Messner's approach to treating the tenant improvements and replacement costs as below-the-line items to be more persuasive.

(Add - 49 (Remand Orders)). The Tax Court largely parroted the County's argument without critical analysis of generally accepted appraisal practices or the evidence in the record – and in utter disregard of this Court's guidance and direction in *444 Lafayette I and Eden Prairie Mall I*, that the Tax Court should not adopt verbatim arguments from briefs, and should instead demonstrate its own critical analysis.

Here, by adopting verbatim an argument lacking evidentiary support, the Tax Court effectively disregarded the fact that the Korpacz study, like the other surveys expert appraisers rely upon, is not an assemblage of data about properties that have sold. Instead, it is a survey of market participants who report their estimated capitalization rates, or required rates of return, when analyzing an investment in different types of properties. (Ex. 1 at 39; *see also, generally* Tr. 112:20 to 121:5 (discussing the methodology and content of capitalization rate studies Amundson considered)). The Tax Court also ignored the undisputed evidence that the Korpacz survey is a national study that is not specific to the local market in Minneapolis/St. Paul, Minnesota, and involves Class A investment properties²² to which lower capitalization rate requirements are applied. (Tr. 121:12-122:7; 110:14-21). The Tax Court's explanation for rejecting Mr. Amundson's capitalization rates is filled with erroneous comparisons and

²² The Subject Property was considered a Class B investment property by both experts. (Tr. 119:1-14; 458:05-10).

misstatements of the evidence. It is not supported by the evidence and should be rejected.

C. The Tax Court's Explanation for its Selection of Operating Expenses Is Erroneous and Not Supported by the Evidence as a Whole.

On remand, the Tax Court determined that Mr. Messner's operating expenses were more persuasive than those of Mr. Amundson, and went so far as to state that, in selecting Mr. Messner's operating expense conclusions, it was giving the Petitioners the "benefit of the doubt" by choosing higher levels of expenses. This explanation is demonstrably incorrect and not supported by the evidence in the record.

The Tax Court's explanation for finding Mr. Amundson's operating expense analysis unpersuasive is not supported by the evidence in the record taken as a whole. The Tax Court seized on the isolated fact that Mr. Amundson's appraisal report initially used a square footage figure that overlooked a small amount of basement office space (2.4% of the total office space) in a chart summarizing the Subject Property's historical operating expenses on a per square foot basis. However, the Tax Court disregarded further evidence in the record that Mr. Amundson corrected his square footage error during his testimony at trial, and carried those corrections through all of his calculations to adjust his value conclusions accordingly. (Tr. 98:5-103:8; Ex. 1 at pp. 42-47, as corrected). He testified that the minor correction would increase his operating expense conclusions upward to account for the small amount of basement office space which he had initially overlooked when totaling his estimated operating expenses. (Tr. 98:5-24).

Mr. Amundson unquestionably did not testify that a minor change in the included square footage would affect the analysis of his operating expenses *on a per square foot basis*; indeed that was not the case at all. There was no reason to modify a chart in his report that reported the historical operating expenses at the Subject Property to account for this change when he had fully corrected his appraisal analysis and calculations on the witness stand. Mr. Amundson corrected his minor oversight and testified to a complete and consistent market level of operating expenses. The Tax Court's stated reason for disregarding Mr. Amundson's testimony is not supported by the uncontroverted evidence in the record.

Secondly, and unequivocally, the Tax Court erroneously found that Mr. Amundson's operating expenses were actually lower than those concluded to by Mr. Messner. The Tax Court was in error when it stated that it was therefore giving the Petitioners the "benefit of the doubt" by adopting Mr. Messner's operating expense analysis.

[W]hen the corrected rentable area in square feet are [*sic*] used to recomputed [*sic*] Mr. Amundson's operating expenses, they actually come out less than those found by Mr. Messner. By adopting Mr. Messner's operating expenses, we give Petitioners the benefit of the doubt.

(Add - 47 (Remand Orders)). There is no evidence in the record that a "re-computing" of Mr. Amundson's operating expense analysis was necessary or appropriate, nor did any expert so testify.

The Tax Court identifies the only basis for this re-computation as a "total expenses chart from Respondent's post trial brief, p. 11." (Add - 46, fn.42 (Remand Orders)).

Here again, this chart is argument of counsel, not evidence. This Court has expressly remanded the present appeal and other proceedings to the Tax Court with the guidance and direction that findings be based on evidence in the record, not arguments of counsel. *444 Lafayette, LLC*, 811 N.W.2d at 108; *Eden Prairie Mall*, 797 N.W.2d at 196.

Ultimately, the evidence of record does not support the conclusion that Mr. Messner’s operating expenses were higher than those of Mr. Amundson. The appraisers’ opinions of market operating expenses, with citations to the record, are set forth below.

	Amundson	Messner	Are Messner’s figures higher?
Market Operating Expenses – 2007	\$1,604,646 (Tr. 99:7)	\$1,540,946 (Ex. I, p. 93; Tr. 377:8-19)	No.
Market Operating Expenses – 2008	\$1,652,786 (Tr. 101:3-9)	\$1,610,989 (Ex. I, p. 94; Tr. 377:20-378:25)	No.
Market Operating Expenses – 2009	\$1,700,925 (Tr. 102:14-17)	\$1,610,989 (Ex. I, p. 94; Tr. 377:20-378:25)	No.

The Remand Orders, in stating that Mr. Messner’s operating expenses were higher, and that accordingly, the Tax Court gave Respondents the “benefit of the doubt,” are in error.

Additionally, if it were in fact the case that Mr. Messner’s office building operating expenses included amounts for parking expenses, then his “Market Operating Expenses,” excluding parking expenses, would be lower by at least \$200,000 in each year. If the only estimate of parking expenses for which there is expert analysis, Mr. Amundson’s levels of parking expenses, are deducted from Mr. Messner’s building

operating expenses, then Mr. Messner's market levels of building operating expenses would be as follows: for 2007, \$1,340,946 or \$4.79 psf of useable area (280,172 sf); for 2008, \$1,404,989 or \$5.01 psf; and for 2009, \$1,398,809 or \$4.99 psf.²³ Mr. Messner's building operating expenses, net of parking expenses he claims were included, are then not supported by the evidence of market levels of operating expenses reported by Mr. Messner in the discussion in his own appraisal report: "Excluding Class A space, operating expenses, excluding real estate taxes, range from \$5.05 per SF to \$7.13 per SF from 2007 through 2009." (Ex. I, p. 87). The average operating expenses for Class B properties, excluding real estate taxes, in the three geographic sectors reported at page 81 of Mr. Messner's report, are \$6.85 for Q4 2007, \$6.25 for Q4 2008, and \$6.19 for Q4 2009. (Ex. I, p. 81).

In light of the actual evidence in the trial record, the Tax Court's conclusions and underlying reasoning are squarely incorrect and are again based only on argument found in the County's post-trial brief, not the evidence of record. The Tax Court's verbatim adoption of this argument of counsel, which was not the testimony of any witness at trial, demonstrates that the Tax Court did not exercise its own independent judgment and drew conclusions without an evidentiary basis. This is error and does not comply with this Court's mandate to comply with the evidentiary standards set forth in *444 Lafayette I* and *Eden Prairie Mall I*.

²³ The 2007 figure is reached by subtracting \$200,000 (Tr. 56:9-17) from \$1,540,946; the 2008 figure is reached by subtracting \$206,000 (Tr. 63:18-64:3) from \$1,610,989; and the 2009 figure is reached by subtracting \$212,180 (Tr. 63:18-64:3) from \$1,610,989.

CONCLUSION

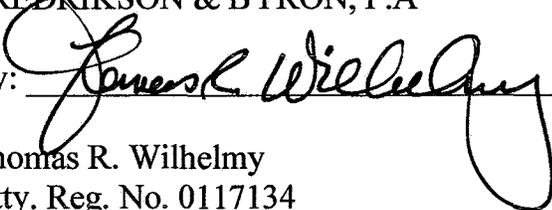
For all of the foregoing reasons, Relators respectfully request that this Court hold that the Tax Court's Orders on Remand fail to comply with the guidance, directions and mandates of this Court in *444 Lafayette I* and *Eden Prairie Mall I*, as its findings are not supported by the evidence in the record as a whole, are inconsistent with the evidence admitted at trial, fail to adequately explain the reasons for the Tax Court's value determinations, and fail to adequately describe in detail the evidence in the record upon which the Tax Court relies. The Remand Orders thereby fail to reasonably consider the guidance, directions and mandate of this Court in its previous decision in this case and in *Eden Prairie Mall I*, and constitute reversible error in violation of Minnesota law.

Relators respectfully request that this Court either decide the fair market values of the Subject Property as of January 2 in 2007, 2008 and 2009 based on the sufficient evidence in the trial record, or, in the alternative, remand the matter to the Ramsey County District Court, where the cases were originally filed before transfer by standing order to the Tax Court, for a decision by a judicial officer of that Judicial District.

Respectfully submitted,

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Dated: July 3, 2012

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STATE OF MINNESOTA
IN SUPREME COURT

444 Lafayette, LLC and
Meritex Enterprises, Inc.

CERTIFICATION OF BRIEF LENGTH

Relators,

v.

Supreme Court No. A12-0963

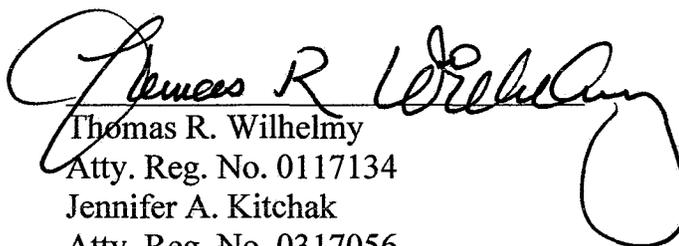
County of Ramsey,

Respondent.

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 13,197 words. This brief was prepared using Microsoft Word 2010.

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