BEFORE THE COURT OF TAX APPEALS
STATE OF KANSAS

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IN THE MATTER OF THE EQUALIZATION APPEAL OF SANDSTONE CREEK APARTMENTS, L.L.C. FOR THE YEAR 2008 IN JOHNSON COUNTY, KANSAS	Docket No. 2008-4637-EQ

ORDER

Now the above-captioned matter comes on for consideration and decision by the Court of Tax Appeals of the State of Kansas. The Court conducted an evidentiary hearing in this matter on May 18, 2010. Taxpayer appeared by its attorney of record, Linda Terrill. Johnson County appeared by its attorney of record, Kathryn D. Myers. Both parties filed post-hearing briefs.

Subject Matter

The Court has jurisdiction over the subject matter and the parties, as an equalization appeal has been properly and timely filed pursuant to K.S.A.. 79-1609. The subject property is described as follows:

> Real estate and improvements commonly known as
> 14030 Riley St., Johnson County, Kansas,
> also known as Parcel ID# 046-079-31-0-40-06-001.00-0.

At issue is the valuation of the subject property for purposes of *ad valorem* taxation as of January 1, 2008. The subject property is a gated apartment complex commonly known as Sandstone Creek Apartments. Constructed in 2000, the subject property is located in Overland Park, Kansas. The complex comprises 364 apartment units with 454,519 square feet of gross building area and 413,116 square feet of net leasable area.

The county lists the subject property as a Class A+ apartment property. Class A is the highest investment classification under the county's mass appraisal model, which is based on the apartment property's condition and age, the size of its units, and the desirability of its location. The subject property is surrounded by other

Class A apartment properties, all with substantially similar characteristics and amenities as the subject property.

Taxpayer appeals from the current appraised value of $39,139,000, asserting an alternative value of no greater than $28,000,000.

Two principal questions are presented:

(1) Does the county's appraisal evidence deviate from the Uniform Standards of Professional Appraisal Practice (USPAP) to the extent that it is materially detrimental to the county's overall opinion of value and thus unreliable as a matter of law?

(2) What is the most reasonable estimate of the subject property's fair market value as of January 1, 2008, based on the available valuation evidence?

USPAP Objections

Taxpayer questions whether the county's appraisal is in compliance with USPAP, alleging various deficiencies in the county's documentary evidence. The thrust of Taxpayer's criticism, however, is that the county's written appraisal report fails to comply with certain ethical, competency, and reporting requirements. Of particular note, Taxpayer contends the documents introduced by the county at the hearing should be disregarded because the county violated certain USPAP scope-of-work requirements.

In considering the credibility of valuation evidence, the Court is mindful of the standards of appraisal practice embodied in USPAP. The Court also recognizes that when valuation evidence so deviates from USPAP that it becomes materially detrimental to a party's overall opinion of value, the evidence may be unreliable as a matter of law. *See In re Amoco Production,* 33 Kan. App. 2d. 329, 337, 102 P.3d 1176 (2004); *see also Board of Saline Cty. Comm'rs v. Jensen*, 32 Kan.App. 2d 730, 88 P.3d 242, *rev. denied* 278 Kan. 843 (2004) (holding valuation premised on appraisal approach expressly prohibited by USPAP erroneous as a matter of law).

Here, the county presented its valuation evidence through Stan Moulder, a qualified mass appraisal expert with demonstrated knowledge of the subject property and market area. Mr. Moulder personally inspected the subject property, as well as various comparable properties, in preparing the county's appraisal. He provided uncontroverted testimony at the hearing concerning the salient features and investment classification of the subject property and confirmed that the county considered all factors listed in K.S.A. 79-503a in arriving at its valuation. In addition to his testimony, Mr. Moulder sponsored a computer-assisted mass appraisal (CAMA) report with supporting documentation. In all, the county's documentary evidence consists of the property record card, photographs, maps, geographic data, property characteristic information, a reconciliation statement, market income and expense data for apartment complexes, a review of sales of comparable properties, and a 2007 study of rent concessions. The county documents also include an explanation of highest and best use and a statement attesting to the county's compliance with PVD ratio study requirements.

Upon review of the record, the Court finds Mr. Moulder unambiguously defined the county's scope of work and clearly communicated the information analyzed in the county's appraisal. It is clear from the evidence that the scope of the county's work was a mass appraisal assignment and that the county's appraisal was based on data developed using standard methods applied through computer-assisted mass appraisal modeling. The Court finds nothing misleading in the county's documents and testimony with regard to scope of work.

The Court rejects the notion that the county's inclusion of supplemental materials in its standard mass appraisal report changes, *ipso facto*, the scope and character of the county's valuation evidence. Inclusion of supporting documents assists the Court in its final analysis, and such evidence is not prohibited by law. *See In re Yellow Freight System, Inc.*, 36 Kan.App.2d 210, 215, 137 P.3d 1051, 1055 (2006).

In light of the record taken as a whole, the county's evidence meets minimum standards of reliability under Kansas law. Nothing in the record suggests the county's valuation is premised on an appraisal approach expressly prohibited by USPAP. Nor is there any indication of USPAP deviations that could be construed as materially detrimental to the county's overall opinion of value. Appropriate consideration should be given to the county's evidence, along with Taxpayer's evidence, in arriving at a reasonable estimate of value for tax year 2008.

Valuation as of January 1, 2008

Governing Law and Salient Facts

All real and personal property in Kansas is subject to taxation on a uniform and equal basis unless specifically exempted. Kan. Const. Art. XI, § 1(a); K.S.A. 79-101. It is the duty of the legislature to provide for a uniform and equal rate of assessment and taxation. *See id.* Pursuant to its constitutional dictate, the legislature has enacted a statutory scheme to ensure property is appraised for ad valorem tax purposes in a uniform and equal manner. Central to this statutory scheme is the requirement that property be appraised at fair market value as of January 1 of each taxable year. *See* K.S.A. 79-1455.

Each parcel of non-agricultural real property in Kansas is appraised at its fair market value. K.S.A. 79-501. The term "fair market value" is defined as that "amount in terms of money that a well informed buyer is justified in paying and a well informed seller is justified in accepting for property in an open and competitive market, assuming the parties are acting without undue compulsion." K.S.A. 79-503a.

The statute also provides certain factors that are to be considered in determining fair market value:

> Sales in and of themselves shall not be the sole criteria of fair market value. Sales are to be used in connection with cost, income and other factors including but not by way of exclusion:
>
> (a) The proper classification of lands and improvements;
> (b) the size thereof;
> (c) the effect of location on value;
> (d) depreciation, including physical deterioration or functional, economic or social obsolescence;
> (e) cost of reproduction of improvements;
> (f) productivity taking into account all restrictions imposed by the state or federal government and local governing bodies, including, but not limited to, restrictions on property rented or leased to low income individuals and families as authorized by section 42 of the federal internal revenue code of 1986, as amended;
> (g) earning capacity as indicated by lease price, by capitalization of net income or by absorption or sell-out period;
> (h) rental or reasonable rental values or rental values restricted by the state or federal government or local governing bodies, including, but not limited to, restrictions on property rented or leased to low income individuals and families, as authorized by section 42 of the federal internal revenue code of 1986, as amended;;
> (i) sale value on open market with due allowance to abnormal inflationary factors influencing such values;
> (j) restrictions or requirements imposed upon the use of real estate by the state or federal government or local governing bodies, including zoning and planning boards

> or commissions, and including, but not limited to, restrictions or requirements imposed upon the use of real estate rented or leased to low income individuals and families, as authorized by section 42 of the federal internal revenue code of 1986, as amended; and
> (k) comparison with values of other property of known or recognized value. The assessment-sales ratio study shall not be used as an appraisal for appraisal purposes.

See K.S.A. 79-503a.

For tax year 2008, the county originally appraised the property at $39,139,000, but later revised its valuation downward to correct an error in net leasable area. The county's current value recommendation is $37,371,600.

In its appraisal the county performed both an income and cost analysis[1] but relied principally on the income analysis. The county did not perform a complete sales comparison analysis because its mass appraisal system does not include a state-approved automated sales comparison system for commercial properties. The county did, however, review recent sales of other Class A apartment properties in the area to confirm that its valuation of the subject property was within the range of values indicated by market transactions.

In applying the income approach, the county used the following inputs to arrive at an estimate of net operating income (NOI) totaling $2,761,394:

Rent	$10.55 per square foot
Net Leasable Area	413.116 square feet
Vacancy and Collection	8%
Concession Rate	1%
Miscellaneous Income	5% of PGI, or $198,380
Operating Expenses	$3.40 per square foot

The county's NOI estimate of $2,761,394 was capitalized at a rate of 7.1894% (6% base rate plus 1.1894% effective tax rate), which yielded a value of $38,409,244. The county deducted $960,231 for personal property and $77,382 for rent loss from excess vacancy to arrive at its current recommendation of $37,371,600. The county also considered property-specific information provided by Taxpayer, making corrections and adjustments where appropriate.

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1 The county's cost approach analysis yielded a value of $64,522,590 for the subject property. The county did not reconcile its cost approach analysis with its income approach analysis, and both parties concede that the cost approach is of limited probative value in this case.

Taxpayer disagrees with the county's valuation, asserting deference should be given to the value indicated by the subject property's actual operating history. Merritt Lancaster, Taxpayer's chief investment officer, testified on behalf of the limited liability company. Mr. Lancaster is not an appraiser, but he is involved daily in the operation and valuation of company assets.

According to Mr. Lancaster, actual income and expense data from 2007 is the most reliable basis for estimating the subject property's fair market value as of January 1, 2008. Mr. Lancaster testified that the subject property's historically high vacancy and concession rates substantially reduce the property's operating income, which in turn reduces the asset's fair market value. Additionally, Mr. Lancaster submitted that an adjustment for replacement reserves of $300 per unit was warranted.

Findings and Conclusions

Upon review of the record, the Court notes only a few disagreements as to how the valuation evidence should be interpreted. No evidence was presented to raise a genuine issue with respect to highest and best use. There is no dispute regarding the physical and locational attributes of the subject property and other like properties in the relevant market area. Nor is there disagreement regarding the subject property's investment classification. The parties agree that the income approach provides the only reliable basis for estimating the subject property's fair market value in light of the available evidence, and Taxpayer has acceded to the county's capitalization rate. Finally, the Court notes that although Taxpayer objects generally to the county's documentary evidence based on USPAP concerns, Taxpayer has come forward with no USPAP compliant valuation evidence of its own, opting instead to rely upon the analytical framework provided in the county's appraisal.

Fundamentally, this case involves a narrow dispute over what inputs should be used to arrive at a reliable estimate of net operating income (NOI) for the subject property under the income approach as of January 1, 2008. Specifically, the parties disagree as to the appropriate rates for vacancy/collection loss, replacement reserves, and rent concessions.

At the outset it is important to note that the interest appraised for purposes of *ad valorem* taxation is the undivided fee estate. *See* K.S.A. 79-102 (defining real property in terms of all rights and privileges.) In Kansas, the property tax is a levy upon all legal interests in a parcel as a single unit. *See In re Andrews*, 18 Kan. App. 2d 311, 323, 851 p.2d 1027 (1993). Kansas property tax law contemplates a single assessment of a parcel without consideration given to the separate values of the various interests making up the whole. For purposes of *ad valorem* tax appraisals, the value of the separate interests merge to establish the value of the undivided fee.

In its appraisal the county used data from its analysis of comparable properties in the local market instead of relying solely on site-specific data. The county acknowledges that using Taxpayer's actual operating data is not necessarily inconsistent with a fee simple appraisal; however, the county correctly notes that relying solely on such data is inappropriate. Analysis of data derived from the relevant market, not merely the subject property's operating history, is crucial to any appraisal of the undivided fee estate. By using market data, the appraiser avoids valuing the leased fee estate, which may or may not be reflective of the value of the undivided fee, depending on the actual terms of the lease contract.

In this case, the record reveals that the county reviewed and considered the subject property's actual operating history and made appropriate corrections and adjustments to its valuation based on that data. The county nevertheless declined to make changes where the actual data could not be reconciled with the county's market analysis of comparable apartment properties. The Court finds nothing improper about the county's exercise of appraisal discretion in this manner.

With regard to vacancy/collection loss, the deductions applied by the county are supported by the market evidence. In order to estimate typical losses from these factors over the long term, the county correctly applied a stabilized vacancy and collection loss allowance consistent with its market research findings. The county's use of a stabilized vacancy estimate based on market data is consistent with accepted appraisal practice and is indicative of the property's long-term equilibrium vacancy.

In addition to its allowance for stabilized vacancy and collection loss, which was made "above the line," the county also applied a separate deduction for excess vacancy to account for rent losses exceeding those typically found in the market. According to Mr. Moulder, the county's excess rent loss allowance—which was deducted from the final estimate of value—is based on a "snapshot" of the subject property's vacancy as of the valuation date. Mr. Moulder explained that excess vacancy is in essence a leased-fee concept; however, he said, the county still applies an excess vacancy allowance where it deems an allowance is warranted.

The stabilized vacancy/collection loss allowance applied by the county is based on reasonable and appropriate evidence derived from the relevant market, with due consideration given to the property's actual operating history and relevant property attributes. A review of the evidence reveals nothing inherent in the subject property itself that would justify a vacancy rate in excess of the prevailing rate for Class A apartments in the market area. In fact, based on the uncontroverted evidence, the subject property appears to be well positioned in the market to retain and attract tenants.

The Court now moves to the question of replacement reserves. Taxpayer argues that a separate expense allowance of approximately $300 per unit is warranted to account for funds that must be set aside for periodic replacement of short-lived building components. The Court disagrees.

The uncontroverted evidence shows that replacement reserves were already accounted for in the county's overall capitalization rate, which Taxpayer does not dispute. Thus it would be inappropriate to include replacement reserves as a separate expense item unless an additional adjustment were made to exclude replacement reserves from the capitalization rate.

The final matter in dispute is rent concessions. Until recently it was Taxpayer's practice to offer rent concessions in an effort to increase occupancy. According to Taxpayer, actual concession rates allowed at the subject property for calendar years 2005 through 2007 averaged almost 14%. Taxpayer asserts the county should have appraised the subject property based on loss of rental income from actual concessions given by Taxpayer. The county disagrees, asserting Taxpayer's actual concession rates are unreliable because they are not in line with market concession rates.

Mr. Moulder explained that by the effective date of this appeal (January 1, 2008), area apartment managers generally had abandoned concessions in favor of reduced rents. And, according to Mr. Moulder, the market rents applied by the county in its appraisal of the subject property reflect that shift in rent pricing. Mr. Moulder nevertheless chose to allow an additional concession adjustment of 1%, which was the median observed concession rate in a 2007 market study of Johnson County apartments.

It is clear from the testimony that the interplay between rents, concessions, and occupancy is not straightforward and that optimizing the productivity of an apartment complex through competitive pricing requires management to be keenly aware of what motivates existing and potential tenants in the particular market area. According to the evidence in this case, the extraordinary concessions given by Taxpayer appear to be a consequence of business strategy, not real property influences. There is no evidence the subject property suffers any competitive disadvantage based on structural characteristics such as location, appearance, construction quality, accessibility, functional utility, building efficiency, or availability of amenities. In fact, the weight of the evidence suggests that the productive components of the subject property are on par with, if not superior to, those apartment properties with which the subject property was compared in the county's appraisal.

Overall, the county's value is supported by sound market analysis, and the inputs it used in its income approach reflect typical income and expenses for competing apartment properties. Conversely, Taxpayer's actual income and expenses are discrepant with the relevant market data and are thus not indicative of what a typical owner could expect from the subject property during the course of a normal holding period.

In addition, it should be noted that the county's review of recent sales in the market area supports its valuation. Area sales of investment Class A apartment complexes in 2006 and 2007 indicate a value range of $81 to $102 per square foot of net leasable area. At the county's recommended value, the subject property is appraised at approximately $90 per square foot. In contrast, Taxpayer's asserted value amounts to an estimate of approximately $67 per square foot, a value that finds no support in the record.

The county has sustained its evidentiary burden by presenting substantial competent evidence of the subject property's fair market value as of January 1, 2008. The county's evidence materially conforms to accepted appraisal practice and is consistent with Kansas law. Taxpayer, in turn, has failed to effectively rebut the county's assessment with its own market-based evidence. In light of the proofs presented by the county in this case, Taxpayer's limited presentation of its actual three-year operating history is insufficient.

IT IS THEREFORE ORDERED, for the reasons stated above, that the appraised value of the subject property for tax year 2008 is $37,371,600.

IT IS FURTHER ORDERED that the appropriate officials shall correct the county's records to comply with this Order, re-compute the taxes owed by the taxpayer and issue a refund for any overpayment.

Any party to this action who is aggrieved by this decision may file a written petition for reconsideration with this Court as provided in K.S.A. 2010 Supp. 77-529. The written petition for reconsideration shall set forth specifically and in adequate detail the particular and specific respects in which it is alleged that the Court's order is unlawful, unreasonable, capricious, improper or unfair. Any petition for reconsideration shall be mailed to: Secretary, Court of Tax Appeals, Docking State Office Building, Suite 451, 915 SW Harrison St., Topeka, KS 66612-1505. *A copy of the petition, together with any accompanying documents, shall be mailed to all parties at the same time the petition is mailed to the Court. Failure to notify the opposing party shall render any subsequent order voidable.* The written petition must be received by the Court within fifteen (15) days of the certification date of this order (allowing an additional three days for mailing pursuant to statute). If at 5:00 pm on the last day of the specified period the Court has not received a written petition for reconsideration of this order, no further appeal will be available.

IT IS SO ORDERED

THE KANSAS COURT OF TAX APPEALS

BRUCE F. LARKIN, CHIEF JUDGE

DISSENTING OPINION

J. FRED KUBIK, JUDGE

TREVOR C. WOHLFORD, JUDGE

SEAL

ATTEST:

JOELENE R. ALLEN, SECRETARY

DISSENTING OPINION

I respectfully dissent from the majority. The county's principal argument in support of its valuation seems to be that Taxpayer's asserted value, based on actual historical data, is a leased-fee value, not a fee-simple value. This is a familiar argument in cases of custom-built properties where the existing lease is structured to recoup the original cost of construction. Such properties often have distinctive design features built to suit the unique business model of a particular occupant, features unlikely to garner demand in the general market. Leases of these so-called "built to suit" properties may more accurately represent a financing arrangement for a credit-worthy tenant than a fair market rental rate for the property itself.

In the case at hand, however, we are presented with an apartment complex with 300-plus apartment units individually leased and operated by a company that owns and operates apartment properties throughout the country. The county alleges that Taxpayer's asserted value, based on actual income and expense data, is a leased-fee value. The county argues that the fair market value of the subject property's fee simple estate must be calculated using the county's conclusions concerning rents, occupancy, and operating expenses derived from the market. This presumes that Taxpayer, an experienced apartment property owner and operator, is under-pricing its apartments, a presumption I find objectionable.

Attached is a schedule comparing the calculation of fair market value made by the County to a calculation made from the financial data submitted by the Taxpayer. The County's calculation appears at page 22 of its Exhibit 1. The Taxpayer's calculation was made from an average of data from the Taxpayer's financial statements for the years ended December 31, 2005, 2006, and 2007, which are Taxpayer Exhibits 2, 3, and 4. It is apparent that the major difference is in the allowance for concessions. The County has calculated more net operating income of $604,919 and less allowance for concessions of $638,277.

The Taxpayer's witness was Merritt Lancaster, chief investment officer of Flournoy Development Company, which owns and operates approximately 40 apartment complexes, including the subject property, encompassing approximately 12,000 units. Mr. Lancaster testified that the gross potential rent shown on Taxpayer's financial statements represents a number generated when it built the property. The concessions represent anything they gave in order to rent the apartments. It could be, for example, a lower rent, a month of free rent, a commission or referral fee, anything they have to give in order to rent the property other than advertising. Mr. Lancaster also testified that Taxpayer no longer uses that system, but rather lowered its rents. Its current financial statements no longer show a line for concessions. The County witness also indicated that the practice of giving and accounting for concessions had generally lost favor in the market and that most complexes had simply lowered rents.

The Taxpayer's published rental rates are, therefore, in the nature of target rents. They represent the amount the landlord hopes to receive in rentals, similar to the asking price for residential property. If the County is not adjusting for this pricing procedure in its survey of rental rates, then its rate study is flawed. However, no evidence was presented on this issue. What was presented was the County's study of concession rates for Class A apartment complexes for the year 2007. Eighteen complexes were surveyed in its study. Seven of these complexes had no concessions at all. Three had concessions of 1%, and the remaining seven had concessions of 2%, 3%, 4%, 6%, 7%, 9%, 10%, and 14%. From this the County determined the appropriate "market" concession rate was 1%, the median rate in the study. The county apparently did not consider that the differences in concession rates might be the result of different philosophies in setting published rental rates.

At root, this controversy is about the evidentiary burden. The county has the duty "to initiate the production of evidence to demonstrate, by a preponderance of the evidence, the validity and correctness of [its] determination." K.S.A. 79-1609. On one side we have the county's high-level, statistical analysis drawn from the market in general; on the other side we have Taxpayer's historical income and expense data specific to the subject property. From all accounts, the subject property is a well-managed apartment complex. This Court should be reticent to presume that tenants of a commercially operated apartment complex are being charged inadequate rents. Without convincing evidence to the contrary—which I find lacking here—the ongoing operating data of a large, commercially operated apartment complex should provide *prima facie* proof of fair market value.

The subject property's chronic problems with rent concessions over the three years immediately preceding the tax year in issue are well documented. The long-term costs associated with these problems should be accounted for in the county's appraisal. Based on the weight of the evidence, I would conclude that Taxpayer's asserted valuation based on actual historical data is a more reasonable estimate of fair market value. However, I agree that a reserve for replacements is not appropriate under this valuation scheme. Consequently, it is my opinion that a value of $29,250,000 is more appropriate than the Taxpayer's suggested value of $28,000,000.

It also should be noted that the county's value does include an adjustment for rent loss in the amount of $77,382, which was deducted from the final computed value. Aside from the fact that this deduction seems completely inadequate, it also appears to be a short-term adjustment for a long-term problem.

J. Fred Kubik

J. FRED KUBIK, JUDGE

ATTACHMENT

	COUNTY	TAXPAYER 3 YR. AVERAGE
Potential gross income	$ 4,360,009	$ 4,455,357
Vacancy/collection loss County 8%, Taxpayer actual 12.6%	$ (348,801)	$ (562,479)
Concessions -County 1%, Taxpayer actual 15.3%	$ (43,600)	$ (681,877)
Net rental income	$ 3,967,608	$ 3,211,001
Miscellaneous income	$ 198,380	$ 195,002
Total revenue	$ 4,165,988	$ 3,406,003
Total expense	$ (1,404,594)	$ (1,249,528)
Net operating income	$ 2,761,394	$ 2,156,475
Overall Capitalization Rate (6% plus 1.1894% tax)	$ 38,409,244	$ 29,995,201
2.5% personal property	$ (960,231)	$ (749,880)
Indicated Value	$ 37,449,013	$ 29,245,321
Less - rent loss	$ (77,382)	$ -
Calculated value	$ 37,371,631	$ 29,245,321
Rounded to	$ 37,371,600	$ 29,250,000

CERTIFICATION

I, Joelene R. Allen, Secretary of the Court of Tax Appeals of the State of Kansas, do hereby certify that a true and correct copy of this order in Docket No. 2008-4637-EQ and any attachments thereto, was placed in the United States Mail, on this 15th day of April, 2011, addressed to:

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IN TESTIMONY WHEREOF, I have hereunto subscribed my name at Topeka, Kansas.

Joelene R. Allen

Joelene R. Allen, Secretary