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In This Issue...

Three Tests to a Fair Value A Dallas Experience

By Paul Pennington Page 1

Important Upcoming Tax Dates

..... Page 1

NATIONAL PROPERTY TAX CALENDAR

State	PP Return Deadline	RE Appeals Deadline	State	PP Return Deadline	RE Appeals Deadline
CA	4/1	9/15	SC	4/15	
FL	4/1		TX	4/15	5/31
GA	4/1	4/1	DC	4/15	
LA	4/1	4/1	AL	4/19	
MN	4/1		SD	EXEMPT	4/19
MS	4/1		MO	4/30	6/21
VT	4/20	4/1	WA	4/30	5/1
NC	4/5		AZ	5/1	
HI	4/8		ID	3/15	5/1
ND	4/12		NE	5/1	4/1
CO	4/15	5/27	OK	3/15	5/3
KS	4/15		WI	3/1	5/10
KY	4/15	5/31	IA	5/15	4/15
MD	4/15		IN	5/15	
ME	4/15		WY	4/1	5/25
OH	4/15		AR	5/31	
			VA	5/31	

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Three Tests To A Fair Value A DALLAS EXPERIENCE

by Paul Pennington

PREAMBLE

Sometimes we must re-examine the methods we have used in the past in determining taxable value of property. As Claude Bernard once said, *“Our ideas are only intellectual instruments which we use to break into phenomena; we must change them when they have served their purpose, as we change a blunt lancer that we have used long enough.”*

The purpose of this article is to present ideas and issues that are of concern to all of us in the property tax field. Moreover, to create a forum whereby all appraisal districts and taxpayers can work together to create a better property tax system for the State of Texas. It is not my intention to flame the fires of controversy that already exist. Moreover, I look forward to those who review my comments and welcome any constructive criticism they might have.

THE STATUS QUO

This article’s genesis is based on a disagreement between the Dallas Central Appraisal District (D.C.A.D.) and myself relating to their income approach model (“the model”). “The model” purportedly results in a market value based on a fee simple estate moreover results in fair and equal values. My study of this disagreement quickly grew to include more than just “the model” and would grow to include the very foundation of their valuing income producing properties.

“The model” is very direct and systematic but in my opinion full of inconsistencies, which is based on the following formula:

1. Examine the January rent roll and select the most recently signed leases. Using these leases an aggregate rate as of January 1 is applied to the entire property.
2. Deduct market vacancy.
3. Deduct D.C.A.D. standards expenses, with no allowances for reserves, tenant finish out, leasing commissions, etc..)
4. Generate a net operating income (NOI) on the subject.
5. Use a capitalization rate reflective of the market based on the property class.
6. This calculation would result in a fee simple market value.

In all fairness to the D.C.A.D. staff, they do not, as a policy, limit themselves to the income approach to value, which requires the taxpayer or representative to supply them with an annualized December

continued on page 2

31 profit and loss statement and January rent roll. Consideration of additional information is also given to recent appraisals, purchase prices, asking prices, the sales comparison approach and cost approach to value.

THE PROBLEM

It is my opinion that to determine a “fair” value, one should use commonly accepted valuation techniques; the sales comparison approach, income approach and cost approach. However, since this discussion revolves around property tax valuation we should extend our examination considering a test consisting of three components to avoid an incorrect valuation. These components, as noted above (market value, fee simple estate, fair and equal taxation) are interwoven throughout this commentary and make up the analysis each property should be exposed to in order to determine a “fair” valuation.

First lets consider, the D.C.A.D. income model described above. My position differs with “the model” based on their assumption that a knowledgeable investor, developer or institution would use a leased fee capitalization rate when buying a property on a fee simple basis. The market place tells us that a knowledgeable buyer is counting on income appreciation when purchasing a leased fee estate. “The model” noted above relies on the assumption that an aggregate lease rate (which averages three to five years depending on property type) as well as an occupancy rate of 90% to 95%, applied to the property. In other words, the property is assumed to maintain these lease rates and occupancy levels throughout the year for purposes of taxation. This in my opinion creates problems. These problems are best explained by Jeff Tarpley, MAI, with the Dallas appraisal firm of Butler-Burgher, Inc., in the following excerpt from a recent fee simple appraisal.

“...This method involves capitalizing the stabilized net operating income (NOI) by an appropriate capitalization rate (Ro) in order to estimate the stabilized value of the project. Ideally, the Overall Capitalization Rate (Ro) utilized in Direct Capitalization is typically derived from comparable sales. Income producing properties subject to existing leases are normally purchased on the basis of actual rents at the date of sale (leased fee estate). **However, the subject is being appraised on a fee simple basis (subject to market rent at the date of valuation). The overall rates derived from existing rents at the date of sale (leased fee) are much lower than those derived utilizing market rent (fee simple).** Mathematically, this is attributable to market rent being higher than existing rents; consequently, the resulting overall rate should be higher. With regard to appraisal methodology, this is a reflection of the risk inherent in attempting to achieve market rents when there are higher than actual rents at the date of sale. For example, tenants may resist paying the higher rates and vacate the property. In addition, the landlord may have to offer tenant finishout and other concessions above those offered in the past in order to lease the building at higher market rental rates.”

If we were to accept “the model,” we would need to consider a higher capitalization rate. This higher rate takes into consideration the increased risk of the owner since “**the model**” leaves no room for an increased risk factor, appreciation of the income stream over the investment period in an efficient market. Thus placing a negative impact on the owner’s leased fee taxpayer. Furthermore, there is a risk of a dip in the market rental rates during the investor’s holding period. For example, if the building is tied into high rental rates, and the market shifts downward the tenant will attempt one of three options;

1. Stay through the term of the lease and then renegotiate a new market lease with the landlord.
2. Try to buy themselves out of the current lease and move to a new building with lower market rates.
3. Break the existing lease and move.

Another facet of “**the problem**” from the Taxpayers’ point of view would be questions revolving around market value, fee simple estates, and fair and equal valuations. For example, as a matter of procedure, if a taxpayer was to bring as evidence a recent, arm’s length, multi-tenant market value sale, the D.C.A.D. would normally accept the sale and make the appropriate valuation adjustment. Now, consider if under this situation the sale used by the taxpayer pertains to an income producing property. Add to this scenario that the subject property is a leased fee sale in which the property is bought on the basis of its existing income. Would this property meet the three areas required by the Code and the Texas Constitution to be a market value fee simple valuation which is also fair and equal?

The first test would be to determine if the sale is a market value sale. The Texas Property Tax Code (Code) 23.01 a & b, requires all property to be appraised at market value as of January 1 of each year. The Code defines market value under Sec. 1.04, 7(a) (b) & (c) as:

What is Taxable Market Value?

“Market value” means the price at which a property would transfer for cash or its equivalent under prevailing market conditions if:

- (A) exposes for sale in the open market with a reasonable time for the seller to find a purchaser;
- (B) both the seller and the purchaser know of all the uses and purposes to which the property is adapted and for which it is capable of being used and of the enforceable restrictions on its use; and
- (C) both the seller and purchaser seek to maximize their gains and neither is in a position to take advantage of the exigencies of the other.

Under the scenario I described earlier the leased fee sale would be a market value sale. However, we would need to recognize it as a leased fee market value sale and does not meet criteria of being market value fee simple sale for property tax purposes, failing the first test of a “fair value.” Therefore, one must add the notion of fee simple ownership when using market value sales and or capitalization rates. Over the years Texas courts have defined market value based on a fee simple basis. The latest cases namely Cherokee Water Co. v. Gregg County Appraisal District and Dallas Central Appraisal District v. Jagee Corporation have reaffirmed this approach.

The Dictionary of Real Estate Appraisal (Second Edition) **identifies a fee simple estate as “Absolute ownership unencumbered by any other interest or estate subject only to the four powers of government.”** The fee simple estate is divided into several components as noted in Capitalization Theory and Techniques by C. B. Akerson, MAI,

1. **LEASED FEE.** The lessor’s interest; the right to receive the rent as stipulated by the lease and the reversion of the property at the expiration of the lease.
2. **LEASEHOLD.** The lessee’s interest; the right to use and occupy the real state during the term of the lease, subject to any contractual restrictions. The leasehold may include rights to develop, alter, sublease, etc.

continued on page 3

The origins of fee simple ownership came, according to Worldwide Legal Information, from a medieval concept, specifically that, "...the common law holds land ownership under the guise of a legal fiction. Since the Norman Conquest in England, all land ownership could only come from the sovereign. Technically, nobody but the king (i.e., now our government) ever owned land outright as it was merely "loaned" by the king. Others are only allowed to hold "estates"..." But, today, after gaining private ownership from the king, we can answer the question; what is a fee simple estate.

In other words, a fee simple estate deals with ownership, whereas earlier the component (market value) deals with the valuation of property. The Code and Courts would tell us, when using general accepted appraisal techniques, we should assume the need to make adjustments to income data, sale comparisons and costs components to make them comply with the definition of a fee simple estate. For example, fee simple adjustments would need to be considered on sales comparables, capitalization rates, market leases, previously noted by Jeff Tarpley, MAI. We know that Appraisal Districts and most protesting taxpayers do not normally use such information. They generally use leased fee sales, capitalization rates, etc... without making adjustments to estimate a property's fee simple ownership value versus the subject's leased fee interest value. Clearly leased fee closing statements are used to obtain tax reductions on a daily basis. **Thus, in most cases using a leased fee closing statement would fail the second test of determining a "fair value" due to the lack of a reconciliation to reflect the property's fee simple market value.**

It should be pointed out that market value on a fee simple basis may not result in the highest value for taxation purposes. As an illustration would be a market where leased fee interests parallel those of fee simple as noted in the Appraisal of Real Estate, 11th Edition, "...assignment is to estimate the market value of a fee simple ownership interest. Appraisers also study markets for real estate space, identifying supply and demand relationships and tracking the activity of market participants to develop value estimates consistent with the definition of market value. **The specific form of ownership may or may not be relevant to the final value conclusion.**" This is an interesting concept in the market value fee simple approach as it relates the Code and Courts mandated method of valuation in Texas. Another example could be found in Lloyd D. Hanford, Jr., MAI, article in the October 1989 issue of The Appraisal Journal, where he stated **"...Dividing real property into a large number of partial interests results in the syndicator realizing a gross price greater than could have been realized from a sale of the 100% interest to a single purchaser. Thus, the sum of the parts can be greater than the whole."** Another example would be in a down market where a property's leased fee estate has older leases that are higher than current market rents. **Thus the value of the leased fee estate is greater than that of the fee simple estate.**

Therefore the question that begs to be asked is the equal and uniform question. One taxpayer gets a better appraised value using a leased fee closing statement and another using the D.C.A.D. income model gets another, perhaps higher valuation. The 1997 Taxpayers' Rights, Remedies and Responsibilities, published by the Comptroller's office states;

"The Texas Constitution sets out five rules for the property tax. Taxation must be equal and uniform. All property must be valued and taxed equally and uniformly. This applies to similar types of property — for example, all residential homes — and to differing types of property — for example, commercial properties and utility properties. No single property or type of properties should pay more than its fair share of taxes."

Thus, in Texas, property must be valued equally and uniformly, but we

have already seen above how as matter of fact this does not necessarily occur. **Thus it would appear on the surface that under our original scenario the property in question would fail the third test of obtaining a "fair value."** This assumption may or may not be correct based on the guidelines required by the Code under Sec. 41.43 that cover the procedures to establish inequality of an appraised value.

1. A reasonable and representative sample of other properties in the appraisal district; or
2. A sample of properties in the appraisal district consisting of a reasonable number of other properties similarly to, or of the same general kind or character as, the property subject to the protest.

As of January 1, 1996, the D.C.A.D. appraised 768,258 properties. These properties include commercial real estate, residential and personal property. The D.C.A.D., as does all other appraisal districts, uses statistical testing to determine how close to 100% market value their values are as of the first of the year. Even though the methodology used by all appraisal districts are standardized, one must ask, is it possible to determine the market value of 768,258 properties as of January 1. **After discussing this proposition with a number of fee appraisers, other property tax professionals and my own involvement in an appeal based on equal and uniform assessments, it is my opinion that such a goal would be impossible with any degree of acceptable certainty.** As noted by David Kaplan, an attorney with Geary, Porter & Donovan, noted in his commentary of recent changes to the Code by the 1997 legislature; **"...an owner may now use the median level of appraisal of a reasonable number of comparable properties, appropriately adjusted."** **Certainly this topic is compounded by the issues of market value on a fee simple basis as discussed previously.**

In attempting to determining a "fair" value pursuant to the Code and the Texas Constitution, **we as professionals must not assume that a multi-tenant income producing sale constitutes a "fair" value.** It may very well constitute the market value of a leased fee estate but not market value on a fee simple basis. Further, we need to recognize that **"the model" needs to include fee simple components, specifically fee simple capitalization rates.** Moreover, it must be acknowledged the adverse effect "the model" has on the taxpayer by raising the risk factor, in addition to the loss income and value appreciation. **Finally, we must be willing to admit that using leased fee sales and capitalization rates do not appear to be equal and uniform to other taxpayers' using "the model."**

In attempting to determine a "fair" valuation for a taxpayer the three tests relating to market value, fee simple ownership, fair and equal taxation need to be addressed. If one or all of these tests are ignored the taxpayer will most likely end up with an incorrect value. **Furthermore, the changes to the Code, relating to the protest of unequal appraisals, the use of the Uniform Standards of Professional Appraisal Practice and other changes should improve the quality of many appraisal rolls.** The disregard of the issues discussed above will result in tax rolls will being flawed and subject to taxpayer appeal.

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Ad Team, Inc.	Franklin Federal Bancorp	Ruey-Lin Liu	Charles See
Aguirre, Inc.	Jack W. Frost	Shing Mao	Shannon Management
Ahmad-Continental Foods	Furr's Cafeterias	McCaslin Development	Sierra Management Company
(Jack in the Box Franchisee)	GKD Partnership, Ltd.	McElreath Family Ltd. Partnership	Simpson Housing Corporation
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