BEFORE THE IDAHO BOARD OF TAX APPEALS

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| SANDPOINT EQUITIES, LLC,<br><br>Appellant,<br><br>v.<br><br>BONNER COUNTY,<br><br>Respondent. | APPEAL NOS. 17-A-1309<br>& 17-A-1310<br><br>FINAL DECISION<br>AND ORDER |

**COMMERCIAL PROPERTY APPEALS**

These appeals are taken from two (2) decisions of the Bonner County Board of Equalization concerning protests of valuation for taxing purposes of properties described by Parcel No. RPS0129010001BA and Parcel No. RPS013300Q001BA. The appeals concern the 2017 tax year.

The matters came on for hearing October 24, 2017 in Sandpoint, Idaho before Board Member Kenneth Nuhn. Attorney John Magnuson represented Appellant at hearing. Assessor Jerry Clemons represented Respondent.

Board Members David Kinghorn, Leland Heinrich and Kenneth Nuhn join in issuing this decision.

**The issue on appeal concerns the market value of two (2) commercial properties.**

**The decisions of the Bonner County Board of Equalization are modified and affirmed.**

FINDINGS OF FACT

Though separate legal parcels, the subject properties are used together in a single commercial operation. As such, the above-captioned appeals were consolidated for purposes of this decision.

<u>Appeal No. 17-A-1309</u> - (Parcel No. RPS0129010001BA)

The assessed land value of this 1.793 acre parcel is $1,952,577, and the improvements' value is $6,857,559, totaling $8,810,136. This parcel is improved with an 86,100 square foot three (3) story commercial office building constructed in 2008. The parcel is additionally improved with a parking lot which provides surface parking for about seventy (70) vehicles.

Appeal No. 17-A-1310 - (Parcel No. RPS013300Q001BA)

The assessed land value of this .604 acre is $657,756, and the improvements' value is $21,970, totaling $679,726. This parcel is improved with paving and lighting fixtures. It has roughly fifty (50) parking stalls and serves as additional parking for the other subject parcel.

The two (2) subject parcels are non-contiguous properties situated in the core business district in Sandpoint, Idaho. The parcels are currently operated together as a multi-tenant commercial office building. Appellant contends the combined value of the parcels is $4,550,000.

Subjects were originally developed to serve as the corporate headquarters of a locally owned community bank. The building's construction is of the highest quality and was characterized by Appellant as the predominant office development in Sandpoint. Intended as a flagship property in the business core, the building includes several unique amenities including, a glass-ceiling atrium with a water feature, an auditorium, as well as large conference rooms and meeting areas. While impressive, these amenities reduce the net leasable area of the building by roughly 30,000 square feet. It was also noted, despite serving as the bank's corporate headquarters for an extended period, the building was never fully occupied and some of the office space remains in a raw shell state.

Appellant further highlighted the available private parking is inadequate for the building's size, and should have closer to 300 spaces, instead of the 123 parking stalls it currently has between the main property and the parking lot parcel. It was noted the limited parking required a variance from the City of Sandpoint and represents a non-conforming legal use of the building parcel.

Appellant purchased subjects in August 2017 for $4,100,000 after negotiating with the prior owner for more than one (1) year. The property was not widely marketed though it was reported multiple parties were interested in purchasing the property and Appellant's ultimate purchase came after intense negotiations. Appellant pointed out the prior owner was a publicly-traded company and had a fiduciary responsibility to obtain the highest price possible for its shareholders, which in Appellant's view was strong evidence the purchase price represented the current market value of the property.

Appellant provided an independent fee appraisal report for subjects where the two (2) parcels were treated as a single unit. The effective date of valuation was July 11, 2017. The appraisal developed value opinions using the sales comparison and income approaches to value. Due to the property's super-adequate improvements the cost approach was deemed an unreliable indicator of current market value and was therefore not considered.

The appraisal report noted there have been few recent sales of large scale office developments similar to subjects in tertiary markets like Sandpoint, so the geographic scope was expanded beyond subjects' local market to find sales of comparable property. The bulk of the eight (8) sales considered were located in Coeur d'Alene, Idaho and Spokane, Washington, and two (2) of the sales were from the more distant locations of Tacoma and Yakima, both in Washington state. Five (5) of the sales occurred during 2016, two (2) were from 2015, and one (1) closed in 2014. The appraisal described the sale properties as generally similar to subjects in terms of age, economic characteristics, condition, and quality. Sale prices ranged from

$4,100,000 to $29,000,000, or from $46.34 to $176.89 per square foot. Adjustments were made to the sales to account for differences compared to subjects, including adjustments for market conditions, location, size, condition, construction quality, parking, and tenant profiles. Adjusted price rates ranged from $85.64 to $155.60 per square foot.

Primary emphasis was placed on the five (5) sales regarded most comparable to subjects physically and economically, and which also required the least amount of adjustment. These sales ranged in adjusted price from $140 to $155 per square foot. The appraisal concluded a hypothetical "stabilized" value of $9,200,000 for subjects. This hypothetical stabilized value was noted to represent the probable value once subjects' occupancy becomes stabilized. The appraisal estimated subject could realize stabilized occupancy of 91% in July 2020. Because only roughly 48% of the building is currently occupied, the appraisal adjusted the hypothetical stabilized value downward by $4,700,000 to account for lease-up costs until physical and economic stabilization could be achieved. The result was an "as-is" value for subjects of $4,500,000, or $69.83 per square foot, which the appraisal noted was within the lower range of the unadjusted price rates indicated by the sales.

For the income approach, the fee appraisal identified four (4) categories of space within the subject building; bank branch space (13,109 square feet), first generation office space (14,654 square feet), second generation office space (33,204 square feet), and executive suites (3,471 square feet). In developing an estimate of potential gross income, the appraisal gathered market data from actual leases and opinions of market professionals for each category of space identified above. For the bank branch space, the appraisal considered five (5) bank branch leases, which lease rates ranged from $22.75 to $33.00 on a triple net basis. Because subjects are located in an office neighborhood instead of near a big box retail anchor, and because subjects' bank branch space area is significantly more than a typical bank branch, the appraisal concluded a reasonable lease rate of $21 per square foot, which was noted to be similar to the $20.87 per square foot actual lease rate the bank agreed to in connection with subjects' 2017 purchase.

Subjects' first and second generation office areas were regarded as similar and would likely command comparable lease rates, so the appraisal utilized the same eight (8) rent comparables for estimating the potential gross income for these areas. Four (4) of the leases concerned offices located in Sandpoint, and the remaining four (4) were located in Coeur d'Alene, with primary weighting afforded the comparables nearer subject. Lease rates ranged from $10 to $17 per square foot. The appraisal estimated a lease rate of $13.50 per square foot for subjects' first and second generation office space, which was noted to be well supported by the range indicated by the lease comparables and information obtained from market participants.

For subjects' executive office space, a lease rate of $26 per square foot was concluded based on the most recent leasing activity at subjects and the opinions of market professionals. The appraisal concluded an effective gross income for subjects, based on prospective stabilized cash flows, of $1,452,271, which figure includes $454,000 attributable to expense reimbursements from tenants.

In similar fashion, the fee appraisal analyzed expense information of properties regarded as generally similar to subjects. Three (3) such comparables were utilized, resulting in estimated operating expenses of $592,082 for subjects. Subtracting the operating expenses from effective gross income yielded an estimated stabilized net operating income of $860,190.

The appraisal next considered an appropriate capitalization rate to be applied to the above-indicated net operating income. The verified overall capitalization rates indicated by the eight (8) sales considered in the sales comparison approach were used. These rates ranged from 5.98% to 10.91%. Primary weight was given to the four (4) sale properties exhibiting the most similarity to subjects in terms of tenant quality and lease profiles. The capitalization rate range for these sales was from 7.6% to 9.4%. The appraisal also considered capitalization rate ranges from the most recent national investor surveys, as well as information from four (4) real estate professionals active in the local and regional market. Based on these three (3) sources, the appraisal determined an overall capitalization rate of 9.25% for subjects. Applying this rate to the above net operating income estimate resulted in a rounded value of $9,300,000.

In determining an "as-is" value for subjects, the appraisal noted an actual vacancy rate of 47.8% and some unfinished shell space. The appraisal made an adjustment to the $9,300,000 prospective stabilized value for costs associated with a lease-up process. These costs were identified as lost rent from downtime, free rent, lost expense reimbursement revenue, tenant improvements, and leasing commissions. The appraisal estimated the sum of these costs at $3,478,914, to which the appraisal added an investor profit rate of 35%, or $1,217,620. The profit rate, representing the higher end of the indicated profit rate range of 10% to 40%, was considered reasonable given the amount of subjects' unleased space, tertiary market location, and outstanding leasing costs associated with absorption. The final "as-is" income approach value for subjects was $4,600,000. Reconciling the value indications from the sales comparison approach and the income approach, the appraisal concluded a total prospective stabilized value of $9,300,000, and a total "as-is" value of $4,550,000.

Respondent noted the effective date of the fee appraisal, July 11, 2017, was well beyond the January 1, 2017 assessment date, and contended the appraisal should therefore not be considered in determining subjects' 2017 assessments. The fee appraiser acknowledged the appraisal date was mid-2017, however, testified the value conclusions reached therein would not have varied much if the effective date of valuation were January 1, 2017. Rather, the fee appraiser explained because the market during 2017 was stable or perhaps slightly appreciating, the value conclusions may have been even a little lower on January 1.

In addition to the fee appraisal report, Appellant also provided a summary report for the property. The report detailed subjects' history, from the initial construction to the current status. Included in the report were current value estimates of the property using the income approach. The report considered subjects' income potential under three (3) scenarios; 1) without the bank lease, 2) with the bank lease at the actual 2016 lease rate of $18 per square foot, and 3) with the bank lease at the rate agreed to upon Appellant's August 2017 purchase at $20.87 per square foot. Total operating expenses were the same under each scenario, yielding net operating income figures of -$30,988, $204,971, and $332,720, respectively. The report then calculated subjects' value under each scenario using capitalization rates of 9%, 8%, 7%, and 6.5%. The first scenario indicated negative values for each of the considered rates of capitalization. The second scenario produced value estimates of $2,277,456, $2,562,138, $2,928,158, and $3,153,401, using the respective capitalization rates. The third scenario concluded values of $3,696,886, $4,158,997, $4,753,139, and $5,118,765, respectively. Appellant remarked none of the value estimates approached the current assessed values of roughly $9,500,000.

Rather than valuing subjects as a single property, Respondent separately considered both parcels and developed distinct appraisals for each. For the parking parcel, Respondent employed the sales comparison approach to value the land component and the cost approach for the paving and lighting improvements. Five (5) sales were offered in support of the assessed land value, three (3) of which were vacant lot sales and two (2) were improved. The vacant sales ranged in size from .097 to .163 acres and all sold during 2015. The sale prices were $70,000, $100,000, and $125,000, or $29.58, $23.67, and $19.72 per square foot, respectively. The improved parcels both sold in 2006. The .202 acre parcel sold for $200,000, or $22.73 per square foot, and the .342 acre parcel sold for $400,000, or $26.85 per square foot. Details concerning the improvements situated on the sale properties were not shared. Respondent concluded a value of $25 per square foot for the subject parking parcel, or $657,756. The combined value of the improvements was $24,970, resulting in a total value of $679,726 for the parking parcel.

Respondent valued the parcel containing the office building with consideration given to both the sales comparison and income approaches to value. Respondent reported there were no sales comparable to this subject in Sandpoint during 2015 or 2016, so no direct comparisons between the referenced sale properties and the subject were attempted. Instead, Respondent chose the six (6) sales closest in size to subject's building and added the sale properties square footages together, then divided the total by six (6). A downward adjustment of 10% was applied for subject's large size, which yielded a value rate of $115 per square foot, or $9,877,650.

Respondent offered two (2) income approaches, both of which concluded similar values for the improved subject parcel. Because subject is unique in the local market, the property's actual contract rents were used to develop income estimates under both models. In the first model, Respondent broke the building area into two (2) groups. The first group was for space currently leased on a triple net basis and the second was for space with gross leases in place. Respondent applied a 2% vacancy and collection loss factor to the income estimated for the first group, resulting in net operating income of $357,275. For the second group, a vacancy and collection loss rate of 20%, and a 35% expense rate was applied, resulting in a net operating income estimate of $285,580. Total net operating income was $642,855, to which a capitalization rate of 6.5% was applied. Respondent then removed the assessed value of the parking parcel from the indicated total value of $9,890,077, and additionally removed $400,212 for the determined cost to finish the shell space in the building. The final value for this subject was $8,810,136.

In Respondent's second income model, the building's total leasable space was divided into the same two (2) groups as in the first income model. The income attributable to the triple net space was $811,848, to which Respondent applied a 20% vacancy and collection loss factor, and a 5% management expense. A net operating income of $617,005 was calculated for the triple net space. The income for the gross lease space was calculated at $136,320, which resulted in a net operating income of $77,702 after Respondent applied a 5% collection and loss factor, and a 40% expense rate. Total net operating income of $694,707 was capitalized at a 6.5% rate, resulting in an estimated total value of $10,687,806. From this figure, Respondent deducted the $679,726 assessed value of the parking parcel and another $1,260,439 for the cost to finish the building's unfinished space and for lost rent. Respondent concluded a value of $8,747,641 for the building parcel under this model. The assessed value of the building parcel is $8,810,136, and the combined assessed value of both properties is $9,489,862.

## CONCLUSIONS OF LAW

This Board's goal in its hearings is the acquisition of sufficient, accurate evidence to support a determination of fair market value, or as applicable exempt status. This Board, giving full opportunity for all arguments and having considered all testimony and documentary evidence submitted by the parties in support of their respective positions, hereby enters the following.

Idaho Code § 63-205 requires taxable property be assessed at market value annually on January 1; January 1, 2017 in this case. Market value is defined in Idaho Code § 63-201, as,

> "Market value" means the amount of United States dollars or equivalent for which, in all probability, a property would exchange hands between a willing seller, under no compulsion to sell, and an informed, capable buyer, with a reasonable time allowed to consummate the sale, substantiated by a reasonable down or full cash payment.

Market value is estimated according to recognized appraisal methods and techniques. The three (3) generally-recognized approaches for determining market value include the sales comparison approach, the cost approach, and the income approach. *Merris v. Ada County*, 100 Idaho 59, 63, 593 P.2d 394, 398 (1979). Income-producing property is often valued using the income approach, however the sales comparison approach is also commonly considered. In the present case, the parties used the income and sales comparison approaches.

Undoubtedly the building associated with subjects has been and continues to be a unique property in the Sandpoint marketplace. As such the question of its market value presents a special appraisal problem. The initial purpose of the development was to function as corporate headquarters for a locally-owned bank. The property was also intended to serve as a community showpiece. The building was thus designed for single tenancy with little regard for how the facility might function as a multi-tenant office building. The result was a super-adequate building for the local market with a notable amount of unleaseable space. These factors complicate the determination of current market value.

The parties took different approaches in estimating the value of the subject properties. Appellant valued the subject parcels as a single unit, whereas Respondent valued each parcel on a standalone basis. While the parcels are not contiguous, they are used together to form a single business operation. We found without the secondary parking parcel there would likely be insufficient parking to serve the main building parcel. Even with the secondary parking parcel, the number of private parking spaces fell below the number typically associated with commercial office space. Given these particular facts, it is unlikely the parking parcel would be sold independent of the main building parcel. Therefore, it was more reasonable in the Board's view to value the subject parcels as a single marketable unit.

Though the parties used the same valuation approaches, there were notable differences in both the information relied upon and the accompanying analyses. The parties agreed there were no recent local sales of property closely comparable to subject. As a result, Appellant's appraisal expanded its consideration to sales of larger commercial developments from outside the immediate area and also considered sales from prior years. Location and time adjustments were made, as were other adjustments for purposes of comparing the sale properties with subject. The Board found the analysis to be well explained and generally well supported.

The Board was less persuaded by the analysis in Respondent's sales comparison approach. Rather than look for sales outside Sandpoint, Respondent instead relied solely on the six (6) local sales most similar to the subject building in terms of square footage.

Respondent's analysis consisted of "adding the six most comparable sales total square footage & dividing by 6 less 10% for size." *See* Respondent's Exhibit 3A, page 2. A list of nearly forty (40) sales from 2014 through 2016 was submitted. Physical details of the sale properties were scant or missing and it was not clear which sales on the list were used in the analysis. Typically the sales comparison approach considers recent sales of similar property with adjustments made for differences between the subject and the comparable sale properties. Other adjustments might also be made, for instance for the date or terms of sale. Respondent's methodology was not generally representative of a traditional sales comparison approach, but was instead found to be a simplistic approach which primarily considered square footage. The Board did not place much weight on this value evidence.

The Board was likewise concerned with aspects of Respondent's income approach. The subject building's actual lease rates were used, which the parties agreed were representative of current market rates. The Board found no error in this regard. The Board's concerns came from the expense rates used by Respondent -- which varied widely between the two (2) income models offered, the capitalization rate applied, and the differing estimates of costs to finish shell space and for lost rent. It was not clear the information sources from which some of these factors came, nor why there was so much variance in the numbers and rates used in the two (2) models. The different factors appeared rather suddenly without evidentiary support other than Respondent's verbal assertions they were appropriate. It was also deemed peculiar both models, despite the widely varied inputs, yielded nearly the same value conclusion. In all, the Board found it difficult to rely heavily on these value indications.

Though the income approach models offered by Appellant were better received, there too we had concerns. Most notable was the fee appraisal's July 11, 2017, effective date of valuation. As noted above, the controlling assessment date in these appeals is January 1, 2017, which would render the appraisal untimely. That being said, much of the market data utilized in the appraisal report was from 2016 or earlier, which was timely. The fee appraiser also testified the local commercial real estate market remained steady or perhaps even appreciated during the first half of 2017, and therefore the value conclusion would have been the same or a little lower as of January 1, 2017. This appraisal considered subjects' value under two (2) very distinct scenarios; "as-is", and "as stabilized". The "as-is" value was argued to represent subjects' current market value. The Board notes "as-is" valuations often will not represent the fair market value sought for assessment purposes. However due to the various issues concerning subjects, the Board found the fee appraisal's consideration of the subject building in its currently unfinished state and going through a use change to multi-tenant occupancy was more appropriate than the alternative valuations in record.

Less weight was afforded the alternate income approach models offered by Appellant. These approaches relied on subjects' actual income and expenses under three (3) scenarios specific to subject, with rather little supported consideration for how such rates compared to the market. As noted earlier, the parties agreed subjects' lease rates were at market, however, it was not clear whether subjects' actual expense rates were typical for the marketplace, or what the normal vacancy factor should be. The value conclusions under each scenario varied widely and application of four (4) different capitalization rates further diversified the value estimates. The information was appreciated, however, with so many different final value indications the report represented more of a range of potential value instead of a focused and definitive market value conclusion.

In appeals to this Board, Appellant bears the burden of proving error in subjects' assessed valuations by a preponderance of the evidence. Given the information provided by the parties and accompanying analyses, the Board finds the burden of proof satisfied in this instance. Appellant's valuation was found to be a thoughtful consideration of subjects and their current unique status in the local market. The analysis was relatively thorough and generally supported by market data existing before the assessment date. Though we normally look for a market value appraisal to use typical vacancy, the Board found cause here to adopt Appellant's value conclusion of $4,550,000 given the properties' current state and the questions about its future use and acceptance in the market.

Because subjects are distinct parcels each must be assigned value for property taxation purposes. The allocated parcel values must be further split between the land and improvement components. Appellant did not provide an allocation of total value. Respondent, on the other hand, separately valued subjects and identified values attributable to the respective land and improvements. Though the land values determined by Respondent appear high in relation to total value, the Board has no other information available by which to assign values to the individual assessment categories. As such, the Board will accept Respondent's land value determinations for each parcel, and will also not alter the value of the improvements Respondent concluded for the parking parcel.

Based on the above, the decisions of the Bonner County Board of Equalization are modified and affirmed, as follows:

Appeal No. 17-A-1309 - (Modified)

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| Land | $1,952,577 |
| Improvements | $1,917,697 |
| Total | $3,870,274 |

Appeal No. 17-A-1310 - (Affirmed)

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| Land | $657,756 |
| Improvements | $ 21,970 |
| Total | $679,726 |

FINAL ORDER

In accordance with the foregoing Final Decision, IT IS ORDERED that the decisions of the Bonner County Board of Equalization concerning the subject parcels be, and the same hereby are, MODIFIED with respect to Appeal No. 17-A-1309, and AFFIRMED with respect to Appeal No. 17-A-1310, as detailed above.

IT IS FURTHER ORDERED, pursuant to Idaho Code § 63-1305, any taxes which have been paid in excess of those determined to have been due be refunded or applied against other *ad valorem* taxes due from Appellant.

Idaho Code § 63-3813 provides that under certain circumstances the above ordered values for the current tax year shall not be increased in the subsequent assessment year.

DATED this 15th day of February, 2018.