STATE OF MINNESOTA

IN SUPREME COURT

A19-1420

Tax Court Lillehaug, J.

Medline Industries, Inc.,

Relator,

vs. Filed: April 1, 2020
Office of Appellate Courts

County of Hennepin,

Respondent.

Grover C. Sayre, III, Thomas C. Atmore, Jordan W. Sayre, Leonard, O'Brien, Spencer, Gale & Sayre, Ltd., Minneapolis, Minnesota, for relator.

Michael O. Freeman, Hennepin County Attorney, Sara Bruggeman, John March, Assistant County Attorneys, Minneapolis, Minnesota, for respondent.

S Y L L A B U S

The tax court's valuation of a distribution-warehouse property was not clearly erroneous.

Affirmed.

Considered and decided by the court without oral argument.

O P I N I O N

LILLEHAUG, Justice.

This case is about the market value of a distribution-warehouse property in Rogers, Minnesota. Medline Industries asserts that, in valuing the property, the tax court erred in four ways. We affirm.

FACTS

Medline owns a 300,000-square-foot warehouse on a 915,000-square-foot site in Rogers (the Property) that is used to distribute medical supplies. Hennepin County assessed the Property to be worth $15,912,000 in each of tax years 2014 and 2015 (for taxes payable in 2015 and 2016). Medline timely filed petitions with the tax court to challenge the assessments. The tax court consolidated the two petitions into one case.

At trial, the tax court received into evidence the appraisal reports prepared by the parties' experts. Medline's main appraisal was prepared by Paul Bakken. The County's main appraisal was prepared by Joseph Mako. After receiving all testimony and exhibits, the tax court concluded that the County's valuation in 2014 and 2015 was overstated, by $274,000 in 2014, and by $315,000 in 2015.

In its memorandum, the tax court first addressed the highest and best use of the Property. The parties agreed that, in general, the highest and best use was continued use as a distribution warehouse. The tax court, however, rejected the County's position that the highest and best use was as a *multi-tenant* facility.

The tax court then turned to the market valuation. The tax court considered the three traditional approaches to determine market value: the cost approach, the sales-comparison approach, and the income approach.

Under the cost approach, "the appraiser determines the current cost of constructing the existing improvements on the property, subtracts depreciation to determine the current value of the improvements, and then adds the value of the land to determine the market value." *Cont'l Retail, LLC v. Cty. of Hennepin*, 801 N.W.2d 395, 403 (Minn. 2011). In this case, the tax court found the building to be of Class C average construction, and then subtracted depreciation. The tax court found no evidence in the record to support a reduction in value for functional obsolescence. The tax court gave roughly equal weight to the parties' expert opinions on economic obsolescence and reduced the value by 20 percent for each tax year. After adding land value, the resulting market value under the cost approach was $18,605,669 in 2014, and $17,886,320 in 2015.

The sales-comparison approach requires the analysis of recent sales of other properties to determine their comparability, and adjusts sale prices as necessary for age, size, location, and condition. *See* Appraisal Inst., *The Appraisal of Real Estate* 381–82 (14th ed. 2013). Using the sales-comparison approach, the experts reached different conclusions. Bakken considered the sales of 9 warehouse properties, but relied heavily on the 2017 sale of a former Walgreens distribution center in Rogers. Mako relied on the sales of 14 other warehouse properties. After selecting and analyzing the sales prices for comparable properties, the tax court arrived at a value of $15,924,000, in each of the two tax years at issue.

As to the income approach, the tax court first determined the potential gross income, represented by market rent attributable to the real property at full occupancy, before vacancy and operating expenses are deducted. The tax court found that the market rent for the Property was $1,153,916 per year as of January 2014 and 2015.

The tax court then reduced the potential gross income by vacancy losses and by operating expenses. The tax court concluded that the appropriate capitalization rate was 6.25 percent in 2014 and 6 percent in 2015. The tax court found the value of the Property under the income approach to be $13,480,245 as of January 2, 2014, and $15,048,121 as of January 2, 2015.[1]

In arriving at a final reconciliation of value, the tax court gave "relatively more weight to the income and sales-comparison approaches, and relatively less weight to the cost approach." The tax court opined that the cost approach was less reliable because "the building does not fit neatly into a particular cost category, with some features typical of 'good,' of 'average,' and of 'low-cost' construction." *Medline Indus., Inc. v. Cty. of Hennepin*, Nos. 27-CV-15-6887, 27-CV-16-5829, 2019 WL 3241566, at *22 (Minn. T.C. July 12, 2019). Accordingly, the tax court placed the greatest reliance on the sales-comparison approach, but "temper[ed] that reliance" with the income approach, "which yielded somewhat lower values." *Id.* The tax court concluded that the market

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[1] A discrepancy exists between the 2014 value of the Property as stated in the income-approach section ($13,480,245) and in the table in the final reconciliation of value ($14,481,139). The difference is discussed below.

value of the Property was $15,638,000 as of January 2, 2014, and $15,597,000 as of January 2, 2015. Medline appealed the tax court decision.

ANALYSIS

Our review of the final order of the tax court is limited. *Hutchinson Tech., Inc. v. Comm'r of Revenue*, 698 N.W.2d 1, 6 (Minn. 2005). We determine only whether the tax court lacked jurisdiction, whether the tax court's order is supported by the evidence and in conformity with the law, and whether the tax court committed any other error of law. Minn. Stat. § 271.10, subd. 1 (2018); *Jefferson v. Comm'r of Revenue,* 631 N.W.2d 391, 394 (Minn. 2001). We will not disturb the tax court's decision unless it is clearly erroneous, that is, when "the evidence as a whole does not reasonably support the decision." *Menard, Inc. v. Cty. of Clay*, 886 N.W.2d 804, 811 (Minn. 2016) (citation omitted) (internal quotation marks omitted). Specifically, we have recognized that property valuation is an "inexact" science and thus we "defer to the decision of the tax court unless the tax court has either clearly overvalued or undervalued the subject property, or has completely failed to explain its reasoning." *Macy's Retail Holdings, Inc. v. Cty. of Hennepin*, 899 N.W.2d 451, 455 (Minn. 2017) (citation omitted) (internal quotation marks omitted); *see Eden Prairie Mall, LLC v. Cty. of Hennepin*, 797 N.W.2d 186, 192 (Minn. 2011).

Medline argues that the tax court's decision should be reversed and the case should be remanded because the tax court erred in four ways.[2] The County disagrees.

[2] For ease of analysis, we do not consider Medline's arguments in precisely the order they were made.

First, Medline argues that the tax court clearly erred by crediting some of Mako's opinions, despite rejecting his opinion about the highest and best use of the Property as a multi-tenant facility. Medline argues that Mako's incorrect opinion on highest and best use permeated all aspects of the County's appraisal.

Our role is not "to reweigh the evidence, and it is firmly within the tax court's province, as the factfinder, to weigh the evidence and assess the credibility of the witnesses." *Macy's Retail Holdings, Inc.*, 899 N.W.2d at 457; *see Lewis v. Cty. of Hennepin*, 623 N.W.2d 258, 262 (Minn. 2001) ("[T]he tax court is in the best position to evaluate the credibility of witnesses."). "The tax court need not accept an appraiser's valuation in its entirety; instead, it may adjust the calculations based on evidence in the record and its own expertise." *KCP Hastings, LLC v. Cty. of Dakota*, 868 N.W.2d 268, 275 (Minn. 2015). Thus, we have squarely rejected the argument that, "because the tax court rejected a portion of [] expert analysis, it was clearly erroneous for the tax court to accept any of it." *See Macy's Retail Holdings, Inc.*, 899 N.W.2d at 457–58.

After carefully reviewing the record, we conclude that the tax court did not err by crediting some of Mako's expert opinions after it had rejected his highest and best use analysis. Medline has not demonstrated that Mako's incorrect opinion on that issue fatally tainted his other opinions, or that the tax court gave them too much weight.

Second, Medline argues that the tax court erred in the sales-comparison approach by not considering the May 2017 sale of the former Walgreens distribution center as a comparable sale. Here, the respective experts chose their comparable sales differently. Bakken relied primarily on the former Walgreens sale. Mako relied on the sale of 14 other warehouse properties, which occurred before the valuation dates, and he did not include the later Walgreens transaction.

The tax court did not rely on either expert's selection of comparables, but chose its own. The tax court considered the properties presented as comparables and assigned different weights to each property depending on size, clear height, multi-tenant vs. single tenant, and sale date. The tax court then selected what it considered to be the best four comparable sales, of which the former Walgreens property was not one.

The tax court can abuse its discretion by refusing to consider comparable sales. *See S. Minn. Beet Sugar Coop. v. Cty. of Renville*, 737 N.W.2d 545, 556 (Minn. 2007) (holding that the tax court erred when it failed to make "any findings or conclusions related to . . . comparable sales evidence" because it "violated the tax court's duty to 'use its independent judgment in evaluating all testimony and evidence before the court' ") (citation omitted); *McNeilus Truck & Mfg., Inc. v. Cty. of Dodge*, 705 N.W.2d 410, 413–14 (Minn. 2005) (holding that the tax court abused its discretion in refusing to consider comparable out-of-state sales). But we cannot conclude that that was the case here.

It is not quite accurate to say that the tax court refused to consider the 2017 Walgreens sale, as Medline argues. Instead, the tax court considered the "universe" of properties presented by the parties that included the 2017 Walgreens sale, but it did not choose that sale as one of its final four comparables. The tax court reasoned that all sales after the valuation date, including the Walgreens sale, were entitled to relatively less weight.

Had we been the trier of fact, we might well have given more weight to the Walgreens sale. But the tax court has discretion to decide how to weigh the evidence, and that decision must be "sustained upon review unless [it is] clearly erroneous." *See Northerly Centre Corp. v. Cty. of Ramsey*, 248 N.W.2d 923, 926 (Minn. 1976). In this case, we cannot say that the tax court's decision to rely on four other comparable sales was clearly erroneous.

Third, Medline argues that the tax court erred in its income approach analysis in three respects.

Medline first argues that the tax court erred in accepting Mako's capitalization rates. The parties' experts disagreed on the appropriate capitalization rate. The tax court credited "Mr. Mako's calculations." But not entirely. Mako opined that the capitalization rate was 6 percent for both valuation dates. The tax court decided that the appropriate rate was 6.25 percent in 2014, and 6 percent in 2015. The tax court placed little weight on Bakken's analysis "because the adjustments he made to [the] capitalization rates differ[ed]—sometimes significantly—from the adjustments he made to the sale prices of the same properties as part of his sales comparison approach."

We cannot say that the tax court erred in its capitalization rate analysis. The rates that the tax court chose were within the range that the expert appraisers suggested. Even if Mako erred by double counting vacancy rates, as Medline suggests, the tax court did not fully credit his rates.

Medline next argues that the tax court erred by relying on market surveys as primary evidence for capitalization rates. But we afford the tax court "broad discretion" to rely upon or disregard the evidence presented at trial. *Menard, Inc.*, 886 N.W.2d at 813. The decision to rely in part on market surveys was within the tax court's discretion.

Medline further argues that our decision in *Archway Marketing Services v. County of Hennepin* questioned the tax court's reliance on market surveys. 882 N.W.2d 890 (Minn. 2016). That argument is not precisely on the mark. In *Archway*, we said that we "need not decide whether the tax court erred by relying solely on survey data to determine a capitalization rate" because the case had already been remanded on other grounds. *Id.* at 899. In any event, here, the tax court did not solely rely on market surveys.

Medline's third challenge to the income analysis asserts that the tax court erred in its conclusions under the income approach because it cited one number when summarizing the income approach ($13,480,245), and another number in its final reconciliation of value ($14,481,139). The former number appears to be in error. But the error is not material to the tax court's final analysis, and so the result is not clearly erroneous.

Fourth, Medline argues that the tax court's reliance on the cost approach was erroneous, in three ways.

Medline first argues that the tax court should not have relied on the cost approach at all, and failed to explain why it did. We review the weight given to the respective valuation approaches for an abuse of discretion. *KCP Hastings*, 931 N.W.2d at 785.

Here, Medline has not demonstrated that the tax court's partial use of the cost approach was an abuse of discretion. We have said that the cost approach is useful when "estimating the market value of new or relatively new construction, and is best applied 'when land value is well supported and the improvements are new or suffer only minor depreciation.' " *Cont'l Retail, LLC*, 801 N.W.2d at 403 (quoting Appraisal Inst., *The Appraisal of Real Estate* 382 (13th ed. 2008)). In this case, the land value was well supported. The tax court also properly gave less weight to the approach because the building did not fit into a particular cost category, making the cost approach less reliable. The tax court acted within its discretion to the extent it considered the cost approach in its valuation.

Next, Medline argues that the tax court should have reduced the value of the Property for functional obsolescence. Functional obsolescence arises from "a flaw in the structure, materials, or design that diminishes the function, utility, and value of the improvement." Appraisal Inst., *The Appraisal of Real Estate* 576 (14th ed. 2013). But the tax court found no evidence in the record, beyond Bakken's testimony that it did not credit, to support a reduction for functional obsolescence. This conclusion was not clearly erroneous.

Finally, Medline argues that the tax court did not find enough economic obsolescence. The weight to be given to expert testimony is within the discretion of the tax court. *See Menard, Inc.*, 886 N.W.2d at 813. The tax court gave roughly equal weight to the opinions of the two experts, and reduced the estimate of value under the cost approach by 20 percent as of each valuation date. The tax court did not abuse its discretion.

CONCLUSION

For the foregoing reasons, we affirm the decision of the tax court.

Affirmed.