STATE OF MINNESOTA

IN SUPREME COURT

A23-1419
A23-1420

Tax Court — Procaccini, J.
Took no part, Hennesy, J.

Tamarack Village Shopping Center, LP,

Relator,

vs. — Filed: July 31, 2024
Office of Appellate Courts

County of Washington,

Respondent.

Larry D. Martin, L. D. Martin Law Office, Chaska, Minnesota, for relator.

Kevin Magnuson, Washington County Attorney, James Zuleger, Assistant Washington County Attorney, Stillwater, Minnesota, for respondent.

S Y L L A B U S

1. When calculating potential gross income under the income capitalization approach to valuation, the tax court did not err by declining to use an effective rent calculation to account for tenant improvement allowances because the taxpayer's tenant improvement allowances were typical of the market.

2. The tax court did not clearly err by declining to deduct lease-up costs from a property's indicated value to account for its above-market vacancy rate on the assessment date because the taxpayer failed to show that such a deduction was required.

Affirmed.

O P I N I O N

PROCACCINI, Justice.

This appeal from the tax court concerns the valuation of two commercial properties in a Woodbury shopping center. We consider two questions about the tax court's income capitalization approach to valuing the properties: (1) whether the tax court erred when it declined to use an effective rent calculation when estimating the properties' value; and (2) whether the tax court erred when it declined to reduce the value of one of the properties to account for lease-up costs due to the property's above-market vacancy rate. The taxpayer, Tamarack Village Shopping Center, LP, appealed Washington County's initial assessments of the properties. At trial, the tax court heard testimony from three witnesses—the taxpayer's real property asset manager, the taxpayer's expert appraiser, and the County's expert appraiser. Following trial, the tax court largely accepted the opinions of the County's appraiser and rejected the opinions of the taxpayer's appraiser. The tax court's ultimate value conclusions increased the properties' assessed market values over the county assessor's initial valuations. In this appeal, the taxpayer contends that the tax court erred in its analysis by declining to use an effective rent calculation to determine potential gross income and by not deducting certain lease-up costs from the indicated value of one of the properties. Because the tax court did not err, we affirm.

FACTS

These consolidated cases come to us on the taxpayer's appeal from two orders of the tax court. *Tamarack Vill. Shopping Ctr., LP v. County of Washington*, Nos. 82-CV-20-2003, 82-CV-20-2004, 2023 WL 2669686 (Minn. T.C. Mar. 28, 2023) (trial order); 2023 WL 5537070 (Minn. T.C. Aug. 28, 2023) (post-trial order). The appeal concerns the assessed market values of two contiguous parcels as of January 2, 2019 (the assessment date). These values are used to calculate the real estate taxes due and payable in 2020. Both parcels are part of the Tamarack Village Shopping Center (Tamarack Village), a multi-tenant retail "power center" consisting of several related parcels in Woodbury.[1] We follow the lead of the parties and tax court in referring to the parcels individually as "Center" and "Main," and collectively as "the properties" or "the subject properties." Center and Main comprise the majority of the taxpayer-owned portion of Tamarack Village. The taxpayer challenged the properties' assessed values in two separate petitions, but the petitions were consolidated at the tax court and in this appeal.

In early 2019, shortly after the assessment date, the taxpayer worked with a broker to market its portion of Tamarack Village for sale. The 2019 sale offering included the two subject properties, as well as two additional parcels that are not part of this appeal. In its efforts to sell the properties, the taxpayer prepared a confidential offering memorandum that described Tamarack Village and the Woodbury commercial retail market in terms

[1] A "power center" is "[a] large community shopping center with more than 250,000 square feet of space anchored by three or more tenants that occupy 60% to 90% of the space; the number of specialty stores is kept to a minimum." Appraisal Institute, *The Dictionary of Real Estate Appraisal* 174 (6th ed. 2015).

attractive to potential investors. Relevant here, the memorandum marketed the properties together and advertised a single occupancy rate across the entirety of the taxpayer-owned parcels in Tamarack Village. The memorandum advertised the occupancy rate of Tamarack Village at 95 percent and noted an overall 95 percent average occupancy rate across Woodbury's Interstate 94 retail corridor. It also described the Woodbury retail market as "one of the Twin Cities' strongest submarkets with superb trade area demographics in the heart of one of the Twin Cities' most dominant retail corridors."

Center is an aptly named circular parcel at the center of Tamarack Village with a land area of 183,679 square feet. Center has been improved by construction of a single multi-tenant commercial building containing 14 retail tenant spaces, ranging in size from 1,100 to 7,460 square feet. Constructed in 1996, the building is of good quality and was in average condition on the assessment date. The Center building's location inside the larger Tamarack Village development increases its overall appeal. Center's highest and best use was its continued use as a multi-tenant retail shopping center. The county assessor valued Center at $10,615,600 as of the assessment date.

As of the assessment date, Center had a vacancy rate of 16.89 percent—higher than the 6 percent market vacancy rate in the Woodbury retail rental market. The tax court found that this vacancy rate meant that Center was "technically destabilized."[2] But the tax court also found that "[n]othing about Center itself suggests that Center could not perform

[2] A property is "destabilized" when it is not capturing its appropriate share of market demand, either at a given point in time or over a specified projection period. *Cf.* Appraisal Institute, *The Dictionary of Real Estate Appraisal* 219 (6th ed. 2015) (defining "stabilized occupancy").

at market occupancy" and that the above-market vacancy rate on the assessment date was a "routine market fluctuation" and "would not influence a potential purchaser's evaluation of Center's long-term income-earning capacity."

The other parcel—Main—essentially surrounds Center. Main is a much larger parcel, with an overall land area of 2,285,945 square feet and a usable land area of 2,198,825 square feet. Main has been improved by construction of eight buildings comprised of 47 tenant spaces for commercial use, ranging in size from 959 to 87,996 square feet. The layout of structures is typical for a large retail center. Constructed in 1996 and 2004, the Main buildings are of good quality and were in average condition on the assessment date. Main's highest and best use was its continued use as a multi-tenant retail shopping center. The county assessor valued Main at $75,792,500 as of the assessment date.

The taxpayer and the County presented expert opinions from professional appraisers. The taxpayer's expert was Kelsey Malecha, and the County's expert was Ethan Waytas.

As of the assessment date, free rent was not a common concession in the Woodbury retail rental market, and the tax court found that the taxpayer did not offer free-rent concessions to its tenants. The tax court based its finding on the testimony of the taxpayer's asset manager that Tamarack Village did not offer free rent, though it did not require payment of rent during a 90- to 120-day initial build-out or fixturing period. The tax court also noted that the County's expert witness testified that he had not received any information from Tamarack Village indicating that it had provided free rent.

All three witnesses testified that tenant improvement allowances were standard in the Woodbury market as of the assessment date and that the taxpayer provided those allowances at levels typical in the market. The tax court accepted this testimony.

We recognize three approaches for estimating the market value of real property: the income (or income capitalization) approach, the sales (or sales comparison) approach, and the cost approach. *Inland Edinburgh Festival, LLC v. County of Hennepin*, 938 N.W.2d 821, 825 (Minn. 2020); *S. Minn. Beet Sugar Coop v. County of Renville*, 737 N.W.2d 545, 555 (Minn. 2007). Malecha appraised the properties under the income and sales approaches but did not complete a cost approach valuation. Waytas used all three approaches in his appraisal.

The valuations of the county assessor, parties' experts, and tax court are summarized in the tables below.

Center				
	County Assessor	Taxpayer (Malecha)	County (Waytas)	Tax Court
Sales Approach	N/A	$8,200,000	$11,860,000	$11,455,000
Income Approach	N/A	$8,150,000	$12,115,000	$12,121,000
Cost Approach	N/A	N/A	$11,200,000	$11,200,000
Final Valuation	$10,615,600	$8,150,000	$11,900,000	$11,900,000

Main				
	County Assessor	Taxpayer (Malecha)	County (Waytas)	Tax Court
Sales Approach	N/A	$66,000,000	$89,555,000	$85,062,000
Income Approach	N/A	$65,975,000	$82,545,000	$82,582,000
Cost Approach	N/A	N/A	$74,880,000	$74,880,000
Final Valuation	$75,792,500	$65,975,000	$85,000,000	$83,000,000

In arriving at their final valuations, both experts, as well as the tax court, placed primary weight on the value derived under the income approach and secondary weight

on the value derived under the sales approach. The tax court gave the income approach 70 percent weight and the sales approach 30 percent weight in reconciling its final valuations. Waytas attributed tertiary weight to the value derived under the cost approach. The tax court gave "scant weight" to the cost approach, accounting for that approach by simply rounding down the weighted value it had reached after reconciling the other two approaches.

Because the sales and cost approaches are not at issue, we set forth here only the relevant aspects of the two experts' valuations under the income approach. To provide context to our discussion of the experts' income approach valuations, we briefly summarize the analytical steps relevant to this appeal.

"The income capitalization approach determines the value of income-producing property by capitalizing the income the property is expected to generate over a specific period of time at a specified capitalization yield rate." *Cont'l Retail, LLC v. County of Hennepin*, 801 N.W.2d 395, 402 (Minn. 2011). In this appeal, there are five relevant steps to arrive at a valuation of real property under the income approach.[3] First, the appraiser estimates the potential gross income of the subject property based on the income and expense data for the subject property and comparable properties. Appraisal Institute, *The Appraisal of Real Estate* 432 (15th ed. 2020). Second, the appraiser calculates the effective gross income by subtracting from potential gross income the estimated vacancy and

[3] Our description of these steps reflects the commercial retail property context. The application of these steps may vary depending on the types of income derived by the commercial property.

collection losses associated with applicable income streams. *Id.* Third, the appraiser calculates the net operating income by estimating the total operating expenses of the subject property and subtracting them from the estimated effective gross income. *Id.* Fourth, the appraiser applies a direct or yield capitalization technique to the data to arrive at an "indicated value," or final estimate of value, under the income approach. *Id.* Fifth, "[i]f necessary," the appraiser adjusts the indicated value to "account[] for the cost of leasing up the property." *Id.* We discuss the experts' differing approaches to these five steps below.

At the first step, the two experts estimated the properties' potential gross income based on a market rent estimate. In arriving at a market rent estimate, Malecha used eight comparable retail spaces for Center and 15 comparable retail spaces for Main (inclusive of the same eight comparables used for Center). Malecha's comparables were based on retail space at the subject properties in four size categories, and she did not adjust her comparables to account for factors such as location or building quality. In the four size categories, from smallest to largest, Malecha determined market rents of $20, $15, $12, and $10 per square foot. She then employed an effective rent calculation, which reduced the market rents to account for rent concessions and tenant improvement allowances, amortized at 3 percent over a specified lease period. In each of the four respective size categories, she applied rent concessions of 3, 3, 6, and 6 months and tenant improvement allowances of $25, $20, $15, and $10 per square foot to lease periods of 5, 7, 10, and 12 years, resulting in effective rents of $13.56, $11.19, $9.54, and $8.55 per square foot.

Malecha used these effective rent estimates to calculate the potential gross income of the subject properties. In doing so, she multiplied the amount of rentable square feet at the subject properties in each class of retail space by her effective rent, and then totaled the result from each class to arrive at a potential gross income for each property. Malecha calculated the potential gross income of Center at $537,334 and Main at $4,647,962.

The tax court took issue with Malecha's use of lease renewals, rather than new leases, for three of her rent comparables. Nevertheless, the tax court's "principal concern" with Malecha's rent comparables was her "failure to adjust . . . for pertinent elements of comparison, and for location in particular." It found that "Malecha's failure to adjust her rent comparables for retail location—plainly a critical consideration for investors (as the offering memorandum demonstrates)—is sufficient in itself to undermine the credibility of her entire market rent analysis."

The tax court also took issue with Malecha's effective rent analysis. First, the tax court found no justification for reducing market rent to account for free-rent concessions. It noted that Malecha had conceded in her testimony that she had no evidence of any rent concessions for either of the two largest classes of retail space among her comparables, that the taxpayer's real property asset manager had testified that the taxpayer did not offer free rent, and that Waytas testified that free rent was not a common concession in the market. Second, the tax court determined that there was no reason to adjust market rent for tenant improvement allowances, because tenant improvement allowances were standard in the retail rental market as of the assessment date and the taxpayer's allowances were at market levels and not excessive. The tax court noted that Malecha testified that

none of the allowances adjusted for in her effective rent calculations were excessive, that the taxpayer's asset manager testified that typical tenant improvement allowances in the market were indeed far higher than those estimated by Malecha, and that Waytas testified that recent allowances at the properties were consistent with the market and not atypical.

Waytas used 23 rent comparables of retail space in four size categories to arrive at market rents of $24, $24, $19.50, and $11.25 per square foot.[4] Waytas used only new leases for comparison. He adjusted the comparable leases to account for factors including location, lease date, age, condition, and quality/appeal. The adjustments for location included consideration of visibility, traffic, access, exposure, and trade-area purchasing power based on population and household income. Waytas used his market rent estimates to calculate the potential gross income of the properties as $945,045 for Center and $6,514,701 for Main.

The tax court adopted Waytas's estimates of potential gross income, in part because it found his market rent analysis "more rigorous and persuasive" than Malecha's analysis. The tax court noted that the most important reason for crediting Waytas's market rent analysis over Malecha's was his use of trade-area purchasing power to make a location adjustment for each comparable lease. It also noted that Waytas had not relied on lease renewals.

When determining an estimated market vacancy rate at step two, Malecha concluded that the market vacancy rate for the Woodbury retail submarket was 5.3 percent

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4 The size categories used by Waytas differed slightly from those used by Malecha.

and noted that, as of the assessment date, Center was 76.7 percent leased and Main was 97.9 percent leased.[5] Waytas arrived at a 5 percent vacancy rate for the Woodbury retail submarket but used a 6 percent vacancy rate in valuing the subject properties, noting the historical vacancy rates at the properties.

The tax court declined to deviate from the market vacancy rate when valuing the properties, notwithstanding Center's much higher (16.89 percent) vacancy rate as of the assessment date. It referred to the offering memorandum and observed that the properties had a "common owner who operates them together and who plainly considers them as—and recently marketed them as—related assets." Additionally, noting that Center had historically maintained high occupancy and that Main continued to maintain a below-market vacancy rate on the assessment date, the tax court credited Waytas's testimony that Center's recent above-market vacancy rate was a routine market fluctuation and that his 6 percent market vacancy rate was consistent with investor expectations over the holding period.[6] The tax court also credited Waytas's testimony that management decisions may have impacted Center's occupancy and found that nothing about the property itself suggested it "could not perform at market occupancy." Lastly, the tax court

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[5] The tax court determined that Malecha's figure for Center, which reflected a 23.26 percent vacancy rate, was based on an erroneous reading of the rent rolls on the valuation date.

[6] "Holding period" refers to "[t]he time during which a capital asset must be held to determine whether gain or loss from its sale or exchange is long-term or short-term." *Holding period*, *Black's Law Dictionary* (11th ed. 2019); *see also Equitable Life Assurance Soc'y v. County of Ramsey*, 530 N.W.2d 544, 549 (Minn. 1995) (equating "holding period" and "the term of ownership").

agreed with Waytas's testimony that using an above-market vacancy rate to value Center required the unsupported assumption that Center would perform perpetually at that level of vacancy. Accordingly, the tax court adopted Waytas's 6 percent vacancy rate.

At the third step, both experts agreed that the sole non-recoverable operating expense to be deducted in arriving at the net operating income was a replacement reserve. The tax court adopted a replacement reserve calculation that neither party disputes.

At step four, both experts used the "direct capitalization" method, and Malecha also performed a yield capitalization technique known as the "discounted cash flow" method. The tax court declined to rely on Malecha's discounted cash flow analysis, finding that analysis unnecessary for valuing the properties and less reliable than the direct capitalization method. The taxpayer does not argue that the tax court erred in relying solely on the direct capitalization method.

Under the direct capitalization method, both experts estimated a capitalization rate by looking to the rates implied by recent sales of comparable properties, investor surveys, and the band of investment.[7] In doing so, Waytas derived a capitalization rate of 7 percent,

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[7] A capitalization rate is "[a] ratio of one year's net operating income provided by an asset to the value of the asset," and it is "used to convert income into value in the application of the income capitalization approach." Appraisal Institute, *The Dictionary of Real Estate Appraisal* 31 (6th ed. 2015).

The band of investment method derives a capitalization rate based on a weighted average of rates that satisfy market return requirements of investors of both debt and equity capital. *See The Appraisal of Real Estate*, *supra*, at 463–65.

while Malecha derived a capitalization rate of 6.75 percent.[8] The tax court adopted Waytas's slightly higher capitalization rate. After adjusting, or "loading," the capitalization rate to account for the portion of property tax borne by the taxpayer due to vacancy, the tax court arrived at a 7.18 percent final loaded capitalization rate for Center and a 7.19 percent final loaded capitalization rate for Main.

Malecha's application of the capitalization rate differed between the two properties. For Main, she applied her 6.75 percent capitalization rate to the property's 2019 net operating income estimate and arrived at an indicated value under the income approach of $65,807,066. When calculating Center's value, Malecha again used a 6.75 percent capitalization rate. But Malecha did *not* apply that rate to her estimate of Center's 2019 net operating income, as she asserted it would be inappropriate to capitalize "unstable" net operating income. Instead, she calculated the 2021 net operating income of Center at stabilized occupancy, indexed that value backward to the present value on the assessment date, and finally applied the capitalization rate to the resulting value.[9] In doing so, Malecha arrived at an indicated value under the income approach of $8,359,807 for Center.

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[8] Although Malecha's rate was lower than Waytas's rate, and therefore less advantageous to the taxpayer, the tax court observed that "its selection was problematic." Specifically, the tax court explained that because Malecha's effective rents incorporated above-the-line deductions for tenant improvement allowances, she ought to have developed a capitalization rate that also treated such allowances as above-the-line expenses, which Malecha conceded she did not do. The tax court concluded that if Malecha had appropriately adjusted her capitalization rate data, it would have resulted in a lower capitalization rate and, resultingly, higher valuations of the properties.

[9] The back-indexed 2021 net operating income that Malecha capitalized was $564,287—less than the 2019 net operating income that she calculated at $598,663.

For reasons not fully explained, Malecha then took deductions from the indicated values of both properties to account for tenant improvements and lease-up costs.[10] The tax court surmised, and the taxpayer repeatedly asserts, that this deduction from the indicated value of Center was intended "to address costs a prospective purchaser would incur to eliminate Center's recent, above-market vacancy of almost 17%" at step five. Malecha's corresponding deduction taken from *Main's* value remains unexplained, however, since Main had a *below-market* vacancy rate. After incorporating these deductions and rounding, Malecha arrived at indicated values of $7,950,000 for Center and $65,425,000 for Main under the direct capitalization variant of the income approach.[11]

For his part, Waytas applied his 7.18 percent loaded capitalization rate for Center and 7.19 percent loaded capitalization rate for Main, and after rounding, arrived at indicated values of $12,115,000 for Center and $82,545,000 for Main under the direct capitalization variant of the income approach. Waytas made no step-five deductions from his indicated values. The tax court adopted Waytas' preliminary value conclusions, corrected clerical errors and, after rounding, derived final indicated values of $12,121,000 for Center and $82,582,000 for Main under the direct capitalization method.

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10 The tax court surmised that the amount of the deduction from the indicated value of Center was equivalent to the tenant improvement and lease-up costs in years one through three of Malecha's discounted cash flow calculation, while the amount of the deduction from the indicated value of Main was equivalent to those costs solely from year one of Malecha's discounted cash flow calculation. We do not find substantiation for that explanation in the record.

11 These figures do not match Malecha's final indicated values under the income approach because Malecha relied on her discounted cash flow analysis to arrive at those value indications.

After reconciling these valuations under the income approach with its valuations under the sales and cost approaches, the tax court ultimately ordered that Center's assessed value be increased from $10,615,600 to $11,900,000 and Main's assessed value be increased from $75,792,500 to $83,000,000. The taxpayer moved for amended findings or a new trial, raising the two principal issues present in this appeal, along with other arguments not before us. The tax court declined to amend its findings on procedural grounds and, alternatively, on the merits. Because the tax court found that the challenged facts in its prior decision were adequately supported by the record evidence, it denied the request for a new trial. Upon the taxpayer's petitions, we issued writs of certiorari and, upon the parties' joint motion, consolidated the cases on appeal.

ANALYSIS

This appeal concerns the valuation of real property for taxation purposes. A taxpayer may challenge such a valuation by filing a petition with the tax court. *See* Minn. Stat. § 278.01 (2022).[12] We conduct a limited and deferential review of the tax court's final decision. *See Eden Prairie Mall, LLC v. County of Hennepin* (*EPM I*), 797 N.W.2d 186, 192 (Minn. 2011). We review the tax court's legal determinations de novo and its factual findings for clear error. *All. Hous. Inc. v. County of Hennepin*, 4 N.W.3d 355, 357 (Minn. 2024).

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[12] Taxpayers generally must offer evidence to overcome the prima facie validity of an assessment order. *See S. Minn. Beet Sugar Coop v. County of Renville*, 737 N.W.2d 545, 558 (Minn. 2007). Because the County waived the prima facie validity of its assessor's valuations, this appeal involves only the tax court's determination of the properties' market values.

A tax court's factual finding is "clearly erroneous" if it is "not reasonably supported by the evidence as a whole." *Hansen v. County of Hennepin*, 527 N.W.2d 89, 93 (Minn. 1995). "The inexact nature of property assessment necessitates that this court 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." *Id.* The tax court "brings its own expertise and judgment to the hearing, and its valuation need not be the same as that of any particular expert as long as it is within permissible limits and has meaningful and adequate evidentiary support." *Montgomery Ward & Co. v. County of Hennepin*, 482 N.W.2d 785, 791 (Minn. 1992). On appeals from the tax court, we will not reweigh the evidence or reassess the credibility of witnesses. *Medline Indus., Inc. v. County of Hennepin*, 941 N.W.2d 127, 131 (Minn. 2020).

I.

The taxpayer first challenges the tax court's valuation of the properties under the income approach, contending that the tax court erred by declining to calculate the properties' potential gross income based on an effective rent, rather than a market rent.

Real property is taxable in Minnesota, unless it is otherwise exempt. Minn. Stat. § 272.01, subd. 1 (2022). Real property is generally "valued at its market value" for taxation purposes. Minn. Stat. § 273.11, subd. 1 (2022). Market value is "the usual selling price at the place where the property to which the term is applied shall be at the time of assessment; being the price which could be obtained at a private sale or an auction sale." Minn. Stat. § 272.03, subd. 8 (2022).

As noted above, we recognize three approaches for estimating the market value of real property: the income (or income capitalization) approach, the sales (or sales comparison) approach, and the cost approach. *Inland Edinburgh Festival, LLC v. County of Hennepin*, 938 N.W.2d 821, 825 (Minn. 2020). "Whenever possible, appraisers should apply at least two approaches to market value because the alternative value indications derived can serve as useful checks on each other." *Equitable Life Assurance Soc'y v. County of Ramsey*, 530 N.W.2d 544, 553 (Minn. 1995). "However, the three valuation approaches are neither exclusive nor mandatory and the quantity and quality of available data ultimately determines which approaches are useful and how much weight each is given." *Nw. Racquet Swim & Health Clubs, Inc. v. County of Dakota*, 557 N.W.2d 582, 587 (Minn. 1997). "We 'accord the tax court broad discretion in choosing which valuation approach to use.' " *Menard, Inc. v. County of Clay*, 886 N.W.2d 804, 819 (Minn. 2016) (quoting *Evans v. County of Hennepin*, 548 N.W.2d 277, 278 (Minn. 1996)). The approaches to valuation are applied in light of a "property's highest and best use." *Id.* at 811. "The highest and best use of a property is the one that is physically possible, legally permissible, financially feasible, and maximally productive." *Id.*; *see also The Appraisal of Real Estate*, *supra*, at 305.

The taxpayer's appeal attacks the tax court's valuation of the properties exclusively based on perceived deficiencies in the tax court's analysis of the income approach.[13] As

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[13] The taxpayer contends in its reply brief that its arguments about lease-up costs also apply to the tax court's analysis of the sales comparison approach. The taxpayer forfeited this argument by failing to raise it in its principal brief. *See Moorhead Econ. Dev. Auth. v. Anda*, 789 N.W.2d 860, 887 (Minn. 2010).

noted above, "[t]he income capitalization approach determines the value of income-producing property by capitalizing the income the property is expected to generate over a specific period of time at a specified capitalization yield rate." *Cont'l Retail, LLC v. County of Hennepin*, 801 N.W.2d 395, 402 (Minn. 2011). We have "recognized the usefulness of the income approach in valuing income producing properties." *Nw. Racquet*, 557 N.W.2d at 587. "Under the income capitalization approach, the 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." *EPM I*, 797 N.W.2d at 195. Net operating income is "the actual or anticipated net income that remains after all operating expenses are deducted from gross income, but before debt service and book depreciation are deducted." *Id.*

As noted above, in this appeal there are five relevant steps to arrive at a valuation of real property under the income approach: (1) estimation of the subject property's potential gross income; (2) calculation of the subject property's effective gross income by subtracting the estimated vacancy and collection losses; (3) calculation of the subject property's net operating income by estimating its total operating expenses and subtracting them from the estimated effective gross income; (4) application of a direct or yield capitalization technique to the data to arrive at a final estimate of value; and (5) "[i]f necessary," adjustment of the value indicated at the prior step to "account[] for the cost of leasing up the property." *The Appraisal of Real Estate*, *supra*, at 432.

The taxpayer's first argument concerns the proper calculation of potential gross income at step one. When the income generated by an investment property primarily takes

the form of rent, a fee-simple property valuation will estimate the value of rentable space using market rent levels. *EPM I*, 797 N.W.2d at 195. "Market rent, or the rent that could be obtained in the open market, may be different than the actual rent negotiated by the parties to a lease." *Archway Mktg. Servs. v. County of Hennepin*, 882 N.W.2d 890, 897 (Minn. 2016). "To calculate the market rent of the subject property, an appraiser often gathers, compares, and adjusts rental data" from comparable leased properties reflecting arm's length transactions. *Id.*

To develop an estimate of market rent by comparing leases with different provisions, appraisers sometimes use an analytical tool known as "effective rent." *The Appraisal of Real Estate*, *supra*, at 421–22. Effective rent reflects "the total base rent, or minimum rent stipulated in a lease, over the specified lease term minus rent concessions—e.g., free rent, excessive tenant improvements, . . . and other leasing incentives." *Id.* at 422. We have clarified that an effective rent calculation may be necessary "[w]here market conditions require rent concessions." *EPM I*, 797 N.W.2d at 195. "Tenant improvement allowances are rent concessions that provide tenants with financial assistance to construct improvements to the leased space." *Eden Prairie Mall, LLC v. County of Hennepin* (*EPM II*), 830 N.W.2d 16, 21 (Minn. 2013). "[W]hether tenant improvement allowances should be deducted to arrive at effective market rents must be determined on a case-by-case basis" by looking to whether they are "excessive or atypical" in the market. *EPM I*, 797 N.W.2d at 196.

"When an appraiser determines it is appropriate to deduct tenant improvement allowances, the appraiser must decide whether those allowances should be considered an

‘above-the-line expense’ or a ‘below-the-line expense.’ ” *EPM II*, 830 N.W.2d at 21. “An ‘above-the-line expense’ is recorded ‘above’ the net operating income line and is considered part of the total operating expenses for the property.” *Id.* “In contrast, a ‘below-the-line expense’ is recorded ‘below’ the net operating income line and is not considered part of the total operating expenses for the property.” *Id.* “Generally, tenant improvement allowances ‘are the most common line items recorded below the net operating income line.’ ” *Id.* (quoting Appraisal Institute, *The Appraisal of Real Estate* 480 (13th ed. 2008)). “If tenant improvements are considered as above-the-line expenses, they are subtracted from market rents to determine effective market rents.” *Macy’s Retail Holdings, Inc. v. County of Hennepin*, Nos. 27-CV-09-15221, 27-10-CV-08453, 27-CV-11-07991, 27-CV-12-10082, 2014 WL 5823033, at *14 (Minn. T.C. Nov. 6, 2014) (citing *EPM II*, 830 N.W.2d at 21). “If, on the other hand, tenant improvements are considered as below-the-line expenses, they are addressed through the selection of the appropriate capitalization rate.” *Id.* (citing *EPM II*, 830 N.W.2d at 21). Whether adjusted above or below the line, the comparable properties used to derive the capitalization rate must account for tenant improvements on the same basis to maintain internal consistency and avoid artificially inflated or lowered value indications. *Id.*

A straightforward application of our case law supports the tax court’s decision not to utilize an effective rent calculation. Here, it is uncontested that the taxpayer’s tenant improvement allowances were typical of the market, and our case law is clear: Where tenant improvement allowances are not atypical or excessive, they function as a below-the-line expense that is recovered through market rent. *See EPM I*, 797 N.W.2d at

195–96; *EPM II*, 830 N.W.2d at 21. Under the direct capitalization method, an appraiser assumes that the operating expenses required to generate revenue will be stable over the holding period. *See* Appraisal Institute*, The Appraisal of Real Estate* 459 (15th ed. 2020). As the tax court correctly reasoned, because a market-level tenant improvement allowance is an anticipated below-the-line expense used to estimate market-level rent over the holding period, market rent incorporates a corresponding, amortized repayment of a market-level tenant improvement allowance. An effective rent calculation is therefore not required to account for a market-level tenant improvement allowance. *See EPM I*, 797 N.W.2d at 195–96. Accordingly, because the taxpayer's tenant improvement allowances were typical of the market, the tax court did not err in declining to use an effective rent calculation.

The taxpayer attempts to avoid the clear command of our previous decisions by arguing that an effective rent calculation was nevertheless required for three reasons. First, the taxpayer asserts a theory based on a general principle that real property be valued "as-is" on the assessment date. Second, the taxpayer argues that its position is supported by the Uniformity Clauses of the United States and Minnesota Constitutions. And third, the taxpayer contends that fixturing or build-out time at the beginning of leases at the properties is "free rent." We discuss these arguments in turn.

A.

The taxpayer contends that Minnesota law imposes a duty to appraise property subject to taxation, which "requires that real property values be determined based upon the improvements that existed in their current condition on the assessment date" and that any deviation from this standard "results in the appraisal of a hypothetical property rather than

the real subject property in question." The taxpayer argues that this asserted requirement, which we refer to as a "current condition requirement," arises from Minnesota statutes and case law.[14]

The taxpayer relies on three statutes to support its current condition requirement. First, the taxpayer cites Minnesota Statutes section 272.03, subdivision 1(a) (2022), which reads: "For the purposes of taxation, . . . 'real property' includes the land itself, . . . *all buildings, structures, and improvements or other fixtures on it*, . . . and all rights and privileges belonging or appertaining to the land . . . ." (Emphasis added.) Second, the taxpayer cites Minnesota Statutes section 273.08 (2022), which reads: "The assessor shall actually view, and determine the market value of each tract or lot of real property listed for taxation, including the value of *all improvements and structures thereon*, . . . and shall enter the value opposite each description." (Emphasis added.) Third, the taxpayer cites Minnesota Statutes section 273.11, subdivision 1, which provides that, subject to limited exceptions, "all property shall be valued at its market value" and that "[i]n assessing any tract or lot of real property, the value of the land, exclusive of structures and improvements, shall be determined, and also the value of *all structures and improvements thereon*, and the aggregate value of the property, including all structures and improvements." (Emphasis added.)

The taxpayer also supports its current condition requirement by citing to five opinions without explaining their significance. In the first, *Bloomington Hotel Investors,*

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[14] The taxpayer refers to this as the "as-is" requirement. To avoid confusion with other usages of that term in appraisal practice, we refrain from doing so.

LLC v. County of Hennepin, we concluded that the tax court did not clearly err in adopting an expert's estimated reserve for replacement fund based on reasoning that, in part, reflected the tax court's conclusion that "the income approach requires that the subject property is valued in its current condition and, under Minnesota law, only items fully deteriorated and in need of immediate repair should be categorized as deferred maintenance." 993 N.W.2d 875, 888 (Minn. 2023) (emphasis omitted).

The taxpayer also cites four tax court opinions, all of which relate to property that was not currently at its highest and best use due to existing structures or conditions of the property. *Arcadia Dev. Corp. v. County of Hennepin*, Nos. TC-12755, TC-15430, 1992 WL 366495, at *3–4 (Minn. T.C. Dec. 10, 1992), *amended* (Minn. T.C. Jan. 26, 1993) (finding that where the market value of land improved with a mobile home park had an alternative highest and best use, the property's valuation on the assessment date required a deduction for costs associated with closing the park); *Weed v. County of Hennepin*, No. TC-11220, 1991 WL 169083, at *2 (Minn. T.C. Aug. 15, 1991) (affirming county assessor's valuation because taxpayer failed to establish overvaluation but noting, in dicta, that county had produced a second estimate of market value with a highest and best use for the property as vacant and the second appraisal was higher than the initial assessed value after accounting for demolition of structure); *Brastad v. County of Hennepin*, Nos. TC-5365, TC–5425, 1987 WL 12481, at *4–5 (Minn. T.C. May 28, 1987) (finding that where an improved industrial parcel had a highest and best use as a more intensive industrial use, market valuation at a higher use would be reduced to account for soil remediation and structure demolition, among other things); *Koneck v. County of Hennepin*,

No. TC-5322, 1987 WL 9996, at *2 (Minn. T.C. Apr. 16, 1987) (finding that market value of lot with an unusable structure required a deduction for demolition and site-preparation costs).

The above statutes and opinions do not create the sweeping requirement that the taxpayer ascribes to them. Rather than "requir[ing] that real property values be determined based upon the improvements that existed in their current condition on the assessment date" and that "[a]ny deviation from [this] standard results in the appraisal of a hypothetical property rather than the real subject property in question," as the taxpayer contends, these authorities stand for the more limited proposition that the valuation of real property must account for the market value of the land and the improvements or structures upon it. *See* Minn. Stat. §§ 272.03, subd. 1(a); 273.11, subd. 1. None of the taxpayer's authorities undermine the appropriateness of the income approach—with its focus on cashflows and investor expectations rather than cost of physical improvements—in estimating the market value of real property. To decide otherwise would run contrary to the cases in which we have approved the tax court's treatment of tenant improvement allowances under the income approach. *See EPM II*, 830 N.W.2d at 21; *444 Lafayette, LLC v. County of Ramsey*, 830 N.W.2d 25, 30 (Minn. 2013).

Moreover, the opinions cited by the taxpayer are simply inapposite. The proper classification of deferred maintenance, the issue in *Bloomington Hotel*, is not in dispute here. And this appeal does not involve properties that would require demolition, reconstruction, or remediation to achieve their highest and best use, like the properties at issue in the four tax court opinions cited by the taxpayer. To the contrary, the parties agree

that Center and Main are already at their highest and best use as a multi-tenant retail shopping center. As a result, no adjustment is necessary to properly value the properties at their highest and best use.

B.

The taxpayer next argues that our decision in *Bloomington Hotel Invs., LLC v. County of Hennepin*, 993 N.W.2d 875 (Minn. 2023), requires the use of an effective rent calculation under the Uniformity Clauses of the United States and Minnesota Constitutions.[15] U.S. Const. art. I, § 8; Minn. Const. art. X, § 1. The taxpayer appears to suggest that failing to use an effective rent calculation to exclude so-called "non-existent tenant improvements" results in the taxation of non-taxable, non-real property in violation of the Uniformity Clauses.

The taxpayer's constitutional argument relates to the following passage from *Bloomington Hotel*:

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[15] The County contends that the taxpayer forfeited this argument by failing to raise it before the tax court and addressing it for the first time in its opening brief before this court. In general, a relator forfeits arguments not raised before the tax court. *See Macy's Retail Holdings, Inc. v. County of Hennepin*, 899 N.W.2d 451, 455 n.2 (Minn. 2017) (citing *Thiele v. Stich*, 425 N.W.2d 580, 582 (Minn. 1988)). But an argument is not forfeited when an intervening change in the law makes available an argument that would have previously been futile. *Leiendecker v. Asian Women United of Minn.*, 895 N.W.2d 623, 631–33 (Minn. 2017). As the taxpayer notes, we decided *Bloomington Hotel* after briefing and oral argument had concluded on its post-trial motions before the tax court. Because we can easily resolve this question on the merits, we will set aside the forfeiture issue and address the taxpayer's argument on the merits. *See Stone v. Invitation Homes, Inc.*, 4 N.W.3d 489, 494 (Minn. 2024) (stating that a forfeited theory may be overlooked where "decisive of the matter at hand" and presenting " 'no possible advantage or disadvantage to either party' " (quoting *Holen v. Minneapolis-St. Paul Airports Comm'n*, 84 N.W.2d 282, 286 (Minn. 1957))).

> [W]e reject Bloomington Investors' argument that the use of the management fee method is unconstitutional. The United States and Minnesota constitutions require that similarly situated properties be taxed uniformly. U.S. Const. art. I, § 8; Minn. Const. art X, § 1. And as stated above, *one rule that must be applied uniformly is that non-taxable non-real property value must not be included in the taxable assessed value of property*. Accordingly, if the management fee method failed to effectively separate the value of taxable real estate assets from non-taxable assets while the parsing income/proxy rent method much more effectively distinguished the value of taxable real estate assets from non-taxable assets, then use of the ineffective method may present a constitutional uniformity problem. But because we conclude that the management fee method is not so flawed that it is ineffective as a matter of law for use in separating the value of taxable real estate assets from non-taxable assets, Bloomington Investors' constitutional uniformity argument fails.

993 N.W.2d at 886–87 (emphasis added). The taxpayer relies solely on the phrase, "one rule that must be applied uniformly is that non-taxable non-real property value must not be included in the taxable assessed value of property," *Bloomington Hotel*, 993 N.W.2d at 887, to support its contention that "the inclusion of non-existent tenant improvements and non-existent occupancy in the tax value is unconstitutional."

This contention misses the mark because the taxpayer has not raised the same constitutional concern discussed in *Bloomington Hotel*. The Uniformity Clause of the Minnesota Constitution provides that "[t]axes shall be uniform upon the same class of subjects." Minn. Const. art. X, § 1.[16] We have said that the scope of protection under this

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[16] *Bloomington Hotel* also referred to the Uniformity Clause of the United States Constitution. 993 N.W.2d at 887. This reference was an error because that provision imposes a restriction on congressional, rather than state, authority, and *Bloomington Hotel* dealt only with state taxation. *See* U.S. Const. art. I, § 8 ("The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States . . . ."). Accordingly, we do not address the taxpayer's invocation of the federal Uniformity Clause.

clause is "identical" to that of the Equal Protection Clause of the United States Constitution. *Minn. Automatic Merch. Council v. Salomone*, 682 N.W.2d 557, 561 (Minn. 2004). The taxpayer in *Bloomington Hotel* asserted that valuation under the management fee method of the income approach was constitutionally impermissible because it was less effective than a different approach (the parsing income/proxy rent method) at distinguishing between a full-service hotel's income attributable to real property and income attributable to food and beverage and other retail or service operations. 993 N.W.2d at 886–87. In that appeal, the constitutional argument advanced in the taxpayer's brief alleged disparate treatment by the tax court, which used the management fee method despite its decision to reject that method in favor of the parsing income/proxy rent method in an earlier case involving a different full-service hotel.

In this appeal, the taxpayer makes no similar claim of disparate treatment. The taxpayer offers no comparator and otherwise fails to connect this appeal to the Minnesota Constitution's guarantee of uniform taxation. Because the taxpayer raises no colorable Uniformity Clause claim, such a claim provides no support for the taxpayer's overarching argument for an effective rent calculation.

C.

The taxpayer also argues that the tax court should have used an effective rent calculation given the evidence that Tamarack Village offered new tenants a 90- to 120-day no-rent period for build-out and fixturing. Specifically, the taxpayer argues that the tax court should have considered whether the fixturing or build-out time amounted to "free rent" by considering the substance of the concession rather than the terminology used to

describe it by sophisticated market participants, including the taxpayer's own asset manager.

This argument does not overcome our deference to the tax court's factual findings on clear error review. *See All. Hous. Inc. v. County of Hennepin*, 4 N.W.3d 355, 357 (Minn. 2024). The tax court reasonably relied on the testimony of all three witnesses, including the taxpayer's own witnesses, in concluding that free rent was not present in the market and not offered by Tamarack Village. Like the taxpayer's own asset manager, the tax court reasonably distinguished between free rent and no-rent periods for build-out and fixturing time, and we see no reason to conclude that the tax court clearly erred in finding that "free rent" was neither standard in the market nor offered by the taxpayer. Accordingly, because the no-rent periods for build-out and fixturing were not "free rent," they provided no basis for an effective rent, rather than market rent, calculation in determining potential gross income.

II.

The second issue in this appeal concerns whether, under the income approach to appraisal for taxation purposes, the tax court erred by not deducting lease-up costs from the indicated value of Center given its above-market vacancy rate on the assessment date. This issue involves the final relevant step under the income approach, when an appraiser takes the indicated estimate of value after application of the appropriate capitalization rate and, "[i]f necessary, calculate[s] a rent-up adjustment for the value indication that accounts for the cost of leasing up the property." *The Appraisal of Real Estate*, *supra*, at 432. "[A]djustments may be necessary to account for lease-up costs and the time involved in a

lease-up" because in fee-simple valuations, all rentable space, including vacant space, is estimated at market rent levels and on market terms. *Id.* at 421.

The taxpayer challenges the tax court's decision not to make a lump-sum deduction to account for lease-up costs ostensibly necessary to bring Center up to market levels of occupancy. The tax court reasoned that a deduction to account for Center's above-market vacancy rate in a fee-simple valuation was unnecessary.[17] In coming to that determination, the tax court credited Waytas's opinion that lump-sum stabilization adjustments were unwarranted. In its post-trial order, the tax court noted that, although deductions for lease-up costs *may* be necessary in some circumstances, such a deduction was not *required* in this instance. The taxpayer argues that the tax court's reasoning ignores the factual destabilization of Center's vacancy rate and fails to account for lease-up costs to achieve stabilization that would be expected in the market.

Whether or not the taxpayer's legal argument holds water, this issue is squarely resolved by the factual record. Although the taxpayer and tax court both assumed that Malecha's deduction from the indicated value was intended to account for lease-up expenses given Center's above-market vacancy rate, her written appraisal report provides no indication as to her purpose in making the deduction. When questioned by the taxpayer's counsel at trial about her deduction from Center's indicated value under the direct capitalization method, Malecha discussed it as accounting for below-the-line

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[17] A fee-simple valuation assesses the value of "absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat." *The Appraisal of Real Estate*, *supra*, at 60.

expenses to be deducted *from net operating income*, even though her written report treats those expenses as a deduction from indicated value. In response to follow-up questions from the taxpayer's counsel, Malecha appeared to justify the deduction in the context of a *discounted cash flow* analysis.[18] Further complicating the assertion that Malecha believed this deduction for lease-up costs was necessary due to the *above-market* vacancy rate at Center is her decision to take an analogous deduction from the indicated value of Main, notwithstanding that property's *below-market* vacancy rate. On cross-examination by the County regarding the lease-up deduction from the indicated value of Main, Malecha said that it was intended to account for the actual lease-up costs—such as lease commissions—of specific tenants at Main whose leases were "rolling over." Malecha further testified on cross-examination that she performed a similar analysis on Center as she did on Main.

In sum, Malecha's written report did not explain the nature of the deductions, her testimony was inconsistent with her written report and failed to justify the properties' similar treatment despite their different circumstances, and Waytas credibly testified that no stabilization adjustment was warranted because Center's above-market vacancy rate was a temporary market fluctuation. Given this factual record, and regardless of the legal standard, the taxpayer did not present the tax court with evidence that lease-up costs should

[18] As noted above, the taxpayer did not appeal the tax court's decision not to credit Malecha's discounted cash flow analysis, and that decision is not at issue here.

have been deducted. Accordingly, the tax court did not clearly err in declining to deduct lease-up costs to account for Center's above-market vacancy rate on the assessment date.[19]

CONCLUSION

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

Affirmed.

HENNESY, J., not having been a member of the court at the time of submission, took no part in the consideration or decision of this case.

[19] Because we conclude that the record does not support a factual finding in favor of a lease-up deduction, we need not address the taxpayer's additional legal arguments in support of such a deduction.