IN THE OREGON TAX COURT
MAGISTRATE DIVISION
Property Tax

CHIEF TYEE LLC,	)	
	)	
Plaintiff,	)	TC-MD 030459C
	)	
v.	)	
	)	
JACKSON COUNTY ASSESSOR,	)	
	)	
Defendant.	)	**DECISION**

This appeal involves a low income housing project in Ashland, Oregon. By its Complaint, Plaintiff seeks a reduction in the real market and specially assessed values for the 2002-03 tax year. Trial was held November 18, 2003, in the courtroom of the Oregon Tax Court in Salem. Plaintiff was represented by W. Scott Phinney, Attorney at Law, Lake Oswego, Oregon. Mark Skelte (Skelte), Registered Appraiser, testified on behalf of Plaintiff. Defendant was represented by David Arrasmith (Arrasmith), Deputy Assessor, employed by the Jackson County Assessor's Office as a commercial appraiser.

STATEMENT OF FACTS

The subject property consists of a 32-unit garden apartment complex built in 1970. The unit mix is 6 one-bedroom, one-bath units, and 26 two-bedroom, one-bath units. Twenty-five of the two-bedroom units are townhouse floor plans with 828 square feet each. The one flat-style unit contains 814 square feet. The one-bedroom units contain 565 square feet each. The buildings sit on a 1.24 acre site located at 102 Garfield Street, Ashland, Oregon.

The property operates under the federal Housing and Urban Development (HUD) Section 236 low income housing program (Section 236 program) pursuant to a regulatory agreement. The property was financed with the proceeds of a 40-year

mortgage loan insured by the HUD Secretary under the Section 236 program; the mortgage note is dated July 1, 1970. (Ptf's Ex 14 at 1.) The original regulatory agreement, also dated July 1, 1970, was amended on February 20, 1984. (*Id*.) It was again amended effective November 1, 1993. (*Id*. at 7.) The agreement, as amended, expires June 1, 2011. (*Id*. at 2.)

Plaintiff introduced no testimony regarding the parameters of the Section 236 program but a review of certain of its exhibits reveals the following:

Under the Section 236 program, the property owner receives subsidies to reduce mortgage interest rates to 1 percent in exchange for its agreement to rent to low-income individuals at government-controlled rental rates. (Ptf's Ex 12.) At least some tenants receive government rental assistance and the income to the owner is a mix of tenant and government rental payments. Owners are further restricted in their ability to sell or encumber the property and consent to government inspection of their financial records. Plaintiff was originally limited to a 6 percent return on equity. (*Id*. at 6.)[1] However, the 1993 amendment to the regulatory agreement preserved the government's credit support and rent restrictions, in exchange for certain incentives for the owner, including the right to withdraw surplus cash instead of the very limited dividend tied to initial investment. (Ptf's Ex 14 at 2; Ptf's Ex 2 at 2.)

Pursuant to ORS 308.704,[2] Plaintiff elected to have the property valued in accordance with the provisions of ORS 308.712(1)(a). That statute provides for special

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[1] There was no testimony on that issue. Plaintiff's Exhibit 2 is a capitalization rate analysis for property governed by the Section 236 program that was prepared by Skelte and James A. Lyon, MAI. Page two of that report references the 6 percent return limitation as a restriction applicable to the 236 program, but the reference to a 6 percent return on equity for "limited-dividend owners" in the Glossary of definitions submitted as Plaintiff's Exhibit 12 is less clear on the point. Moreover, the Skelte and Lyon report states on page two that the 1993 amendment to the regulatory agreement replaced the limited dividend with the right to withdraw surplus cash.

[2] All references to the Oregon Revised Statutes (ORS) are to 2001.

assessment of multiunit rental housing subject to government restriction (low income housing) based on a modified income approach. That statute is addressed in detail in the court's analysis below.

For the tax year at issue the property was identified in the Jackson County assessor's records as account number1-007634-0. The real market value (RMV) of the property is $1,684,990, with $1,499,370 allocated to the building(s) and $185,620 to the land. The specially assessed value (SAV) is set at $1,089,006, and the maximum special assessed value (MSAV) is $892,980. Plaintiff has requested that the RMV and SAV be reduced to $600,000, and that the assessed value (AV) be calculated by multiplying the SAV by the CPR.[3] Defendant in its Answer requested that the court sustain the RMV, SAV, and AV. However, in its appraisal report Defendant has requested that the court reduce the RMV to $1,170,420, and sustain the SAV, MSAV, and AV.

Actual income for the subject property in 1999, exclusive of interest income, was $177,016. The income for calendar year 2000 was $182,032 and for 2001 was $196,898. The actual expenses for the three years were $84,450, $86,024, and $88,590, respectively.

Each party submitted a considerable amount of evidence related to the value of the subject property. The evidence includes copies of the relevant statutory provisions, administrative rules, rent rolls, audited financial statements, and information regarding

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[3] The acronym "CPR" stands for changed property ratio. The CPR is a statutory mechanism to adjust the MAV of new property or new improvements to property occurring after July 1, 1995, so that the property receives the benefits of Measure 50, which established the concept of MAV, defined as 90 percent of the property's RMV on the rolls as of July 1, 1995. Or Const, Art XI, § 11(1)(a). The ratio is "average maximum assessed value to average real market value of property located in the area in which the property is located that is within the same property class." *Id*. at (1)(c). The special assessment statute applicable here also provides for the application of a CPR in calculating SAV. *See* ORS 308.707(3)(a)

various low income housing programs, including the Section 236 program under which the subject property operates.

Skelte submitted a Limited Restricted appraisal prepared to determine the fee simple "As Is" value for the property as of January 1, 2002. The value is based on the rules and regulations of the Section 236 program and applicable Oregon statutes for special assessment. In Skelte's opinion, the SAV of the subject property is $750,000. That estimate is based on an analysis of income and expenses for the subject property for the three prior years (1999, 2000, and 2001). The estimate is based on an effective gross income (EGI)[4] of $192,137 and total stabilized expenses of $98,306, resulting in a net operating income (NOI) of $93,831. The appraiser then applies a built-up capitalization rate of 12.29 percent, comprised of a base rate of 9 percent (.09), a risk adjustment of 20 percent (.018),[5] and a tax rate of $14.90 per thousand dollars assessed value (.0149).

Defendant submitted a written report estimating both SAV and RMV. The SAV estimation is based on a two-page worksheet concluding with a value of $1,089,006. That estimate is also based on an analysis of income and expenses for the years 1999 through 2001, from which Defendant estimates stabilized EGI at $196,898 and total expenses at $86,355, for a NOI of $110,543. Defendant capitalizes NOI at 10.15 percent, comprised of a base rate of 9 percent and an adjusted tax rate of 1.15 percent. The adjustment to the tax rate is based on the application of the prior year's CPR to the actual tax rate of 1.49 percent.

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[4] EGI represents total property income (either potential or actual) less an amount for vacancy and collection loss.

[5] .09 x 1.2 = .1080; .1080 - .09 = .0180. For a "selected" rate of 10.8 (.108). *See* OAR 150-308.712(3)(h).

Defendant estimates RMV to be $1,170,420 based on the methodology laid out in *Wilsonville Heights Assoc., Ltd. v. Dept. of Rev.*, 17 OTR 139 (2003). The analysis is based on market rents and expenses, from which Defendant estimates NOI at $128,917 (unrestricted), which it capitalizes at 10.15 percent to arrive at a value of $1,270,120 for the property without regard to restrictions (VPWR). From that value Defendant subtracts $99,700 as the value of the government interest (VGI) based on a rent loss calculation of $18,374, discounted at 13 percent.

II. ANALYSIS

A. *Statutory framework*

The 2001 Oregon Legislature created a special assessment program for "multiunit rental housing that is subject to a government restriction on use." Or Laws 2001, ch 605, § 3; *see generally* §§ 1-10. The enactment is codified as ORS 308.701 to 308.724. The program first became effective for the tax year beginning July 1, 2002 (tax year 2002-03). An owner is not required to participate in the program. ORS 308.704. Inclusion in the special assessment program is contingent upon the owner's application as provided in ORS 308.709 and the assessor's approval. Plaintiff in this case filed an application that was approved by Defendant.

As part of the program, an owner can elect one of several methods by which to have the property valued. ORS 308.707(2). Plaintiff elected the method set forth in ORS 308.712(1)(a). That statute provides, in relevant part:

> "The property owner must elect one of the following methods to determine the specially assessed value of the property:

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> "Through an annual net operating income approach to value that uses actual income and stabilized operating expenses that are based on the actual history of the property (if applicable) and a capitalization rate. The income, expenses and capitalization rate used must be consistent with the Uniform Standards of Professional Appraisal Practice and may be further defined by rules adopted by the Department of Revenue."

ORS 308.712(1)(a).

Using the authority granted to it by the legislature, the Oregon Department of Revenue (department) promulgated an administrative rule (OAR 150-308.712), with an effective date of December 31, 2001. The parties agree that the legal framework set forth above shall govern the outcome of this case.

B. *Actual Income*

As Indicated above, the statute provides that the property is valued based on actual income. The department's rule states that "[f]or the initial year of special assessment, the assessor utilizes the property's actual income statements for at least the prior three years." OAR 150-308.712(3). According to the rule,

> "Actual revenues included are those which result from the operation of the property. They include the rent paid by tenants and any monthly rent subsidies. Also, rent for parking or other amenities must be included. Revenue not directly related to the property, such as interest income, should be excluded."

OAR 150-308.712(3)(d).

Both appraisers considered actual income from the three prior tax years, including revenue from laundry and vending machines and other amounts generated from the operation of the property, as required by the statute and the rule. They both factored in an amount for vacancy and collection losses based on actual reported amounts for the three years. However, the appraisers disagree on the appropriate EGI because each uses a different amount for stabilized vacancy and collection losses.

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For his part, Arrasmith simply used all of the 2001 income figures (actual rental

revenue, other income, and reported vacancy and collection losses). Income was at a three-year high in 2001 because total revenues were the highest that year ($195,116) and losses attributable to vacancy and collection were at a three-year low ($2,064). Skelte, on the other hand, used the same revenue (PGI) as Arrasmith, but estimated stabilized vacancy and collection loss based on a percentage of PGI.[6] Skelte determined stabilized vacancy and collection loss to be $6,829, which is higher than the reported amount for any of the three prior years. Those numbers ranged from a low of $2,064 in 2001 to a high of $5,353 in 2000. Skelte testified that he simply used 5 percent of PGI as an estimate of stabilized vacancy and collection losses. The court calculates Skelte's dollar amount ($6,829) to be 3.5 percent of PGI.

There is no apparent discernible pattern to the fluctuations in vacancy and collection losses reported for the relevant three-year period. Those amounts were $4,007 in 1999, $5,353 in 2000, and $2,064 in 2001. Income rose steadily over the same time period, from a low of $176,220 in 1999 to a high of $195,116 in 2001. The average loss for vacancy and collection between 1999 and 2001 was $3,808, or roughly 2 percent. The court rejects Arrasmith's estimate of EGI because it is based solely on the performance of the property in 2001, a year in which the property achieved its highest revenues and lowest vacancy and collection losses. At the same time, the court cannot accept Skelte's vacancy and collection loss estimate because it is inconsistent with the property's actual performance for the relevant three-year period. Although 3.5 percent is not atypical for the general market, the statute requires consideration of actual income and Skelte has acknowledged that "[v]acancies for properties such as this are typically lower than the market with many properties having a waiting list." (Ptf's

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[6] PGI stands for potential gross income and represents total property revenue before subtraction of vacancy and collection losses.

Ex 2 at 3.)

Given the actual fluctuation in vacancy and collection losses, the court finds that the three-year average is a fair reflection of what the property is likely to experience on a stabilized basis. Therefore, the court finds that the appropriate revenue for the property (EGI) is $195,000. That amount is based on the property's 2001 revenue picture ($195,116 for rental revenue, including tenant's assistance payments, and $3,850 for other income), but adjusting the vacancy and collection loss amount to $3,808. The court's EGI ($195,000) fits comfortably between Skelte's EGI of $192,137 and Arrasmith's $196,898 estimate.

C. *Stabilized Operating Expenses*

The statute provides that the SAV is derived by using "stabilized operating expenses that are based on the actual history of the property." ORS 308.712(1)(a). In computing the stabilized expenses for the property, the OAR states that the "goal is to find the typical level of expenses." OAR 150-308.712(3)(e). "Stabilized expenses are those that would be expected to be typical for the property; not those that reflect unusual or extraordinary circumstances." *Id*. The OAR states that the following expenses specifically relating to "the operation of the property" should be included: "repairs and maintenance, utilities, government required tenant services, management and insurance." OAR 150-308.712(3)(f). In contrast, "[c]ertain expenses such as depreciation, mortgage interest, payments to developers and property taxes must be excluded." *Id.*

Here, both appraisers have estimated stabilized operating expenses "based on the actual history of the property" as required by the statute. Each appraiser tabulates actual expenses for the three prior years, excluding depreciation, mortgage interest, and property taxes, in conformance with the OAR. Furthermore, a careful review by the

court reveals that Skelte and Arrasmith report exactly the same expense totals for each year, except that Skelte includes an additional amount for replacement reserves each year and Arrasmith does not. Skelte reports total operating expenses of $91,950 for 1999; $93,524 for 2000; and $96,090 for 2001. Those totals include $7,500 for replacement reserves. Arrasmith reports total expenses of $84,450; $86,024; and $88,590, respectively, for the same three-year period. Arrasmith's numbers each year are $7,500 less than Skelte's.

The OAR permits a reserve for replacement to be included providing "any expense in the repair and maintenance category should be disallowed if it comes from the reserve account." OAR 150-308.712(3)(f). Skelte's annual $7,500 replacement reserves amount is based on actual contributions of that amount to the reserve account each year. The court finds $7,500 to be a reasonable and appropriate amount for replacement reserves. However, contrary to the OAR, Skelte failed to remove the expenses recorded in the repair and maintenance category that were charged to the reserve account. For example, a review of the audited financial statement for 2001 shows annual reserve deposits of $7,500, but two withdrawals (bathroom vinyl and cabinet doors) totaling $7,130. (Ptf's Ex 21 at 13.) None of the $7,130 was capitalized[7] and the court presumes it was taken as an expense.[8] Accordingly, expenses should be reduced $7,130, consistent with the OAR. The court found a similar situation for 1999

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[7] The 2001 balance sheet does not reflect any additions to fixed assets.

[8] The replacement reserve account is established for the upkeep of fixed assets (generally long lived items). *See e.g.*, Appraisal Institute, *The Appraisal of Real Estate* 487 (12th ed 2001). There are only two options for handling deductions from the reserve account; they either appear as additions to the fixed asset list (balance sheet) or get expensed. Therefore, any deductions from the reserve account that do not appear as an addition to fixed assets were necessarily expensed and OAR150-308.712(3)(f) requires an adjustment to repair and maintenance commensurate with amounts that come from the reserve account.

and 2000, with expenses overstated by $4,384[9] and $3,330,[10] respectively, for those years. Applying those adjustments to Skelte's expenses reduces Skelte's totals to $87,566 for 1999, $90,194 for 2000, $88,960 for 2001.

Arrasmith did not include an amount for replacement reserves. Of course, adding $7,500 each year and then adjusting repair and maintenance as outlined above brings the parties to consensus as to the expense history for the property for 1999, 2000, and 2001. Total expenses are $87,566 for 1999, $90,194 for 2000, $88,960 for 2001.

The only other difference between the reports of the two appraisers is in their conclusions about stabilized operating expenses based on the property's actual history. The court has already demonstrated that the parties' expense histories for the three prior years match once Skelte's numbers are adjusted to remove duplicate reporting (in both replacement reserves and maintenance and repair) and replacement reserves are added to Arrasmith's "expenses." The gap in ascertaining stabilized expenses stems from the parties' divergent approaches. The appraisers are nearly $12,000 apart in their estimates, with Skelte using $98,306 and Arrasmith using $86,355. In arriving at those numbers, Arrasmith averages actual expenses for the three years whereas Skelte's method is unexplained and seems to come out of the air. Skelte reports an amount that is higher than any of the reported amounts for the three prior years.

The OAR supports Arrasmith's averaging approach, although Arrasmith's numbers are low because he omitted an amount for replacement reserves. It provides:

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[9] In 1999, $6,917 was charged to the reserve account. Of that amount $2,533 was added to the balance sheet as office equipment. According to the charge from the reserve account, Plaintiff purchased a computer on July 7, 1999, for $2,533. (Ptf's Ex 19 at 12.) The balance of $4,384 was expensed and should be removed from expenses because it is reflected in the reserve account.

[10] In 2000, $3,330 was charged to the reserve account and none of that amount was capitalized. (Ptf's Ex 20 at 12.)

> "The assessor may use averages for the three years and may express expenses on a per-unit basis or as a percentage of revenue. Expenses for a particular year should be adjusted if they are atypical."

OAR 150-308.712(3)(e). The three-year average, as adjusted by the court, is $88,907. Additional support for the averaging method is found in the fact that the court-adjusted expenses show little variability during the prior three years ($87,566 for 1999; $90,194 for 2000; $88,960 for 2001), suggesting relative stability, and a narrow difference between the low and high numbers.

The court cannot accept Skelte's opinion because there is not an adequate explanation for his decision to estimate stabilized expenses in excess of reported actuals. Skelte's stabilized expenses appear even farther out of line when compared to the expense history for the property as adjusted by the court to conform to OAR 150-308.712(3)(f) (requiring "any expense in the repair and maintenance category should be disallowed if it comes from the reserve account"). The highest actual expenses (adjusted) were $90,194 compared to Skelte's stabilized estimate of $98,306.[11] Skelte's estimate assumes further increases in expenses yet both appraisers assumed that revenues stabilized in 2001 and the court finds relative stability in expenses, once adjusted.

From the foregoing analysis of income and expenses, the court calculates NOI to be $106,093, based on an EGI of $195,000 and stabilized expenses of $88,907. The court's NOI determination of $106,093 is considerably higher than Skelte's estimate of $93,831 (by $12,262) and $4,450 below Arrasmith's $110,543 estimate.

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[11] Although Skelte's expense estimate is only about $2,000 above the amount he calculates for total expenses in 2001, the gap increases to roughly $10,000 when measured against expenses as adjusted by the court.

D. *Capitalization Rate*

When selecting an appropriate capitalization rate, ORS 308.712(1)(a) lists the following factors to be considered: "risks associated with multiunit rental housing subject to a government restriction on use, including but not limited to diminished ownership control, income generating potential and liquidity." The OAR echoes that mandate and adds a requirement that the assessor "must also consider any other factors or risks typically taken into account when estimating a capitalization rate." OAR 150-308.712(3)(h)(A). Finally, the statute states that "[t]he capitalization rate that is set pursuant to this paragraph must be equal to or greater than the capitalization rate used for valuing multiunit rental housing that is not subject to a government restriction on use[.]" ORS 308.712(1)(a).

The procedure set forth in the OAR for estimating a capitalization rate is to choose a "selected rate" that factors in the risk associated with governmentally restricted low income housing, and to then add the property tax rate to the selected rate to come up with an overall rate. OAR 150-308.712(3)(h). Skelte did that as a three-step process, beginning with a base rate, then adding a risk adjustment to establish a selected rate, and then adding the tax component to the selected rate to establish his overall rate. Arrasmith undertook a four-step process, beginning with a base rate, then identifying the appropriate millage rate (for the property tax component), which he adjusted by applying a CPR, and then adding the product of the CPR-adjusted tax rate to his base rate. The court will address the two approaches below, within the framework of the OAR.

1. *Base Rate*

Skelte and Arrasmith both used a selected (base) rate of 9 percent. The court accepts that rate as a starting point, consistent with the OAR.

2. *Additional Risk Component*

The next question is whether there should be an adjustment for the risks associated with the operation of the property and, if so, how much? The statute requires **consideration** of certain risk factors associated with these low income housing properties, "including but not limited to diminished ownership control, income generating potential and liquidity." ORS 308.712(1)(a). The statute goes on to say that "[t]he capitalization rate that is set pursuant to this paragraph must be equal to or greater than the capitalization rate used for valuing multiunit rental housing that is not subject to a government restriction on use." *Id*. However, it does not **require** an increase in the cap rate for additional risk.

Plaintiff insists a risk adjustment is required because of the court's finding in *Wilsonville Heights*. The court in *Wilsonville Heights* did find that there is a substantial economic government interest in having affordable housing and that the interest must "be taken into account in the valuation process." *Wilsonville Heights,* 17 OTR at 147. The court went on to find that "an upward adjustment to general market capitalization rate [wa]s appropriate." *Id*., at 160. That statement must be considered in context. The factors presented to the court by the taxpayer's appraiser in that case were "lack of income increase; lack of property appreciation; and extremely long holding period." *Id*. In the case at hand, Plaintiff's appraiser Skelte explained in his capitalization rate analysis that the owner gets a limited return on equity, and commits to a long-term regulatory agreement. (Ptf's Ex 2 at 2.)

Concerning the limited return on equity, Skelte stated that "the for-profit properties operating underneath this program have an artificial ceiling placed upon them based upon the initial investment and a 6% designated return. The 6% return is not guaranteed underneath this program but is subject to market conditions."

(*Id.*) According to Skelte, the limited return on equity equates to increased risk and requires "an adjustment similar to a minority or partial interest in order to achieve a typical market-derived return." (*Id.*) However, Skelte notes on page two of his written capitalization rate analysis that the 1993 modification to the regulatory agreement "allow[s] the owner to withdraw 'Surplus Cash' instead of the limited dividend." (*Id.*) He goes on to observe that "[t]his is a more favorable operating agreement and lessens the impact of the program restrictions." (*Id.*) Pursuant to that amendment, the partners withdrew $42,220 in 1999 (Ptf's Ex 19 at 5 and 6), $39,430 in 2000 (Ptf's Ex 20 at 5 and 6), and $34,715 in 2001 (Ptf's Ex 21 at 5 and 6). According to another of Plaintiff's exhibits, there was a $44,258 surplus cash withdrawal in 2002. (Ptf's Ex 51 at 1.) The surplus withdrawals come from the Residual Receipt Account and, according to information from HUD and provided to the court by Plaintiff, "[t]his account, which may bear interest, receives any money available at the end of the fiscal year that is in excess of the allowable 6-percent dividend." (Ptf's Ex 12 at 5.) Therefore, although the original Section 236 program restrictions limited the dividend to 6 percent of the initial investment, Plaintiff has overcome that limitation by renegotiating the contract in 1993 to allow surplus cash withdrawals and, in fact, has been able to withdraw substantial amounts of cash in each of the three prior years, a trend that continued for the year at issue. This calls into question Skelte's premise for a risk adjustment similar to a minority or partial interest because it assumes a limited and typically quite nominal return.

As for the effect of the long-term regulatory agreement, the court notes that there are significant restrictions imposed on the owner (including limited management control and restrictions on the right to sell or refinance the property), but the impact in this case is less dramatic than in other cases tried in this court because

the agreement is currently set to expire on June 1, 2011, meaning that there were only eight years left in the contract on the applicable assessment date. (Ptf's Ex 14 at 2.) Thus, any recognition of the risks imposed by the agreement must recognize the approaching termination of the regulatory agreement.

Skelte identified the following additional risks: modest design of the property because of applicable government standards, a restricted right to sell or refinance the property, potential gross income and profit restrictions, higher administrative costs due to the age of the property, high turnover, and poor construction. (Ptf's Ex 2 at 3.)

Some of the identified risks are reflected in expenses (*e.g.*, higher administrative costs) or adjustments to income (high turnover) and have no bearing here. Others, like the restrictions on the owner's ability to sell or encumber the property, do impact value. HUD must approve the sale and the buyer must agree to operate under the Section 236 program requirements. There are also restrictions on management, including restricted rents, mandatory deposits in the reserve replacement account, and government inspection of financial records that involve annual reporting. Those factors constitute limited ownership control and the statute provides that the additional risk must be considered in setting the cap rate. ORS 308.712(1)(a). The lack of true arm's-length sales of these low income properties provides a further indication of the risk inherent in operating such properties.

In evaluating and quantifying the risk, Skelte concludes that a potential purchaser "would require an adjustment similar to a minority or partial interest in order to achieve a typical market-derived return." (Ptf's Ex 2 at 2.) He notes that although the owner has "a 100% interest in the real estate, it suffers from a lack of control, reduced marketability, and reduced financial rewards." (*Id*. at 6.) In discussing the partial

interest theory, Skelte notes that a discount is typically applied because the owner does not enjoy the same bundle of rights because of a lack of control and marketability. Skelte analyzed nine sales of partial interests with discounts ranging from 0 to 84 percent, with most in the range of 20 to 50 percent, and concluded that the appropriate discount in this case is 20 percent. (Ptf's Ex 2 at 7-11.)

The concept of permitting a discount for lack of full control when valuing a minority interest is found throughout Oregon case law. Often, the cases involve the value of stock in a closely held corporation arising from a dissolution of marriage or family estate planning.[12] A discount for lack of marketability of the stock of a closely held corporation has been held by the Tax Court to be appropriate. *Henry v. Dept. of Rev.*, 11 OTR 214, 215 (1989) (quoting *Kingery v. Dept. of Rev*enue, 276 Or 241, 554 P2d 471 (1976)). Although the Internal Revenue Code and federal regulations do not differentiate between whole and partial interests for purposes of valuation, the courts do, applying discounts in recognition of the difficulty inherent in selling a minority interest. Jacob Mertens, Jr, 15 *Mertens Law of Federal Income Taxation*, § 59:108 (1994). The extent of the governmental involvement in the operation of a low income housing project has some parallels to the ownership of a partial interest in an unregulated apartment complex.

Arrasmith did not increase his cap rate for additional risk. Arrasmith studied 18 sales involving government rent restricted properties and found the average capitalization rate to be 6.67 percent. Because that rate was less than several unrestricted properties Defendant analyzed, Arrasmith concluded that no upward

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[12] *See In re Marriage of Barlow*, 111 Or App 179, 826 P2d 18 (1992); *In re Marriage of Kampmann*, 108 Or App 407, 816 P2d 642 (1991), *on recons,* 110 Or App 100, 820 P2d 1379 (1991); *In re Marriage of Tofte*, 134 Or App 449, 895 P2d 1387 (1995); *Kingery v. Dept. of Revenue*, 276 Or 241, 554 P2d 471 (1976).

adjustment was necessary. However, Arrasmith's sales were all discredited on cross examination, either because the sales involved special circumstances that made them not arm's-length (Preservation Act sales) or because the constituent components used to extract a capitalization rate (NOI and sale's price) were not verified by the appraiser.

Ten of Arrasmith's sales involved transactions shared with him by the department, and it was revealed on cross examination that Arrasmith lacked knowledge of the terms of the transactions, how the NOI was reported, and other relevant information about those sales. Accordingly, the court rejects those sales. Arrasmith's eight other sales involved transactions under the Preservation Act[13] which are similarly unreliable for the asserted proposition. This court has previously ruled that "the preservation value does *not* represent the value of the property subject to restrictions." *Piedmont Plaza Investors v. Dept. of Rev.*, 14 OTR 440, 449 (1998) (Piedmont Plaza I) (emphasis in original). The reason for that ruling was that a transfer under the preservation act is based on an appraisal that assumes payoff of the federally assisted mortgage, termination of the rent restrictions, and termination of any federal rental assistance. *Id*.[14] The court must therefore reject Arrasmith's government rent restricted sales, and with that determination, his premise that there is no risk associated with low income housing fails for lack of support.

Although the court has some concerns with Skelte's 20 percent risk determination, any adjustments to that number by the court would be somewhat arbitrary, based on the information provided, and the court therefore finds that number

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[13] The Preservation Act is also known as "Title 6 of the National Affordable Housing Act" (Pub L 101-625, 104 Stat 4079 (1990)).

[14] On appeal, the Supreme Court explained that "[p]reservation transfer sales allow owners of section 236 properties to sell their properties at prices that are adjusted to reflect the value of the properties as if they were not subject to the section 236 restrictions." *Piedmont Plaza Investors v. Dept. of Rev*., 331 Or 585, 589, 18 P3d 1092 (2001) (Piedmont Investors II).

acceptable.[15] Skelte applied the 20 percent risk factor by multiplying the base rate of 9 percent by 1.2, which increases the base rate by 1.8 percent.[16]

3. *Property Tax Component*

The special assessment program dictates that taxes are reflected in the cap rate as opposed to being added to expenses. The OAR provides, "To the selected rate, add the effective property tax rate for the code area where the property is located. This is the overall rate to use for capitalization." OAR 150-308.712(3)(h)(c). However, the OAR does not define the term "effective property tax rate" as set forth in the quoted language above. The "selected rate" is the risk-adjusted base rate.

Skelte used the actual "current" millage rate as the effective property tax rate for the code area. That rate was reported to be 1.49 percent. Skelte added the 1.49 percent tax rate to his selected rate of 10.8 percent, to arrive at an overall rate of 12.29 percent. Arrasmith also used the mill rate of 1.49 percent as a starting point for the development of property tax component of his cap rate, but he then applied a ratio of .77 percent, to arrive at an effective tax rate of 1.15 percent. Arrasmith testified that the ratio he applied was the CPR for the property's code area. When questioned about that procedure on cross examination, Arrasmith acknowledged that the approach might not be found in the OAR but that he was sure he followed **some** guideline.

The only reference to the application of a CPR in the laws governing the special assessment program concerns the establishment of the MSAV for the first year

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[15] One concern is that the court in *Wilsonville Heights* found taxpayer's appraiser's 30 percent estimated risk factor appropriate, and in that case all of the appraisers assumed the property was roughly 10 years into a 43-year governmentally-restricted program (under section 515) which provided for a limited return of equity that came to less than $3,000 per year. *Wilsonville Heights*, 17 OTR at 161. And that amount was contingent upon the existence of sufficient income after all required expenses were paid. In contrast, Plaintiff has eight years left in the Section 236 program and, as explained above, the amended agreement allowed surplus cash withdrawals rather than the limited return on investment. Actual withdrawals averaged $40,000 per year from 1999 through 2002. There is no explanation of how Skelte arrived at his 20 percent risk determination.

[16] See footnote 5.

the property is approved for special assessment. That procedure is applicable in this case, as discussed below, but it has no relevance to the determination of the effective property tax rate. Elsewhere in Oregon's system of property taxation a CPR is used in determining the MAV of new property (ORS 308.153(1)(b)), the MAV of property subdivided, partitioned, rezoned, added as omitted property, or disqualified from exemption or special assessment (ORS 308.156), and in other situations concerned with determining MAV. However, neither the statute nor the rule provides for a CPR adjustment to the applicable tax rate. And, as stated above, the rule does not define effective property tax rate.

Ordinarily an "effective rate" would be an actual rate in a given situation. In the income tax arena, the effective rate is considered the actual rate a taxpayer pays after adjusting income for allowable credits and deductions, etc., and may be comprised of different statutory rates for different types of income (ordinary versus capital gains). It is calculated by dividing the final overall tax bill by some measure of income. A similar calculation could be done with property taxes, but there would need to be some guidance as to which value to put in the denominator. Absent an endorsement in the statutes or rules, the court cannot accept Arrasmith's methodology of applying the CPR from the prior year to the applicable tax rate in determining the effective property tax rate. Therefore, the court concludes that the effective property tax rate specified in the OAR is the actual tax rate for the code area where the property is located, which in this case is 1.49 percent.

4. *Reconciliation of Capitalization Rate*

Based on the foregoing, the court finds the overall capitalization rate to be 12.29 percent. That rate is comprised of the base rate of 9 percent, increased 1.8 percentage points for additional risk (of 20 percent), bringing the "selected"

capitalization rate to 10.80 percent (.1080). Finally, the selected rate is increased 1.49 percent for property taxes (.1080 + .0149 = .1229).

E. *SAV*

The SAV cannot be determined simply by dividing stabilized NOI by the applicable capitalization rate because that approach would include the value of the personal property. The rule requires that the value of the personal property be removed. It provides: "[t]he goal of the income approach is to determine the value of only the real property. No personal property value should be included." OAR 150-308.712(3)(a). The rule provides alternative methods for removing the personal property value, as follows:

> "The assessor may remove personal property value by one of the following methods:
>
> "(A) Include revenues and expenses for both the real and personal property. After the net operating income has been capitalized, deduct the value of the personal property; or
>
> "(B) Remove all income and expense generated by the personal property assets prior to capitalization."

OAR 150-308.712(3)(a).

The appropriate method in this case is to simply remove the personal property value from the total property value.[17] The total value of the property is $863,250 (rounded).[18] Plaintiff reported a personal property value of $10,400. Defendant made no adjustment to remove the personal property. The court accepts the $10,400 figure and subtracting that number from the total value of the property produces an SAV for the real property of $852,850.

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[17] This is because neither party attempted to remove income and expenses related only to the personal property.

[18] $106,093 ÷ .1229 = $863,246.54.

F. *RMV*

By its Complaint, Plaintiff requested a reduction in RMV to $600,000. The property is on the roll for $1,684,990. Defendant initially requested the value be sustained, but later requested a reduction of slightly more than $500,000.[19] At trial, Plaintiff did not put on a direct case regarding RMV. Arrasmith was allowed to testify to his revised RMV estimate of $1,170,420, which is based on his interpretation and application of the *Wilsonville Heights* decision. Plaintiff took exception to one aspect of Arrasmith's formulation - lost rent. Plaintiff's exhibit 51, introduced during Plaintiff's cross examination of Arrasmith, was intended to show that lost rent should be roughly $65,000[20] and not $18,374, which is the number of Arrasmith used to calculate the value of the government interest (VGI).[21] However, Plaintiff did not fully develop the point and some of the information necessary to complete the formula is missing.[22] Directly capitalizing Plaintiff's lost rent substantially increases the VGI, producing a corresponding reduction in RMV (VTI). Nonetheless, the court is not comfortable

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[19] That subsequent request was made by way of a cover letter and submitted two weeks before trial as part of Defendant's valuation report. Because of the more relaxed procedural rules of the Magistrate Division of the Tax Court, Defendant's RMV reduction request was deemed an amendment to the pleadings.

[20] That number was calculated by the court, subtracting Plaintiff's average restricted NOI of $63,670 from Defendant's unrestricted NOI of $128,917.

[21] Under Wilsonville Heights, the RMV of a governmentally restricted property is derived by subtracting the VGI from the value of the property without regard to restrictions (VPWR). The difference is the value of the taxable interest (VTI), which equates to RMV. *Wilsonville Heights*, 17 OTR at 148. Employing the "presumed equivalency of value" concept, the court determined that the VGI could be calculated by, and was equal to, the present value of the lost rent. *Id*. at 150-51. Lost rent, in turn, is the difference between unrestricted NOI (estimated as the NOI of the property but for the participation in the government housing program) and restricted NOI. Restricted NOI was determined to be the sum of the owner's dividend (return to owner) and the owner's portion of the debt service. (Ptf's Ex 51 at 2-4.)

[22] Most importantly, there is no information about the amount of any reversion and an appropriate method of discounting would employ principles of discounted cash flow analysis (DCF). This is so because the property is only eight years away from termination of government participation, at which time the property will be operated in the free market. Additional information missing in performing a DCF analysis is the income projection for years 9 and 10, assuming a typical 10-year DCF projection.

adjusting Arrasmith's RMV calculation. Accordingly, the court finds the RMV of the subject property to be $1,170,420.

G. *MSAV*

The statute provides that:

> "(3)(a) For the first tax year for which property is assessed under this section, the maximum assessed value of property subject to special assessment under this section shall equal the product of the specially assessed value of the property under subsection (2) [providing for valuation per ORS 308.712] of this section multiplied by the ratio, not greater than 1.00, of the average maximum assessed value to the average real market value of property in the same area and property class as the specially assessed property."

ORS 308.707. The rule indicates that the "maximum assessed value of the specially assessed property (MSAV) is found by multiplying the [SAV] * * * by the * * * [CPR]." OAR 150-308.712(6). The CPR is the ratio referred to in the statute quoted above. Defendant shall calculate the MSAV using the SAV set forth above ($852,850).

III. CONCLUSION

Based on the foregoing, the court concludes that the SAV should be reduced to $852,850. The court concludes that the RMV should be reduced to $1,170,420. Finally, Defendant shall calculate MSAV by applying the appropriate CPR to the court's SAV determination. The court's SAV determination was derived by adjusting Plaintiff's vacancy and collection loss amount, which increased stabilized EGI, and reducing Plaintiff's stabilized expenses by removing amounts embedded in the reported expenses for maintenance and repair that were taken as deductions in the replacement reserves account. The court accepted Plaintiff's determination of the capitalization rate, including the 20 percent risk amount. The court's RMV reduction comes from Defendant's calculations. Now, therefore,

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IT IS THE DECISION OF THIS COURT that the SAV of the subject real property as of January 1, 2002 (2002-03 tax year) was $852,850 and that the RMV was $1,170,420.

Dated this _____ day of February, 2004.

DAN ROBINSON
MAGISTRATE

IF YOU WANT TO APPEAL THIS DECISION, FILE A COMPLAINT IN THE REGULAR DIVISION OF THE OREGON TAX COURT, BY *MAILING* TO: 1163 STATE STREET, SALEM, OR 97301-2563; OR BY *HAND DELIVERY* TO: FOURTH FLOOR, 1241 STATE STREET, SALEM, OR. YOUR COMPLAINT MUST BE SUBMITTED WITHIN 60 DAYS AFTER THE DATE OF THE DECISION OR THIS DECISION BECOMES FINAL AND CANNOT BE CHANGED.

THIS DOCUMENT WAS SIGNED BY MAGISTRATE DAN ROBINSON ON FEBRUARY 27, 2004. THE COURT FILED THIS DOCUMENT ON FEBRUARY 27, 2004.