STATE OF NORTH CAROLINA

COUNTY OF WAKE

BEFORE THE PROPERTY TAX COMMISSION
SITTING AS THE STATE BOARD OF
EQUALIZATION AND REVIEW

91 PTC 163

In the matter of:
The appeal of **Belk-Broome Co.**
from the appraisal of certain
real property by the Catawba
County Board of Equalization and
Review for 1991.

Final Decision

This matter was heard before the Property Tax Commission, sitting as the State Board of Equalization and Review in the City of Raleigh, Wake County, North Carolina, on 11 March 1993 pursuant to the appeal of **Belk-Broome Company-Hickory** (hereinafter "Taxpayer") from a decision of the Catawba County Board of Equalization and Review for 1991.

Statement of Case

The property under appeal is a two story anchor tenant department store building located in the Valley Hills Mall in Hickory. The building contains 164,387 square feet and was constructed in 1978. It is situated on a tract of 14.39 acres. The property was appraised by the County in its 1991 general reappraisal of real property at a value of $10,041,000: $2,600,100 for the land and $7,441,000 for the improvements.

The Taxpayer contends that the value of the property should be $6,000,000. The Taxpayer further contends that the valuation of the property is excessive not only using the sales comparison approach, but also using the income approach. The County contends that the property was appraised in accordance with the County's schedule of values and that due consideration was given to the matters raised by the Taxpayer.

The Taxpayer was represented at the hearing by Michael T. Medford and David A. Colf, attorneys at law; Catawba County was represented by W. Gene Sigmon and Michael Newby, attorneys at law.

Issues

In their Order On Final Pre-hearing Conference filed with the Commission, the parties stipulated that the issue to be decided was: "What is the true value in money, within the meaning of G.S. 105-283, of the Taxpayer's real property located at the Valley Hills Mall, Hickory, N.C.?" Noting that under the guidelines set by the North Carolina Supreme Court for property tax appraisal appeals in In re Appeal of AMP, Inc., 287 N.C. 547, 215 S.E.2d 752 (1975), the Taxpayer has the burden of establishing: (1) that the County employed an arbitrary or illegal method of appraisal and (2) that the value assigned by the County is substantially greater than the "true value in money" (a term of art under the provisions of G.S. 105-283) of the property, the Commission finds that the issues presented in this appeal are:

1. Did the County employ an arbitrary or illegal method of appraisal in reaching the value assigned by the County to the subject property for 1 January 1991?
2. Did the County's appraisal of the subject property substantially exceed the true value in money of the property as of 1 January 1991; and
3. If the first two issues are answered in the affirmative, what was the true value in money of the property as of 1 January 1991?

Evidence

The evidence presented by the Taxpayer and considered by the Commission consisted of the following:

1. Taxpayer Exhibit 1 - Appraisal report of Belk Department Store, Valley Hills Mall, Hickory, N.C. as of 1 January 1991, prepared by Thomas B. Harris Jr., MAI and Mark T. Lambert of T. B. Harris Jr. & Associates.
2. Oral testimony of Mr. Mark Thomas Lambert. Admitted to testify as an expert witness in the field of real estate appraisal.
3. Oral testimony of Mr. Frank Matthews II.

The evidence presented by the County and considered by the Commission consisted of the following:

1. County Exhibit 1 - Appraisal report.
2. County Exhibit 2 - Operating agreement.
3. Oral testimony of Mr. Dale O. Campbell.

Commission Exhibits

In addition to the evidence presented by the parties, the Commission also considered the following procedural documents:

C-1 Notice of appeal, filed 6 June 1991.

C-2 Commission acknowledgement of C-1, 14 June 1991.

C-3 Application For Hearing, filed 15 July 1991.

C-4 Commission acknowledgement of C-3, 18 July 1991.

C-5 Letter from Mr. Mercer to Commission, dated 5 November 1992.

C-6 Commission acknowledgement of C-5, 24 November 1992.

C-7 Transmittal letter for proposed hearing calendar, 20 January 1993.

C-8 Letter from Mr. Lassiter to Commission, filed 26 January 1993.

C-9 Letter from Commission to Mr. Lassiter denying continuance request, 27 January 1993.

C-10 Notice of hearing (County), 17 February 1993.

C-11 Notice of hearing (Taxpayer), 17 February 1993.

C-12 Letter from Commission to Mr. Medford concerning time and date for hearing, 25 February 1993.

C-13 Letter from Mr. Lassiter to Commission transmitting an original copy of the Appraisal Report for Belk Department Stores, filed 2 March 1993.

C-14 Order On Final Pre-hearing Conference, approved by the Vice-Chairman and ordered filed 11 March 1993.

C-15 Brief for Catawba County, filed 11 March 1993.

C-16 Letter from Mr. Colf to Mr. Newby (copy to Commission), filed 13 April 1993.

C-17 Taxpayer's Memorandum of Law in Opposition to County's Motion To Dismiss, filed 16 April 1993.

Stipulations

In their pre-hearing order, the parties stipulated the following facts:

1. The Taxpayer owns a fee simple interest in certain real property and improvements located at the Valley Hills Mall in Hickory, North Carolina. That real property is more fully described in the General Warranty Deed dated May 10, 1977, a copy of which is attached as Exhibit A to this order.

2. Taxpayer's interest in the real property is subject to certain easements, restrictions, and conditions as more fully set forth in the General Warranty Deed attached to this order as Exhibit A and then of the records of the Office of the Register of Deeds for Catawba County, North Carolina.

3. The Taxpayer operates the Belk Department Store on the real property, and the remainder of the real property is parking for the store and other facilities of the Valley Hills Mall.

Findings of Fact

After carefully considering the evidence presented by the parties, as listed above, the Commission adopts the Stipulations of the parties contained in the pre-hearing order and set forth above as part of its Findings of Fact, and makes the following additional Findings of Fact:

1. The subject property consists of 14.39 acres of land and the improvements located thereon. The improvements consist of a two story building (plus equipment rooms) containing approximately 167,387 square feet, together with the paving, lighting, and other accessories normal to a retail department store located in a high quality shopping mall. See Taxpayer Exhibit 1 at pages 6-14.

2. The subject building was originally constructed during 1978, and opened with the Mall itself in 1978; see Taxpayer Exhibit 1 at page 6 and page 12.

3. The land, building, and other improvements at issue, though separately owned, are physically contiguous with the Valley Hills Mall. The building has its own outside entrances, as well as entrances from within the Mall.

4. The Valley Hills Mall is a successful shopping mall property. One indicator of its commercial success is the expansion of the Mall in 1988 with the addition of J.C. Penney (109,260 square feet); see Taxpayer Exhibit 1 at page 6. Another indicator is the renovation of the subject property in 1988; see Taxpayer Exhibit 1 at page 14.

5. The subject building is a special purpose property. It is designed and built to be used as a location for a retail department store located in a major shopping mall. The commercial success of any retail operator occupying the subject property is inextricably linked to the commercial success of the mall itself.

6. The highest and best use of the subject property is its present use as a Belk department store; see Taxpayer Exhibit 1 at page 39. As long as Valley Hills Mall continues to be a successful shopping mall (which it clearly was as of 1 January 1991), the highest and best use of the subject property will continue to be the present use as a department store.

7. After carefully examining the evidence presented by the Taxpayer and the County concerning sales of land in the immediate area of the subject property, the Commission finds

that the County's appraisal of the subject land was consistent with the County's appraisal under its schedule of values of similar land in this area. The Commission further finds that the County's appraisal of the subject land at a value of $2,600,100 did not exceed its true value in money as of 1 January 1991.

8. Turning to the subject improvements, the Commission finds, based on the evidence presented by the Taxpayer, that the County's appraisal was substantially greater than the true value in money of the improvements as of 1 January 1991.

9. The Commission finds that the cost approach analysis of the subject improvements contained in Taxpayer Exhibit 1, after an improper adjustment is eliminated, is the best evidence indicator of the value of the subject improvements.

10. The Commission finds that the true value in money of the subject improvements as of 1 January 1991 was $8,489,012, computed as set out below:

Adjusted cost of improvements per Taxpayer Ex'ibit 1, page 57	$5,888,912
Land value under original County appraisal	$2,600,100
Total value:	$8,489,012

11. The Commission rejects the adjustment of $1,317,912 contained in the Taxpayer's cost approach analysis for purposes of *ad valorem* appraisal. The premise upon which this adjustment is based (see Taxpayer Exhibit 1 at page 55) is that any building

which houses a store which experiences sales per square foot that are lower than the national average should be appraised under the cost approach to appraisal at a value lower than its depreciated cost. There are several flaws with this premise. First, this novel adjustment is not based on any generally accepted appraisal technique. Second, even if the premise were valid, the use of a national, instead of a regional average would be suspect. Finally, and most importantly, if such a method were used for ad valorem appraisal, it would have to be used consistently; that is, any building housing a store with sales higher than the average would have to be appraised at a value higher than its depreciated cost. The fallacy of such an approach is that it leads to the appraisal of management, not property. This violates the principles contained in In re Greensboro Office Partnership, 72 N.C. App. 635, 325 S.E.2d 24, cert. denied, 313 N.C. 602, 330 S.E.2d 610 (1985) and In re Property of Pine Raleigh Corp., 258 N.C. 71, 128 S.E.2d 855 (1963). By attempting to make the appraisal of each building dependent on that building's actual income, this adjustment violates the principle of uniformity of appraisals for ad valorem tax purposes. As the Court in Pine Raleigh pointed out, "[t]o hold otherwise would be to penalize the competent and diligent and to reward the incompetent or indolent," 258 N.C. 398, 403, 128 S.E.2d 855, 859.

12. The Commission finds that the income approach, as applied in Taxpayer Exhibit 1, does not reflect the value of the full fee simple interest in the subject property. It is customary in the development of major shopping malls for developers to construct anchor store buildings and to lease these buildings to anchor store tenants at lease rates which will not cover the cost to construct the buildings. Such developers are not engaged in charity; they offer attractive lease rates and other incentives (but only to desirable department store operators) to induce the operators to locate in their mall and enter into a long term operating agreement. One prime characteristic of the operating agreement is the store operator's commitment to operate a retail establishment (bearing its valuable name) on the premises for a specified period of time. This commitment is extremely valuable to the developer, but is not reflected in the lease rate. For this reason, application of the income approach to value to nominal rents in this situation inevitably leads to an appraisal much lower than the true value in money of the property.

13. For similar reasons, the sales comparison approach as applied in Taxpayer Exhibit 1 is an appraisal of a partial interest in real estate, not the full fee simple interest. These sales are generally, as the author of the report points out, sales from retail department store to retail department store; see Taxpayer Exhibit 1 at page 42. Whether the sale of an anchor

store building is from the developer to the first retail department store tenant or from retail store to retail store, a substantial portion of the value of the real property is not reflected in the sales price. The sales comparison approach is a valid method of estimating the value of real property for ad valorem appraisal only when the underlying assumptions of the approach are not violated. The fundamental assumption that the purchase price reflects all the value exchanged for the property is violated when the monetary value flowing to the developer from the operating agreement is not considered. The behavior of mall developers and anchor store operators in the marketplace suggests that the market value of these agreements, for a typical store, is in the range of one to two million dollars. When the three approaches contained in Taxpayer Exhibit 1 are analyzed in this light, the $1,317,912 adjustment which the Commission rejected in its analysis of the Taxpayer's cost approach is seen to represent value inherent in the subject real property which is not captured by the other two approaches.

Conclusions of Law

Based on its Findings of Fact, as set forth above, the Commission makes the following Conclusions of Law:

1. The County's appraisal of the subject land was conducted in accordance with the County's duly adopted schedule of values for the 1991 reappraisal. The County properly applied its

schedule of values to the subject land as of 1 January 1991, in a manner consistent with the County's appraisal of similar land. The County's appraisal of the subject land did not exceed its true value in money as of 1 January 1991.

2. The County's appraisal of the subject improvements was not consistent with the Taxpayer's evidence concerning the reproduction cost new and physical depreciation of the improvements. The County's appraisal of the subject improvements at a value of $7,441,000 substantially exceeded the true value in money of the improvements, which the Commission found to be $5,888,912.

3. The Commission concludes as a matter of law that the estimates of value found by Mr. Lambert in Taxpayer Exhibit 1 violate the rule laid down by this Commission and affirmed by the North Carolina Court of Appeals in <u>In re Greensboro Office Partnership</u>, 72 N.C. App. 635, 325 S.E.2d 24, cert. denied, 313 N.C. 602, 330 S.E.2d 610 (1985). Mr. Lambert applied the Cost, Income and Sales approaches in a manner which is calculated to determine the value only of a <u>partial</u> interest in the subject land and improvements. His estimates under these three approaches arrived at the value of <u>part</u> of the bundle of rights in the subject property, not of the entire bundle of rights. Under North Carolina law, all appraisals of property for property tax purposes must determine the value of the entire bundle of rights. This is true whether or not the owner has

bargained away some of his rights. Like the property owner in the Greensboro case, the Taxpayer here does not have the entire bundle of rights, and seeks to have only his partial interest appraised. North Carolina law simply does not permit this. The owner is treated as if he owns the entire bundle of rights, even though he may have bargained some of them away. This is precisely the point settled in the Greensboro case.

Decision and Order

Relying on the opinions issued by our courts in the Greensboro case and in In re Appeal of AMP, Inc., 287 N.C. 547, 215 S.E.2d 752 (1975), this Commission has found on other occasions (e.g. the Final Decision issued in the appeal of Kildaire Farm Swim and Racquet Club v. Wake County 89 PTC 63) that G.S. 105-283 requires all property to be appraised at its true value in money. The "property" to be appraised consists of all the rights and interests in the property that are capable of private ownership. This is variously described as the unencumbered fee simple interest or the "whole bundle of rights." Property is appraised without regard to the various privately created encumbrances affecting it. While publicly created encumbrances such as zoning are considered in appraisals for property tax purposes, private encumbrances such as leases or the operating agreements considered here are not. One application of this principle is the use of market or "economic" rents instead of actual or "contract" rents in circumstances such as those considered in the Greensboro case.

Another application of this principle is in the appraisal of property subject to a life estate, where, for property tax purposes, the value of the full fee simple interest in the property is determined and the taxpayer (the life tenant) is billed based on this value. The fact that the life tenant may be 100 years old (so that, as a practical matter, his life estate is worthless) is irrelevant when determining the value of the fee simple interest. The "true value in money" of the property is appraised under G.S. 105-283, not the life tenant's interest in the property. The law leaves it to the life tenant and the remainderman to arrange for the payment of the tax, though certain statutory provisions protect the life tenant from unscrupulous remaindermen.

The subject property is contiguous with a major shopping mall and is subject to an operating agreement governing mall operations. The comparable properties utilized by Mr. Lambert in his income and sales comparison approaches were similar properties, similarly located and all subject to similar agreements. As this Commission has found in other recent cases involving the appraisal of anchor store buildings located in major shopping malls (Dillard Department Store, Inc. v. Forsyth County, 91 PTC 398 and The May Department Stores Company v. Forsyth County, 91 PTC 403), it is customary in this business for retail department store operators to receive incentives from shopping center developers in the range of one to two million dollars, in addition to the incentive of being given free land. These incentives are not considered by the income and sales approaches as applied by Mr. Lambert. This is the reason Mr.

Lambert's income and sales approach estimates of value group tightly around $6.0 million while his cost approach estimate of value (which considers all the costs necessary to acquire the land and construct the improvements) is $1,317,912 higher after the inappropriate "sales" adjustment is eliminated.

Shopping mall developers are willing to construct anchor tenant stores and then either lease them _to appropriate tenants_ at rental rates which will never cover the costs of construction or sell them _to appropriate owners_ at prices which will never cover the cost of construction, provided only: (1) that the tenant or purchaser is one of a very limited number of retail operators with "name" recognition, and (2) the tenant or purchaser enters into an operating agreement which obligates it to operate a store _with its name on the store_ for a specified number of years (e.g. operate a Sears department store on the premises for thirty years).

Such developers are not engaged in charity; they are rational, knowledgeable business persons pursuing a course of action in their own best interest. By attracting a recognized anchor department store to his shopping center, the developer makes the center a more attractive location for smaller retail establishments. The rental income the developer receives from an anchor store will not justify the cost of constructing the store. But the _presence_ of the anchor store is critical to the success of the shopping mall itself. Without the anchor store, the developer cannot attract the smaller tenants that make the mall a success. Locking in the right kind of anchor store to a long term operating agreement is necessary to the success of the venture.

Rental rates charged to anchor tenants and sales to anchor store operators reflect the practices of the mall business. These rental rates and sales prices do not include the value of incentives, nor the impact of the operating agreements. Neither the rental rates nor the sales prices reflect arm's length transactions in a free market. When an anchor store is purchased (for instance Sears purchases a store from J. C. Penney) the purchase price reflects the market value of a partial interest in the subject real estate. The real estate is encumbered by the operating agreement, which gives the mall developer the right to insist that a suitable "name" department store be operated on the premises. Neither Sears nor Penney is free to change the use of the property from that of a department store to a corporate headquarters or other use.

For example, suppose a developer is seeking a retail department store as an anchor store for his new shopping mall project. He is willing to either rent the anchor store space at $3.50 per square foot (a rental rate that would not support the cost to construct the store space) or sell the anchor store (at a price one to two million dollars less than the cost to construct the store). The only thing the developer asks in return is: (a) that the lessee or purchaser be one of the eighteen to twenty known anchor department store operators active in the United States, and (b) that the lessee or purchaser be willing to sign the operating agreement. The operating agreement obligates the lessee or purchaser to continue to operate the anchor store for a long period of time unless the developer approves a successor anchor store operator.

Note that the developer is willing to offer this arrangement only to one of a group of approximately eighteen to twenty (testimony of Mr. Curry) potential operators. These operators are well known retail department store operators whose presence will attract shoppers to the mall. Any other business that might desire to lease or purchase the anchor store space is not wanted at any price because it will not draw retail shoppers. The developer will lease to Belk (or J.C. Penney, Dillard, Sears, etc.) for $3.50/square foot, but the developer will not lease to other businesses (e.g. IBM, Glaxo) who might be willing to pay more than $3.50/square foot for the space for office use. The same circumstances control any sale of the anchor store space. Only those who fit the desired profile are welcome. Those who fit the profile will pay the low rental rates and purchase prices reflected in Mr. Lambert's income and sales approach analyses.

But when Belk or one of the other players in this market leases or purchases an anchor store, it pays non-monetary consideration over and above the stated rental rates and purchase prices. It enters into an operating agreement under which it is obligated to operate a full line department store, bearing its valuable name, on the premises for a long period of time. This agreement is part of the consideration which the lessee or purchaser pays to the lessor or seller. It has great value to the mall operator, distorting rental rates and sales prices; but this additional consideration is not captured when the income approach or the sales approaches are applied as Mr. Lambert did in his report.

The rights accruing to the developer from the operating agreement are valuable to the developer; this is why developers are willing to spend one to two million dollars (or more) to induce suitable anchor store operators to enter into an operating agreement. Because practices in this industry are relatively standardized, the rental rates and sales prices examined by Mr. Lambert are all reflective of rentals and sales of partial interests, and do not reflect the value of the entire interest. Under these circumstances, only the cost approach, properly applied, can generate an estimate of the value of the whole bundle of rights in the property.

The Taxpayer's argument fails here for the same reason the taxpayer failed to prevail in the AMP case: there is a strong presumption, not overcome in AMP or here, that property is worth what it costs to construct or acquire it. This is known in economic theory as the principle of substitution. When property is nearly new and is being used for precisely the purpose for which it was acquired or constructed (another way of saying that the property is not affected by either physical deterioration or obsolescence) the presumption is difficult to overcome and the cost approach is the best indicator of value.

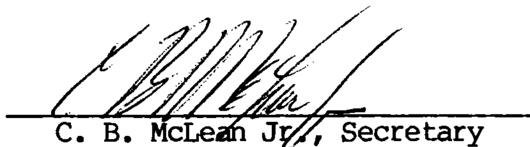
WHEREFORE, IT IS ORDERED, ADJUDGED, AND DECREED that the decision of the Catawba County Board of Equalization and Review for 1991, assigning a value of $10,041,000 to the subject property as of 1 January 1991 is **Reversed**; the County is instructed to make such changes in its tax records as may be needed to reflect the findings and conclusions of the Commission set forth herein, assigning a value to the subject property of $8,489,012 as of 1 January 1991.

Entered this the 16th day of August, 1993.

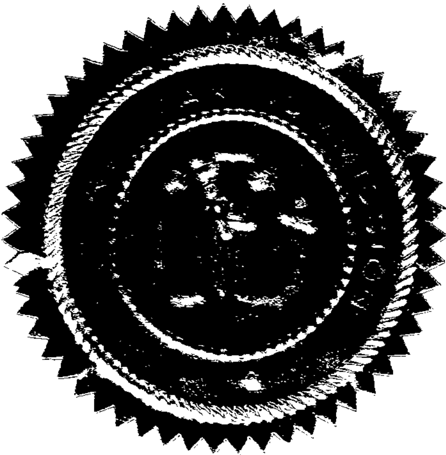
NORTH CAROLINA PROPERTY TAX COMMISSION

John A. Cocklereece, Chairman

Attest:



C. B. McLean Jr., Secretary



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