No. 2014-CI-11636

LOWE'S HOME CENTERS, INC.	*	IN THE DISTRICT COURT
	*	
VS.	*	BEXAR COUNTY, TEXAS
	*	
BEXAR APPRAISAL DISTRICT	*	57th JUDICIAL DISTRICT

No. 2015-CI-13547

LOWE'S HOME CENTERS, INC.	*	IN THE DISTRICT COURT
	*	
VS.	*	BEXAR COUNTY, TEXAS
	*	
BEXAR APPRAISAL DISTRICT	*	166th JUDICIAL DISTRICT

DECISION OF ARBITRATORS

I. FACTS AND PROCEDURAL HISTORY.

In these two lawsuits, Lowe's challenges the District's appraisals of four "Big Box" properties for tax years 2014 and 2015. Lowe's owns and occupies each of the subject properties.

After the cases were mediated without success, the parties agreed to submit the matter to the undersigned panel of arbitrators for an advisory decision. The parties agreed that the panel's decision will be admissible in court, subject to details known to the parties and not relevant here.

The arbitration hearing took place from Monday morning until noon Friday, October 17-21, 2016. There was full examination and cross-examination of witnesses. Thorough expert reports and other exhibits were admitted. The arbitrators asked numerous questions. The parties submitted post-hearing briefs. The panel has studied the statutes and case law, the

expert reports and articles and other exhibits, and the briefs and arguments of counsel.

Lowe's evidence consisted primarily of the expert testimony of Jim Amorin, Brett Harrington, and David Lennhoff (on methodology). Their opinions emphasized comparable properties that were *vacant* big box properties.

The District's evidence consisted primarily of the expert testimony of Joshua Wood. His opinions emphasized comparable properties that were *occupied* big box properties.

The parties agreed there should be limits and boundaries on the panel's decision. They asked that the panel not give them its own appraisal numbers. Instead this was characterized as a "baseball arbitration," in which the panel would choose one side's appraisal figures or the other. The District asked for a decision limited to bottom-line appraisal figures. Lowe's asked for a decision as to which side's methodology is proper. Each side's proposed decisions, submitted after the hearing, consist of suggested findings of fact and conclusions of law. The panel's decision falls within all these boundaries.

II. LOWE'S' ARGUMENT.

Lowe's argues as follows:

(1) An appraiser must value the fee simple interest, not a leased-fee interest. "When a property is leased, the property owner holds a 'leased-fee interest,' not a fee-simple interest." (Lowe's Proposed Arbitration Award, page 4, ¶ 12). Mr. Amorin (p. 19) made essentially the same point in different words: "A lease destroys the fee interest and by definition becomes a leased fee estate no matter the duration of the lease or its rates and terms."

(2) The definition of "market value" requires that the taxable property and improvements be *available* for lease. That is, a tax appraiser must assume that the property is not under an existing lease, but is available for lease, which means vacant.

(3) This means that the leasehold interest (which the appraiser is entitled to value as part of the fee under the case law below) will be minimal because the big box building is useful

for only a small pool of buyers. Because the pool of potential buyers is small, there is great risk that the property will lie vacant and unrented for a long time. (In his testimony and his 2014 article, Mr. Lennhoff analogized big box property to a house with a built-in racquetball court—useful to the owner, but a drawback and a negative feature to most potential buyers, expensive to remove.)

(4) The next step in Lowe's' argument is that the appraiser should use comparables that are vacant, unrented big box properties. On this point, however, the District has Texas law on its side; and it is reasonable and certainly within the District's discretion to agree with Mr. Wood that it is better to use *occupied* big box properties as comparables.

III. The District's Argument.

The District argues as follows:

(1) Texas appraisal law presumes that a property's "highest and best use" is its current use. On January 1 of 2014 and 2015, the highest and best use of the subject properties was the home improvement retail business. This was not a contested issue.

(2) For ad valorem tax purposes, comparable properties must reflect the same or similar highest and best use.

(3) Under Texas law, the leasehold value (i.e. the value of an existing lease or of the right to lease) is subsumed within the fee simple; and when determining fee simple value, it is appropriate for an appraiser to consider leased fee comparables, with appropriate adjustments.

(4) Under the sales comparison approach to valuation, the selection of properties as "comparable" to the subject property must comply with Tax Code § 23.01 (d), which lists "occupancy" as one of the characteristics that should be similar. Texas law does not support the notion that appraisal of the subject properties should be conducted as if they were *vacant*.

(5) Under Texas law, the comparable sales considered by the District's expert Joshua

Wood were more appropriate than the comparables used by the Lowe's experts.

IV. Case Law and Statutes.

We are of the firm opinion that any decision in these cases must be faithful to the Texas cases and statutes and must be guided by them.

A. Texas Case Law. A valuation approach that has the effect of eliminating the leasehold value from a tax appraisal of the fee would violate longstanding Texas law.

Longstanding Texas case law says that the market value of a leasehold is included in the fee simple valuation. Several Texas cases have held that when realty is subject to a lease, the owner must pay taxes on the entire fee, including the part of the fee that is subject to lease.

• *Cherokee Water Co. vs. Gregg County Appraisal Dist.*, 801 S.W.2d 872 (Tex. 1990), said:

> It has long been the law that the lessor rather than the lessee is responsible for taxes on the full value of the property. [case citations from 1888 to 1980 omitted] The lessor's interests in the property are not just the future right to receive the property back at the end of the term, but the present right to receive income in the form of rent. *Id.* at 875.

Referring to the passage just quoted, the *Cherokee* court said that in enacting the Tax Code the Legislature did not intend to "overturn a century of precedent." *Id.*

• *County of Dallas Tax Collector vs. Roman Catholic Diocese of Dallas*, 41 S.W.3d 739 (Tex. App.—Dallas 2001, no pet.), summarized and cited the statements from *Cherokee* above and added the following:

> *The value of the entire fee necessarily contains the lesser value of the leasehold the fee contains.* . . . Unless the leasehold involves exempt property, *the leasehold* is not independently taxed, but rather, it *is subsumed within the value of the fee simple estate.* *Id.* at 744 (emphasis added).

• *Dallas Central Appraisal Dist. vs. Jagee Corp.*, 812 S.W.2d 49 (Tex. App.—Dallas 1991, writ denied), involved two properties subject to long-term leases to K-Mart. The owners wanted to be taxed only on the underlying fee without including the value of the leasehold interests. That is, the owners wanted to factor out the value of the leaseholds. The appellate court held that the entire property was taxable, *including the market value of the leasehold*. The court said:

> By being taxed on [K-Mart's] leasehold, Jagee [the owner] is being taxed on the value of a leasehold that is subsumed within the value of the fee simple it owns. It is not being taxed on property it does not own. The value of the entire fee necessarily contains the lesser value of the leasehold that it includes. *Id.* at 52-53.

In view of these authorities, it is beyond dispute that an appraiser may include a valuation of the leasehold interest that the fee "contains." There may be disagreement about the *market value* of the right to lease property, but the value of a leasehold (including the right to lease) is a proper subject of taxation.

B. Texas Statutes. Mr. Wood's use of comparables is more true to the Texas statutes than that of Lowe's, because the comparables used by Wood better satisfy the "similarities" requirement of Texas Tax Code § 23.01 (d).

Section 23.01 (d) says:

> Whether a property is comparable to the subject property shall be determined based on similarities with regard to location, square footage of the lot and improvements, property age, property condition, property access, amenities, views, income, operating expenses, occupancy, and the existence of easements, deed restrictions, or other legal burdens affecting marketability.

The District's methodology is more faithful to these statutory commands than is the Lowe's methodology.

V. Decision.

Our decision is:

(1) The District's methodology and appraisal conclusions are consistent with Texas case law because they properly value the subsumed leasehold interest within the fee.[1]

(2) The comparable properties used by the District are consistent with the mandates of § 23.01 of the Texas Tax Code.

(3) The following values stated by Mr. Wood are correct:

Store	Tax Year	Value
• North Store # 1579	2014	$13,250,000
	2015	$13,600,000
• Northeast Store # 1625	2014	$12,250,000
	2015	$12,500,000
• West Store # 1504	2014	$11,750,000
	2015	$12,000,000
• South Store # 2786	2014	$11,000,000
	2015	$11,250,000

[1] The cases from outside Texas are of little help because they interpret different statutes and yield mixed results.

Signed: January 10, 2017

David Peeples

Judge David Peeples, Arbitrator

Michael Peden

Judge Michael Peden, Arbitrator

Hon. George Brin, Arbitrator