

LOUIS & DAVID W. STEINBACH,
TRUSTEES

vs.

SUPERVISOR OF ASSESSMENTS
OF ALLEGANY COUNTY

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IN THE

MARYLAND TAX COURT

No. 09-RP-AL-0537

MEMORANDUM AND ORDER

This case is an appeal by Petitioners, Louis and David W. Steinbach, Trustees, from the decision of the Property Tax Assessment Appeals Board for Allegany County (PTAAB) setting the assessment of the commercial property titled to the Petitioners, which is located at 10 N. Liberty Street, Cumberland, Maryland, at \$2,917,100. Petitioners, asserting defects in the appraisal by Respondent's appraiser, Thomas E. Farrell, rely on the report and testimony of the appraiser they retained, Mark R. Shonberg, in arguing for a reduction in the assessment of the subject property to \$1,900,000. The date of finality is January 1, 2009.

The subject property is a six-story building with 9 commercial units on the first floor and fifty-eight one-bedroom and eleven two-bedroom residential units on the remaining floors. As noted by David W. Steinbach, after the acquisition of the property, it was completely gutted and renovated with the renovations being completed in January, 1981.

Mr. Steinbach explained that the property, upon renovation and to the present, has been operated as a "HUD 221 (d) (4) property for the elderly, as opposed to families." The rents for the residential units have, since the renovations, been subject to a

Housing Assistance Program (HAP) contract which establishes the rents, of which 70% are subsidized by the Department of Housing and Urban Development (HUD). The original HAP contract expired after 20 years. Thereafter, the renewals occur at five-year intervals. The next renewal is scheduled for December, 2010. The property is subject to a HUD financed mortgage with a 30 year term beginning in 2002. See Respondent's Exhibit #1.

In Petitioners' counsel's Hearing Memorandum, it is suggested that the three "major areas of departure" between the Petitioners and Respondent are the expenses/reserves, the vacancy rate, and the capitalization rate. The Court accepts this suggestion and will address these issues *seriatim*.

Mr. Farrell relied on "the actual expenses provided..." by Petitioners in determining the expenses, while Mr. Shonberg relied on a market premised analysis. The Court finds Mr. Farrell's analysis more reliable. As noted by Mr. Farrell, Mr. Shonberg's projections included salary increases of eight percent and a 19.63 percent increase in operations and maintenance expenditures, which do not comport with history or the Cumberland market. And, in this regard, the Court also notes that Mr. Shonberg incorporates health insurance expenses in the projections, which "have not been historical offered." See Petitioners' Exhibit # 2 at p. 44. It is illogical to permit Petitioners' historic lack of largesse in this regard to now increase their expense projections. Hence, the Court will rely upon Mr. Farrell's stated expenses of \$311,182.

Mr. Shonberg incorporated in his calculation of reserves the impending need to replace the roof and the HVAC system which Mr. Steinbach explained. Mr. Farrell relied on what he described as the "industry standard" of four percent of effective

gross income for reserves. The Court finds the four percent "industry standard" more appropriate.

Mr. Steinbach noted that the roof and HVAC system were original to the 1981 renovation. "We cannot complain about how long it lasted," he observed insofar as the roof. It is reasonable to assume that over the 28 years since their original installation reserves had been accumulated for the replacement of the roof and HVAC system. Had there been a catastrophic or other unanticipated event necessitating replacement before their anticipated duration, the consideration Mr. Shonberg proposes would be appropriate. But, in this circumstance, the Court feels it is not. As Mr. Farrell noted, these capital expenditures were factored into the four percent.

Mr. Shonberg proposes a three percent vacancy adjustment to gross potential income while Mr. Farrell proposes \$2600 or .4 percent. Mr. Steinbach's testimony justifies only a minimal vacancy adjustment as although he hypothesized new challenges to securing both commercial and residential renters, he acknowledged there had been "virtually 100% occupancy ever since the project opened" and, insofar as the commercial tenants, they were "longstanding." This history must be attributable to the property's favorable "100% location [at] Main and Main," he described and which Mr. Shonberg described as a "...prominent corner in a good downtown location." See Petitioners Exhibit # 2 at p. 31. Mr. Shonberg also testified that the location is alluring to seniors for reasons including its proximity to medical services and a senior center.

But, Mr. Farrell proposes essentially no vacancies which is not realistic. As Mr. Shonberg aptly suggested, turnover cannot be managed to avoid lapses in tenancy. This reality is reflected in the actual occupancy rates he presented. See *Id.* at p.

38. The average vacancy rate reflected in those occupancy rates for 2006 to 2008 is 2.18% which the Court will incorporate into its final calculation of the appropriate Net Operating Income of \$341,807.

The remaining component to determine the property's fair market value is the appropriate capitalization rate. Mr. Farrell's proposed capitalization rate is nine percent, while Mr. Shonberg's proposed capitalization rate is 12.5 percent. The significant deviation between the rates reflects Mr. Shonberg's view that future rent uncertainty should be a significant factor in the capitalization.

Mr. Shonberg attributes the rent uncertainty to the scheduled December, 2010 renegotiation of the HAP contract. A critical component of this renegotiation will be a review of the appropriate market rent for the residential units. In this regard, Mr. Shonberg presented convincing market evidence that HUD will insist on lower rents for the renegotiated contract. See. Petitioners Exhibit #2 at pgs. 49 & 51.

Mr. Farrell did not dispute the likelihood of lower rents in the renegotiated contract, arguing that any rent decrease would be offset by HUD concessions in the debt structure. Mr. Steinbach explained this concession as a "soft second," by which HUD would reduce the first mortgage by an amount necessary to compensate for the reduced rents. The reduced amount would be reflected in a second mortgage which would be payable only if there was positive cash flow. Mr. Steinbach suggested this structure would deter any potential profit, which would arise only through expense reductions or increased rental income for the commercial units.

Mr. Farrell opined that the HUD debt concessions would be cash flow neutral, creating a “stable environment.” Hence, he did not consider rent risk in his proposed capitalization rate.

The Court finds rent risk exists and it is a relevant consideration in the capitalization rate calculation. As Mr. Steinbach noted, the property is operated as a for-profit venture. With rent reductions likely, the commensurate “soft second’s” terms would impede the profit potential of the property, rendering rent risk a relevant consideration in the capitalization rate determination.

In assessing the appropriate capitalization rate, the Court initially accepts the nine percent base capitalization rate proposed by Mr. Farrell. This rate is supported by the capitalization rate of 8.59 percent for comparable sale number 2 cited by Mr. Shonberg, which was one of three cited sales of “...properties operated under similar subsidy programs.” *Id.* at 47. This sale was indicated to be the only of the three properties under a subsidized program specifically for the elderly, similar to the program for the subject property. Although Mr. Shonberg suggests that purchasers of the property may have anticipated a more favorable HAP contract, the Court finds there was no evidence that the purchasers were not knowledgeable and that Mr. Shonberg had any doubts about identifying it as a comparable sale in his report. The nine percent capitalization rate is also supported by the *Korpacz* mean range for non-institutional sales in the first and second quarters of 2009 between 8.71 and 8.85 percent cited by Mr. Shonberg. *Id.* at 48.

But, the nine percent capitalization rate would only be appropriate for the non-residential component of the Net Operating Income, as that component would not be

subject to the rent risk described above. The rent risk justifies an enhancement to the capitalization rate for the residential component only of the Net Operating Income. In assessing that enhancement, and while not clearly analogous, the Court finds guidance from the Maryland Assessment Procedures Manual suggestion for a 1.5 to 2 percent enhancement in the capitalization rate for projects subject to Section 42 Tax Credits. See Petitioner's Exhibit # 1. Relying on this guidance, the Court will apply a 10.75 percent base capitalization rate to the residential component of the Net Operating Income.

The remaining determinations to compute the fair market value are the effective tax rate and the apportionment between residential and other Net Operating Income. Insofar as the effective tax rate, Mr. Farrell and Mr. Shonberg suggested 2.4513 and 2.4408 percents, respectively, leading the Court to apply a 2.45 percent tax rate. Insofar as the apportionment, the Court relies on Mr. Shonberg's Income Summary to conclude that 86 percent of the Net Operating Income is attributable to residential operations. See Petitioner's Exhibit # 2 at p. 38. Applying the differentiated capitalization rates plus the effective tax rate to the apportioned Net Operating Income results in a fair market value calculated in accordance with the income approach, the methodology recommended by both appraisers, of \$2,644,854.

Accordingly, it is this 19th day of February, 2010, by the Maryland Tax Court ORDERED that the decision of the Property Tax Assessment Appeals Board for Allegany County is **REVERSED**, and the proper full cash value for the subject property is reduced to \$2,644,854.