

**PROPERTY ASSESSMENT APPEAL BOARD
FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER**

PAAB Docket No. 2017-077-10260D

Parcel Nos. 241/00844-501-000

Cornerstone Commons LLC,

Appellant,

vs.

Polk County Board of Review,

Appellee.

Introduction

The appeal came on for hearing before the Property Assessment Appeal Board (PAAB) on June 24, 2019. Richard Stradley represented Cornerstone Commons LLC (Cornerstone). Assistant County Attorney Mark Taylor represented the Polk County Board of Review.

Cornerstone is the owner of a dual-classed commercial and multi-residential apartment complex located at 6365 Merle Hay Road in Johnston. (Ex. A). The Polk County Assessor valued the property as of January 1, 2017 as follows:

Classification	Land	Building	Total Value
Commercial	\$65,000	\$272,950	\$337,950
Multi-residential	\$435,000	\$1,826,650	\$2,261,650
Total	\$500,000	\$2,099,600	\$2,599,600

The record does not contain a Board of Review petition, but the record does reflect that the Board of Review modified the assessment of the property to the following:

Classification	Land	Building	Total Value
Commercial	\$435,000	\$1,826,650	\$2,261,650
Multi-residential	\$65,000	\$272,950	\$337,950
Total	\$500,000	\$2,099,600	\$2,599,600

Cornerstone appealed the Board of Review's action to PAAB, claiming the property was assessed for more than the value authorized by law and there was an error in the assessment under Iowa Code section 441.37(1)(a)(1)(b, d).

General Principles of Assessment Law

PAAB has jurisdiction of this matter under Iowa Code sections 421.1A and 441.37A. PAAB is an agency and the provisions of the Administrative Procedure Act apply to it. Iowa Code § 17A.2(1). This appeal is a contested case. § 441.37A(1)(b). PAAB may consider any grounds under Iowa Code section 441.37(1) properly raised by the appellant following the provisions of section 441.37A(1)(b) and Iowa Admin. Code Rule 701-126.2(2-4). PAAB determines anew all questions arising before the Board of Review related to the liability of the property to assessment or the assessed amount. § 441.37A(3)(a). New or additional evidence may be introduced, and PAAB considers the record as a whole and all of the evidence regardless of who introduced it. *Id.*; see also *Hy-Vee, Inc. v. Employment Appeal Bd.*, 710 N.W.2d 1, 3 (Iowa 2005). There is no presumption that the assessed value is correct. § 441.37A(3)(a). However, the taxpayer has the burden of proof. § 441.21(3). This burden may be shifted; but even if it is not, the taxpayer may still prevail based on a preponderance of the evidence. *Id.*; *Richards v. Hardin County Bd. of Review*, 393 N.W.2d 148, 151 (Iowa 1986).

Findings of Fact

The subject property is a 62-unit apartment complex built in 2012. As of the assessment date, the complex consisted of seven units eligible to be rented at market rates and fifty-five units restricted for rent to low-income individuals and families as authorized by section 42 of the Internal Revenue Code. The property is dual-classified;

the Section 42 income-restricted units are classified commercial and the market-rate units are classified multi-residential.

Chief Deputy Assessor Rod Hervey testified for the Board of Review about the subject property's assessment. Hervey did not personally appraise the property, but reviewed the assessment and testified he would have valued it the same way. Hervey testified that the Assessor sends out a notification to Section 42 property owners to submit income and expense information required by Iowa Admin. Code R. 701-71.5(2)(c). Cornerstone submitted its income and expense information using a "Section 42 – Reporting Form" spreadsheet provided by the Iowa Department of Revenue. (Ex. B). The Section 42 Reporting Form contains income and expense information for 2014, 2015, and 2016, and reports a normalized net operating income (NOI) of \$204,911. At or near the same time, Cornerstone provided a Rent Roll Detail that includes information about the units and rental rates as of December 31, 2016. (Ex. C).

Hervey testified the subject's assessment was determined by calculating the NOI of the complex using the Section 42 Reporting Form and the Rent Roll. In particular, the Rent Roll was used to determine the Potential Gross Income (PGI) for the subject for 2017. Normalized expenses were taken from the Section 42 Reporting Form to arrive at a NOI of \$240,578, as reported in Exhibit E. Cornerstone was critical of this method and believed it overstated the NOI since the assessor relied on current rents from the Rent Roll, but historical expenses taken from the Section 42 Reporting Form.

Hervey asserts that the same methodology for classification and allocation is used for all Section 42 properties in Polk County. He further stated his office had made inquiries to the Department of Revenue regarding the procedures being followed and asserted that no changes were made, implying the methodology was found to be correct.

Next, the NOI was proportionally allocated to the Section 42 units and the market-rate units as shown in Exhibit G. Cornerstone does not contest the allocation, but disagrees with the capitalization rate the assessor used. The Assessor applied different capitalization rates to the Section 42 units and the market-rate units. The table below replicates the Assessor's method.

	# of Units	Allocation	Allocated NOI	Capitalization Rate	Indicated Value
Section 42 (Commercial)	55	88.71%	\$ 213,416	9.40%	\$ 2,270,383
Market-Rate (Multi-Residential)	7	11.29%	\$ 27,162	8.25%	\$ 329,236
					\$ 2,599,619

The Iowa Department of Revenue provided the Section 42 capitalization rate pursuant to Iowa Admin. Code. Rule 701-71.5(2)(d). The 8.25% market-rate capitalization rate was derived from data in Exhibit F. The data indicates capitalization rates for apartments with a range between 7% and 9%, and 8% being typical.

Dr. K. Edward Atwood is a Wisconsin certified appraiser, business and real estate professor, and CPA. (Ex. 1). Atwood testified on behalf of Cornerstone and detailed two primary concerns he had with the subject property's assessment. First, he believed the Assessor incorrectly applied Iowa Admin. Code Rule 701-71.5(2) when determining the NOI of the subject property. Second, he believed the Assessor erred by applying a market capitalization rate to the market-rate units in the complex.

Atwood contends Rule 701-71.5 provides different methods for deriving NOI for Section 42 properties, but that the Assessor misapplied the method it used. He believes the subject property has a normalized operating history and, therefore, the property's NOI can be derived by using historical income and expenses. He indicates the correct NOI is \$204,912. (Ex. 11).

Atwood also argues the Assessor should have used the Section 42 capitalization rate for all of the units in the complex, including the market-rate units. He testified the entire complex is subject to a Land Use Restriction Agreement and the market rate units represent an undivided portion of the total development. We note the Land Use Restriction Agreement was not submitted into evidence. Atwood states that when Section 42 properties are sold, the "total value is based on one capitalization rate regardless of the mix of restricted and 'market rental rate units' that is applied to potential NOI." (Ex. 11, p. 5). This is contrary to statements made during the hearing indicating that Section 42 properties cannot be sold due to the Land Use Restriction Agreement. Atwood asserts the use of a market-rate capitalization rate for the market-

rate units encompasses the value of the tax credits used to finance the project, which is prohibited by Iowa Code section 441.21(2) and Rule 701-71.5(2)(b).

Atwood also asserts “the total development is subject to a Land Use Restriction Agreement and should be classified as commercial,” (Ex. 11, p. 5) but during the hearing he admits the market-rate units are properly classified as multi-residential and says he has no problem with the allocation of the different classifications. He testified that he did not analyze the subject’s classification and believes the property would be valued the same regardless of its classification. Atwood believes the subject should first be valued and then the resulting value should be allocated to the commercial and multi-residential portions of the property.

Atwood compares differently derived NOI estimates to support his assertion that the assessor’s estimate is unreliable. (Ex. 11, p. 6). The table on Page 6 of Exhibit 11 shows the calculated NOI based on a variety of income and expense projections. The first NOI represents the income and expenses based on the past three year average, the second is for the budgeted income and expenses, the third is from actual income and expenses, and finally the assessor’s estimated NOI. The table indicates NOI’s of \$204,912, \$212,254, \$218,154, and \$240,578, respectively. Atwood contends this table shows a similar NOI in the first three columns and more importantly how the assessor’s estimate is inconsistent with the other three.

Based on historical NOI and applying the Section 42 capitalization rate to the entirety of the property, Atwood calculated a value for the subject property of \$2,179,915. (Ex. 11). Cornerstone contends this is its correct value. The table below summarizes his conclusions.

	# of Units	Allocation	Allocated NOI	Capitalization Rate	Indicated Value
Section 42 (Commercial)	55	88.71%	\$ 181,777	9.40%	\$ 1,933, 798
Market-Rate (Multi-Residential)	7	11.29%	\$ 23,135	9.40%	\$ 246,117
			\$ 204,912		\$ 2,179,915

Analysis & Conclusions of Law

Cornerstone contends its property is assessed for more than the value authorized by law and that there is an error in the subject property's assessment. § 441.37(1)(a)(1)(b, d).

Most property in Iowa is assessed at its market value under Iowa Code section 441.21(1). Section 441.21(2) creates an exception for properties "rented or leased to low-income individuals and families as authorized by section 42 of the Internal Revenue Code." When assessing Section 42 property, the assessor shall value the property using "the productive and earning capacity from the actual rents received as a method of appraisal and shall take into account the extent to which that use and limitation reduces the market value of the property." § 441.21(2). "The assessor shall not consider any tax credit equity or other subsidized financing as income provided to the property in determining the assessed value." *Id.* Section 441.21(2) gives the Iowa Department of Revenue (IDR) authority to adopt rules to implement the section.

As part of a comprehensive property tax reform package adopted in 2013, the Iowa legislature established a new property classification – multi-residential – and permitted limited instances of dual-classification. In pertinent part, section 441.21(13)(a)(2) states:

Beginning with valuations established on or after January 1, 2016, all of the following shall be valued as a separate class of property known as multiresidential property . . .

(e) A parcel primarily used or intended for human habitation containing three or more separate dwelling units. If a portion of such a parcel is used or intended for a purpose that, if the primary use, would be classified as commercial property or industrial property, each such portion, including a proportionate share of the land included in the parcel, if applicable, shall be assigned the appropriate classification pursuant to paragraph "c".

(f) For a parcel that is primarily used or intended for use as commercial property or industrial property, that portion of the parcel that is used or intended for human habitation, regardless of the number of dwelling units contained on the parcel, including a proportionate share of the land included in the parcel, if applicable. The portion of such a parcel used or intended for use as commercial property or industrial property, including a

proportionate share of the land included in the parcel, if applicable, shall be assigned the appropriate classification pursuant to paragraph “c”.

Section 441.21(13)(c)(2) further states:

(2) Beginning with valuations established on or after January 1, 2016, for parcels for which a portion of the parcel satisfies the requirements for classification as multiresidential property pursuant to paragraph “a”, subparagraph (2), subparagraph division (e) or (f), the assessor shall assign to that portion of the parcel the classification of multiresidential property and to such other portions of the parcel the property classification for which such other portions qualify.

IDR adopted administrative rules implementing these code provisions.

For assessment years beginning January 1, 2016, and after, assessors shall use dual classification on properties where the primary use of the parcel meets the requirements of the multiresidential classification and a portion or portions of the parcel meet the requirements of the commercial classification under subrule 71.1(6) or the industrial classification under subrule 71.1(7). If the primary use of a parcel is for human habitation and the parcel contains fewer than three separate dwelling units, it shall be classified as residential real estate under subrule 71.1(4).

The only permissible combinations of dual classifications are commercial and multiresidential or industrial and multiresidential. The assessor shall assign to that portion of the parcel that satisfies the requirements the classification of multiresidential property and to such other portions of the parcel the property classification for which such other portions qualify. The assessor shall maintain the valuation and assessment of property with a dual classification on one parcel record.

Iowa Admin. Code. R. 701-71.1(5)(b).

Cornerstone agreed the subject’s market rate units should be classified as multi-residential and, pursuant to section 441.21(13)(d), Section 42 property is not to be classified as multi-residential. Cornerstone also agreed the Assessor must allocate value to the multi-residential portions of the property.

In valuing, dual-classified property, the IDR rules state:

The assessor shall value as a whole properties that have portions classified as multiresidential and portions classified as commercial or industrial using the methodology found in rule 701—71.23(421,428,441).

After the assessor has assigned a value to the property, the value shall be allocated between the two classes of property based on the appropriate appraisal methodology. The assessor shall allocate land value proportionately by class.

Iowa Admin. Code R. 701-71.24(1).

The rules specify that “multiresidential real estate shall be assessed at a percent of its actual value as defined in Iowa Code section 441.21.” R. 701-71.23. In determining actual value, the assessor shall use the Iowa Real Property Appraisal Manual, assessment/sales ratio studies, comparable sales, and other relevant data. *Id.*

The rule concerning commercial real estate valuation contains similar language, but also includes a specific provision detailing the method for valuing low-income housing subject to Section 42 of the Internal Revenue Code. Iowa Admin. Code R. 701-71.5(2). The rule states that Section 42 property should be valued by the income approach using the direct capitalization method. *Id.* “The direct capitalization method of the income approach involves dividing the Net Operating Income (NOI) on a cash basis by an overall capitalization rate to derive an indication of the value of the property for the assessment year.” *Id.*

The two primary issues in this appeal are: 1) What is the proper method for calculating NOI? and 2) How should the capitalization rate be applied?

1. Methodology for Calculating NOI

The rule provides three methods for determining a property’s NOI. *Id.* The methods are as follows:

Method 1 - Iowa Admin. Code r. 701-71.5(2)(b), paragraph 2

“In applying the direct capitalization method, the assessor *shall* develop a normalized measure of annual NOI . . . utilizing (1) the actual rent schedule applicable for each of the available units as of January 1 of the year of assessment indicating the actual rent to be paid by the resident plus any Section 8 rental assistance . . ., (2) a normal vacancy/collection allowance, (3) the prior year’s actual and current year’s projected annual operating expenses associated with the property . . ., and (4) an appropriate provision for replacement reserves.” (Emphasis added).

Method 2 - Iowa Admin. Code r. 701-71.5(2)(b), paragraph 3

“For properties that have attained a normalized operating history, the NOI results of the prior three years . . . *may* be used to provide the basis for determining the normalized NOI used for purposes of applying the direct capitalization method for the year of assessment.” (Emphasis added).

Method 3 - Iowa Admin. Code r. 701-71.5(2)(b), paragraph 3

“In addition, the assessor *may* utilize the current year operating budget to develop a measure of NOI for the assessment year.” (Emphasis added).

Cornerstone refers to Methods 2 and 3 as sound and preferred, and states that Method 1 is an alternative. (Ex. 11, p. 2). We note, however, that the rule uses “shall” when discussing Method 1, but uses the word “may” when describing Methods 2 and 3. Thus, not only does it appear first chronologically in the rule itself, the language indicates that Method 1 is the preferred method under the rule. *Kopecky v. Iowa Racing & Gaming Comm’n*, 891 N.W.2d 439 (Iowa 2017) (stating that when used in a statute, the term ‘shall’ imposes a duty and the term ‘may’ is permissive).

Cornerstone argues that the Assessor should have used Method 2 to value the subject property. It contends the Assessor did not have adequate information to complete Methods 1 or 3 because the Assessor did not request the property’s current year projected annual operating expenses. Cornerstone believes the Assessor’s use of current year PGI along with historic, normalized operating expenses results in an inflated NOI.

After considering the evidence and testimony, we find the Assessor’s method is not consistent with the methods permitted by the rule and resulted in an inflated NOI determination for this property.

The record contains sufficient information to apply Method 1, resulting in an NOI of \$224,261.¹ The calculation is shown in the table below.

¹ The figures in the table were taken from Exhibits B and 11.

Potential Gross Income from Rent Roll		\$583,980
Less:		
2016 Actual & 2017 Projected V&C Loss	$((12,629 + 15,252) / 2) =$	(\$13,941)
2016 Actual & 2017 Projected Op. Expenses	$((340,578+350,977) / 2) =$	(\$345,778)
Net Operating Income		\$224,261

2. Applying the Capitalization Rate

The remaining distinction between the Assessor’s method and Atwood’s method concerns the capitalization rate. The Assessor applied the Section 42 capitalization rate supplied by the IDR to an allocated portion of the property designated as Section 42, which are commercially classified. Then, the Assessor applied a market-derived capitalization rate to the non-Section 42 portion of the property, which is classified multi-residential. The resulting values were added together to arrive at a total value for the parcel.

Cornerstone does not dispute the allocation or the classification, but argues the Assessor did not properly apply the capitalization rate. It believes the Section 42 capitalization rate should be applied to the entirety of the property to arrive at a total value, which is then allocated to the commercial and multi-residential portions.

Cornerstone contends that the Section 42 capitalization rate must be used for the market rate units because the entire development is subject to a Land Use Restriction Agreement. Atwood testified that when Section 42 properties are sold, the “total value is based on one capitalization rate regardless of the mix of restricted and ‘market rental rate units’ that is applied to potential NOI.” (Ex. 11, p. 5). In essence, Cornerstone believes the Section 42 capitalization rate represents a market capitalization rate for the market-rate units. Additionally, Cornerstone asserts the use of a market-rate capitalization rate for the market-rate units encompasses the value of the tax credits used to finance the project, which is prohibited by Iowa Code section 441.21(2) and Rule 701-71.5(2)(b).

We admit resolution of this question is difficult, requiring an analysis of the various Iowa Code and administrative code provisions that are not easily harmonized

and do not appear to contemplate the situation at-hand. Rule 701-71.24 would appear to support Cornerstone's position that the entirety of the property must be valued and then the value should be allocated back to the commercial and multi-residential portions. Such an approach, however, ignores other provisions of section 441.21 and 701.71 et al. describing the methodology to be used in valuing properties of different classifications. Amongst those provisions, multi-residential property is to be valued at its actual, fair market value based, preferably, on comparable sales. § 441.21(1, 2); R. 701-71.23. Only if comparable sales cannot readily establish the value can other methods of valuation be considered. § 441.21(2). Conversely, Section 42 property is an exception to the general valuation rules in section 441.21(1) and is to be valued by using productivity and net earning capacity from its actual rents (i.e. not the market). *Id.*

In asking that its multi-residential, non-Section 42 property be valued using the Section 42 income approach, Cornerstone is seeking an exception to the statutory requirement that this property be valued at its market value based, preferably, on comparable sales. As section 441.21(2) limits the application of the Section 42 valuation methodology to "property that is rented or leased to low-income individuals," we question whether Cornerstone's approach is consistent with legislative intent. As further demonstration of the problem with Cornerstone's argument, it is seeking to apply the valuation methodology from Rule 701-71.5 (*Valuation of Commercial Real Estate*) to its multi-residential property. In the end, we believe there is insufficient statutory and conceptual support for PAAB to adopt Cornerstone's argument.

Moreover, we find Cornerstone failed to substantiate the remainder of its arguments. There is insufficient evidence to conclude a Section 42 capitalization rate represents the market value for the multi-residential units or that using a market capitalization rate results in a valuation encompassing tax credits.

As a result, we find the capitalization rates were properly applied to Cornerstone's property.

Order

PAAB HEREBY MODIFIES the Polk County Board of Review's action. Based on the foregoing, we find the property should be valued as follows:

	# of Units	Allocation	Allocated NOI	Capitalization Rate	Indicated Value
Section 42 (Commercial)	55	88.71%	\$ 198,942	9.40%	\$ 2,116,404
Market-Rate (Multi-Residential)	7	11.29%	\$ 25,319	8.25%	\$ 306,897
			\$ 224,261		\$ 2,423,301

PAAB ORDERS the assessment is modified to a total value of \$2,423,301, allocated as \$2,116,404 to the commercial real estate and \$306,897 to the multi-residential real estate.

This Order shall be considered final agency action for the purposes of Iowa Code Chapter 17A (2017).

Any application for reconsideration or rehearing shall be filed with PAAB within 20 days of the date of this Order and comply with the requirements of PAAB administrative rules. Such application will stay the period for filing a judicial review action.

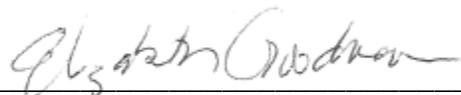
Any judicial action challenging this Order shall be filed in the district court where the property is located within 20 days of the date of this Order and comply with the requirements of Iowa Code sections 441.38; 441.38B, 441.39; and Chapter 17A.



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