Analysis of the CAF Decision

MICHIGAN COMMERCIAL PROPERTY TAX ASSESSMENTS AFTER CAF INVESTMENT

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INTRODUCTION

The landmark case of **CAF Investment Co v State Tax Commission** [1] has had a significant effect on the valuation of income producing property in Michigan. Clearly, property tax assessments should take into consideration the actual rental income of commercial property. The role of actual income as a component of valuation will fluctuate in different factual contexts. In some cases, actual income will be adjusted to reflect current market conditions. The purpose of this paper is to analyze the CAF decision in light of an increased judicial involvment in property tax assessments.

BACKGROUND

The Michigan property tax is imposed upon property in accordance with its true cash value, Const. 1963, Art. 9, § 3. The concept of true cash value is synonomous with fair market value. The Legislature has defined true cash value as:

"(T)he usual selling price at the place where the property to which the term is applied is at the time of assessment, being the price which could be obtained for the property at private sale, and not at forced or auction sale . . . In determining the value the assessor shall also ***consider*** the advantages and disadvantages of location, quality of soil, zoning, existing use, ***present economic income of structures*** . . ." (emphasis added) MCLA 211.27; MSA 7.27.

But the statutory test is not exclusive, says the Court of Appeals in **Consumer Power Co vs Big Prairie Twp.** [2] In the vagaries of real estate valuation, different appraisal methods can be used to reach the constitutional result of true cash value. The Court of Appeals suggested the following three tests for such determination:

1) Actual Cash Value or Market Approach: This method uses a comparison of the property with the actual sales of other comparable properties. It is commonly used to value residential property and other property with relatively high turnover and an identifiable market. **Consumers Power,** at 130.

2) Adjusted Reproduction Cost: The assessor examines the structure on the property and calculates the present cost to reproduce it. The current reproduction cost is then depreciated for physical wear-and-tear and economic obsolescense. Generally, the approach is a good measure of value on properties with relatively new improvements. However on older properties, the reduction of value due to all sources of depreciation may be difficult to measure. **Consumers Power,** at 130.

3) Capitalization of Income: This method estimates the present value of the amount of net income the property is expected to generate over its remaining useful life. The underlying premise is that there is a relation between the income a property can earn and the value of that property. Many commercial properties leased to tenants are assessed by capitalization of income. Two common techniques are annuity capitalization which discounts the total of all projected future income and direct capitalization which divides net income by the capitalization rate of the property. The capitalization rate is a rate of interest, expressed in percentage terms which equates a future stream of income and its present value. Widely employed in finance where it is known as the internal rate of return, the capitalization rate is a finding of fact. See **Northwood Apts vs City of Royal Oak.** [3]

Any appraisal method which is recognized as accurate and reasonably related to fair market valuation of the property is an acceptable indicator of true cash value. **Safran Printing Co vs Detroit.** [4]

Under the General Property Tax Act [5], all property subject to taxation within the state is assessed annually by the various cities, villages or townships. These assessments, after approval by the local board of review of each assessing unit [6] are submitted to the county Board of Commissioners. [7] The county board can change the aggregate valuation of an assessing unit to assure that property within the county has been equally and uniformly assessed at true cash value. Assessing officers generally have considerable discretion in appraising individual property values. Which valuation method is most appropriate is to be determined from the facts of that individual case, in light of the assessor's experience and reasoned judgment. **Consumers Power,** at 131.

It is important to recognize that the assessor is required to reach a particular result, i.e., "true cash value," not apply a specific formula such as income capitalization. As a consequence, the assessing authority may use any common valuation method as long as it recognizes the various value components set forth in MCLA 211.27. It is an overriding principle that, no matter the seeming appropriateness of the method adopted, the result must be checked for unfairness or discrimination.

Disputes between the various assessing units and individual taxpayers invariably occur. The normal procedure is for the taxpayer to protest before the local board of review, and if unsuccessful at this level, to file a written petition before the Tax Tribunal. [8] The Tax Tribunal is empowered to make an independent determination of true cash value. This determination can be appealed to the Court of Appeals and Supreme Court. [9] It must be emphasized that judicial review in property tax cases is substantially limited by Art 6, § 28 of the Constitution:

In the absence of ***fraud, error of law or the adoption of wrong principles,*** no appeal may be taken to any court from any final agency provided for the administration of property tax laws from any decision relating to valuation or allocation. (emphasis added)

The restricted judicial review of property tax valuation cases has sometimes improperly led the courts to approve highly unreasonable assessments based upon irrelevant appraisal methods and unsound data. [10] **CAF Investment Co v State Tax Commission** (1974) indicates the willingness of the courts to examine the appraisal methods applied by the assessing authorities and the Tax Tribunal. While the actual holding may be factually limited, the following analysis of the case is intended to offer some insight into the judiciary's grappling with the true cash value problem.

THE FACTS

In 1963, CAF Investment Company constructed a K-Mart store on a 10.55-acre parcel of land near Saginaw. Prior to construction, CAF had entered into a lease agreement with its tenant, the S. S. Kresge Co., for a term of 20 years with three renewal options of five years each. The lease offered a reasonable return for 1963 economic conditions, but inflation devalued the fixed return, so that the lease is considered a poor economic investment in current dollars. In 1971, CAF appealed its property tax assessment by Saginaw Township to the State Tax Commission (now superceeded by the Tax Tribunal). The commission sustained the assessment and was affirmed by the Court of Appeals. The Supreme Court granted leave to appeal and reversed the decision of the Court of Appeals and remanded to the Tax Tribunal for findings consistent with its opinion. *[11]*

ORIGINAL GROUNDS FOR REVERSAL

The evidence submitted to the State Tax Commission by expert witnesses was based upon the capitalization of income method and the depreciated reproduction cost method of property valuation. Under both methods the Commission staff came up with a current true cash value of $1,600,000. The staff appraiser valued the property by capitalizing the hypothetical income that the property could have earned if it were leased at the current market rate. CAF's expert witness capitalized the actual income realized under the unfavorable lease, and concluded the property was worth $737,500. The State Tax Commission relied heavily on the income capitalization testimony of the staff appraiser, and determined that the true cash value of the property was $1,440,000. The following question warranted full review for alleged "error of law":

. . . whether, under Michigan law, the tax commission was entitled to consider and give weight to evidence of valuation based upon a rate of return which comparable, unencumbered property could earn in the present market place in the face of an existing unfavorable long-term lease with an actual rate of return which is substantially less than the present "going rate." 392 Mich, at 447.

The Supreme Court held that under the circumstances of the case presented, the answer was "no." The failure of the Commission to base its projected income calculations upon the ***actual income*** of the property constituted a clear error of law. To the extent the $1,600,000 determination was based upon testimony of ***hypothetical income*** (i.e. "economic rent"), it did not comport with the constitutional and statutory standard of true cash value.

THE CONCEPT OF ECONOMIC INCOME

While the legislative definition of "true cash value" contains various terms, it is without doubt that the most important element in the commercial setting is the "present economic income of structures." Commercial investors rely heavily upon the present and projected cash flow of income producing properties. In **CAF Investment** (1974), the Supreme Court interpreted the statutory meaning of "economic income" to be actual income. The staff appraiser for the commission had incorrectly interpreted the phrase "present economic income of structures" as being synonymous with a standard appraisal term called "economic rent." Economic rent is the hypothetical amount a property is capable of producing and is based on the assumption that the property in question is available to rent in the marketplace. The Supreme Court ruled that to adopt such a construction would ignore the economic reality that CAF's property was ***not*** available in the marketplace until the expiration of the lease. It would disregard the actual income stream that a potential buyer would take into account. Hence, a valuation based solely upon the economic rent of leased property would bear insufficient relation to true cash value. 392 Mich., at 454.

Superficially, the rejection of economic rent in the above context seems unremarkable. One assumes that the prudent investor in valuating CAF's property would certainly take into account the economic significance of the lease. But there is strong authority that the interpretation of the Court was incorrect as it betrays a rather narrow and unconstitutional stance toward property tax assessment. *[12]*

A major objection is that any valuation calculated on the basis of actual income only evaluates the lessor's interest in the property. Since the property tax is a tax on every right and interest that attaches to real property, the lessee arguably has a measurable interest in the land due to the economic advantage it enjoys by renting property for an amount that is less than the prevailing market rate. The lessee's enhanced value of current possession is ignored under the Court's approach, which focuses on the actual income received by the lessor. When the lessee's enhanced value for the right of possession is combined with the lessor's value of the right to receive income from the property, the aggregate value of the property will reflect current economic rent and comport with true cash value. Admittedly, a sale of the lessor's interest would have reflected the unfavorable lease, but this is not enough. A sale of the lessee's interest, conversely, would have resulted in a return disproportionately higher than his relatively low rental expense would suggest. Thus it is submitted, the court should consider the combined possible return on sale of both interests to determine true cash value. *[13]*

The decision of the Court may also be questioned on the constitutional requirement of uniformity of taxation. Essentially, uniformity requires that similar properties within the same district be assessed on a similar basis. Under the Court's rationale in the instant case, two physically identical pieces of income producing property would pay differing amounts of property taxes if the leases for these properties had different rental terms. One may question whether this tax disparity is a desirable result. A taxpayer with poor business judgment may saddle his property with an unprofitable encumbrance, while another taxpayer as a result of sharp business acumen reaps a handsome profit from a similar property. In a similar vein, it has been argued that a lazy farmer will benefit from a lower property tax assessment than the diligent farmer who tills identical land at full capacity. *[14]* In both cases, should the latter taxpayer be penalized with a heavier property tax burden because of his business foresight?

Valid limitations on the use of land may exist which will lead to disparate valuations of similarly situated properties. Michigan courts have recognized that no violation of the doctrine of uniformity occurs where the taxing authorities take such limitations into consideration when assessing property. For example, property encumbered by zoning restrictions *[15]*, or deed restrictions *[16]* cannot be compared in valuation to other properties having different restrictions. It has been argued that valid limitations can only be imposed by the actions of a third party, whereas a lease is imposed on the property by the property owner himself. The cornerstone of this concept is found in **NeBoShone Association v State Tax Commission:** "A private individual could not self-impose a restriction whereby he might be able to avoid or limit paying his just share of the ad valorem taxes..." [17] But notwithstanding this authority, the 1981 **CAF** opinion holds that different lease terms can lead to disparate valuations of similarly situated properties with no violation of uniformity. 410 Mich. at 464.

CONSIDERATION OF ACTUAL INCOME

If by definition actual income is one of the several factors which "shall be considered" by the taxing authorities under MCLA 211.27, the question becomes just what weight should actual income have in determining true cash value? In its 1974 CAF decision the Court held that the actual income of the property could not be ignored and that its consideration was mandatory:

It is only because ***in this case*** the record indicated that long-term lease rental fairly reflects economic circumstances at the outset of the lease term and bears a demonstrable relation to true cash value that we ***require its consideration.*** (emphasis added) 392 Mich, at 456, n.6.

The directive to "consider" actual rental income was fatal to the State Tax Commission's determination of true cash value which was based on testimony about "economic rent." To make a valuation grounded on the assumption that property was available in the marketplace when it was not, would bear insufficient relation to true cash value. However the Court noted that in different factual contexts the importance of actual income for valuation would vary. This is not to say that actual income ***must*** form the sole basis of valuation under the capitalization of income method. The Court rejected such a rigid statutory construction:

By the holding on this case, we do not mean to suggest that the tax assessor, in utilizing the income capitalization approach to valuation, is limited to, and must accept, the actual rental figure under an existing long-term lease as ***sole measure*** of projected income and basis for capitalization. . . Such factors as the right to repossession of the land at the end of the lease, and the length of the lease term often suggest that the projected income figure should at least be ***adjusted*** to reflect current market conditions. (emphasis added) 410 Mich. at 455.

Emphasized are certain "adjustments" to actual income, which the Court mentioned to illustrate that a valuation arrived at by virtue of a capitalization of actual income may not reflect a truly accurate picture of a property's fair market value. Id. at 461. Recent cases have indicated the flexible role actual income plays in determining true cash value.

In **Ramblewood Associates v City of Wyoming,** [18] the taxpayer's apartments were rented for an initial lease of one year and thereafter on a month-to-month basis. The property was encumbered, yet a potential purchaser could alter the rental structure if market conditions warranted. The Tax Tribunal had determined that the actual rent charged was below the market rental for comparable property. It therefore utilized an amount in excess of actual rent in its capitalization of income calculations in order to make what was, in its judgment, a more accurate determination of true cash value. The Court affirmed utilization of an adjusted rental figure. Although the Tax Tribunal was required to consider actual income in determining true cash value, "it was not precluded from making appropriate adjustments where, in its judgment, market rental in comparable properties or other relevant considerations made the capitalization of an adjusted income figure a more reliable indicator of true cash value." 82 Mich. at 346-347. The Court's willingness to sanction an adjusted income figure turned on the brevity of the leases. The case suggests that as the remaining period of restricted rental rates shortens, the price which a willing pruchaser will pay for the property increases, notwithstanding actual income. This tacit acceptance of economic rent is allowable because the property essentially is available to rent in the marketplace at the market rate. Thus the temporal length of the encumbrance affects the weight attributed to actual income in the ultimate valuation.

The breadth of the principle case has been entended to encumbrances on property other than lease agreements. In **Congress-Hills Apartments v Twp. of Ypsilanti,** [19] the owner of apartment buildings was restricted by maximum rental rates that could be charged for a 20 year period. The court ruled that Federal restrictions on rental income must be considered in determining the true cash value of the property. Accordingly, the Tax Tribunal was in error for assessments which were based upon hypothetical market rents without consideration of actual rental income. In comparing the economic significance of a long term lease with restrictive Federal limitatons the appeals court commented:

The CAF decision stands for the obvious and unremarkable proposition that a buyer will be unwilling to purchase a property based upon current rental rates available in the market where he is unable to enjoy these rates due to an existing lease. It is equally obvious that a potential purchaser will not pay the market rate for an apartment complex where, as here, current market rental rates cannot be obtained due to governmental restrictions. 102 Mich App at 677.

On remand, the Tax Tribunal was not required to make its assessment decision based solely on actual rents received under the HUD restrictions. Yet, consideration of actual income was mandatory in determining the true cash value of the property. As a corollary to its holding, the court also ruled that the Tribunal must consider actual expenses in reaching a determination of true cash value, and not market averages.

The mandatory consideration of actual income extends to all income producing properties, not just traditional commercial parcels like office buildings and apartments. In **Port Sheldon v Ottawa County Board of Commissioners** [20], the county appraiser testified that in reaching the true cash value for agricultural property in the township he disregarded actual income and considered solely the "soil capability" (an enumerated factor under MCLA 211.27). The court held that the assessor could not ignore the actual income effect on the fair market value of the farmland, even though actual income may not be the sole factor in determining true cash value. 80 Mich App, at 105.

CAF INVESTMENT REVISITED

In its 1974 CAF decision the Michigan Supreme Court reversed and remanded the case to the Tax Tribunal for proceedings consistent with its opinion. In a nutshell, the Court had held that for the purpose of finding the true cash value of CAF's property under the capitalization of income approach, the Tribunal could not base its valuation upon a rate of return which comparable unencumbered property could earn in the current market where the property was encumbered by an unfavorable long-term lease. The "consideration" of actual income could not be diluted by reference to the economic rent or potential income of comparable property. Remarkably, the Tax Tribunal committed the same error for which the State Tax Commission had been reversed previously. After a full hearing on remand the Tribunal adopted an appraisal based upon the rate of return on comparable unencumbered property. On appeal the Court of Appeals concluded that since the pertinent underlying facts were not changed, the "law of the case" rule required it to follow the Supreme Court's earlier decision. The Tax Tribunal had committed a clear error of law by failing to base its income capitalization upon the actual income of CAF's property. [21] The Supreme Court again granted leave to appeal and finally put an end to this protracted litigation with its 1981 decision.

The Tax Tribunal's reasoning upon remand, and the township's argument on appeal, was that the prior decision required only that actual income be "considered" as the basis of the valuation, not that actual income must constitute the ***sole*** basis for valuation. This stance correctly assumed that actual income is one of a number of statutory terms which must be considered in determining true cash value, but that consideration may well indicate that the application of some or all enumerated factors is inappropriate. 392 Mich. at 456, n.6. However the township underestimated the controlling weight which had been placed on actual income. The majority of the Court ruled that "our prior decision left no doubt that 'economic income' meant nothing other than actual income under the circumstances of this case." Id., at 458. The Court would not allow any adjustment to the actual income figure as in **Ramblewood Associates,** nor allow the other enumerated factors of MCLA 211.27 to counterbalance the imperative importance of actual income. In conclusion, the Court relied upon the Tax Tribunal's findings of fact for the actual income figure and capitalization rate. It directed that the Tax Tribunal enter a final order in accordance with the following figures which essentially "plugged" the actual rent into the income capitalization formula: *[22]*

TRUE CASH VALUE

	1971 thru 1974		1975	
Actual income after expenses:	104,314	= $852,935	133,490	= $1,046,980
Capitalization rate:	.1223		.1275	

INCREASED JUDICIAL REVIEW

As noted earlier, the appraisal method to be used by the assessor is generally decided at the assessment level. The final determination of true cash value for CAF's property was not an unqualified endorsement of the capitalization of income valuation method. The Court expressly left open the prospect of utilizing other appraisal methods to determine true cash value for income producing properties. 410 Mich. at 450 n.4. The majority relied heavily upon the testimony of the appraisers that the capitalization of income method reflected the most accurate and reasonable assessment of true cash value. In doing so the Court had previously noted: "...there may be such facts, peculiar to the circumstances under consideration, as would indicate that the income capitalization approach is too speculative to be a reliable indicator of valuation." 392 Mich at 456. This arguably indicates a judicial activism which is changing the Michigan courts' carte blanche acceptance of the appraisal methods adopted by the local assessors and Tax Tribunal. In **Consumers Power,** the Court examined five appraisal methods and concluded that "the Tax Tribunal's decision that adjusted depreciated reconstruction cost is the most appropriate method for determining the value of Hardy Dam reflects a ***proper weighing*** of the various methods." 81 Mich App, at 136 (emphasis added).

Attorneys and tax assessors should heed that this reflects a liberalized judicial willingness to scrutinize appraisal methods in property assessment cases. Under the CAF case, it is obvious that any method of valuation which did not take into account the effect of the long term lease (and the ensuing emphasis on actual income) would probably be rejected. Of course, if a court is unduly venturesome, its findings may be unconstitutional as outside the court's limited (but not too limited) scope of review.

CONCLUSION

The Michigan Constitution dictates that property be assessed in accordance with its true cash value. Differing appraisal methods can be used to reach the result of true cash value. The methods to be used by the assessor are a matter for the assessing unit with consideration to be given to the enumerated factors of MCLA 211.27. One of these factors, the "present economic income of structures" is especially relevant for income producing property.

In its 1974 CAF decision, the Court defined this term to mean "actual income" notwithstanding charges that such an interpretation would be unconstitutional. In the particular circumstances of the case, CAF's property was encumbered by a long term lease and was not available in the marketplace. The Court ruled that the Commission's determination of true cash value was erroneous to the extent that it was based on economic rent without consideration of actual income. The later Supreme Court opinion in the same case expressly indicated that actual income was the ***sole*** basis of capitalization for CAF's property. Differing factual contexts may indicate that adjustments to actual income are necessary to reflect an accurate picture of a property's true cash value. In some unusual situations "consideration" of the various factors may indicate that actual income be ignored. Finally, the CAF case and its progency underscore the increased willingness of the courts to scrutinize appraisal methods despite limited judicial review.

NOTES

[1] CAF Investment Co v State Tax Commission, 392 Mich 442; 221 NW2d 588 (1974). CAF Investment Co v Saginaw Twp. 410 Mich 428, 302 NW2d 164 (1981).

[2] 81 Mich App 120, 129; 265 NW2d 182, (1978).

[3] 98 Mich App 721, 726; 296 NW2d 639 (1980), and Michigan State Tax Comm. Assessor's Manual (1972), ch. 10; There are actually 5 capitalization methods—direct capitalization, annuity, straight line, cash flow and equity mortgage methods.

[4] 88 Mich App 376, 380; 276 NW2d 602 (1979).

[5] MCLA 211.1 et seq.; MSA 7.1 et seq.

[6] MCLA 211.29; MSA 7.29.

[7] MCLA 211.34; MSA 7.52.

[8] MCLA 205.735.

[9] MCLA 205.753.

[10] Opper, Stanley, Tunstall, "Annual survey 1976," 22 Wayne L Rev, 600 (1976).

[11] Note 1, Supra 444-445.

[12] See Justice Moody's dissenting opinion in CAF Investment Co v Saginaw Twp, 410 Mich 428, 302 NW2d 164 (1981); Note that since the Supreme Court followed the "law of the case" doctrine the lessee's interest and uniformity arguments may still be valid.

[13] See Opper, et al Note 10, supra, 599-600.

[14] See Note 12, supra, and Port Sheldon v Ottawa County Board of Commissioners, 80 Mich App 91, 104; 263 NW2d 299 (1977).

[15] Kensington Hills Development Co v Milford Twp, 10 Mich App 368; 159 NW2d 330 (1968).

[16] Lochmoor Club v Grosse Pointe Woods, 10 Mich App; 394; 159 NW2d 756 (1968).

[17] 58 Mich App 324; 227 NW2d 358 (1975).

[18] 82 Mich 342, 344; 266 NW2d 817 (1978).

[19] 102 Mich App 668, 302 NW2d 279 (1981).

[20] Note 14, supra.

[21] CAF Investment Co v Saginaw Twp, 79 Mich App 559; 262 NW2d 863 (1977).

[22] 410 Mich at 465 n. 10. The Tax Tribunal determined that no unusual income fluctuations in income had occurred for 1972, 1973 and 1974.