IN THE SUPREME COURT OF THE STATE OF OREGON

HEWLETT-PACKARD COMPANY, Plaintiff-Respondent, v. BENTON COUNTY ASSESSOR, Defendant, v. DEPARTMENT OF REVENUE, State of Oregon, Defendant-Appellant.	Tax Court No. 4979 Supreme Court No. S061456

APPELLANT'S REPLY BRIEF

Appeal from the Judgment of the Oregon Tax Court
The Honorable Henry C. Breithaupt, Judge

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Introduction

Contrary to Hewlett-Packard's contention, its appraisal violates OAR 150-308.205-(F)(3)(k). By relying on that appraisal, the Tax Court's decision depends upon and incorporates that legal error. This court should therefore reverse the Tax Court decision.

I. Hewlett Packard's appraisal is based on a legal error.

In appraising the property, Hewlett-Packard's appraiser, Litolff, considered two possibilities regarding how the property's excess space could be used in the future: it could be left vacant or it could be converted for multi-tenant use and leased. Litolff's calculations revealed that both options would result in a loss (i.e., a negative real market value), but that converting and leasing the space would, over the life of the property, result in much less of a loss from the anticipated future returns than simply leaving it vacant. Yet Litolff paradoxically—and erroneously—concluded that leaving the space vacant was the option to use in his cost approach functional obsolescence calculation. That choice makes no sense – and it is also unlawful.

Contrary to Hewlett-Packard's argument beginning at p. 28 in its Response Brief, Litolff's highest and best use calculations actually support rather than defeat the department's contention that he failed to follow the requirements of the *value of the loss* administrative rule. OAR 150-308.205-(F)(3)(k). Litolff's highest and

best use analysis begins with a recognition that the subject property consisted of both occupied space and unoccupied space on the valuation dates. The occupied space consisted of 916,869 square feet. The unoccupied space (i.e., "excess or alternative use space") consisted of 626,134 square feet.[1] (Plaintiff's Exhibit 1 at 59).

To determine the highest and best use, Litolff performed an income capitalization approach on one scenario of anticipated returns from that unoccupied excess space (626,134 square feet):

> "The Income Capitalization Approach is based on the premise that value is created by the expectation of future benefits. We estimated the present value of those benefits to derive an indication of the amount that a prudent, informed purchaser-investor would pay for the right to receive them as of the valuation date."

(Plaintiff's Exhibit 1at 49). Litolff made a forecast of those "future benefits" that would be anticipated by that "prudent, informed purchaser-investor," referred to in his explanation quoted above, when purchasing that excess space. Those "future benefits" are the net operating income generated by that excess space.

Litolff explained, in the next step in his highest and best use analysis, that "[t]he estimated net operating income is then converted to a value indication by use of either the direct capitalization method or the discounted cash flow analysis."

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[1] For sake of argument and to avoid confusion on the error of law issue with questions of fact, this discussion will solely use Litolff's inputs.

(Plaintiff's Exhibit 1 at 49). In this case, Litolff used a direct capitalization method. After accounting for all "conversion costs" for converting that excess space so that it may be leased to multiple tenants, and the loss of income during the fourteen years that it would take for the converted excess space to reach a stabilized net operating income—a $42,630,000 charge against real market value (Plaintiff's Exhibit 1 at 60) —Litolff concluded that the "Real Market Value" of the excess space alone was a negative $13,000,000. Plaintiff's Exhibit 1 at 62. Litolff's real market value calculation of the excess space is shown in Figure 1.

Hewlett-Packard "Test of Feasibility" (Income Approach)	
Potential Gross Income	$10,142,516
Less: Vacancy and Collection Loss	($1,217,102)
Effective Gross Income	$8,925,414
Less: Operating Expenses	($4,239,063)
Net Operating Income	$4,686,351
Overall Rate of Capitalization	11.45%
Indicated Value of Improvements and Land as Stabilized	$40,928,827
Less: Lease-Up to Stabilization Allowance	**($42,630,000)**
Less: Land Value	($11,045,663)
EQUALS	
Real Market Value Improvements of excess space – Income Approach	**($13,000,000)**

Figure 1. (Calculations from Plaintiff's Exhibit 1 at 62)

Based on that calculation, Litolff decided that the excess space not only failed to contribute to the real market value of the total subject property, converting it to leased space actually caused a loss in the real market value of the total subject

property. And the value of that loss was $13,000,000 according to Litolff.[2]

Litolff testified that there would be no conversion, "[b]ecause we analyzed in our highest and best use, that if you did that it would give you a negative return; and, therefore, *our highest and best use is not to lease our space*." (Tr at 1069) (Emphasis added). In other words, because a $13,000,000 loss of value (i.e., a negative $13,000,000 real market value) to the entire subject property resulted from the scenario of leasing the excess space, Litolff chose a different use scenario for determining the value of the loss for his cost approach —keeping the excess space vacant for the economic life of the subject property.

Litolff then performed a second income capitalization approach for the excess space, this time based on the scenario of leaving the excess space vacant for the life of the subject property. This second measurement resulted in a value of the loss of negative $38,525,819.[3] (Plaintiff's Exhibit 1 at 85).

Consequently, Litolff's calculations indicated that there is a greater loss

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[2] A negative $13,000,000 real market value equals a $13,000,000 value of the loss.

[3] Despite the similarity of amounts, Litolff's lease-up deduction of $42,630,000 (Plaintiff's Exhibit 1 at 60) should not be confused with his final value of the loss conclusion of $38,525,819. That $42,630,000 is the difference in real market value between the superadequate asset (excess space) as if it had a stabilized level of occupancy on the valuation date versus the superadequate asset (excess space) as vacant on the valuation date and needing 14 years out of total economic life of 36 years to reach a stabilized level of occupancy. The value of loss involves a different calculation. It represents the real market value of the superadequate asset.

from not leasing the excess space, a $38,525,819 loss, than from converting and leasing the excess space, a $13,000,000 loss. Yet, he chose the *greater* loss, $38,525,819, to use in his cost approach rather than the smaller loss of $13,000,000. Thus, when faced with two possible uses of the excess space, Litolff chose an anticipated income that resulted in a greater value of the loss in his cost approach and, thus, a lower indication of real market value for the subject property.

Litolff's choice in that regard was not simply a factual error, it was legally incorrect. The value of the loss formula for the cost approach required under OAR 150-308.205-(F)(3)(k) is one of the permitted "methods and procedures" adopted by the Department of Revenue under ORS 308.205(2) for determining real market value. Pursuant to ORS 308.205, real market value is based on the price that can reasonably be expected between an informed buyer and an informed seller. Consequently, the choice of the "anticipated income," as described in the rule, to be selected to determine the value of the loss must be consistent with that reasonable expectation under ORS 308.205. Choosing the larger loss resulting from leaving the space vacant is not consistent with that expectation under ORS 308.205.

Just as an informed buyer and seller would choose the lesser amount between the cost to cure and the value of the loss to deduct in the cost approach as required by the rule (OAR 150-308.205-F(3)(b)), an informed buyer and seller

would choose the smaller value of the loss, namely $13,000,000 versus $38,525,819. Choosing the lesser loss, which is the reasonable expectation required by ORS 308.205, and including that value of the loss in Litolff's cost approach, results in his cost approach indicator of real market value being $90,483,578 rather than his rounded $65,000,000.

The source of that reasonable expectation to choose the use with the smaller loss is contained in two places. First, it is specifically found in the Oregon administrative rule definition of the replacement cost approach which was performed by Litolff. As discussed in the department's Opening Brief at pp. 8-9, a replacement cost approach must be based on "the present value of anticipated after tax net income (cash in-flows) that produces the *highest net present value*." OAR 150-308.205-(F)(3)(b) [Emphasis added]. Litolff's choice of the greater loss fails to comply with that requirement of OAR 150-308.205- (F)(3)(b) since it resulted in the lowest net present value.

Second, the requirement to choose the "highest net present value" is implied within ORS 308.205 and the value of the loss administrative rule. Underlying the statutory definition of real market value and the accompanying rule for determining the value of the loss in the cost approach is the understanding that market participants act in a rational manner to maximize the returns on their investments by choosing the use that is maximally productive since "value is

created by the anticipation of benefits to be derived in the future." *The Appraisal of Real Estate* (13th ed.) at 35. Choosing the one of two "anticipated incomes," as described in OAR 150-308.205-(F)(3)(k), that results in the greater loss in the value of the loss calculation is contrary to that principle. Litolff's choice of the greater value of the loss, which was accepted by the Tax Court, is contrary to that requirement of the value of the loss rule.

II. Because the tax court relied on and adopt Litolff's legally erroneous appraisal, the tax court's decision is also based on a legal error.

Hewlett-Packard incorrectly characterizes the Tax Court's adoption of Litolff's determination of the subject property's real market value as merely a factual determination.[4] For the reasons explained above, Litolff's appraisal in this case violated the department's rules – his cost approach indicator of real market value is built upon an error of law. Moreover, because in his reconciliation Litolff's final determination of real market value mathematically gives 100% weight to his cost approach that itself depends upon a legally flawed value of the loss calculation,[5] his final determination of real market value is built upon an error

[4] Hewlett-Packard relies on *Reynolds Metals Co. v. Dept. of Rev.*, 299 Or 592 P2d 712 (1985) for claiming a determination of functional obsolescence is a question of fact rather than law. But at that time OAR 150-308.205-(F) did not yet exist.

[5] Litolff's sales comparison approach indicator of real market value was $63,000,000 for each of the three tax years. His cost approach indicator of real

of law. It is not a question of fact whether a negative return of $38,525,819 from not leasing the excess space is worse for the "prudent, informed purchaser-investor" than a negative return of $13,000,000, which is the loss that Litolff determined would result from converting and leasing the excess space.

This court has held that property appraisals must comply with the department's applicable property tax rules. *Delta Air Lines, Inc. v. Dept. of Revenue*, 328 Or 596, 609, 984 P2d 836 (1999). In this case, Litolff's appraisal did not comply with those rules. Furthermore, the Tax Court fully accepted and adopted Litolff's legally erroneous determination of real market value. The Tax Court's decision, therefore, is likewise based on an error of law.

III. The proper remedy is to remand the case to the Tax Court.

Because the Tax Court adopted Litolff's erroneous determination of real market value the decision of the Tax Court must be reversed and remanded. In arguing to the contrary, Hewlett-Packard insists that even if Litolff's cost approach determination was erroneous, the Tax Court's decision to adopt that determination was nonetheless harmless. In particular, Hewlett-Packard notes that Litolff also

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market value was $65,000,000 for the first tax year, $68,000,000 for the second tax year, and $64,000,000 for the third tax year. His final reconciled opinion of real market value was identical to each of the cost approach indicators with no mathematical weighting given to the sales comparison approach. (Plaintiff's Exhibit 1 at 88-89).

used a market approach to calculate the real market value of property and the department has not challenged that determination, which was somewhat lower than the cost approach. But that argument is unavailing. Litolff mathematically based his determination of real market value solely on his cost approach, and the Tax Court relied on that determination. Indeed, the Tax Court adopted the precise value that resulted from that erroneous cost approach. Moreover, as explained in this and Appellant's opening brief, if Litolff had done the cost approach correctly, the resulting cost approach indicator of real market value would have been at least $25,525,819 more in real market value. This court should remand the case to the tax court so that it can determine the real market value of the property based on legally correct valuations.

V. Conclusion.

The Tax Court should be reversed and this case should be remanded to the Tax Court.

DATED this 27th day of May 2014.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE
WITH ORAP 5.05(2)(d)

Brief length

I certify that (1) this brief complies with the word-count limitation in ORAP 5.05(2)(b) and (2) the word-count of this brief (as described in ORAP 5.05(2)(a)) is 2,111 words.

Type size

I certify that the size of this brief is not smaller than 14 point for both the text of the brief and footnotes as required by ORAP 5.05(4)(f).

Dated this 27th day of May, 2014.

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CERTIFICATE OF SERVICE

I certify that on May 27, 2014, I directed the original DEFENDANT-APPELLANT'S REPLY BRIEF to be electronically filed with the Appellate Court Administrator, Appellate Records Section, and served upon David L. Canary, of attorneys for Hewlett-Packard and also upon Cynthia M. Fraser, attorney for Hewlett-Packard, and Vance Croney, Benton County counsel, by regular United States Mail and addressed to the following:

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