

IN THE SUPREME COURT OF THE STATE OF OREGON

HEWLETT-PACKARD COMPANY,

Plaintiff-Respondent,

v.

DEPARTMENT OF REVENUE,  
State of Oregon,

Defendant-Appellant.

Tax Court No. 4979

Supreme Court No. S061456

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**APPELLANT'S AMENDED OPENING BRIEF  
TO INCLUDE EXCERPT OF RECORD**

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

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DAVID L. CANARY, #760869  
CYNTHIA M. FRASER, #872243  
Garvey Schubert Barer  
121 SW Morrison, 11th Floor  
Portland, OR 97204  
Telephone: (503) 228-3939  
Fax: 503-226-0259  
[dcanary@gsblaw.com](mailto:dcanary@gsblaw.com)  
[cfraser@gsblaw.com](mailto:cfraser@gsblaw.com)

Of Attorneys for Plaintiff-Respondent  
HEWLETT-PACKARD COMPANY

ELLEN F. ROSENBLUM, #753239  
Attorney General  
JOSEPH A. LARONGE, #841330  
Senior Assistant Attorney General  
Department of Justice  
1162 Court Street NE  
Salem, OR 97301  
Telephone: (503) 947-4342  
Fax: (503) 378-3784  
[joseph.laronge@state.or.us](mailto:joseph.laronge@state.or.us)

Of Attorneys for Defendant-Appellant  
DEPARTMENT OF REVENUE,  
State of Oregon

VANCE M. CRONEY, #920450  
Benton County Counsel  
PO BOX 3020  
Corvallis, OR 97339-3020  
Telephone: (541) 766-6890  
Fax: (541) 766-6014  
[vance.m.croney@co.benton.or.us](mailto:vance.m.croney@co.benton.or.us)

Of Attorneys for Defendant

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## **I. STATEMENT OF THE CASE**

### **A. Nature of the Action or Proceeding**

Benton County assessed real property taxes for tax years 2008-2009, 2009-2010, and 2010-2011 on Hewlett-Packard's real property based on its real market value. The real market value was divided into the three typical categories of (1) land, (2) machinery and equipment, and (3) buildings and structures. Hewlett-Packard appealed those real market values to the Oregon Tax Court. A trial was held to determine the real market value of the buildings and structures (the parties settled the real market values of the other property categories). The Tax Court entered an opinion deciding against the department and, without stating a real market value, accepted the real market value determined by Hewlett-Packard's appraiser (Litolff). This appeal followed.

### **B. Nature of the Judgment**

The Tax Court entered a General Judgment finding that appraiser Litolff had correctly appraised the total real market value of the subject property as \$65,000,000, \$68,000,000, and \$64,000,000 for tax years 2008-2009, 2009-2010, and 2010-2011 respectively.

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**C. Statutory Basis of Appellate Jurisdiction**

This appeal is brought pursuant to ORS 305.445. Under that statute, this court may affirm, modify, or reverse the Tax Court’s decision with or without remanding the case for further hearing, as justice may require.

**D. Entry of Judgment and Timely-Filed Notice of Appeal**

The General Judgment was entered on June 6, 2013, and the Department of Revenue’s (department) Amended Notice of Appeal was served and filed on July 3, 2013, within the statutory 30-day time period for appeal. ORS 305.445 and ORS 19.255.

**E. Questions Presented on Appeal**

1. Did Hewlett-Packard’s appraiser (Litolff)—in determining his opinion of the real market value of the subject property via a “replacement cost approach”—fail to comply with OAR 150-308.205(F)(3)?
2. Did the Tax Court err by adopting and relying on Litolff’s opinion of real market value?

**F. Summary of the Arguments**

Litolff determined—using a “replacement cost” approach—that the real market values of Hewlett-Packard’s buildings and structures were \$65,000,000, \$68,000,000, and \$64,000,000 for tax years 2008-2009, 2009-2010, and 2010-2011 respectively. In arriving at those values, he failed to follow the requirements of

OAR 150-308.205(F)(3) for calculating the *value of the loss* and the *cost to cure*, which are necessary components of the replacement cost approach. That failure resulted in an incorrect determination of real market value. When that administrative rule is followed correctly, Litolff's replacement cost approach results in a real market value of \$113,505,609 for tax year 2008-2009.<sup>1</sup> Therefore, this court should hold that the correct real market value of the subject property is \$113,505,609 for tax year 2008-2009. The real market values for the remaining two years should be adjusted on remand as described in Section IV of this brief's Argument section.

#### **G. Summary of the Facts**

Hewlett-Packard appealed to the Oregon Tax Court the real market value, pursuant to ORS 308.205, of Hewlett-Packard's buildings and structures in Benton County Assessor's Account No. 417659 for tax years 2008-2009, 2009-2010, and 2010-2011. The subject property consists of eleven primary buildings that were built as an industrial manufacturing campus on a 178 acre site. There are over 2,000,000 gross square feet of building space. Approximately 626,000 of the 2,000,000 square feet were treated as vacant by Litolff. He categorized that

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<sup>1</sup> Litolff used two approaches to determine value, a replacement cost approach and a market data (comparable sales) approach. (Plaintiff's Exhibit 1 at 88). Litolff gave 100% weight to his replacement cost approach, and the Tax Court adopted that weighting. (Plaintiff's Exhibit 1 at 88). This brief, therefore, focuses on Litolff's replacement cost approach.

626,000 square feet as “[e]xcess or alternate use” space. (Plaintiff’s Ex. 1 at 58). It is the quantification of the contribution (positive or negative) that this 626,000 square feet of excess building space makes to the real market value of the subject property as a whole that separates the parties to the appeal.

Litolff determined—for use in his replacement cost approach—that the impact of this excess or alternate use space consisting of 626,000 square feet was a negative \$37,119,383 on the real market value of the subject property. By contrast, the department’s rebuttal witness testified that—based on Litolff’s own estimate of Total Cash Flow and when OAR 150-308.205(F)(3)<sup>2</sup> is correctly applied—the contribution of that “excess” space to the overall real market value was a positive \$10,022,031. Compared with Litolff’s approach, correct application of OAR 150-308.205(F)(3) results in an increase of \$47,141,414<sup>3</sup> in the real market value for a total amount of \$113,505,609 for tax year 2008-2009.

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<sup>2</sup> The Tax Court disregarded the department’s appraisal that was presented in its case-in-chief, but the Tax Court was silent as to the department’s rebuttal testimony. This appeal addresses only the legal error in Litolff’s misapplications of the department’s rule, which was a subject of the testimony of department’s rebuttal witness and its post-trial brief.

<sup>3</sup> Assuming a tax rate of \$15 per \$1,000 of value, the tax due in 2008-09 based on Litolff’s appraisal was \$975,000. When Litolff’s appraisal is corrected, the resulting real market value of \$113,505,609 results in tax due of approximately \$1,702,500, an increase of about 75 percent. The difference would be the same for each of the three years at issue in the cases before this court, and this result affects an additional five years because that real market value is frozen for five years



In sum, Litolff determined the real market value of the property at issue in this case to be \$65,000,000, \$68,000,000, and \$64,000,000 for tax years 2008-2009, 2009-2010, and 2010-2011 respectively, all based on his replacement cost approach. The Tax Court adopted Litolff's appraisal as containing the correct opinion of real market values.

### **ASSIGNMENT OF ERROR**

The Tax Court erred by adopting Litolff's appraisal because the appraisal—in determining the real market value of Hewlett-Packard's property—failed to comply with OAR 150-308.205(F)(3).

#### **A. Preservation of Error**

The assigned error is preserved. The department argued in rebuttal testimony and in briefing that the Tax Court would err by relying on Litolff's replacement cost approach because Litolff failed to comply with the requirements of OAR 150-308.205(F)(3) for determining the *value of the loss* and the *cost to cure* components of the replacement cost approach formula set forth in OAR 150-308.205(F)(3)(b). (Defendant' Opening Post-Trial Brief<sup>4</sup>, pp 51-59 and App. VIII

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pursuant to ORS 309.115. Overall, then, correction of Litolff's appraisal would result in increased revenues to the county of approximately \$5.6 million over that eight year period.

<sup>4</sup> "In his value-of-the-loss, Litolff assumes some excess space is leased and misapplies OAR 150-308.205(F)(3)(k)." (Department's Opening Post-Trial Brief

and IX; Defendant's Post-Trial Response Brief, pp70-73 and Appendix; see also Defendant's Trial Exhibit V and related testimony).

### **B. Standard of Review**

This court reviews Tax Court decisions for "errors or questions of law or lack of substantial evidence in the record to support the Tax Court's decision." ORS 305.445. The assigned error is an error of law.

## **ARGUMENT**

This case is both simple and complex. It is simple in the sense that the overarching issue is whether the Tax Court, in determining the real market value of the subject property, improperly adopted Hewlett-Packard's appraisal because that appraisal failed to comply with two sections of an applicable rule promulgated by the department. It is complex in the sense that the property tax valuation concepts embodied in the rule are far from elementary. And the definition of one concept typically relies upon other appraisal concepts. Accordingly, we begin with an explanation of the pertinent concepts. Following that primer we present an overview of the basic argument: the Tax Court erred because it relied on an appraisal that failed to follow two sections of an applicable administrative rule.

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at 51). "Litolff's cost to cure measurement does not comply with OAR 150-308.205(F)(3)(h)." (Department's Opening Post-Trial Brief at 57).

Finally, we address the argument in detail to better reflect the complexity of the two main appraisal concepts at issue—*value of the loss* and *cost to cure*.

**I. A primer on specialized terms germane to this case.**

“Real market value” is the first relevant appraisal term. The property taxes in this case were based on the real market value of Hewlett-Packard’s buildings and structures. Real market value is defined as follows:

“Real market value of all property, real and personal, means the amount in cash that could reasonably be expected to be paid by an informed buyer to an informed seller, each acting without compulsion in an arms-length transaction occurring as of the assessment date for the tax year.”

ORS 308.205(1).

“Real market value in all cases shall be determined by *methods and procedures* in accordance with rules adopted by the Department of Revenue.”

ORS 308.205(2) (emphasis added). The “replacement cost” approach is one of those “methods and procedures” described in ORS 308.205(2) to determine the real market value of real property. The department has prescribed—by rule—the following replacement cost approach formula:

“The formula for this [Replacement Cost Approach] method is: Market Value equals the Replacement Cost New less physical depreciation less the *cost to cure* (or the *value of the loss*, if less) less external obsolescence.

OAR 150-308.205(F)(3)(b) (emphasis added).

Within that replacement cost approach “formula,” the “*value of the loss*” is one of the two key relevant variables in this appeal. It is defined by rule as follows:

“The *value of the loss* equals the present value of the after-tax loss in anticipated income from the continuing operation of the property with a deficiency or superadequacy compared to the projected operation of the *replacement property*. For industrial plants, this loss in income is often the result of excess operating costs due to inefficiencies in the subject plant compared to the subject property when cured of the functional obsolescence.”

OAR 150-308.205(F)(3)(k) (emphasis added). The *value of the loss* measures the impact on value from any anticipated higher net operating costs on the subject property compared to the net operating costs being experienced by the hypothetical replacement property. This measurement relies upon comparing the anticipated future net income stream of the subject property compared with that of the replacement property.

The “replacement property” described in that rule—to which the property with the “superadequacy,” (the subject property) is compared to determine the *value of the loss*—is the following:

“a property having equivalent utility to the subject property but built with the most cost-effective materials, design, and layout. The most cost effective materials, design, and layout is that combination of investment (cash out-flows) and 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). In this case, the replacement property is a hypothetical property that is similar to the subject property but without the excess 626,000 square footage.

The other key relevant variable described in the replacement cost formula is the *cost to cure*. The *cost to cure* “equals the net cash out-flow anticipated to be necessary to eliminate the deficiency or superadequacy.” OAR 150-308.205(F)(3)(h). In more basic terms, the *cost to cure* is what it will cost to relieve the owner of the ongoing excess net operating costs, if any, attributable to the excess space in the subject property. For example, one way to relieve any potential ongoing excess net operating costs caused by maintaining excess space might be to demolish the excess space.

Much more is involved in appraising real property, but those are the concepts germane to this appeal. More specifically, what matters is whether Hewlett-Packard’s appraisal—relied on by the Tax Court—complied with department rules governing how the *value of the loss* and the *cost to cure* are to be calculated.

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**II. Because the Tax Court relied on a Hewlett-Packard appraisal that failed to conform to two sections of a department rule, the Tax Court decision must be reversed and the appraisal must be corrected to comply with the rule.**

As more fully explained in Sections IIIA and B below, Hewlett-Packard's appraisal failed to conform to OAR 150-308.205(F)(3)(k) requirements for determining the *value of the loss* component of the replacement cost approach formula set forth in OAR 150-308.205(F)(3)(b). Litolff's appraisal also failed to conform to OAR 150-308.205(F)(3)(h) requirements for determining the *cost to cure* component of the replacement cost approach formula set forth in OAR 150-308.205(F)(3)(b).

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). Because the Tax Court ignored the pertinent rule, the decision of the Tax Court must be reversed.

As more fully discussed below, this case needs to be remanded to the Tax Court because the infirmity in Hewlett-Packard's appraisal is correctable by an arithmetic calculation. The department urges this court to reverse the Tax Court decision and enter judgment as described below.

**III. Litolff’s failure to follow OAR 150-308.205(F)(3)(k) for determining the “value of the loss” and OAR 150-308.205(F)(3)(h) for determining the “cost to cure” resulted in an incorrect determination of real market value.**

Litolff’s appraisal failed in two respects to follow applicable law.

Specifically, as discussed in detail below, Litolff’s calculations of *the value of the loss* and the *cost to cure* do not follow the formula in the department’s rule.<sup>5</sup>

**A. The Hewlett-Packard appraisal failed to comply with the *value of the loss* formula in the department’s rule.**

The Tax Court erred by relying on Litolff’s replacement cost approach because Litolff failed to follow OAR 150-308.205(F)(3)(k) for determining the *value of the loss*. As a result, instead of subtracting \$37,119,383 as the *value of the loss* variable, Litolff should have added \$10,022,031 which is the result compelled by proper application of the rule. As a result of Litolff’s error, the subject property was undervalued. That subject property consisted of eleven primary buildings that were built as an industrial manufacturing campus on a 178 acre site. A portion of the total square footage was vacant—626,000 square feet—and being offered for lease. That square footage was described by Litolff as “excess space.”

The appraisal methodology used to determine real market value “in all cases shall be determined by methods and procedures in accordance with rules adopted

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<sup>5</sup> Hewlett-Packard did not challenge the validity of the rule, nor did the Tax Court consider the validity of the rule.

by the Department of Revenue. ORS 308.205(2).<sup>6</sup> Those “methods and procedures” fall into the three appraisal methodology categories: “the market data approach (sales of comparable properties), the cost approach (reproduction or replacement cost of the plant) or the income approach (capitalization of income) or by two or more approaches.” ORS 308.411(1). Litolff used two of those approaches, the market data approach (sales of comparable properties) and the replacement cost approach. Litolff gave 100% mathematical weight to his replacement cost approach to arrive at real market values of \$65,000,000, \$68,000,000 and \$64,000,000 for tax years 2008-09, 2009-2010 and 2010-2011, respectively. (Plaintiff’s Exhibit 1 at 88). The Tax Court agreed with Litolff’s weighting, and the department does not challenge that determination. Accordingly, we focus on Litolff’s replacement cost approach.

The replacement cost approach is based on the principle of substitution. That principle recognizes that an “informed buyer”—described in ORS 308.205’s definition of real market value—would pay no more for the property at issue than the cost to build a replacement property with the same utility and desirability as the

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<sup>6</sup> “Before this court and the Tax Court, both parties focused their arguments upon the theoretical propriety of making a leased-equipment adjustment when appraising Delta’s taxable property. We need not engage in that debate, however, because an administrative rule answers the question whether such an adjustment is permissible.” *Delta Air Lines, Inc. v. Dept. of Revenue*, 328 Or 596, 609, 984 P2d 836, 844 (1999).



subject property. The required “methods and procedures” to perform the replacement cost approach are defined by rule:

“The formula for this method is: Market Value equals the Replacement Cost New less physical depreciation less the cost to cure (or the *value of the loss*, if less) less external obsolescence.”

OAR 150-308.205(F)(3)(b) (emphasis added). The first step is to estimate the cost to build a new hypothetical plant similar to the subject property. The second step is to subtract from that estimate of replacement cost new the cost for the physical depreciation of the subject property. The third step is to subtract from the resulting subtotal the *cost to cure* or the *value of the loss* if less. The fourth step involving external obsolescence was not pertinent to this appeal.

Litolff appropriately took that first step by estimating the cost to build a new hypothetical plant similar to the subject property. That new hypothetical plant was smaller than the subject property because it correctly did not include the excess space (626,000 square feet). That exclusion of the excess space was justified because Litolff’s highest and best use<sup>7</sup> analysis correctly indicated that constructing the excess space was not cost effective.

Next, for step two Litolff correctly deducted from his estimate of the cost to construct a new hypothetical replacement property the amount that reflected the

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<sup>7</sup> The highest and best use is a property’s most profitable use.

physical depreciation of the Hewlett-Packard subject property. That amount is not in dispute. So far...so good. But the third step in the replacement cost formula—subtracting the correct amount of the *value of the loss*—is where Litolff went off course.

The formula for the “*value of the loss*” variable in the replacement cost approach is also set forth by rule:

“The *value of the loss* equals the present value of the after-tax loss in anticipated income from the continuing operation of the property with a deficiency or superadequacy compared to the projected operation of the replacement property.”

OAR 150-308.205(F)(3)(k) (emphasis added). In more basic terms, the *value of the loss* reflects the impact on the real market value of the subject property created from the ongoing existence of its “excess space.” That excess space does not exist in the smaller hypothetical replacement property that is used for comparison purposes. Litolff failed to follow that prescribed formula. Specifically, he failed to use his estimate of that difference in “anticipated income” over the remaining economic life between the Hewlett-Packard property (which contains the excess 626,000 square feet) and the smaller hypothetical replacement property (which does not include the “excess space”). That failure violated the rule.

OAR 150-308.205(F)(3)(k).

Litolff did use his estimate of “anticipated income,” however, for the critical determination of highest and best use of the subject property and for guiding the selection of other properties for his market (comparable sales) approach. The highest and best use is a property’s most profitable use. “One rationale for relying on ‘highest and best use’ as a step in arriving at market valuation is that a seller of property reasonably can expect to receive the highest offer from a prospective buyer who intends to put the property to its most profitable use.” *STC Submarine, Inc. v. Dept. of Rev.*, 320 Or 589, 592, 890 P.2d 1370 (1995). Litolff’s spreadsheet (Plaintiff’s Exhibit 1 at 60) indicates his estimated “anticipated income” from the excess space for that determination of highest and best use. His estimates are contained in the row labeled “Total Cash Flow.” As his spreadsheet indicates, Litolff estimated that the “excess” 626,000 square feet of space was anticipated to cause a negative cash flow for the first six years of the total of the 36 year remaining economic life (for tax year 2008-2009) beginning with the first year Cash Flow at negative \$4,331,365. After the first six years, however, Litolff estimated that the “excess” space will generate an increasing positive cash flow up to year 14. And he estimated that from years 15 to 36 this “excess” space will continue to earn a positive cash flow of at least \$10,934,967 per year when the income has stabilized as the vacancy has decreased, as indicated for year 14 in Litolff’s spreadsheet.

When the formula in the rule is followed to determine the *value of the loss*—in other words, taking Litolff’s estimate of anticipated income and applying it as required by the rule to determine *value of the loss*—the present worth of Litolff’s Total Cash Flow numbers for the “excess” space including the land underneath the “excess” space over the total 36 years yields a present worth of a positive \$21,067,694. (Defendant’s Exhibit V at 18). That is the lump sum amount one would pay as of the date of valuation for the right to receive that “anticipated income” produced from the “excess” space. Since both the “excess” space and the land underneath contribute to that “anticipated income” stream, the real market value attributable to the land under the “excess” space (\$11,045,663) must be removed from that lump sum amount (\$21,067,694) in order to reach only the buildings and structures real market value at issue. The result of that subtraction—when the requirements of the rule are followed—yields a present value for the net income from the excess space in the amount of \$10,022,031. So the correct formula indicates that the excess space is an asset rather than a burden to the subject property. It contributes \$10,022,031 to the real market value of the subject property as a whole. To the contrary, Litolff’s misapplication of the rule resulted in a negative impact on the real market value of the subject property in the amount of \$37,119,383. This is a difference of \$47,141,414.

Admittedly, the \$10,022,031 contribution to real market value from the excess space is relatively small considering that it is nearly one-third of the total space. The reason is that, as indicated in Litolff's highest and best use analysis, he projected that it would take a number of years to lease the space to a stabilized occupancy level. During those early years, the excess space was estimated to lose money.

While the excess space contributes to the real market value of the subject property, it is still properly classified as "superadequate" as defined by OAR 150-308.205(F)(3)(c)(C).<sup>8</sup> The reason is that this net present value amount of \$10,022,031 (i.e., *value of the loss*) does not contribute to real market value an amount that is at least equal to the cost to construct the excess space. (See Exhibit 1 at 87, reflecting that Litolff's estimated cost to construct the excess space was over \$100 million).

A part of a property being classified under the rule as "superadequate"

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<sup>8</sup> "Functional obsolescence due to a superadequacy is caused by an asset present in the subject property that is not present in the replacement property and does not contribute to value an amount equal to its cost." OAR 150-308.205(F)(3)(c)(C). A similar explanation is provided in *The Appraisal of Real Estate* (13<sup>th</sup> ed.). "An item of incurable functional obsolescence caused by a superadequacy is a property component that exceeds market requirements. It represents a cost without any corresponding increment in value or a cost that the increment in value does not meet." In more basic terms, a superadequacy is a part of real property that is not anticipated to pay for its full cost to construct.

means, as applied to the present case, that the hypothetical replacement property would not be built from scratch to include the “excess” space as an alternative to purchasing the Hewlett-Packard property. But the “excess” space does have a relatively small contribution to value for the subject property that has already been built, namely, \$10,022,031, which is the present value of the net after-tax in-flow and out-flow cash flows determined in accordance with the rule.

Instead of using his estimate of the anticipated income over the economic life of the subject property as required by the rule, Litolff simply used the net of two dollar amounts. The first amount was the estimated annual operating costs (\$13,722,009) for the entire subject property in 2009 times the ratio of the gross square footage of the excess space (approximately 817,000) divided by the total gross square footage of the subject property (approximately 2,026,000). That calculation resulted in the amount of \$5,530,309.

Litolff then offset that amount by the existing income for only a small portion of the excess space square footage. That income for the small portion of the excess space amounted to \$916,933 per year for the remaining 34-36 year (depending on which tax year) economic life of the buildings. The net amount per this calculation was \$4,613,376 (\$5,530,309 - \$916,933) or a negative income of \$4,613,376 per year. (Plaintiff’s Exhibit 1 at 87.) That amount was, thus, not his

estimate of the difference between the anticipated income of the subject property compared to that of the replacement property as required by the rule.

The present value of that negative income stream equaled a negative \$37,119,383. (Plaintiff's Exhibit 1 at 87). That amount was then subtracted by Litolff from the physically depreciated replacement cost of \$101,593,803 to equal Litolff's replacement cost indicator of real market value for the subject property of \$64,474,419. (Plaintiff's Exhibit 1 at 87). Instead of subtracting \$37,119,383, however, he should have added \$10,022,031 according to the calculation that complies with the rule. By not using the "anticipated income" as required by the rule formula, Litolff's incorrectly determined real market value of the total subject property at \$64,474,419 as indicated by his replacement cost approach. And, thus, he undervalues Hewlett-Packard's property.

**B. The Hewlett-Packard appraisal failed to comply with the *cost to cure* formula in the department's rule.**

Litolff's replacement cost approach also failed to follow OAR 150-308.205(F)'s requirement for calculating the *cost to cure*. That failure also renders his replacement cost approach calculation incorrect. The *cost to cure* "equals the net cash out-flow anticipated to be necessary to eliminate the deficiency or superadequacy." OAR 150-308.205(F)(3)(h). Like the *value of the loss*, the *cost to cure* consideration arises out of the comparison a buyer— in attempting to

determine an appropriate purchase price for the subject property—would make between the cost of constructing the hypothetical replacement property and purchasing the subject property. In this case, the subject property has a superadequacy consisting of the excess space (the vacant 626,000 square feet). The reason it is classified as superadequate is that, according to Litolff, the anticipated income from the excess space (Plaintiff’s Exhibit 1 at 60) would not at least offset the cost to construct that excess space in the hypothetical replacement property. Therefore, the hypothetical replacement property—used for comparison purposes—would not have that excess space.

Eliminating (curing) the superadequacy (excess space) at Hewlett-Packard’s property could be done, for example, by demolishing all of the excess space, demolishing a portion of the excess space if another portion of it could be leased, or donating the space to another owner to avoid ongoing expenses, if any, from maintaining the excess space. Under OAR 150-308.205(F)(3)(h), the cost of eliminating the excess space is the “cost to cure,” which in turn is one of the components of the formula prescribed in the rule for a replacement cost approach.

Instead, rather than following the rule and determining a cost to eliminate the ongoing expenses of the excess space as a *cost to cure*, if any, from the existence of the excess space, Litolff added the depreciated reproduction cost of the excess space (\$107,977,177) to the additional cost to convert this excess space



to a multi-tenant use (\$11,195,474) for a total amount of \$119,172,651 as his *cost to cure* amount. Not only does this calculation not follow the rule, it lacks common sense. An owner of the Hewlett-Packard property would not actually spend another \$107,977,177 to construct a duplicate of the excess space located right alongside the existing excess space in order to remove the burden of the excess space that already exists. Litolff's calculation reflects an owner doubling the problem of the excess space rather removing the problem. Litolff's *cost to cure* method goes in the wrong direction. Expenditures to construct 626,000 square feet of more excess space would not "eliminate the deficiency or superadequacy [excess space]." OAR 150-308.205(F)(3)(h) (bracketed insertion added).

The seeds of Litolff's error may rest in a misunderstanding of the rule. The formula for the *cost to cure* is:

"The physically depreciated cost of the replacement property, plus the retrofitting costs associated with installing the replacement property in the subject property plus the cost to remove the property with a deficiency or superadequacy, less the salvage value of the property with a deficiency or superadequacy."

OAR 150-308.205(F)(3)(h). The Appraisal of Real Estate (13<sup>th</sup> ed.) discusses the same cost to cure formula:

"Cost to tear out or remove existing component plus Cost of correct replacement component plus Any costs above and beyond total cost if included in initial construction minus Salvage value (if any)"

*The Appraisal of Real Estate* (13<sup>th</sup> ed.) at 436. An example in the 13<sup>th</sup> edition illustrates the correct application of the *cost to cure* formula set forth in the rule and thus helps demonstrate how Litolff erred. The example considers a warehouse with an oversized HVAC (heating, ventilation, and cooling system) that would not exist in the hypothetical replacement property. *The Appraisal of Real Estate* (13<sup>th</sup> ed.) at 436. The reason given is that “typical warehouse uses” would use a smaller HVAC system. *The Appraisal of Real Estate* (13<sup>th</sup> ed.) at 436. In this example, the warehouse has a superadequacy consisting of the excess capacity of the existing HVAC (just like the property at issue in this case has a superadequacy consisting of the excess capacity of the 626,000 square feet of space).

The *cost to cure* the operating burden caused by the excess capacity of the HVAC in the example equals: Cost of removal of the old HVAC (e.g., demolition) (\$5,000) minus the salvage value of the old HVAC (\$8,000) plus the cost of installing a smaller capacity HVAC (\$22,000). Thus  $\$5,000 - \$8,000 + \$22,000 =$  a \$19,000 *cost to cure*. *The Appraisal of Real Estate* (13<sup>th</sup> ed.) at 436. That expenditure would, thus, make the subject property (the property with the excess HVAC capacity) identical to the hypothetical replacement property which would not have the excess HVAC capacity and the ongoing operating burden that it represents.

Similarly for Hewlett-Packard's property, the *cost to cure* equals: Cost of removal (e.g. demolition) of the excess space (unknown dollar amount) minus the salvage value of the demolished buildings (unknown dollar amount) plus the cost of installing any needed replacement for the excess space (\$-0-). In the case of Hewlett-Packard's property, there would be no need to replace the excess space, so that last amount is zero dollars. Once the excess space is removed, the Hewlett-Packard property would be identical to the hypothetical replacement property that a prospective purchaser would consider as an alternative to buying the subject property. No further adjustment is appropriate.

Oddly, Litolff mistakenly added the costs to *duplicate* the excess space (\$119,172,651) as part of his *cost to cure* calculation. But unlike the 13<sup>th</sup> edition example, in which the warehouse needs to replace the excess capacity HVAC with a smaller HVAC capacity, there is no need to replace the excess space at the subject property since it would not exist in the hypothetical replacement property. Thus, Litolff did not correctly follow the *cost to cure* rule.

Of course, since the *value of the loss* (\$10,022,031) actually contributes to the overall real market value of the subject property, it will always be appropriately selected over the *cost to cure* in the replacement cost formula. Therefore, Litolff's erroneous *cost to cure* calculation should not affect the outcome of this case.

However, if this court holds that Litolff's *value of the loss* amount is correct, then

this case should be remanded for the Tax Court to conduct a fact-finding hearing to determine whether the *cost to cure* is less as required by the rule.<sup>9</sup>

**IV. When Litolff’s *value of the loss* calculation is corrected to conform to the required *value of the loss* formula set forth in OAR 150-308.205(F)(3)(k), plaintiff’s replacement cost approach indicates a real market value of \$113,505,609 for tax year 2008-09.**

When the *value of the loss* methodology required by the rule is followed, Litolff’s replacement cost approach results in a real market value not of \$65,000,000, but of \$113,505,609 for tax year 2008-2009. This is illustrated by plugging the relevant numbers into the rule:

“The formula for this method is: Market Value [**\$113,505,609**] equals the Replacement Cost New [**\$177,685,060**] less physical depreciation [**\$74,201,482**] (subtotal of \$103,483,578) less the cost to cure (or the value of the loss, if less) [**negative<sup>10</sup> \$10,022,031**] less external obsolescence [**\$ -0-**].”

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<sup>9</sup> According to Litolff, Hewlett-Packard “was getting an estimate” on the cost of demolition. That estimation was part of their evaluation of whether or not to tear down the buildings with the excess space. Trial Transcript at 1191. That estimate was not, however, in the trial record. And Litolff testified “No, I did not,” in response to the question “Did you examine that [‘financially feasible or appropriate’ to demolish issue] at all in your analysis of functional obsolescence and the cost to cure?” Trial Transcript at 1191.

<sup>10</sup> Since the value of the loss (\$10,022,031) actually contributes to the real market value in this instance, it is treated as a negative number in this formula because the subtraction of a negative number results in a positive amount reflecting its contribution to real market value. An extended example of how a *value of loss* can contribute to real market value rather than detracting from it is found in Defendant’s Opening Post-Trial Brief at Appendix VIII – A8-22 to A8-36. This illustration uses “Example 2 (Superadequacy)” which is part of OAR 150-308.205(F) to explain this *value of the loss* contribution concept.

OAR 150-308.205(F)(3)(b). That difference results from substituting the correct amount of the *value of the loss*—determined through a correct application of the rule, and using Litolff’s estimate of the “anticipated income”—for Litolff’s erroneous *value of the loss* amount. Again, we include only the *value of the loss* amount and not the *cost to cure* amount, because any *cost to cure* would be more than the *value of the loss*. There is no burden needed to cure when the excess space generates a positive contribution (\$10,022,031) to the real market value of Hewlett-Packard’s property.

The real market value of \$113,505,609 for tax year 2008-2009 represents the correct application of the *value of the loss* formula required by OAR 150-308.205(F)(3)(k), and reflects utilization of Litolff’s estimate of net cash flows (Plaintiff’s Exhibit 1 at 60) over the total remaining life of the property. That same methodology needs to be applied by the Tax Court on remand to correct Litolff’s determinations of real market value for tax years 2009-2010 and 2010-2011.

## **V. Conclusion**

The Tax Court’s opinion should be reversed and this court should find the real market value for tax year 2008-2009 at \$113,505,609 and remand this case to the Tax Court to determine the correct real market values of the subject property for tax years 2009-2010 and 2010-2011 following the methodology described

herein for the 2008-2009 tax year.

DATED this 18<sup>th</sup> day of February 2014.

Respectfully submitted,

ELLEN F. ROSENBLUM  
Attorney General

By: /s/ Joseph A. Laronge  
Joseph A. Laronge, #841330  
Of Attorneys for Department of Revenue,  
State of Oregon, Defendant-Appellant  
[joseph.laronge@state.or.us](mailto:joseph.laronge@state.or.us)

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 5,778 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 18<sup>th</sup> day of February, 2014.

By: /s/ Joseph A. Laronge  
Joseph A. Laronge, #841330  
Of Attorneys for Defendant-Appellant

## CERTIFICATE OF SERVICE

I certify that on February 18, 2014, I directed the original DEFENDANT-APPELLANT'S AMENDED OPENING BRIEF to be electronically filed with the Appellate Court Administrator, Appellate Records Section, and served upon David L. Canary, of attorneys for respondents. And also upon Vance Croney, Benton County counsel, by regular United States Mail and addressed to the following:

VANCE M. CRONEY  
Benton County Counsel  
PO BOX 3020  
Corvallis, OR 97339-3020

Dated this 18<sup>th</sup> day of February, 2014.

By: /s/ Joseph A. Laronge  
Joseph A. Laronge, #841330  
Of Attorneys for Defendant-Appellant