

NO. CV 03 0070359S : SUPERIOR COURT
JOHN R. SHERIDAN : JUDICIAL DISTRICT OF
 : WINDHAM
 : AT PUTNAM
v.
TOWN OF KILLINGLY : JANUARY 12, 2007

MEMORANDUM OF DECISION

The Supreme Court remanded this case to the trial court for the limited purpose of applying the proper legal standard set by the Court and addressing factual issues raised by the plaintiff dealing with the valuation of the leasehold interests involved in this case. See Sheridan v. Killingly, 278 Conn. 252, 266-67, 897 A.2d 90 (2006) (hereinafter referenced and cited as Sheridan).

The Sheridan court recited the factual issues before it as follows: “We next address the town’s claim that, if the trial court had applied the proper legal standard in the present case, it reasonably could not have concluded that the plaintiff had met his burden of proving that the assessment was excessive. The plaintiff counters that, even if the trial court improperly determined that the town was barred as a matter of law from assessing the value of the leasehold interest against him, the court properly rejected the town’s appraisal because Flanagan’s methodology was flawed. Specifically, the plaintiff argues that Flanagan ignored actual rental income information in calculating the value of the

lessor's interest under an income capitalization approach; his appraisal of the leasehold interest was based on the unfounded assumption that the price paid by the buyers did not include the value of the improvements; there was no specific factual support for his testimony that the value derived from a comparable sales analysis was confirmed by a cost approach analysis, which resulted in a price of \$23,000 to \$24,000 for each one-tenth of an acre lot if the land were subdivided; his appraisal did not sufficiently take into account the unique characteristics of the property; and the evidence compelled a finding that the actual rent on the leasehold tracts reflected fair market value." Id.

While the facts and procedural history are recited in Sheridan, briefly stated, the subject property consists of 31 acres of a 202-acre tract of land surrounding Alexander Lake in the town of Killingly (town) that have been divided into 274 lots (the lots), each approximately one-tenth of an acre in size. The taxpayer leased the lots to various tenants who constructed improvements upon them.

On remand, the issue is whether, for the purpose of determining fair market value of property for tax purposes, the leasehold interests of the 274 lots have value independent of the lessor's interest in the property and, if so, what that value is. As part of the proceedings upon remand, the trial court requested, and the parties provided, draft findings and memorandums of law related to the leasehold interests. Before considering the parties' draft findings, the trial court's original factual findings in its memorandum of decision dated November 5, 2004 (hereinafter MOD) briefly consist of the following:

1. The subject property surrounds, but does not include, Alexander Lake in the town of Killingly. The property constitutes one parcel, yet contains several different components. (MOD, p. 1.)
2. Approximately 31 acres of the parcel have been divided into tracts and set aside for leasing to residential users. (MOD, pp. 1-2.)
3. The term tract refers to the layout of small lots, too small to meet the zoning minimum lot size requirements, similar to those in a campground that are leased to tenants for a short period of time. (MOD, p. 2, n.1.)
4. There are 274 separate leasehold tracts on the 31 acres, each approximately one-tenth of an acre in size, measuring about 45 feet by 100 feet. (MOD, p. 2.)
5. The subject property produces income of approximately \$12,000 per year from the operation of the restaurant and a gross income of \$499,118 per year from the rental income derived from the leasing of the 274 tracts. (MOD, p. 2.)
6. Each lease was for a ten-year period beginning in 1997 and contained an option to extend the ten-year term subject to negotiation with the owner of the land. (MOD, p. 2.)
7. All of the leases will expire on the same date in the year 2007. The lessees pay an annual rent of \$2,220 per tract. (MOD, p. 2.)
8. Sixty-five percent of the tracts have been improved by the lessees with the construction of new homes that provide the tenants with year-round use of those tracts. (MOD, p. 3.)
9. The assessor lists the ownership of the structures on each tract in the name of the lessee and lists the plaintiff as the owner of all of the underlying land. (MOD, p. 3.)
10. The lessees are responsible for the payment of property taxes for improvements on their tracts as well as the sewer use charge. (MOD, p. 3.)
11. There are four sewerage pumping stations for the tracts and all of Alexander Lake is serviced by public sewers. (MOD, p. 3.)

12. Some tracts have access to the public water supply, while most have wells that provide good quality water. (MOD, p. 3.)

13. The subject property is located in a special zoning area known as the Alexander Lake Zoning Overlay District (ALZOD). This “overlay zone” was created in response to the fact that the lots do not meet the minimum lot size requirements of the underlying low density zone, and therefore, could not be subdivided and sold as separate lots. This special zoning regulation allows lessees to modify the structures on their tracts without obtaining a variance. (MOD, p. 3.)

14. The subject can only be marketed as one unit containing all the tracts and its highest and best use was the continuation of its present use. (MOD, pp. 4-5.)

15. In valuing the leased portion of the subject property, Flanagan determined that the market value of the individual tracts included both the lessor’s leased fee interest and the tenant’s leasehold interest. (MOD, p. 6.)

16. Flanagan chose this approach after concluding ““that the tenants had an interest in value in excess of what the landlord received in rent”” (MOD, p. 6.)

17. Flanagan was influenced by the fact that there was a market for the tenants’ leasehold interests even though the leases were for a limited ten-year period. In other words, Flanagan found that a purchaser of a leasehold interest would pay for the balance of the lease term with improvements made to the leasehold. (MOD, p. 6.)

18. After examining sales of that nature, Flanagan was of the opinion that there was a market for the leasehold interests that had a value of \$35,000 per tract. (MOD, p. 6.)

19. Utilizing the income approach, Flanagan further opined that the leased fee interest of the lessor had a value of \$15,000 per tract. Combining these two figures, Flanagan determined that each leased tract on the subject property had a value of \$50,000. (MOD, p. 6.)

20. Multiplying the \$50,000 value by 274, the total number of tracts, Flanagan arrived at a total value for the leased portion of the subject property of \$13,700,000. (MOD, p. 6.)

21. The subject property is unique in that it encompasses a portion that is leased for profit, open space land, a residence used by the owner, a restaurant and other buildings of no practical use other than for cold storage. All of these factors contribute to the basic operation of the property for the production of income. (MOD, p. 8.)

The town argued, and the Sheridan court agreed, that there are two components to the valuation of the 274 tracts: 1) the income component based upon the rental income returned to the owner under existing leases (contract rent) and 2) the sales component based upon excessive sales prices developed in a secondary market between tenants and assignees of existing leases. See Sheridan, 278 Conn. 265-66; see also defendant's proposed findings of fact #17 and #18.¹

The Sheridan court concluded that "the trial court's statement that 'the value of the tenant's leasehold interest cannot be tacked on to the lessor's interest, because that would require the plaintiff to pay a real estate tax on property that cannot be attributed to him, as the owner,' was an incorrect statement of the law. As we have indicated, considering the value of the lessee's interest does not require the plaintiff to pay a tax on

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In its proposed findings of fact #17, the defendant stated that "Flanagan determined two, cumulative, values for each Tract as a component of the value of the land aspect of the Subject Property: (a) a value for Sheridan's return based on rental income under the existing leases (hereinafter, the 'Income Component'), and (b) an additional value based on the leasehold interest itself, reflected in the excessive sales prices (hereinafter, the 'Sales Component'). See Test. Flanagan, July 16, 2004, at 26-27; Appraisal [Report], December 15, 2002, Defendant's Exhibit B at 44-47."

In its proposed findings of fact #18, the defendant stated that "[t]he leasehold interest has a value because of the existence of a low rental rent, a below market rate, which leads to the creation of a secondary market between tenants. See Test. Flanagan, July 16, 2004, at 36-37, 48-50."

property that belongs to the lessee, but only to pay a tax on the true and actual value of his own property *as measured*, in part, by the value of the lessee's interest." (Emphasis in original.) Sheridan, 278 Conn. 265.

In following the Sheridan court's direction, it is for the trial court to determine the fair market value of the subject premises for taxation purposes as affected by the valuation of the leasehold interests.

The Sheridan court discussed the holding in First Bethel Associates v. Bethel, 231 Conn. 731, 651 A.2d 1279 (1995) (hereinafter referenced and cited as First Bethel) and stated that "a leased property might have a fair market value that exceeds the capitalized value of the actual rental income and that excess value may be taken into account in assessing the true and actual value of the property for purposes of taxing the owner, even though the tenant receives the economic benefit of that excess value." Sheridan, 278 Conn. 262-63. The Sheridan court further stated that "[t]o the extent that any of these cases [cited in footnote 9] suggest that *only* market rents may be considered when determining the true and actual value of a rental income property, such a conclusion is foreclosed by our conclusion in First Bethel Associates v. Bethel, supra, 231 Conn. 740, that *both* actual rents and market rents must be considered." (Emphasis in original.) Sheridan, 278 Conn. 263 n.9.

The genesis of the problem in this case is the legislature's mandate, pursuant to General Statutes § 12-63 (a), that in determining the value of real estate for assessment

purposes, “[t]he present true and actual value . . . shall be deemed by all assessors . . . to be the fair market value thereof”

General Statutes § 12-63b (b) further provides that when considering the valuation of rental income property “the term ‘market rent’ means the rental income that such property would most probably command on the open market as indicated by present rentals being paid for comparable space. In determining market rent the assessor shall *consider* the actual rental income applicable with respect to such real property under the terms of an existing contract of lease at the time of such determination.” (Emphasis added.) The clear meaning of this statutory section is that the bench mark of valuation is “market value”, not contract rent. In reaching market rent pursuant to the statute, the court must take into consideration what effect contract rent has on market rent. Market rent is, in reality, contract rent that has been arrived at in the open market for comparable space. Market rent has been defined as “[t]he rental income that a property would probably command in the open market; indicated by the current rents that are either paid or asked for comparable space as of the date of the appraisal.” *The Appraisal of Real Estate* (12th Ed. 2001) p. 83.

As part of the revaluation process, the town’s assessor Melissa Bonin (Bonin) did a study of the “sale” of lots at the subject property and concluded that the owner, Sheridan, charged rents that were below market. Bonin concluded that the value of the leasehold units could be determined by taking the sales prices of the lots that were “sold”

by the tenants to buyers who “purchased” the leased land and deducting the value of the improvements using the cost approach.²

While Flanagan reported that he only used the direct sales comparison approach to determine the value of the subject property, he, in fact, also considered the income approach.³ Flanagan determined that the net rental income was \$330,000⁴ by valuing the

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Redirect examination of Bonin proceeded as follows:

“Q Is it your position that . . . a single family house on a single family lot in the Town of Killingly or all single family houses on single family lots in the Town of Killingly can reasonably be compared to structures on tenth of an acre leased tracts in Alexander Lake? Is that a fair comparison?

“A It’s my contention that the value that those properties are selling for should represent the same market conditions or be at seventy percent of market just like everybody else’s when you go through revaluation. And if you cannot achieve that, there’s a reason that you cannot get those markets there . . . because there’s an underlying value that is not being seen in our assessment. And we cannot add land to those cottages or homes.”

(Transcript of July 15, 2004 (hereinafter 7/15/04 Tr.), p. 92.)

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“The Direct Sales Comparison Approach was found to be the most appropriate in estimating the market value of the subject property. Both the income and cost approaches were considered but not used as neither applied to the appraisal problem involved, i.e. the valuation of land with some improvements.” (Defendant’s Exhibit B, p. 43.)

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Flanagan used an average annual rental of \$1,800 per lot, as below market rent, less expenses to arrive at \$330,000. Flanagan derived this figure of \$1,800 per lot from conversations with David Pechie (Pechie), Sheridan’s manager of the subject property for 32 years. He then capitalized the net rental income at 8% producing a leased fee value of \$4,125,000 or approximately \$15,000 per lot for each of the 274 lots. Flanagan explained that “it was explained to us, and it’s further explained in the information we got after the appeal was taken, that there was a great deal of money paid, about eighty-three thousand dollars paid in the previous year for 2001 rentals. So . . . we calculated an average rent on site, given the fact that we have some leases below – we didn’t have the actual leases, by the way. But, through

landlord's leased fee interest using the income approach by taking the contract rent and capitalizing the net rental income from the subject property.

As discussed above, Flanagan used the sales comparison approach to value the tenant's leasehold interest. Flanagan selected five sales of the 274 lots that sold "as vacant" assuming that when the tenant's interest was sold, the value of the improvements on the five selected comparables were either non-existent or minimal in value. According to Flanagan, this allowed the lot's sale price to reflect the value of the tenant's leasehold interest only. Using this concept, Flanagan determined that the leasehold interest of the tenants varied between \$25,000 and \$65,000 per lot, with an average price of approximately \$35,000 per lot. Combining the leased fee interest of the landlord and the leasehold interest of the tenant, Flanagan concluded that the value of each of the 274 lots was \$50,000, for a total amount of \$13,700,000.

Considering Flanagan's testimony that the so-called "sale" of a tenant's leasehold interest on the lots ranged from \$25,000 to \$65,000, the trial court, during the course of the trial, interjected:

conversations with Mr. Pechie, he told us that so many were below eighteen hundred, so many were above, in rough numbers. We used an average rental of eighteen hundred dollars per site to represent the landlord's lease fee interest." (Transcript of July 16, 2004 (hereinafter 7/16/04 Tr.), p. 40.)

But see a contrary view in Sun Valley Camping Cooperative, Inc. v. Stafford, 94 Conn. App. 696, 710-11, 894 A.2d 349 (2006) (where the issue was the valuation of a cooperative campground with 303 campsites with an average campsite size of 3,000 to 4,000 square feet; the appellate court held that the trial court erroneously valued the campsite as a whole by using the average price per unit).

“Court: Well, it almost seems like there is something underlying that is not known either to the parties or to the court as to why the lessees would lease the lots for such a large amount of money with such a short period left on the lease unless there was something - that there was something hidden - that there was a guaranty that there would be a renewal of the lease at some agreed upon price. But I haven’t heard that; I haven’t seen it in the leases that have been introduced in evidence. So, it’s somewhat of a mystery as to why people would be leasing these lots under such a short term lease and spend such money in doing it.”

(7/16/04 Tr., pp. 32-33.)

In response to the court’s concern, Flanagan explained that he looked at existing lease rates for other types of properties such as campgrounds, RV parks and trailer parks that typically rent for \$2,200 to \$4,000 per six-month season. See 7/16/04 Tr., p. 36.

Flanagan further noted that he compared the subject lots being leased for approximately \$150/month compared to trailer parks in eastern Connecticut that typically rent for about \$250/month as an example that the lease rates are very low on the subject property. See 7/16/04 Tr., p. 37. None of Flanagan’s references to campgrounds, RV parks or trailer parks were identified in his appraisal report. See 7/16/04 Tr., pp. 36-37.

Mr. Pechie’s testimony provides another glimpse of the dynamics at work at the subject property:

“Q Do you follow at all the sales price[s] of these cottages?”

“A Not really, no.

“Q You don’t know . . . just your own recollection, the highest price that one of these cottages might -

“A I might hear what something sold for. But as far as the sale itself, we don’t get involved.

“Q And what do you hear? Are there cottages offered for sale at this point that you know of?

“A There are cottages, yeah.

“Q And at what range are they being offered?

“A They range from - well, offhand, there’s a couple listed, one for four hundred fifty thousand, another for three and a quarter. And they run down to less than a hundred thousand, depending on the structure.

“Q So, from a hundred thousand to upwards of four-fifty, you’ve got listing. And what they’re selling is just the cottage itself. Right?

“A Correct.

“Q And the right to lease the land. Is that correct?

“A Correct.

“Q What were Mr. Sheridan’s investment objectives in leasing these tracts[?] What was he trying to achieve? Do you recall?

“A I don’t think it was a business venture. I think it was more like a lake community. He wanted to establish a close knit lake community.

“Q And how did he achieve that?

“A Well, most of the people there know each other. They’re local people. They know each other generation, after generation, after generation. He’s kept the - the land rent has been kept fairly reasonable.

“Q And he did that intentionally to allow people to keep coming back?

“A Yes.

“Q And did he have some level of income he did want to achieve from those cottages, if you recall?

“A I don’t recall. He never mentioned how much money he wanted to make.

“Q Did he have any minimal amount that he needed, that you recall?

“A No.

“Q Did he ever, in your experience, compare the rents that he was charging for these properties with any other land rents?

“A Not really.

“Q Didn’t look at mobile homes?

“A Not him, personally, I don’t think.

“Q How often did he increase the rents?

“A Approximately, every five years prior to the leases. Something like that.

“Q When you say prior to the leases, I take it there have only been leases since what?

“A ‘97, the written lease.

“Q But back when there were oral leases, how often did he increase -

“A About every tax reval time.

“Q And since then about every five years. What would be the level of the increases?

“A Minimal. From like three hundred and thirty dollars to five hundred and twenty dollars and onto seven hundred twenty to eighty thirty. Something like that.”

(7/15/04 Tr., pp. 27-28, 37-38.)

Flanagan’s five “sales” of tenant interests leave much to be desired as credible comparable sales for the 274 lots. First, five sales out of 274 lots represent 1.8% of the total. This is an insignificant number by which to judge the whole, on a per lot basis. Flanagan’s analysis of the five sales is the only basis for his conclusion that “market evidence demonstrates that buyers are willing to pay \$35,000 (on the average) for a leasehold interest in a building lot [in this] Alexander Lake locale.” (Defendant’s Exhibit B, p. 47.)

The fair market value of property, as mandated by the legislature,⁵ is defined as the “value that would be fixed in fair negotiations between a desirous buyer and a willing seller, neither under any undue compulsion to make a deal Uniroyal, Inc. v. Board of Tax Review, 174 Conn. 380, 390, 389 A.2d 734 (1978).” First Bethel, 231 Conn. 740 n.7.

Flanagan selected five sales that expire on December 31, 2007 and all five sales contain an option to renew for a period of ten years until December 31, 2017 “upon the same terms and conditions herein set forth, except that the rental for such extension shall be negotiated by the parties hereto at least sixty (60) days prior to the commencement of the extension period. . . . If the parties hereto have not negotiated a satisfactory rent for the extension period . . . then the option to renew shall be null and void. . . . There will be

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General Statutes § 12-63 (a) provides, in relevant part, that “[t]he present true and actual value of all property shall be deemed by all assessors . . . to be the *fair market value* thereof and not its value at a forced or auction sale.” (Emphasis added.)

no further options to renew.” (Plaintiff’s Exhibit 3.) In other words, come December 31, 2007, all of the 274 leases on the subject will expire, subject to being renewed through negotiation.

Recognizing that all of the tenants must negotiate a new rental agreement with the landlord and assuming that the term “negotiate” in the subject leases meets the criteria in the definition of “fair market value” in § 12-63 (a), the rents established through negotiation should be representative of market value. See First Bethel, 231 Conn. 740 n.7.

Another important provision in the subject leases states that “the parties of the second part [the tenants] will not, during said term, assign or underlet said premises or any part thereof without the permission in writing of the party of the first part [the landlord], which permission or consent will not be unreasonably withheld; and said parties will not occupy the said premises for other than residential purposes without the like consent, and will do no waste.” (Plaintiff’s Exhibit 3.)

Flanagan apparently did not investigate whether Sheridan had given his permission to the tenants for the assignment of their leases to third parties although he knew that the tenants were “selling” their leasehold interests within a range of \$25,000 to \$65,000 per lot.⁶

Flanagan also did not investigate why third parties negotiated the “purchase” of lots knowing that the leases would terminate on December 31, 2007 unless an option to

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Flanagan did not consider or follow up on the reason why some of the cottages were listed for sale between \$100,000 and \$450,000 as reported by Pechie. See 7/15/04 Tr., p. 27.

renew was entered into, contingent upon negotiating the rent for the additional ten years. Under these restrictions, it is difficult to understand Flanagan's conclusion that his five selected sales represent sales at fair market value.

Without a doubt, the death of Sheridan during the pendency of this appeal must have been a shock to all the tenants whose leases will expire in 2007, especially when Sheridan and his tenants shared personal relationships and the assignees of the original tenants invested in the property by purchasing leasehold interests and building substantial improvements such as year-round homes.

Although Flanagan considered the five "sales" to be representative of a sale between a willing buyer and a willing seller, under no undue compulsion to make a deal, the facts in this case support a contrary conclusion. In his role as appraiser, Flanagan did not make an extensive investigation into the motivation behind the tenants' "sales" of leasehold interests, when a red flag should have been raised and the following questions asked: whether the transactions were representative of fair market value in light of the relatively short-term leases coming due in five years and whether it was necessary for the tenants and the assignees to obtain the landlord's consent to any assignments?⁷

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The court notes that "[t]he data collected should be meaningful and relevant. All pertinent value influences, facts, and conclusions about trends should be clearly indicated in the report and related specifically to the property being appraised. Because the data selected forms the basis for the appraiser's judgments, a thorough explanation of the significance of the data reported ensures that the reader will understand these judgments." *The Appraisal of Real Estate* (12th Ed. 2001) p. 59.

If Flanagan had investigated, he would have encountered this problem: that the subject 202 acres of land is unique and cannot be compared to the sale of “comparable” lots in a subdivision or the sale of one-tenth of an acre lots because the subject cannot be sold piecemeal under the town’s zoning restrictions. Given the circumstances here, it is not credible for an appraiser to rely on five “sales” of lots out of a tract containing 274 lots without a full investigation into the underlying reasons for the transactions as well as a more expansive investigation into the activities of Sheridan and his tenants. Certainly, it would have been productive for Flanagan to have interviewed Sheridan, the tenants and the assignees of the tenants to understand the rental arrangements and Sheridan’s knowledge of tenant sales; Sheridan’s reason for granting permission to assign and whether there was any consideration paid to him for permission to assign the lots.

“In § 12-117a tax appeals, the trial court tries the matter de novo and the ultimate question is the ascertainment of the true and actual value of the [taxpayer’s] property. . . . At the de novo proceeding, the taxpayer bears the burden of establishing that the assessor has overassessed its property.” (Internal quotation marks omitted.) United Technologies Corp. v. East Windsor, 262 Conn. 11, 22, 807 A.2d 955 (2002). “Only after the court determines that the taxpayer has met his burden of proving that the assessor’s valuation was excessive and that the refusal of the board . . . to alter the assessment was improper, however, may the court then proceed to the second step in a § 12-117a appeal and exercise its equitable power to ‘grant such relief as to justice and equity appertains’” Konover v. West Hartford, 242 Conn. 727, 735, 699 A.2d 158 (1997).

The assessor placed a value upon the 274 lots in the amount of \$13,700,000 by using Flanagan's methodology. The 1994 revaluation of the subject, as a whole, established an assessment in the amount of \$1,226,320 with a fair market value of \$1,751,886 (\$1,226,320 divided by 70%).

Under Flanagan's determination of value, each of the subject lots has, on average, a fair market value of \$50,000, resulting in a total value of \$13,700,000. Recognizing that Flanagan's average lot size is approximately one-tenth of an acre, one acre of the subject would equal \$500,000 an acre for land (except for roads and utilities) without improvements.

Comparing the valuation of the lots at \$500,000 per acre with the valuation of other land portions of the total 202 acres valued by Flanagan (consisting of the Sheridan residence on one-half acre at \$35,000 and the two-acre site of the restaurant at \$50,000 per acre and the valuation of the remaining 83 acres of land at \$1,000 per acre), the value of \$500,000 per acre, on its face, lacks credibility that a willing buyer would pay such a steep price for what amounts to a campsite. No credible evidence exists to support this conclusion and it is therefore suspect. See Defendant's Exhibit B, pp. 48-49.

Contrary to Flanagan's valuation of the 274 lots, Morra, the plaintiff's appraiser, used only the direct income capitalization approach. See Plaintiff's Exhibit 10, p. 43.

Morra's description of the 274 lots is as follows:

"The subject as of October 1, 2002 had 256 tract leases. The leases are ten year renewable leases. The lease grants the tenant the right to use the tract to construct a 'cottage' and garage. The lease grants the tenant access to

the tracts from the public street over the existing private road way and by the leaser. . . .

“In addition to the stated annual rental, after the third year the tenant is liable to a proportional share of an increase in expenses arising from an increase in the owner insurance, operation cost, taxes, and cost of living based on ‘CPI’. The total annual increases are limited to 20% of the previous year rental.

“The leases all have options to extend the leases an additional 10 years at a rate to be negotiated. The options extend most leases to December 21, 2017. The leases have been structured in this manner for some time, ten year leases with an option to renew for an additional 10 years.

“Tract Rental. The majority of the leases are for individual tracts. Two hundred and twenty five of the individual tracts each lease for \$1,850.00 per year for a total base annual income of \$416,250.00. The remaining leases are for combined tracts from one and one half tracts to three and one half tracts. The majority are two combined tracts at a rental rate of \$2,620.00 per year. The rental rate for the other combination varies from \$2,235.00 to [\$2,555.00] per year. The rental rates appear to reflect the combined tract size and location. The rental rates appear to reflect fair market rental. The total Gross Income generated by the tract leases for year 2002 was \$499,118.00.”

(Plaintiff’s Exhibit 10, p. 43.)

It is Morra’s opinion that there are no other comparables. As a result, his determination of value, using the income approach, is that the subject rental rates were the exclusive basis for finding fair market rental rates.

One could argue that given the activity surrounding the leasing of 274 lots to individual tenants, that this activity, in itself, was sufficient to establish market rental value for the lots.

“Market forces create market value, so the analysis of market forces that have a bearing on the determination of highest and best use is crucial to the valuation process. When the purpose of an appraisal is to develop an opinion of market value, highest and best use analysis identifies the most profitable, competitive use to which the property can be put.” *The Appraisal of Real Estate* (12th Ed. 2001) p. 305.

“The highest and best use of a specific parcel of land is not determined through subjective analysis by the property owner, the developer, or the appraiser; rather, highest and best use is shaped by the competitive forces within the market where the property is located.” *Id.*

In *Mashantucket Pequot Tribal Nation v. North Stonington*, Superior Court, judicial district of New London at Norwich, Docket No. CV 01 0122894 (August 14, 2003, *Aronson, JTR*), the market force was the taxpayer, the Mashantuckets. Although the plaintiff’s appraiser Silverstein concluded that there was no demand for industrial property in North Stonington, and therefore, an agricultural or residential use was appropriate as the highest and best use, he ignored the fact that by buying a large number of industrial properties, his client, the Mashantuckets, were thereby creating a market for industrial property.

Similarly here, given the fact that there are no comparable sales of this unique property, Sheridan’s leasing of 274 lots establishes a market rental in itself for each of the lots. Flanagan was of the same mind that there were no comparables to the subject lots since his comparable sales consisted of the sale of five of the subject lots, not the sale of

off-site property. While Flanagan apportions a value of \$50,000 for each of the 274 lots, Morra, on the other hand, based his apportionment of value for the lots based on the contract rent entered into by the parties as an indication of fair market value.⁸

Flanagan's approach to finding fair market rental rests upon the concept of splitting the interest of the landlord from the interest of the leasehold tenant. In doing so, Flanagan based the valuation of the landlord's leased fee interest using the contract rent the tenant paid to the landlord.

The Sheridan court stated that "[t]his court concluded that the trial court [in First Bethel] properly had concluded that it must consider 'both (1) net rent for comparable properties, and (2) the net rent derived from any existing leases on the property. This legislative approach makes sense because it reflects the reality that a willing seller and a willing buyer—whose ultimate judgments are what we mean by fair market value—would themselves consider in arriving at a price for the property that is subject to leases that do not closely approximate current rentals for similar properties.'" (Emphasis in original.) Sheridan, 278 Conn. 262.

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Recross-examination of Mr. Morra proceeded as follows:

"Q And how did you make the determination . . . [the rentals] were reasonable?

"A Again, as I indicated earlier, two reasons: one, that you had two hundred and sixty plus or minus individuals negotiating arms length transaction[s] with the landowner. That's a pretty good indicator of value. Plus, my knowledge of the area."

(7/15/04 Tr., p. 140.)

If the Sheridan court's decision is to be interpreted correctly, this court must assume that the proper method to use in determining the value of the subject property is to: 1) determine the value of the leased fee interest of the owner as landlord and 2) value the leasehold interest of the tenant. The Sheridan court cited with approval Folsom v. Spokane, 106 Wash. 2d 760, 769-70, 725 P.2d 987 (1986), for the proposition that "[i]f market rents exceed contract rent, the appropriate method of valuation is to add the present value of the leasehold bonus to the capitalized value of contract rent[.]" (Internal quotation marks omitted.) Sheridan, 278 Conn. 263 n.9. The Sheridan court also cited Supervisor of Assessments v. Ort Children Trust Four, 294 Md. 195, 208-11, 448 A.2d 947 (1982) for the proposition that the "assessing authority must consider both contract rent and fair market rent in assessing [the] value of property subject to [a] long-term lease[.]" Sheridan, 278 Conn. 263 n.9.

Although the trial court in Sheridan did not accept Flanagan's valuation of the leasehold interest for tax assessment purposes and accepted Morra's valuation of the subject as the true and actual value of the property, the Supreme Court in Sheridan held that the trial court's failure to consider Flanagan's valuation of the leasehold interest in the lots by use of the sales comparison approach was error. *Id.*, 258-59. The Sheridan court stated that "considering the value of the lessee's interest does not require the plaintiff to pay a tax on property that belongs to the lessee, but only to pay a tax on the true and actual value of his own property *as measured*, in part, by the value of the lessee's interest." (Emphasis in original.) *Id.*, 265. The Sheridan court further stated that "[t]he

town merely used the value of the tenants' leasehold interest as an indicator of that fair market value." Id., 266.

It should be noted that First Bethel relied on valuation based upon "net rent for comparable properties" and "net rent derived from any existing leases on the property." First Bethel, 231 Conn. 740. On remand, the Supreme Court in Sheridan instructed the trial court to determine the fair market value of the 274 lots on the subject property by considering the impact of the tenant's leasehold interest as an indicator of fair market value.

As previously discussed, it was Flanagan's position that the tenant's leasehold interest had value because the tenants of the subject lots assigned their leases to third parties for a value Flanagan determined to be in excess of contract rent. These tenant activities resulted in a bonus to the tenants that was reflected by adding the value to the lessor's leased fee interest. The town's assessor concurred in this analysis that, compared to other activity in town, assignees of Sheridan's tenants were paying more for the lots than just the value of the improvements and that this excess value had to be attributed to the increased value of the leasehold interest.

In determining the value of the subject lots, the key consideration is fair market value, as previously defined in § 12-63 (a). Although the trial court had previously accepted Morra's opinion that the contract rent and the market rent for the subject property were equivalent, the remand requires this court to put aside its previous finding

of credibility and reexamine its findings by considering the tenant's leasehold interest as part of the valuation process.

For the most part, the evidence produced from the testimony of Pechie, Bonin and Flanagan indicated that there was some type of activity occurring at the subject 274 lots that was too difficult to explain in basic real estate valuation terms. Tenants entered into leases with Sheridan at rental rates that were set to attract a congenial community. The tenants would then pass their interests in the lots from generation to generation, providing stability and preserving the close knit community that Sheridan desired. The tenants assigned their lease interests to third parties for a consideration that is too difficult to apportion with respect to improvements and the leasehold interest.

Bonin was inclined to determine the value of the improvements on the sold lots using the cost approach and deducting the net of cost less depreciation from the sale price of the lease to obtain what she determined would be the leasehold value.

However, instead of using this approach, Flanagan selected sales of lots on the subject tracts where the value of the improvements were, in his opinion, minimal, so that the sale would reflect the value of the leasehold interest only and not the value of any improvements. This court has previously stated that Flanagan's reliance on five lot sales with improvements on the subject leaves much to be desired. As Mr. Pechie testified, the 30-foot mobile home trailer on Flanagan's sale four was fairly new to the site. Flanagan's sale six contained a two-stall garage across from the lot. Mr. Pechie had personal

knowledge of the structure in sale seven containing “new floors, new electric, new electric hot water heater, new tile, tile floors, good roof.” (7/16/04 Tr., p.120.)

Flanagan relied on the assessor’s records for information regarding the condition of improvements on the five lots he selected.⁹ There are additional questions factoring into the mystery here: why would assignees of tenants acquire a short-term lease when all leases are due to expire in 2007 and construct substantial improvements on these lots at the cost of thousands of dollars when all of the money spent for “purchasing” the lease and building year-round homes would be lost? In other words, there is no reversionary value to the tenant’s leasehold interest once the lease expires in 2007.

Given that both appraisers agree that the subject property is unique and that there are no true comparables to the subject and given that the court concluded that the taxpayer is an aggrieved party, it is necessary to turn to the income capitalization approach as it is the most credible process to employ in valuing the subject lots.

“Leasehold interests are typically valued using the income capitalization approach. The income . . . is the difference between market rent and contract rent. The capitalization or discount rate selected usually depends on the relationship between contract rent and market rent, and frequently the appraiser’s judgment is critical in the rate selection. Since the leasehold interest ceases to exist at the expiration of the lease, there is usually no reversion to the leasehold interest. The sales comparison approach is only meaningful in

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Flanagan did not conduct a cost analysis for any of these improvements. See 7/16/04 Tr., pp. 71-73.

those relatively rare situations in which there are sales of similar leasehold interests that the appraiser can analyze. The cost approach is rarely, if ever, applicable to the valuation of a leasehold interest.” The Appraisal of Real Estate (12th Ed. 2001) pp. 83-84. It should be noted that one of the trial court’s original findings, restated above as #21, recited that the subject property was operated for the production of income.

Recognizing the deficiencies in this case from the lack of credible sales information, it is necessary to consider the valuation of the leasehold interest using the income capitalization approach by determining the difference between market rent and contract rent. See Sheridan, 278 Conn. 263 n.9 citing with approval Folsom v. Spokane, supra, 106 Wash. 2d 769-70. In other words, the difference between the market rent produced by the 274 lots and the contract rent realized from leasing the 274 lots is capitalized. See Barnini v. Sun Oil Co., 161 Conn. 59, 64, 283 A.2d 217 (1971) (“[t]he value of the lease is properly arrived at . . . by subtracting the rent provided for under the lease from the fair market value of the lease”). (Internal quotation marks omitted.)

This concept has been recognized as the “bonus value” method. See, e.g., Folsom v. Spokane, 106 Wash. 2d 769-70. “[P]roperty valuation based solely on capitalization of contract rent does not account properly for the value enjoyed by the lessee when market rent rises above contract rent. This value, often referred to as ‘bonus value’, ‘leasehold bonus’ or the ‘surrender value’ of the lease, is readily transferable by assignment or sublease assuming no contractual restrictions, and therefore has a market value capable of assessment.” B. Boyce & W. Kinnard, Jr., *Appraising Real Property* 421-22 (1984). In

fact, commentators have suggested an approach to valuation that recognizes the present value of the leasehold bonus to the lessee. See generally Koeppel & Kramer, "Property Tax Assessments: Contract Rent Is Fair Market Rent, Or Is It?" 2 Real Est. L. J. 561 (1973); J. Youngman, "Defining and Valuing the Base of Property Tax," 58 Wash. L. Rev. 713, 714-46 (1983).

The only evidence the court has when considering the market rent for the 274 lots comes from Morra's opinion that the contract rent was equal to the market rent with no supporting comparable rentals other than the recitation of the rents attributed to the various leases; i.e., 225 lots leased at \$1,850 per lot; 2 combined lots at \$2,600 and other combinations. Flanagan was more specific that there were no comparable rentals to compare with the subject leases.¹⁰

¹⁰

Redirect examination of Flanagan proceeded as follows:

"Q We are talking about comparable rentals of leasehold interest that weren't of the quality of this one. What are you talking about?"

"A I'm talking about campsites that rent for the season between twenty-two hundred and four thousand dollars a season for six months or, inferior trailer park type properties that are renting for two fifty a month compared to our subject, one fifty a month. Those are rentals that indicate that we have very low leases in place at [the] subject property."

"Q And you could compare Mr. Sheridan's leases with those and you could tell that we are well below them?"

"A Well below."

"Q But you couldn't find anything similar to Lake Alexander with lease tracts out in the market to come up with what the market rate rent for one of these lease tracts was."

Flanagan concluded that the existing lease rate for the Sheridan lots was \$150 per month. This is in line with Morra's finding as to the subject's contract rent.

Flanagan's input in developing a market rental rate for the subject 274 lots was that the net value of the 274 lots was between \$23,000 and \$24,000, after deducting the costs of site improvements. Flanagan's conclusion was based upon his comparison of the subject lots to a subdivision and its attendant costs of improvement such as sewers, water, paved roads and other utilities that exist at the subject. Flanagan acknowledged that the subject lots are not subdivided lots nor could they be. See 7/16/04 Tr., p. 47. Because Flanagan initially recognized that there are no comparable properties to the subject, his comparison of the 274 lots, which cannot be subdivided under current zoning regulations, to saleable subdivision lots, is not credible.

Using "leasehold bonus value", the concept determined by subtracting the contract rent from the market rent, where the market rent exceeds the contract rent, the court must determine the fair market rental of the subject lots as of October 1, 2002.

With regard to the issue of market rent, Flanagan did not consider in his analysis of the activity taking place at the subject site that the leases will expire on December 31, 2007. He further did not consider that the market rent will be established at the time of lease expiration, given the fact that in an arms length transaction with a willing lessor and

"A Right. There's - really, I didn't have any information to similar type situations. This is a unique property."

(7/16/04 Tr., p. 115.)

a willing lessee, under no compulsion to make a deal, the renewal of the leases will result in the establishment of market rental with no “bonus value.” In other words, at the expiration of all leases in 2007, any negotiated future rents attributed to the lots will reflect market rent, not contract rent.¹¹

The court had previously accepted Morra’s valuation of the subject property for a total of \$2,355,000. To this amount the court now adds the additional value of the leasehold bonus value of \$398 per year, per lot which is arrived at by deducting the contract rent of \$1,822, as established by Morra, from market rent, as determined by the court, of \$2,220 per year.

Multiplying the bonus leasehold value of \$398 by 274 lots results in a total bonus value of \$109,052 and then capitalizing this amount at 9.82%, results in an additional bonus value of \$1,110,509. (The capitalization rate of 9.82% represents a market capitalization rate of 8% plus a tax adjusted capitalization rate of 1.82%). This amount, added to the court’s previous finding of fair market value at \$2,355,000, results in a final fair market value of the subject property, as of October 1, 2002, in the amount of \$3,465,509.

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Even by assuming the accuracy of Flanagan’s leasehold value of \$35,000, spread over the life of the existing lease and the ten-year extension of the lease (which the appraisers assumed would take place) and amortizing the \$35,000 value over 15 years, without any reversionary value, the result would be an annual market rental income to Sheridan of \$2,333 per year.

The computation by the court recognizes that Morra's previous net operating income included the contract rent of the 274 lots which Morra considered to be market rental. In this way, the court has complied with the Supreme Court to value the subject property by considering the value of the leased fee and the value of the tenant's leasehold interest. The court finds that the valuation of the tenant's leasehold interest using the capitalization of the income approach, rather than using the comparable sales approach selected by Flanagan, is a more credible way because this court's previous analysis found Flanagan's conclusion to be flawed.

Accordingly, judgment may enter in favor of the plaintiff, without costs to either party, sustaining this appeal, with a final valuation of the subject in the amount of \$3,465,509. To this amount, by agreement of the parties, \$13,280 is added for the valuation of forest land,¹² resulting in a grand total of \$3,478,789.

Arnold W. Aronson
Judge Trial Referee

¹²

Forest land was omitted from Morra's appraisal of the subject property.