BOARD OF ASSESSMENT APPEALS, STATE OF COLORADO 1313 Sherman Street, Room 315 Denver, Colorado 80203	Docket No.: 75924
Petitioner: **RJL II-RH BOULDER LLC,** v. Respondent: **BROOMFIELD COUNTY BOARD OF EQUALIZATION.**	

ORDER

THIS MATTER was heard by the Board of Assessment Appeals ("the Board") on March 4, 2020, Gregg Near and Sondra Mercier presiding. Petitioner was represented by Thomas E. Downey, Jr., Esq. Respondent was represented by Karl Frundt, Esq. Petitioner is protesting the 2019 actual value of the subject property.

EXHIBITS AND EXPERT WITNESSES

The Board admitted into evidence Petitioner's Exhibits 1-4, Respondent's Exhibits A-E, and expert testimony by Petitioner's witness David J. Brooks, Certified General Appraiser, and Respondent's witness Mark R. Linné, Certified General Appraiser.

DESCRIPTION OF THE SUBJECT PROPERTY

500 Flatiron Boulevard, Broomfield, Colorado 80021
Broomfield County Schedule No. R1149023

The subject property is a 232-room full-service hotel constructed in 2002. The property is situated on a 4.0-acre site. Amenities include meeting rooms, restaurant and lounge, fitness facility, and indoor pool. The subject property's actual value, as assigned by the County Board of Equalization ("CBOE") below and as requested by Petitioner, are:

CBOE's Assigned Value:	$25,520,000
Petitioner's Requested Value:	$19,200,000

BURDEN OF PROOF AND STANDARD OF REVIEW

In a proceeding before this Board, the taxpayer has the burden of proof to establish, by a preponderance of the evidence, that the assessor's valuation is incorrect. *Bd. of Assessment Appeals v. Sampson*, 105 P.3d 198, 204 (Colo. 2005). Proof by a preponderance of the evidence means that the evidence of a circumstance or occurrence preponderates over, or outweighs, the evidence to the contrary. *Mile High Cab, Inc. v. Colorado Public Utilities Comm'n*, 302 P.3d 241, 246 (Colo. 2013). The evaluation of the credibility of the witnesses and the weight, probative value, and sufficiency of all of the evidence are matters solely within the fact-finding province of this Board, whose decisions in such matters may not be displaced on appeal by a reviewing court. *Gyurman v. Weld Cty. Bd. of Equalization*, 851 P.2d 307, 310 (Colo. App. 1993). The determination of the degree of comparability of land sales and the weight to be given to the various physical characteristics of the property are questions of fact for the Board to decide. *Golden Gate Dev. Co. v. Gilpin Cty. Bd. of Equalization*, 856 P.2d 72, 73 (Colo. App. 1993).

The Board reviews every case de novo. *See Bd. of Assessment Appeals v. Valley Country Club*, 792 P.2d 299, 301 (Colo. 1990). In general, a de novo proceeding before the Board "is commonly understood as a new trial of an entire controversy." *Sampson*, 105 P.3d at 203. Thus, any evidence that was presented or could have been presented in the board of equalization proceeding may be presented to the Board for a new and separate determination. *Id*. However, the Board may not impose a valuation on the property in excess of that set by the CBOE. § 39-8-108(5)(a), C.R.S. (2019).

APPLICABLE LAW AND AUTHORITATIVE SOURCES

Section 39-3-118 of the Colorado Revised Statutes, 2019, states: "Intangible personal property shall be exempt from the levy and collection of property tax."

Standard appraisal methods, including methods for allocating intangible assets, are presented in Chapter 35, "Valuation of Real Property with Related Personal Property or Intangible Property," in Appraisal Institute, *The Appraisal of Real Estate,* pp. 703-715 (14th ed. 2013). As this reference book explains, at pages 710-711:

> The appropriate method of valuing or allocating intangible assets has been highly controversial among real property appraisers, particularly over the past 30 years. It is important for all involved in this form of valuation work to understand the history and intensity of the debate and to understand the various alternative methodologies advocated by real property appraisers regarding how intangible assets should be accounted for in the valuation process. Given the complexity of the issues and intensity of the controversy, generalizations can be dangerous.

The International Association of Assessing Officers ("IAAO") issues technical standards and other reference publications that are generally accepted in the appraisal community. The Assessors' Reference Library ("ARL") cites IAAO publications extensively. *See, e.g.*, ARL V.3 at 2.31, 8.8, 8.14, 8.15 and ARL V.5 at 3.13, 3.19, and 3.27 (citing *Property Appraisal and Assessment Administration*, IAAO, 1990); ARL V.3 at 4.21 (citing IAAO for the practice of time trending); ARL V.5 at 3.4 (citing *Property Assessment Valuation*, IAAO, 2010); ARL V.2 at 8.16 and ARL V.5 at 3.4 (citing numerous technical standards published by IAAO). As relevant for this case, the IAAO Special Committee On Intangibles has published *Understanding Intangible Assets and Real Estate: A Guide for Real Property Valuation Professionals* (2016), which discusses various methods for allocating intangible assets.

'Business Enterprise Value' is defined as "The value contribution of the total intangible assets of a continuing business enterprise such as marketing and management skill, an assembled workforce, working capital, trade names, franchises, patents, trademarks, contracts, leases, customer base, and operating agreements." Appraisal Institute, *The Dictionary of Real Estate Appraisal* p. 25 (5th ed. 2010).

'Intangible Property' is defined as "Nonphysical assets, including but not limited to franchises, trademarks, patents, copyrights, goodwill, equities, securities, and contracts as distinguished from physical assets such as facilities and equipment." Appraisal Institute, *The Dictionary of Real Estate Appraisal* p. 102 (5th ed. 2010).

The Rushmore Approach is a method of valuing the real property portion of hotels and other lodging properties that involves calculating the property's net operating income after deducting the hotel's management and franchise fees—such fees which, in theory, account for the value of intangible assets. The Rushmore Approach has never been addressed by Colorado courts, but has been been widely upheld by courts in other jurisdictions. *See, e.g.*, *Marriott Corp. v. Bd. of Johnson Cty. Comm'rs,* 972 P.2d 793 (Kan. Ct. App. 1999); *Glenpointe Assoc. v. Teaneck Township,* 12 N.J. Tax 118 (N.J. Super. Ct. App. Div. 1990); *CHH Capital Hotel Partners, LP, v. District of Columbia*, 152 A.3d 591 (D.C. 2017).

FINDINGS AND CONCLUSIONS

After consideration of the testimony and exhibits presented, the Board places significant weight on the following findings and conclusions.

I. Use of the Income Approach

Both parties consider the income approach to value the subject. Petitioner's witness, Mr. David J. Brooks, Certified General Appraiser with Integrity Appraisal, relied solely on the income approach to estimate the value of the subject.

Respondent's witness, Mr. Mark R. Linné, Certified General Appraiser with Chrysalis Valuation Consultants LLC, developed and gave consideration to both the sales comparison and income approaches to estimate value.

An appraisal should be representative of the actions of the marketplace. The Board was convinced that participants in the hotel marketplace depend primarily on the income-producing aspects of a property when making purchase/sale decisions, and generally use the sales comparison approach only to establish a range of potential values or as a test of reasonableness. After consideration of the cost, sales comparison and income approaches to value, the Board finds that the income approach provides the most reliable indication of value for a hotel property such as the subject.

a. <u>Removal of Revenue and Departmental Expenses for Food and Beverage</u>

Both parties developed a pro forma for the subject based on actual revenue and expense information for the subject, with consideration also given to published market data. However, the parties varied significantly on how they addressed the revenue and expenses associated with the subject's food and beverage category.

The Food and Beverage component for the subject includes an on-site full-service restaurant, bar, room service and the extensive conference facilities. Petitioner contends that the food and beverage facilities include high intangible value, citing William N. Kinnard, Jr., MAI, PhD., and stating:

> [T]here are numerous measurable elements of non-realty at a hotel property which are separable from the real property. One of the main elements are the secondary profit centers, such as food and beverage services. Proxy rent can be applied to isolate the rent to just the real estate (as is typical in a retail shopping center or office building).

(Ex. 1, p. 59, internal citation omitted.) Petitioner makes the equivalent of a hypothetical assumption that the food and beverage space is rented to an outside user, eliminates both the departmental revenue and expenses for the food and beverage component, and adds rent of $324,000 to revenue.

A review of the subject operating history for 2015, 2016 and 2017 (Ex. 1, pp. 56-57) would indicate that the food and beverage category derived income well in excess of the attributed rent. As calculated by the Board, the food and beverage category generated department profit ranging from $1.25 million to $1.37 million for the three years reported.

The Board was convinced that the subject property has a strong food and beverage operation, which is operated within the full-service restaurant space, bar area, room service operation and extensive conference space. The Board finds that Petitioner incorrectly valued the subject based on a hypothetical condition that the food and beverage facilities were rented; thereby neglecting the actual performance of this departmental operation in their pro-forma analysis of the subject.

b. <u>Value of the Business Enterprise</u>

Petitioner contends that Respondent's value includes intangible assets of the business, sometimes referred to as aspects of going concern value. (Ex. 4, pp. 1-2.) Petitioner's appraisal report notes,

> There is some controversy or disagreement among authors concerning the extent, composition and amount of business value in an operating hotel. There is no substantive or fundamental disagreement, however, over the fact that the process of valuing the net operating income stream of an operating hotel produces an estimate of going concern value. From that figure, the non-realty elements must be deducted in order to derive an estimate of the market value of the hotel real property/realty.

(Ex. 1, p. 52, citing William N. Kinnard, "Intangible Assets in an Operating First-Class Downtown Hotel," *The Appraisal Journal* (January 2001).) The Board finds that some amount of intangible asset value is inherent in the valuation of hotel properties based on the income approach.

Of concern to the Board is how each party attempted to properly remove the value associated with intangible assets to produce a reliable indication of the value of the real property for tax purposes. There are several methods that can be employed by appraisers to estimate and deduct value related to intangible assets.

Methods for estimating the value of intangible assets were presented in *"Understanding Intangible Assets and Real Estate: A Guide for Real Property Valuation Professionals,"* IAAO Special Committee On Intangibles, November 12, 2016. Standard appraisal methods were also outlined in Chapter 35, "Valuation of Real Property with Related Personal Property or Intangible Property." *The Appraisal of Real Estate,* pp. 703-715 (14th Edition, 2013).

One such method indicated by both sources is the use of the cost approach, as it explicitly excludes any value of intangible assets. Both experts in this case dismissed the cost approach as not applicable or credible in valuing the subject due to the difficulty in estimating depreciation from replacement cost new. The Board concurs.

Petitioner's approach was identified as an "income residual technique." (Ex. 1, p. 54.) The appraiser first estimated the total net operating income to the going concern at $3,950,800; then, income was attributed to the non-realty items for return *of* and return *on* investment. Mr. Brooks described this approach as follows:

> The most straightforward method is a single deduction from income attributed to total assets of the business (I_{TAB}) based on an annual amortization amount that combines return *on* and return *of* investment (conceptually similar to a mortgage payment – the lender makes a loan with the expectation of receiving the full amount back, plus an acceptable return on that amount - interest and recapture of principal). It is important to note that this method involves deductions from going concern income—not real property income—they avoid the potential for "double-counting."

(Ex. 1, p. 73, emphasis added, internal citations and emphasis omitted.) Mr. Brooks applied this methodology to estimate the contributory value of furniture, fixtures, and equipment ("FF&E"), business start-up costs, brand name affiliation, and residual intangibles.

In developing net operating income, Petitioner makes a deduction for reserves for replacement, identified in the *PwC Real Estate Investor Survey* as "An allowance that provides for the periodic replacement of building components, and furniture, fixtures, and equipment, which deteriorate and must be replaced during the building's economic life." (Ex. 1, p. 70.) The annual reserves for replacement applied for hotels is significantly higher than what is applied to most other types of real estate, as the hospitality business is impacted by deficiencies in FF&E and other short-lived items. There is excessive wear and tear on hotel real estate and personal property due to the public nature of this type of real estate. A similar deduction was made by Respondent. The Board finds this type of deduction typical when appraising hotel properties.

To determine the deduction for FF&E from net operating income to the going concern, Mr. Brooks analyzed the *2017 Franchise Offering Circular for Renaissance* flagged hotels. He estimated total cost new to furnish and equip the subject hotel at $10,692,900. At an estimated percent good of 40%, the depreciated value of the FF&E was calculated as $4,277,200. (Ex. 1, p. 75.)

Mr. Brooks' next step was to estimate an implied chattel mortgage rate. This technique was described as the capital cost associated with owning personal property, best represented by a chattel mortgage rate. Lacking sufficient chattel mortgage rate data, Petitioner estimated the chattel rate by starting with a hotel mortgage rate of 4.11% derived from the *ACLI Hotel Mortgage Rate 4th Quarter 2017*. This established a minimum required rate of return, to which a premium of 200 to 500 basis points could be added to recognize the perceived risk of personal property versus real property. Mr. Brooks added 250 basis points to the mortgage rate of 4.11%, which resulted in an implied chattel mortgage rate of 6.61%. Applied to the depreciated value of FF&E over an 8-year amortization period produced a reduction in income of $705,500 for return *of* and return *on* FF&E. (Ex. 1, p. 76.)

Business start-up costs can include assembling and training of staff, management, and an administration team; regulatory compliance; set-up of accounting and other business systems; pre-opening marketing; and initial operating losses. To estimate the deduction for business start-up costs, Mr. Brooks relied on the "*Renaissance 2017 Franchise Disclosure*" document. Start-up costs were estimated at $5,486,400, which was amortized over a 20-year period. An annual rate of 7.61% was derived by adding 100 basis points to the FF&E rate of 6.61%. The deduction to net operating income of the going concern for business start-up costs was estimated at $542,700. (Ex. 1, p. 77.)

Mr. Brooks considered the existence of intangible value associated with the subject's brand name, or sometimes referred to as "flag". To determine the amount of this adjustment, Mr. Brooks considered any RevPAR premium for the subject compared to comparable hotel operations. He also considered the penetration rates of the competitive set compared to the subject. Mr. Brooks applied an adjustment equal to 10% of his concluded net operating income, calculating a deduction of $395,100 for contributory intangible value of the "flag." Mr. Brooks calculated net operating income to the real estate at $2,307,500. (Ex. 1, pp. 78-81.)

After deductions from income for FF&E, business start-up costs, and brand name, Mr. Brooks considered a deduction for residual intangibles. Mr. Brooks describes the deduction for residual intangibles as "comparatively minor." (Ex. 1, p. 80.) The report notes that because "individual identification and quantification of market-typical intangibles is more difficult to isolate, their elimination is achieved by adjusting the overall capitalization rate [applicable to only the real property] upward to reflect its inclusion." (Ex. 1, p. 80.) Mr. Brooks estimated a 10% residual adjustment by adding 80 basis points to the concluded capitalization rate. (Ex. 1, pp. 80-81.) As calculated by the Board, this adjustment resulted in Petitioner's proposed reduction in value of $3,183,000 ($31,827,586 - $28,644,828 = $3,182,758).

In his final calculation of value, Mr. Brooks identified a capitalization rate for the real estate of 7.25%. He then added 80 basis points to account for residual intangible assets, along with 3.9646% for the effective tax rate, to conclude to a total capitalization rate of 12.0146%. Applied to the adjusted net operating income produced a value to the real estate of $19,200,000 or $82,759 per room.

Petitioner relied on a methodology that lacks qualitative factual data. Mr. Brooks notes in his own report (Ex. 1, p. 74) that

> An appropriate capital cost associated with owning personal property is best represented by a chattel mortgage rate. However,

> lacking sufficient chattel mortgage rate data, such a rate can be estimated by starting with a hotel mortgage rate—which establishes a minimum required rate of return — to which a premium of 200 to as much as 500 basis points is then added, to recognize the perceived risk of personal property versus real property.

Petitioner provided insufficient evidence to support the adjustment of 250 basis points, which was then reapplied and compounded with upward adjustment for subsequent deductions.

Appraisers frequently rely on market data extracted from sales, investor surveys, and interviews with market participants. In order for any adjustment to be persuasive in a factual finding of value, it should be founded on reliable data. Petitioner's basis point adjustments were not supported by factual data and therefore were not persuasive.

The Board was not persuaded that a deduction for business start-up costs was relevant in the case of the subject. Business start-up costs such as the assembling and training of staff, management, and an administration team; regulatory compliance; accounting and other business systems; pre-opening marketing; and initial operating losses; among other components have little relevance to a property that had been in operation for 16 years as of the date of value and was managed by an outside management company.

The Board was convinced that Petitioner made deductions for aspects of intangible assets not actually owned by the same ownership of the real estate. In making deductions for intangible assets, "it is important to identify not only those assets but also their owners. Thus, the owner of a franchised hotel does not own the name licensed by the franchisor but pays a fee for its use. The sale of that property does not include rights to the franchised name." (Ex. B, p. 4.)

The concept is further explained in Appraisal Institute, *The Appraisal of Real Estate,* p. 712 (14th ed. 2013):

> By removing management fees and franchise fees from the revenue, appraisers reason that the influence of intangible assets has been eliminated. This approach maintains that the offices, staff, salaries, and overhead associated with management of the hotel reside not with the owner of the real property but with the company that manages and operates the hotel for the owner of the real property. Advocates of this approach state that because the management fee compensates the management company for those expenses, including staffing the hotel, the value of any intangible assets is removed, and any remaining net income is attributable to the real property. Advocates further state that, in the case of

> branded hotels, removal of the franchise fee eliminates intangible assets attributable to the brand and the final result represents only the value of the real and tangible personal property.

The Board was convinced that Petitioner's methodology overstated the value of intangible assets of the subject. The Board did not find Petitioner's deduction for business start-up costs reasonable given the 16-year operating history of the subject. Petitioner's deductions to income for brand affiliation, which is licensed by the franchisor, was already reflected in the franchise fee expense deducted in the development of net operating income to the going concern. Petitioner's deduction for residual intangibles, although described by Petitioner as "comparatively minor," in fact resulted in a sizable 10% reduction in value.

To account for intangible asset value, Respondent relied on what was identified as the "management fee method," commonly referred to as the "Rushmore Method" in the appraisal industry. This method relies on the deduction of a management and franchise fee as an expense in the calculation of net operating income. It also requires a deduction of a reserve amount inclusive of replacement of FF&E, as well as a deduction of the depreciated value of the personal property from the concluded value of the real property.

In his analysis, Mr. Linné calculated net operating income of $5,071,988 and applied a capitalization rate of 12%, after inclusion of the effective tax rate. (Ex. A, p. 142.) After deduction for personal property based on what was reported to the Assessor, at $1,674,140, his analysis produced a value indication of $40,000,000 within the income approach. The Board finds that Respondent did in fact consider and make a deduction for intangible assets by taking an expense of 8.5% of total revenue for the management and franchise fees within the income approach.

The Board was convinced that use of the management fee method, also known as the "Rushmore Approach," named after Stephen Rushmore, is widespread within the appraisal industry, and is the methodology taught by the Division of Property Taxation (DPT) for assessment purposes. This methodology involves making a deduction from income for both a management fee and franchise fee. Market data indicates a narrow range for both fees, which are also supported by agreements that can be provided by individual hotel ownership. The Board finds use of the management fee method (or Rushmore method) compelling as an appraisal approach to eliminate intangible asset value and determine the taxable value of real estate for hotel properties.

II. <u>Use of the Sales Comparison Approach</u>

Respondent's witness developed and gave consideration to both the sales comparison and income approaches to estimate value. While hotel investors typically do not use the sales comparison approach in their evaluation of a potential asset, the sales comparison approach can be used to establish a range of potential values or as a test of reasonableness to the income approach. In this case, the Board finds that the sales comparison approach is only relevant as a test of reasonableness of the value indicated by the income approach.

Petitioner provided no sales and gave no consideration to the sales comparison approach. Respondent considered five sales of lodging properties that transacted within the base period, from January 2017 to June 2018. The hotels sales had between 85 and 370 rooms, bracketing the subject for size. Prior to adjustment, the sales indicated a price range of $105,000 to $189,189 per room for the real estate only, after deduction for any personal property or intangible business value. After adjustment, the data indicated a value range of $126,005 to $189,189 per room, with a mean of $155,180 per room and a median of $156,220 per room. (Ex. A, p. 185.) Petitioner's requested value of $19,200,000 represented a unit value of $82,759 per room, which is significantly (34% to 56%) below the indicated range. The Board finds that Petitioner's concluded value in the income approach does not meet the test of reasonableness based on a comparison of sales.

Based on the evidence presented, the Board finds that Petitioner presented insufficient probative evidence and testimony to prove that the subject property was incorrectly valued for tax year 2019.

ORDER

The petition is denied.

APPEAL RIGHTS

If the decision of the Board is against Petitioner, Petitioner may petition the Court of Appeals for judicial review according to the Colorado appellate rules and the provisions of Section 24-4-106(11), C.R.S. (commenced by the filing of a notice of appeal with the Court of Appeals within forty-nine days after the date of the service of the final order entered).

If the decision of the Board is against Respondent, Respondent, upon the recommendation of the Board that it either is a matter of statewide concern or has resulted in a significant decrease in the total valuation of the respondent county, may petition the Court of Appeals for judicial review according to the Colorado appellate rules and the provisions of Section 24-4-106(11), C.R.S. (commenced by the filing of a notice of appeal with the Court of Appeals within forty-nine days after the date of the service of the final order entered).

In addition, if the decision of the Board is against Respondent, Respondent may petition the Court of Appeals for judicial review of alleged procedural errors or errors of law within thirty days of such decision when Respondent alleges procedural errors or errors of law by the Board.

If the Board does not recommend its decision to be a matter of statewide concern or to have resulted in a significant decrease in the total valuation of the respondent county, Respondent may petition the Court of Appeals for judicial review of such questions within thirty days of such decision.

Section 39-8-108(2), C.R.S. (2019).

DATED and MAILED this 11th day of May, 2020.

BOARD OF ASSESSMENT APPEALS

Drafting Board Member:

Sondra W. Mercier

Concurring Board Member:

Gregg Near
Concurring without modification pursuant to § 39-2-127(2), C.R.S.

I hereby certify that this is a true and correct copy of the decision of the Board of Assessment Appeals.

Jacqueline Lim

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