BEFORE THE STATE BOARD OF EQUALIZATION
ASSESSMENT APPEALS COMMISSION

In Re: HH HPTMI II Properties Trust
a/k/a Nashville Airport Marriott
Real Property
Map 107-00-0, Parcel 113.00
Tax Years 2002-2003

STATEMENT OF THE CASE

This is an appeal of the Initial Decision And Order entered June 10, 2004 by the State Board of Equalization. A Notice of Appeal was timely filed on July ___, 2004.

For tax years 2002 and 2003, the Assessor for Metropolitan Nashville and Davidson County ("Assessor") valued the subject property at $22,251,500. HH HPTMI II Properties Trust ("Taxpayer") appealed the Assessor's valuation to the Metropolitan County Board of Equalization. The County Board of Equalization affirmed the Assessor's valuation and found that the values for each tax year were as follows:

Land Value	Improvement Value	Total Value
$3,923,000	$18,328,500	$22,251,500

Taxpayer appealed this decision to the State Board of Equalization. Administrative Judge Mark J. Minsky conducted a hearing on May 4, 2004. At the hearing, the Assessor argued that the subject property should be valued at $27,100,000 for 2002 and $22,700,000 for 2003. Taxpayer contended that the values should be $13,200,000 and $15,300,000 for the respective tax years. Judge Minsky issued an Initial Decision and Order on June 10, 2004 adopting the Taxpayer's position and relying on the appraisal report and testimony of Taxpayer's expert, David C. Lennoff.

STATEMENT OF ISSUE

The issue in this case is whether the Administrative Judge erred in accepting the methodology of the Taxpayer's expert in allocating the total value of the subject property between real property and intangible and tangible personal property. Also relevant to a resolution of this issue is the Judge's adoption of and favorable citation of Course 800 of the Appraisal Institute. Since the date of the Judge's Decision, the Appraisal Institute has suspended Course 800, issued a disclaimer to the use of Course 800 and instituted a study to determine whether Mr. Lennoff's methodology should be accepted as an appropriate valuation methodology.

FACTS

Judge Minsky adopted the Taxpayer's expert's methodology (the Lennoff Method") for separating the value of real property from the total value of the going concern or business. The Lennoff Method may be summarized as follows:

1. Determine the "stabilized" net operating income ("NOI") of the going concern (excluding real estate tax). In making this determination, Mr. Lennoff applied the following approach:
    a. Project Gross Revenues
    b. Deduct from Gross Revenues
        i. Departmental Expenses
        ii. Undistributed Expenses (including all general and administrative expenses, expenses for operation and maintenance, utilities and marketing)
        iii. Management and Franchise Fees (including Marriott's system (franchise) fees and an assumed allowance of 3% of Gross Revenues to account for self-management)
        iv. Fixed Expenses (including a Replacement Allowance for FF&E equal to 5% of Gross Revenues)
2. Reduce the NOI by the "Return on/of FFE."
3. Reduce the NOI by the "Return on/of Start-Up Costs."
4. Reduce the NOI by the "Marriott/Subject-Specific Residual Intangibles."
5. Divide the balance of the NOI by a capitalization rate (real estate tax loaded).
6. Because Mr. Lennoff assumed that the stabilized NOI would not be achieved until a future year, Mr. Lennoff discounted the stabilized income by 13% for tax year 2002 and 12.75% for tax year 2003.
7. Add the projected NOI from real estate for the year of the appraisal reduced by the real estate taxes paid. Although Mr. Lennoff values the real estate at substantially less that the Assessor, Mr. Lennoff's reduction for real estate taxes is based on the assessed taxes rather than the lower taxes he asserts to be due and payable.

For purposes of this appeal (but without conceding their correctness), we assume that the Gross Revenues, Departmental Expenses, Undistributed Expenses and capitalization rates proposed by Mr. Lennoff are correct.

ARGUMENT

Mr. Lennoff's methodology is a mathematically concocted method for shifting value rightly attributable to the real property component of total value of the going concern to other components. The Appraisal Institute has recognized that this methodology may be materially flawed by its suspension of Course 800 and reconsideration of the methodology. This factor alone should cause the Commission to

carefully review Judge Minsky's Decision because it is totally based upon this flawed methodology. This brief will discuss six major errors in the Lennoff's Methodology.

1. ***Self-Management Fee:*** In determining NOI as a going concern, Mr. Lennoff deducts Franchise and Management Fees. The reduction for Marriott system franchise fees is certainly appropriate. Mr. Lennoff also deducts an amount equal to 3% of Total Revenues as a "market-typical management fee" because the subject property is self-managed. The expenses of management are clearly reflected in the Undistributed Expenses. To deduct the salaries, benefits and costs associated with self-management as an Undistributed Expense and also deduct an additional assumed amount based upon the assumed typical costs of outside management is simply double counting the same expense. Thus, the computation of NOI as a going concern should be increased in the amount of $488,135 $516,011, and $515,609 for the years 2002, 2003, and 2004 respectively.

2. ***Deduction for Return on/of FFE:*** Mr. Lennoff applies two separate deductions from income to reflect the income attributable to FF&E and the value of the FF&E itself. First, Mr. Lennoff provides for a Replacement Allowance in determining Fixed Expenses. He thus reduces NOI by 5% of Gross Revenues (over $800,000) in each of the tax years. In addition, Mr. Lennoff makes a separate and additional deduction from NOI for the Return on/of FF&E. To determine this amount, Mr. Lennoff piles assumption upon assumption. He adopts Marriott's estimate of the costs of outfitting a new property ($7,537,700). Next, he assumes that the subject property's FF&E is valued at 40% of the Marriott estimate ($3,029,480). Finally, he assumes a useful life of eight (8) years and a chattel mortgage rate of 10.44% (based upon 250 basis points above the average hotel mortgage rate for 2001). He concludes that based upon the various estimates, assumptions and averages, NOI should be reduced by $576,985 each year. This approach substantially overstates the income statement and balance sheet realities.

It is widely accepted that the income attributable to FF&E in a hotel context may be approximated at 3-5% of Gross Revenues. Mr. Lennoff has chosen the upper end of the acceptable range to compute the Replacement Allowance. A more reasoned approach for a property of this type would be 4% of Gross Revenues. Thus, Mr. Lennoff's determination of NOI should be increased by approximately $165,000 each year.

Having thus recognized the income attributable to the FF&E, the remaining step is to remove the value of the FF&E itself. Based upon Mr. Lennoff's capitalization rates of 12.037317% and 11.7404% respectively, the Lennoff Methodology values the FF&E at $4,793,302 and $4,914,525 for the respective tax years. This amount is $1,700,000-1,900,000 more than Mr. Lennoff's own assumption of $3,029,480 as the value of FF&E and approximately $4,000,000 more than the amount reported under oath by the taxpayer in its personal property tax returns for the subject years.

The correct methodology for reflecting the value attributable to the FF&E is to reduce NOI by 4% of Gross revenues to remove the income attributable to the FF&E and either (a) use Mr. Lennoff's methodology with the correct FF&E value as reported by

the taxpayer to reduce NOI ($600,000 of reported value amortized over 8 years at 10.44% results in a $114,274 reduction in NOI rather than a $$576,985 reduction as asserted by Mr. Lennoff), or (b) after applying the capitalization rate to determine the value of the realty and personalty, simply subtracting the value upon which the Taxpayer paid personal property taxes for the years in question. The Lennoff Methodology creates a new category of untaxed property, i.e. the difference between the personal property valued reported by the Taxpayer and the value Mr. Lennoff's concocts to deduct from the value of the property for real estate tax purposes. Here that untaxed amount would be $4,000,000.

3. ***Deduction for Start-Up Costs:*** Applying an amazing feat of mathematical prestidigitation, Mr. Lennoff suggests that NOI should be reduced by the amortization of start-up costs. First, Mr. Lennoff assumes the 2002 Marriott Franchise Offering Circular's estimate of start-up costs for new hotels being constructed in 2002. There is no evidence that this start-up cost was incurred by the subject property. If any start-up costs were incurred, they were incurred in 1981, more than twenty (20) years before the effective date of this valuation. Next, Mr. Lennoff amortizes this amount over twenty (20) years. If there were start-up costs, and if it is proper to amortize them over twenty (20) years, the amortization was completed in 2001 and nothing was left to amortize in 2002 or 2003. To suggest that each year NOI should be reduced by a phantom amount based upon start-up costs for 2002 on a twenty-year old property is simply a concocted deduction.

More basic is Mr. Lennoff's misunderstanding or intentional disregard of the realities of hotel operation and management. As Mr. Lennoff points out the hotel industry is a series of limited rental periods, rather than long-term leases. The expenses of the repairs, maintenance, training, supplies and other items reflected in start-up expenses are not only start-up costs, but also continuous expenditures. These expenses are already reflected in the costs of the franchise, management, personnel, marketing, advertising, and supplies deducted as part of the Departmental, Undistributed and Fixed Expenses of the property. To amortize costs that were long ago expensed by the property is clear double counting, nothing more. Thus, no deduction for the amortization of start-up costs is appropriate, and NOI must be increased by $695,452 each year.

4. ***Deduction for Marriott/Subject-Specific Residual Intangibles:*** As with other items, Mr. Lennoff invents a clever way to achieve double counting of expenses. Here, Mr. Lennoff posits that NOI must be further reduced by 5% of Operating Income to reflect the "Marriott [and subject]-specific intangibles.' To justify this deduction, Mr. Lennoff states that revenues have been enhanced by the Marriott brand name affiliation and "everything it embodies, as evidenced by marketplace preference relative to competing brands." Certainly the Marriott brand is valuable and results in increased revenue for the subject property. Marriott is aware of this value and charges an arms-length franchise fee for the right to use its brand. That franchise fee is clearly deducted in determining the NOI, as evidenced by the deduction of the Marriott system fees. No further reduction for this amount is required. Similarly, the subject property is required by Marriott to maintain certain standards for facilities and service. The cost of

maintaining these standards is reflected in the costs of operation. The further reduction of NOI proposed by Mr. Lennoff is double counting, employed by Mr. Lennoff to artificially reduce NOI and ultimate value. NOI should be increased by $137,712 and $155,888 for 2002 and 2003 respectively.

5. ***Discount Rate:*** Mr. Lennoff seems to have difficulty in deciding which year represents "a stabilized" year. In determining the value at January 1, 2002, he states that 2002 is a "ramp-up" year and 2003 is a 'stabilized year." However, when he turns to a valuation at January 1, 2003, 2003 becomes the ramp-up year and 2004 becomes the stabilized year. Assuming for the moment that there is a reasonable explanation for this vacillation, Mr. Lennoff's choice of a discount rate to present value the "future value" is unbelievably high. Without explanation, he chooses 13% to present value 2003 values back to 2002 and 12.75% to discount 2004 values back to 2003. These discount rates have been arbitrarily selected in the lowest interest rate environment in history.

In the period December 2001 through January 2003, the prime rate was between 4 and 4.75%; the thirty-year mortgage rate was between 5.9% and 7.07%; the 6-month Treasury rate was between 1.23% and 1.77 %, and the six-month certificate of deposit rate was between 1.32% and 1.93%. In each case the rates fell during the period. How then can 12.75-13% possibly be the one-year discount rate? It can't. If Mr. Lennoff's methodology is applicable at all, this rate must be reduced to a range of 6-8%.

6. ***Deduction for Real Estate Taxes:*** In applying his methodology, Mr. Lennoff makes another error, an error that demonstrates his intent to construct the smallest possible value by whatever means possible. On pages __ and __ of his report, he concludes his valuations for the respective tax years. For 2002, he capitalizes the "stabilized" income for 2003 to determine the value at January 1, 2003, then discounts that value to January 1, 2002 using an exaggerated discount rate as pointed out above. To this amount he adds the NOI attributable to real estate for 2002, reduced by the real estate taxes for 2002 ($407,647). A similar calculation is applied to determine the value of the subject property at January 1, 2003.

In making these calculations, Mr. Lennoff incorrectly deducts the real estate taxes based upon the Assessor's determination of value ($22,251,500), not Mr. Lennoff's valuation ($13,200,000 for 2002 and $15,300,000) for 2003. If Mr. Lennoff's valuations are to be accepted, the deduction for real estate taxes must reflect Mr. Lennoff's valuation. To do so will result in a reduced deduction in the range of $246,000 to $262,000.

Summary of Results: Assuming Mr. Lennoff's basic methodology, estimates of revenues and expenses are utilized, but that the adjustments discussed in the six numbered paragraphs above are made consistent with the Assessor's position, the reconstructed valuations may be summarized as follows:

Item	2002	2003	2004
Total Revenue	16,271,150	17,200,371	17,186,967
Less: Departmental Expenses	6,755,652	7,052,960	6,958,367
Less: Undistributed Expenses	4,266,560	4,397,900	4,397,900
Gross Profit	5,248,938	5,749,511	5,830,700
Less Management/Franchise Fees Without 3% Self-Management Fee	754,012	796,178	801,327
Less Fixed Expense Without Replacement Allowance Reflected in Return on FF&E	439,000	453,170	441,819
NOI to Going Concern	4,055,926	4,500,163	4,587,554
Return on FF&E 4% of Gross Revenue	650,846	688,015	687,479
Return of FF&E ($600,000 amortized over 8 years at 10.44%)	114,274	114,274	114,274
Return of/on Start-Up Costs	0	0	0
Marriott-Subject Specific Intangibles	0	0	0
NOI Attributable to Realty and Tangible Personalty	3,290,806	3,697,874	3,785,801

Tax Year 2002 [applying Lennoff Methodology]:

- Capitalize 2003 "stabilized" income at 12.037317% = $30,628,857.
- Discount at 6% = $28,791,126.
- Add 2002 income of $3,290,806 reduced by real estate taxes of $407,647
- Value at January 1, 2002. = $31,674,285

Tax Year 2003:

- Capitalize 2004 "stabilized" income at 11.7404% = $32,245,929.
- Discount at 6% = $30,311,173
- Add 2003 income of $3,785,801 reduced by real estate taxes of $407,647.
- Value at January 1, 2003 = $33,601,400

Conclusion:

The Lennoff Methodology adopted by the Administrative Judge is flawed as described above. Accepting for purposes of argument Mr. Lennoff's determination of Gross Revenues, Departmental Expenses, Undistributed Expenses, Management and Franchise Expenses (adjusted as described in paragraph 1 above), Fixed Expenses (except that Replacement Allowance is computed at 4% of Gross Revenue, rather than 5%) and tax loaded capitalization rates, but ignoring Mr. Lennoff's concocted deductions for Return on/of F&E, Return on/of Start-Up Costs, and additional deduction for the Marriott related intangible, and modifying the discount rate to reflect market conditions, the value of the subject property was $31,674,285 and $33,601,400 for the tax years 2002 and 2003 respectively.

While the Administrative Judge did not consider the replacement cost method for valuing the subject property, the credibility of the Taxpayer's position may be tested by considering the Taxpayer's valuation of the improvements to real estate on a per square foot basis. Since the Judge and the Assessor agree that the land is valued at $3,923,000, Mr. Lennoff values the improvements at $9,277,000 for 2002 and $11,377,000 for 2003. Does the Taxpayer really contend that the real property improvements of an 18-story, 398-room, Marriott branded hotel at the Nashville Airport are valued at between $35.79 and $43.89 per square foot? Certainly, the Assessor's valuation of between $ 70.71 and $89.42 per square feet more accurately reflects the true value.