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THE TAX COURT COMMITTEE ON OPINIONS

TAX COURT OF NEW JERSEY

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Re: BRE Prime Properties, LLC v. Borough of Hasbrouck Heights
Docket Nos.: 005271-2010 & 005644-2011

Dear Counsel:

This letter serves as the court's opinion after trial in the above-referenced matter upon complaint challenging the assessments on plaintiff's property for the 2010 and 2011 tax years. For the reasons set forth below, the assessment for each year will be reduced.

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I. Findings of Fact and Procedural History

BRE Prime Properties, LLC ("plaintiff") is the owner of real property located at 650 Terrace Avenue in the Borough of Hasbrouck Heights, New Jersey ("defendant"). The property is designated by defendant as Block 135.02, Lot 14 ("subject property"). For tax years 2010 and 2011, the subject property was assessed as follows:

Land:	$4,800,000
Improvements:	$33,203,000
Total:	$38,003,000

The Director's (chapter 123) ratio for Hasbrouck Heights was 97.35% for tax year 2010 and 101.76% for tax year 2011. Plaintiff filed timely direct appeals with the Tax Court contesting the local property assessment on the subject property for tax years 2010 and 2011. Defendant did not file counterclaims. The matter proceeded to trial, which took place over the course of three days. The court gave the parties the opportunity to submit post-trial briefs after the close of trial. The following findings of fact are based on the testimony of the trial witnesses and from the evidence accepted into the record.

The subject property is a full service "Hilton Hotel." The land is of irregular shape and comprises approximately 7.54 acres. It is accessible from Terrace Avenue and also fronts Route 80. The site is supplied with all utilities. It is located in the B-1 highway commercial zone, and it has been, and continues to be, utilized for its permitted use.

The subject's site is improved with a 355-room hotel facility consisting of various sizes and suites. The subject is also improved with an executive meeting center and

lounge, rooftop ballroom, full-service restaurant, on-site fitness center, and outdoor swimming pool. Located within the subject are four passenger elevators and one service elevator. There is a sprinkler system throughout the improvements. The hotel was built in the early 1970's. Renovations to the guest rooms are part of a reoccurring program to maintain the upkeep of the hotel; however, in 2005, renovations occurred including, but not limited to, the executive conference center and the hotel lobby. During the tax years in question, Hilton Management Corporation, who receives compensation for the services provided, managed the subject.

Each party presented an appraiser to be qualified as an expert at trial and the court accepted each appraiser as an expert in the field of real property valuation. The experts agreed that the highest and best use of the subject property is the current use, that of a full service hotel, to which the court concurs. In developing their opinions of value, both experts relied solely upon the income approach to valuation. Since the estimated stabilized annual net income before real estate taxes of a hotel includes the contribution of assets other than assessable real property, both experts utilized the "Rushmore method", a recognized and accepted technique in the appraisal of hotels, to eliminate the contribution of non-real estate assets to their estimate of net operating income from hotel operations in arriving at their conclusions of value.

In the opinion of plaintiff's expert, the subject property had a true market value of $25,600,000 for tax year 2010 and $25,700,000 for tax year 2011. Defendant's expert opined the subject's true market value was $36,998,000 for tax year 2010 and $40,257,000 for tax year 2011.

II. Conclusions of Law

A. Presumption of Correctness

The court's analysis begins with the well-established principle that "[o]riginal assessments and judgments of county boards of taxation are entitled to a presumption of validity." MSGW Real Estate Fund, LLC v. Borough of Mountain Lakes, 18 N.J. Tax 364, 373 (Tax 1998). As Judge Kuskin explained, our Supreme Court defined the parameters of the presumption as follows:

> The presumption attaches to the quantum of the tax assessment. Based on this presumption the appealing taxpayer has the burden of proving that the assessment is erroneous. The presumption in favor of the taxing authority can be rebutted only by cogent evidence, a proposition that has long been settled. The strength of the presumption is exemplified by the nature of the evidence that is required to overcome it. That evidence must be "definite, positive and certain in quality and quantity to overcome the presumption."
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> [Ibid. (quoting Pantasote Co. v. City of Passaic, 100 N.J. 408, 413 (1985).]

The presumption of correctness arises from the view "that in tax matters it is to be presumed that governmental authority has been exercised correctly and in accordance with law." Pantasote, supra, 100 N.J. at 413 (citing Powder Mill, I Assocs. v. Township of Hamilton, 3 N.J. Tax 439 (Tax 1981)); Township of Byram v. Western World, Inc., 111 N.J. 222 (1988). The presumption remains "in place even if the municipality utilized a flawed valuation methodology, so long as the *quantum* of the assessment is not so far removed from the true value of the property or the method of assessment itself is so patently defective as to justify removal of the presumption of validity." Transcontinental Gas Pipe Line Corp. v. Township of Bernards, 111 N.J. 507, 517 (1988) (citation omitted).

"The presumption of correctness … stands, until sufficient competent evidence to the contrary is adduced." Township of Little Egg Harbor v. Bonsangue, 316 N.J. Super. 271, 285–86 (App. Div. 1998) (citations omitted); see also Atlantic City v. Ace Gaming, LLC, 23 N.J. Tax 70, 98 (Tax 2006). "In the absence of a R. 4:37–2(b) motion ... the presumption of validity remains in the case through the close of all proofs." MSGW Real Estate Fund, LLC, supra, 18 N.J. Tax at 377. In making the determination of whether the presumption has been overcome, the court should weigh and analyze the evidence "as if a motion for judgment at the close of all the evidence had been made pursuant to R. 4:40–1 (whether or not the defendant or plaintiff actually so moves), employing the evidentiary standard applicable to such a motion." Ibid. The court must accept as true the proofs of the party challenging the assessment and accord that party all legitimate favorable inferences from that evidence. Id. at 376 (citing Brill v. Guardian Life Ins. Co. of Am., 142 N.J. 520, 535 (1995)). To overcome the presumption, the evidence "must be 'sufficient to determine the value of the property under appeal, thereby establishing the existence of a debatable question as to the correctness of the assessment.'" West Colonial Enters., LLC v. City of East Orange, 20 N.J. Tax 576, 579 (Tax 2003) (quoting Lenal Props., Inc. v. City of Jersey City, 18 N.J. Tax 405, 408 (Tax 1999), aff'd, 18 N.J. Tax 658 (App. Div. 2000), certif. denied, 165 N.J. 488 (2000)). Only after the presumption is overcome with sufficient evidence at the close of trial must the court "appraise the testimony, make a determination of true value and fix the assessment." Rodwood Gardens, Inc. v. City of Summit, 188 N.J. Super. 34, 38–39 (App. Div. 1982) (citations omitted). If the court determines that sufficient evidence to overcome the presumption has not been produced, the assessment shall be affirmed and the court need

not proceed to making an independent determination of value. Ford Motor Co. v. Township of Edison, 127 N.J. 290, 312 (1992); Global Terminal & Container Serv. v. City of Jersey City, 15 N.J. Tax 698, 703–704 (App. Div. 1996).

The court finds that plaintiff produced sufficient evidence to overcome the presumption of validity attached to the assessment. If taken as true, the opinion of plaintiff's expert and the facts upon which he relied create a debatable question regarding the correctness of the assessment sufficient to allow the court to make an independent determination of the value of plaintiff's property.

Of course, a finding that plaintiff has overcome the presumption of correctness does not equate to a finding that the assessment is erroneous. To the contrary, plaintiff's overcoming the presumption merely permits the court to address the question of what value should be accorded to the subject property. Once the presumption is overcome, the "court must then turn to a consideration of evidence adduced on behalf of both parties and conclude the matter based on a fair preponderance of the evidence." Ford Motor Co., supra, 127 N.J. at 312 (quotations omitted). "[A]lthough there may have been enough evidence to overcome the presumption of correctness at the close of plaintiff's case-in-chief, the burden of proof remain[s] on the taxpayer throughout the entire case ... to demonstrate that the judgment under review was incorrect." Id. at 314–15 (citing Pantasote, supra, 100 N.J. at 413).

B. Valuation

It is well settled that the valuation of income-producing properties is predominantly determined by using the preferred income capitalization approach. Parkview Vill. Assocs. v. Borough of Collingswood, 62 N.J. 21, 23

(1972). Under the income approach, "an appraiser analyzes a property's capacity to generate future benefits and capitalizes the income into an indication of present value." The Appraisal of Real Estate, 445 (13th ed. 2008). The steps involve estimating the property's gross rental income, which should reflect the market rents, then deducting an allowance for vacancy and collection loss resulting in effective gross income. Thereafter, operational expenses are deducted, resulting in net income, which is capitalized to arrive at the property's value to an investor. Lamm Assocs. v. Borough of West Caldwell, 1 N.J. Tax 373, 377 (Tax 1980).

In valuing a hotel, Judge Pizzuto stated:

> [T]he income that the property owner received is not income from the rental of the real estate, but rather the net income of a business conducted at the facility. Therefore, the valuation of the fee simple interest in the real property by capitalization of income is a more complicated exercise than it is in cases where there is a lease of real estate to the operator of a business. It requires the separation of the income attributable to the use of the realty out of the total income generated by the operation of the business before capitalization of the realty income.
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> [Chesapeake Hotel LP v. Twp. of Saddle Brook, 22 N.J. Tax 525, 527-28 (Tax 2005)].

Both experts in this case separated the income attributable to the use of the realty out of the total income generated by the operation of the hotel before capitalization. Referred to as the "Rushmore method," the approach that the experts utilized here has been employed by experts in other hotel valuation cases and followed in reported decisions before the New Jersey Tax Court. See e.g. Chesapeake Hotel LP, supra, 22 N.J. Tax 525; Prudential Ins. Co. v. Parsippany-Troy Hills Twp., 16 N.J. Tax 58 (Tax 1995), aff'd, 16 N.J. Tax 148 (App. Div. 1996); Westmount Plaza v. Parsippany-Troy Hills Twp., 11 N.J. Tax 127 (Tax 1990); see also City of Atlantic City v. Ace Gaming,

LLC., 23 N.J. Tax 70 (2006) (the first time that the Tax Court applied the methodology to a casino hotel as opposed to a conventional hotel).

The Rushmore methodology was explained by Judge Pizzuto as follows:

> Rushmore considered that all payments to the entity that manages and operates the hotel constitute business income generated by the exercise of management and entrepreneurship. Accordingly, he excluded these payments in the computation of realty income subject to capitalization. In addition, Rushmore considered that a portion of the overall income was realized by the employment of furniture, fixtures, and equipment (often referred to as "FF & E"). Since these items are (generally speaking) personal property rather than real estate, the income attributable to them, under Rushmore's method, is also excluded from realty income. Separate adjustments are made to provide for periodic replacement of the personal property (the return of FF & E) and also for a yield on the investment in personal property (the return on FF & E).
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> [Chesapeake Hotel LP, supra, 22 N.J. Tax at 527-28].

The court accepts the Rushmore method for valuation purposes since the subject property is improved with a full-service hotel.

"A determination of stabilized revenue and ultimately stabilized net income is necessary because, in the direct capitalization method, a single net income figure is capitalized in perpetuity to determine value." Prudential Insurance Co., supra, 16 N.J. Tax at 60. "The stabilized net income is intended to reflect the anticipated operating results of the hotel over its remaining economic life, given any or all applicable stages of buildup, plateau, and decline in the life cycle." Id. (quoting Rushmore & Rubin, The Appraisal Journal, The Valuation of Hotels and Motels for Assessment Purposes, 274 (1984)). "History has shown that, during economic downturns, hotel values do not fall in the same proportion that their declining incomes do … Appraisers, therefore, can best reflect market behavior by projecting facilities' net income to a stabilized level reflecting

renewed market stability and applying the proper discounted cash flow procedure over this time." Rushmore & Baum, The Appraisal Institute, Hotels and Motels, Valuations and Market Studies, 13 (2001).

With this background in mind, the Rushmore method contains multiple component parts that will be explained more fully below.

a. Revenues

The first step in the hotel valuation analysis is to calculate gross revenue. Gross revenue consists of three categories: guest rooms, food and beverage, and other revenue. Both experts calculated annual stabilized gross revenues for both tax years at issue as of October 1 of the preceding year.

Both experts derived gross revenue for the guest room department by multiplying the revenue per available room ("REVPAR") times the number of available rooms in the year. REVPAR was calculated by multiplying the appraiser's estimation of the average daily rate ("ADR") by the appraiser's opinion of the average occupancy percentage as of the respective valuation dates.

Plaintiff's expert calculated ADR as of October 1, 2009 and October 1, 2010 by stabilizing the actual ADR for 2009 and 2010 and considering the actual 2011 ADR to corroborate his calculation. Plaintiff's expert did not consider any data before 2009, and testified that the reason was because there was a market reset as a result of a change in economic conditions in 2008 that rendered pre-2009 data remote. Plaintiff's expert concluded ADR for both tax years to be $120. Defendant's expert calculated ADR as of October 1, 2009 and October 1, 2010 by stabilizing the average ADR from 2006-2010

and corroborating his calculation with ADR statistics for other hotels[1]. Defendant's expert concluded ADR to be $135 for 2009 and $128 for 2010.

Plaintiff's expert calculated 70% to be the average occupancy percentage for both years, while defendant's expert calculated 65% for 2010 and 70% for 2011. The average rate over the five-year span 2006-2010 was 67.8% and the actual rates in 2009 and 2010 were 63.8% and 69.1%, respectively. A sharp decline in the hotel market occurred late in 2008, and while revenues were much higher in 2006-2008 than 2009 and 2010, they began to rise in 2011, but still not as a large as the pre-2009 figures.

The court finds ADR and average occupancy rates for both 2009 and 2010 should be stabilized at a single figure for both years. The court is also aware that there was a sharp economic downturn late in 2008 resulting in lower figures moving forward. However, accepting 2009 actual figures to be indicative of the stabilized market would be to overstate the downturn. Stabilized income is defined as "income at that point in time when abnormalities in supply and demand or any additional transitory conditions cease to exist and the existing conditions are those expected to continue over the economic life of the property; projected income that is subject to change, but has been adjusted to reflect an equivalent, stable annual income." The Appraisal Institute, The Dictionary of Real Estate Appraisal, 185 (5th ed. 2010). The text also defines stabilized occupancy as "an expression of the expected occupancy of a property in its particular market considering current and forecasted supply and demand, assuming it is priced at market rent." Id.

The actual revenue figures in 2009 and 2010 were less than the average revenue in 2006-2008. The post-assessment year revenue in 2011 rose. The court will eliminate

[1] Defendant's expert presented 2008-2010 ADR figures for five comparable hotels in Bergen County and conclusions from an STR report from the Rutherford, NJ area to corroborate his ADR conclusions for 2009 and 2010.

abnormalities and stabilize revenue to reflect annual income on the dates of valuation. Therefore, the court finds $125 to be an appropriate ADR and 70% to be an appropriate average occupancy rate for both valuation dates, October 1, 2009 and 2010. The testimony, evidence, and conclusions of both ADR and average occupancy rates presented by both experts support the court's calculation[2].

The corresponding REVPAR with the court's conclusions equates to $87.50[3]. Therefore, gross revenue will be $87.50 times the 355 rooms in the hotel times 365 days. Consequentially, the court finds total gross revenue for rooms at the subject property as of October 1, 2009 and 2010 to be $11,337,800, after accounting for rounding.

Additional support for the court's conclusion is found in the data of comparable hotel properties submitted by the parties, as well as Judge Hamill's decision in Prudential Insurance Company of America v. Twp. of Parsipanny-Troy Hills, 16 N.J. Tax 58 (Tax 1995), aff'd, 16 N.J. Tax 148 (App. Div. 1996). Judge Hamill, facing a similar economic downturn, as well as ADR and average occupancy rate conclusions on both ends of the spectrum, stabilized the values to account for the market. Judge Hamill stated that given the higher average daily room rates before the valuation dates, and the slight upturn in rates post-assessment, an investor reasonably could anticipate a stabilized ADR that is not as high as the average of all the years. The court, here, followed the well-reasoned methodology of Judge Hamill based upon actual operating results at the subject, market participants' expectations, and corroboration of the post-assessment data.

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[2] The evidence presented by defendant's expert regarding comparable hotels' ADR in his report support the ADR calculated by the court. Furthermore, plaintiff's expert's report contained data from comparable hotels to support his expenses, see, fn 3, infra, which also displayed average ADR for the comparable set chosen by the expert for September 2009 to be $124.40.

[3] REVPAR equals ADR times the average occupancy percentage. In this case, REVPAR equals $125 times 70%, or $87.50.

Both experts also calculated gross revenue for the food and beverage department. Although minimal testimony was given by either expert involving this calculation, it appears that plaintiff's expert utilized the same methodology to calculate ADR and average occupancy rate as he did for the food and beverage income, while defendant's expert changed his approach by accepting actual reported revenue. Plaintiff's expert stabilized the food and beverage revenue by comparing the actual revenue at the subject for each year with the pre-assessment figures and corroborated it with the post assessment figures. Plaintiff's expert concluded $3,809,505 for food and beverage revenue, which he noted exceeded the actual performance history of the subject in both 2009 and 2010. Defendant's expert did not state their method, but seems that they utilized actual figures for 2009 and 2010 to compute the values for tax year 2010 and 2011. Defendant's expert concluded $3,688,416 for 2010 and $3,455,500 for 2011, which were the exact same actual numbers for the previous year.

The court accepts plaintiff's expert's figures as most indicative of the market for tax years 2010 and 2011. Although neither expert presented food and beverage revenues from other comparable hotels, the methodology utilized by plaintiff's expert is more reliable than defendant's expert, who simply accepted the actual revenues. Therefore, gross revenue for food and beverage income for both tax years will be $3,809,505.

The final component of total gross revenue is to calculate communications and other income. Plaintiff's expert reported actual income information from the subject broken down into three separate categories: retail operations, communication, and rent and other income. Plaintiff's expert then stabilized the number in total, and calculated $300,000 for both 2010 and 2011. Defendant's expert reported actual income

information from the subject as broken down into only two categories: communications, rent and other income. Defendant's expert then stabilized the numbers individually; however, it seems that defendant's expert once again utilized actual reported revenue as his final conclusion. Adding the two together, defendant's expert concluded $331,913 for 2010 and $237,553 for 2011, the exact same actual numbers for the previous years' reported revenue. Again, the court accepts plaintiff's expert's figures as most indicative of the market for tax years 2010 and 2011. The court also will categorize this item as other income. Therefore, gross revenue for other income for both tax years will be $300,000.

Adding the court's conclusions of gross revenue for all three categories of rooms, food and beverage, and other income, the final gross revenue for both tax years will be $15,446,305.

b. Departmental Expenses

The next step in the valuation analysis is to calculate expenses as they relate to revenue. Therefore, departmental expenses consist of three categories: guest rooms, food and beverage, and other expenses. Both experts calculated annual stabilized departmental expenses for both tax years at issue as of October 1 of the preceding year.

Plaintiff's expert calculated a stabilized expense ratio of 25% as of both effective dates of value based on the actual expense ratios in 2009 and 2010 of 23.6% and 26.5%. Plaintiff's expert calculated his 25% expense ratio for guest rooms by comparing it to the profit range since 2006, ranging between 84%-74%. This range equates to between 26%-16% for expenses of guest rooms. Plaintiff's expert explained that he chose an expense ratio towards the upper end of the range because the guest room expenses in 2006-2008

of the subject were substantially less before the economic downturn. He also corroborated his calculation with expense information from a competitive hotel for 2009 and 2010, along with statistical data from a "Host Study" published by STR[4] reflecting average departmental expense ratios for chain related full-service hotels of 25%, 25.7% for Mid-Atlantic Region, and 26% for upper upscale hotels. Defendant's expert, on the other hand, averaged guest room expenses over the five-year period 2006-2010, rounded the percentage, and accepted it as market value. Defendant's expert provided no further testimony or support for his conclusion of 21%.

The court accepts plaintiff's expert's calculation of guest room expenses as indicative of actual operating results at the subject, along with market participants' expectations. Plaintiff's expert's stabilization of the ratio was properly calculated and reflects the market based upon the evidence adduced at trial. Consequently, the court concludes that a guest room expense ratio of 25% will be utilized.

Both experts calculated food and beverage departmental expenses and communications, rent and other departmental expenses in a manner extremely similar to the way in which they calculated room expenses. Plaintiff's expert relied on a stabilized forecast giving more weight to the actual data during the years at issue, while defendant's expert stabilized the ratio by rounding the average from the five-year period 2006-2010. Plaintiff's expert found food and beverage expenses to equate to 85%, while communications, rent and other totaled a 42% expense ratio. Defendant's expert

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[4] Smith Travel Research, Inc. along with Smith Travel Research Global, Inc. track supply and demand data for the hotel industry and provide market share analysis for all major hotel chains and brands both domestically and internationally. Smith Travel Accommodations Reports (STARs) include data and trends of hotels to compare market share performance against a self-selected competitive list. See http://www.strglobal.com/about/History.aspx (last accessed August 12, 2013).

concluded 78% for food and beverage expense ratio and a 66% communications, rent and other ratio.

The court accepts plaintiff's expert's stabilization of both ratios to reflect the market. The mere averaging of the years under appeal does not take into account the sharp economic downturn late in 2008, as reflected in the market. Unlike plaintiff's expert's stabilization of room revenue, his stabilization of expenses does not overstate the downturn. The court is consistently aware of the trend that the actual figures in 2009 and 2010 were a result of the economic downturn and not as profitable as the averages in 2006-2008 or the post-assessment year data in 2011. Therefore, the court again will eliminate abnormalities and stabilize revenue and expense ratio of 85% for food and beverage department and 42% for communications, rent and other department. Support for these conclusions by the court is also reached because total departmental expenses equal roughly 40% of total revenue, which is indicative of market rates, based upon the evidence presented by both parties.

c. Undistributed Operating Expenses

The next step in hotel valuation analysis is to calculate undistributed operating expenses. Both experts calculated annual stabilized undistributed operating expenses for both tax years at issue as of October 1 of the preceding year. Plaintiff's expert categorized them as: general and administrative costs, sales and marketing, property operations, and energy. Plaintiff's expert calculated these expenses as numerical dollar figures based upon the range of actual reported figures from years 2006-2010 and stabilizing same; therefore, total undistributed operating expenses were the same for both tax years at issue. Defendant's expert categorized undistributed operating expenses as:

general and administrative, sales and promotions, maintenance, utilities, and miscellaneous. Defendant's expert calculated these expenses as a percentage of revenue by averaging the reported figures over the five year period 2006-2010 and rounding accordingly. Therefore, total undistributed operating expenses were slightly different for each tax year at issue, 2010 and 2011, because the total revenue reported for each year was different.

Plaintiff's expert's total undistributed operating expenses total for both tax years at issue was $4,475,000, or 29.8% of total revenue. Defendant's expert's total undistributed operating expenses total for both tax years at issue was 30.6% of total revenue. The court accepts plaintiff's expert's analysis and stabilization of the undistributed operating expenses; however, the figure should be reported as a percentage of total revenue similar to the fashion that plaintiff's expert calculated departmental expenses as a percentage of revenue. The mere averaging of the five-year period including the years under appeal does not take into account the sharp economic downturn late in 2008 and is also not an accepted methodology of stabilization. Consequently, the court finds that 30% of total revenue will account for total undistributed operating expenses for the subject property, during both valuation dates. This 30% figure is also supported by plaintiff's expert's STR Host Study of comparable hotels.

d. Fixed Expenses

The hotel valuation analysis needs to account for fixed expenses as they relate to the operation of a hotel. Both experts included this category in their pro-forma, but minimal testimony and evidence were adduced at trial regarding same. Interestingly, neither party briefed this category in their post-trial briefs. The only evidence the court

has before it, is both experts' reports with minimal explanation or analysis. In any event, the court must account for fixed expenses, and finds that an expense for franchise fees and insurance is appropriate. The foregoing discussion considers each issue in turn.

i. Franchise Fee

A fixed expense for franchise fee was inconsistently reported over the five-year period analyzed by both experts. The reported operating statement of the subject property during 2006-2010 indicates that a franchise fee was only reported during 2006, 2007 and 2008. In both 2009 and 2010 no franchise fee was reported. During 2006-2008, the fee ranged from 3.46-4.06% of rooms' department revenue. Plaintiff's expert did not account for a franchise fee in their pro-forma breakdown of the value of the subject property. No explanation was given. Defendant's expert indicated the inconsistent reporting over the five-year period analyzed. Defendant's expert's report stated that "based on our review of the Hilton Management Agreement[5]…the Brand Services Fee specifies that 4% of Rooms' Department revenue be payable monthly upon Manager's delivery of the monthly report. This expense will be stabilized at 4% of Rooms Department revenue."

The court accepts defendant's expert's calculation and stabilization of the franchise fee expense. The reported actual figures in 2006-2008, as well as the Hilton Management Agreement, support the 4% figure. Further support is found in plaintiff's expert's report in which there are an STK Host Study and a PFK "Trends in the Hotel

[5] On or about February 1, 2009, BRE/Prime Properties, LLC entered into a Management Agreement with Hilton Management, LLC for a 20-year term.

Industry[6]" data compilation. Both the Host Study and Figure 8 of the PFK trends report indicate that a percentage of rooms' revenue was reported for franchise fees in full-service hotels. These reports in plaintiff's expert's report corroborate the court's conclusion that a franchise fee needs to be accounted for at the subject property, despite plaintiff's expert not doing so.

ii. Insurance

A fixed expense for insurance was reported during the five-year period analyzed by both experts. Insurance costs ranged from $130,418 to $254,649 or .92-1.83% of total revenue with an average of $195,927 or 1.25% of total revenue. Defendant's expert simply accepted the five-year average of 1.25% and utilized this figure as the stabilized value for insurance costs. Plaintiff's expert, on the other hand, analyzed the range for the five-year period and gave more weight to the actual figures reported for 2009 and 2010. Plaintiff's expert calculated $175,000 as the insurance cost and corroborated that conclusion with the 2011 post-valuation date insurance figure.

The court accepts plaintiff's expert's analysis and stabilization of the insurance cost; however, the figure should be reported as a percentage of total revenue similar to the fashion that plaintiff's expert calculated departmental expenses as a percentage of revenue. The mere averaging of the five-year period including the years under appeal does not take into account the sharp economic downturn late in 2008 and is also not an

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[6] PFK Hospitality Research, LLC manages an extensive database of hotel property income statements and sale prices. This is the research affiliate of PFK Consulting USA, LLC, which is an international firm of management consultants, industry specialists, and appraisers who provide a full range of services to the hospitality, real estate, and tourism industries. Trends in the Hotel Industry (Trends) is an annual compilation of unit-level hotel financial statements provided by PFK Hospitality Research, LLC. The report provides in-depth analysis of hotel revenues, expenses and profits, and is arrayed in a variety of property type, geographic location, rate, and size categories. See http://www.pkfc.com/en/pkf-hr/PublicationsAndData/trends/default.aspx (last accessed August 21, 2013).

accepted methodology of stabilization. Consequently, the court finds that 1.13% of total revenue is indicative of the market and will account for fixed insurance expenses for the subject property during both valuation dates. Plaintiff's expert's STR Host Study of comparable hotels and PFK's Trends report also support this 1.13% figure.

e. Business & Personal Property Adjustments

As previously stated, both experts in this case separated the income attributable to the use of the realty out of the total income generated by the operation of the hotel before capitalization. The payments to the entity that manages and operates the hotel constitute business income generated by the exercise of management and entrepreneurship. Furthermore, the last items to be deducted from gross income are the amounts to satisfy the return on and return of investment in furniture, fixtures, and equipment ("FF&E"). A portion of the overall income is realized by the employment on FF&E, and a deduction to account for the present value of FF&E is necessary. Finally, an expense to account for the periodic future replacement of the personal property (return of FF&E) is necessary. The Rushmore method excludes these expenses in the computation of realty income subject to capitalization. Both experts traced this logic.

i. Management Fee

Deducting a market-rate management fee mirrors the market by separating the specialized business component from the going-concern in order to arrive at a net income purely attributable to the taxable real property value. Both experts reviewed the Hilton Management Agreement, which stated, "as consideration for Manager's services during the Term, Owner shall pay to Manager a management fee equal to 2.5% of Total

Revenue for each Operating Year." Defendant's expert accepted this 2.5% figure. Plaintiff's expert accepted this figure after analyzing the Korpacz Real Estate Investor Survey, Lodging Management Fees for the Full-Service Segment, which ranged from 2.5-4.0%.

The court finds that a management fee of 2.5% of total revenue is appropriately supported by both experts, market participants' expectations and the evidence adduced at trial. Consequently, 2.5% of total revenue will be utilized and deducted as management fees.

ii. Return on FF&E

"A return on FF&E reflects the owner's cost of capital and is used with the current market value of the FF&E in place." Rushmore, The Appraisal Institute, Hotels and Motels, Valuations and Market Studies, 103 (1983). Both experts made a deduction for the return on the value of FF&E. In developing their annual estimates attributable to the return on the value of the FF&E, both experts opined their estimate of replacement cost new ("RCN") of the FF&E as of October 1, 2009 and October 1, 2010, then deducted 50% of the RCN to account for the loss in its value due to accrued depreciation, then multiplied the result by the number of rooms in the subject property, and then multiplied the depreciated value by their annual rate of capitalization in their report[7]. Given the fact that a hotel's income producing capabilities are partly dependent on the use of FF&E, a deduction is necessary to reflect the cost of capital used to purchase the personal property, which is not taxable.

[7] In other words, both experts utilized the following formula: Return on FF&E = RCN x 355 x 50% x capitalization rate.

Plaintiff's expert concluded $329,440 for tax year 2010 and $323,050 for tax year 2011[8]. Defendant's expert concluded $77,796 for tax year 2010 and $75,050 for tax year 2011[9]. The primary difference between the expert's opinions related to the estimate of RCN.

Plaintiff's expert estimated RCN by relying on a Hotel Development Cost Survey prepared by HVS International[10]. The survey from 2009 indicated that the median FF&E cost for full-service hotels was around $19,000/room; therefore, plaintiff's expert estimated that the subject's RCN of FF&E is $20,000/room as of both valuation dates at issue. He also testified that he supported his estimate by compiling the estimates for the replacement costs of various components of personal property contained in the hotel industry publication[11] "Hotel Cost Estimating Guide 2010" contained in his report. Plaintiff's expert's testimony, however, revealed that many of the items of personalty that he included in his calculation were not present in each of the rooms and was admittedly inexact.

Defendant's expert estimated RCN by use of the Marshall & Swift Valuation Services Cost Manual, a widely relied upon general cost survey. He utilized the equipment costs for "Average Quality Motels" and included the replacement cost estimates for room furniture, linens, maid's carts vacuum cleaners, lobby furniture and ice cube machines totaling approximately $5,547/room as of October 1, 2009 and

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[8] $20,000 x 355 x .5 x .0928 and 20,000 x 355 x .5 x .091, respectively.
[9] $2,774 x 355 x .5 x .079 and $2,916 x 355 x .5 x .0725, respectively.
[10] Hotel Valuations Services, International (HVS) offers a comprehensive scope of services and specialized hotel industry expertise. HVS tracked hotel construction costs throughout the United States and considered data for six lodging types. The researchers compiled data costs from the database of actual hotel construction budgets, industry reports, and uniform franchise offering circulars, which provided the basis for the range of component costs per room in the The Hotel Development Cost Survey for 2009. See http://www.hvs.com/AboutUs/ (last accessed August 23, 2013).
[11] Published by Jonathon Nehmer & Associates, Inc. and HVS compass.

$5,833/room as of October 1, 2010. Defendant's expert's testimony revealed that the costs he estimated were of the FF&E of a motel only and did not include some of the other assets of a full-service hotel.

Furniture, fixtures, and equipment are defined as "business trade fixtures and personal property, exclusive of inventory." The Appraisal Institute, The Dictionary of Real Estate Appraisal, 85 (5th ed. 2010). The court finds that both experts used an inexact method to calculate the return on FF&E. Plaintiff's expert's reliance on the Hotel Development Cost Survey for 2009 indicated a range of $8,800 - $55,300, with a median value of $19,000. The court is not persuaded by Plaintiff's expert analysis in arriving at his RCN as he did not explain the range (i.e. the nature, quality or character of the FF&E that comprises the range) or corroborate his calculation (i.e. independent market analysis) Defendant's expert failed to take into account certain personal property that the subject full-service hotel contains. Neither party presented the court with evidence regarding the actual depreciated book value of the subject's personal property.

The court finds $9,000 to be an appropriate calculation of the return on FF&E. The economic decline in late 2008 decreased costs because of decreasing demand for construction and increasing competition among suppliers. Plaintiff's expert's HVS Cost Survey for 2009 indicated that as revenues have decreased since the beginning of 2008, hotel operators have responded with significant operating cost reductions and other expenses, including inventories and supplies. The $9,000 RCN while on the lower end of the range for full-service hotels reasonably accounts for all of the FF&E that the subject contains. The court finds the $9,000 RCN to be applicable to both tax year 2010 and 2011.

Whereas the parties agree, the court will accept the expert's utilization of a 50% depreciation rate. The amount of return on FF&E before capitalization is, therefore, 50% of $9,000 multiplied by 355 rooms which equals $1,597,500. The total and final return on FF&E will then depend on the appropriate capitalization rate to be utilized for each tax year in question.

iii. Return of FF&E

The second component part of FF&E is the return of the investment in the FF&E. The return of FF&E is typically quantified by deducting a percentage of revenues as an annual reserve for future replacement of personal property and "is based on the replacement cost of the chattels and their estimated useful lives." Rushmore, The Appraisal Institute, Hotels and Motels, Valuations and Market Studies, 103 (1983). These items are "short lived" items and must be replaced periodically during the economic life of a hotel.

Both experts deducted a percentage of total revenue to account for the return of FF&E. The Hilton's Management Agreement, dated February 1, 2009 requires the manager to maintain a reserve of 4% each year of total gross revenues to account for the necessary funds for replacement of short-lived assets. Plaintiff's expert relied upon a Korpacz Real Estate Investor Survey reporting Lodging Replacement Reserves for the Full-Service Segment to range from 1-5% of total revenues. Plaintiff's expert also relied upon excerpts from the 2010 Hotel Cost Estimating Guide previously referenced and presented in his report. Plaintiff's expert opined 4% of total revenues to be an appropriate return of FF&E and corroborated his conclusion with a competitor hotel in Bergen County. Defendant's expert opined 2% of total revenues to be an appropriate

return of FF&E. Defendant's expert's testimony indicated that the Rushmore method does not contain a separate reserve for real property components, whereas the Management Agreement's reserve does include some building components.

The court finds that 2% of total revenues for tax year 2010 and 2011 is an appropriate return of FF&E and is within the range of the Korpacz survey,. The Tax Court has found 2-3% for the return of FF&E to be appropriate. See Prudential Insurance Co., supra, 16 N.J. Tax at 67; see also Westmount Plaza, supra, 11 N.J. Tax at 136.

f. Capitalization Rate

The final component of the income approach is to divide a loaded capitalization rate into the net income to real property to calculate the fair market value of the subject property. An unloaded capitalization rate does not include the tax rate as of each year under appeal. Both experts applied the mortgage-equity band of investment technique in arriving at their calculations of overall unloaded capitalization rates. The technique involves calculating the weighted average of the return required to satisfy the cost of carrying a mortgage for the property and the typical return required by an investor on the equity portion. Both appraisers utilized published studies as support for the estimates developed by the mortgage-equity technique; however, the experts' final conclusion of the capitalization rate for each year was a major point of disagreement.

Both experts considered the American Council on Life Insurance ("A.C.L.I.") Investment Bulletin surveys as benchmarks. For third quarter 2009, the A.C.L.I. survey indicates the average rates to be between 7.80-9.00%. For third quarter 2010, the A.C.L.I. survey indicates the average rates to be between 6.80-8.20%.

Plaintiff's expert also relied upon PFK Hospitality Research for mortgage terms in 2009 and 2010 for hotel properties, market and bond yield rates published by Moodys, comparative yields for various investments in the Korpacz Real Estate Investor Survey, and real estate yields compared to capital market returns published by Real Estate Research Corporation. Plaintiff's expert ultimately found an overall unloaded capitalization rate of 9.28% for tax year 2010 and 9.10% for tax year 2011.

Defendant's expert also utilized the Korpacz quarterly surveys for 2009 and 2010 for full-service hotels. The expert asserted that the subject hotel should be considered much more attractive than the average national hotel, and hence the appropriate capitalization rate should be on the lower end of the ranges reported nationally.

The court accepts the A.C.L.I. data as a source for capitalization rates, although not exclusively, and concludes that the A.C.L.I. tables provide an appropriate guideline in this case. See Prudential Insurance Co., supra, 16 N.J. Tax at 66 (citations omitted). Plaintiff's expert's final overall capitalization conclusions fall outside the upper range of the A.C.L.I. tables that the court relies upon. Furthermore, given the subject hotel's favorable investment characteristics, admitted by both experts through testimony, the court finds that rates on the lower end of the scale are appropriate. The court accepts defendant's expert's calculation and final conclusion of the overall capitalization rate for each tax year and will utilize 7.9% for tax year 2010 and 7.25% for tax year 2011.

To be added to the capitalization rate for each year is the effective tax rate. During the course of trial, the parties agreed that the effective tax rate for 2010 was 2.11, and for 2011 was 2.24.

III. Valuation Summary and Conclusion

The same emphasis is warranted in this case, as Judge Pizzuto so eloquently stated:

> …this decision is based upon the consideration of the reasoning and supporting data addressed in the record of this case for the particular adjustments proposed. It should not be understood as a definitive pronouncement on appraisal practices designed to extract real estate value from the assets of a business or as binding precedent with respect to adjustments of the kind proposed here, should they be offered in other cases with different records.
>
> [Chesapeake Hotel LP, supra, 22 N.J. Tax at 535-36].

The following tables summarize the court's conclusions, utilizing the income approach to valuation, discussed above:

Tax Year 2010					
Revenue					
	Rooms				
		ADR			125
		AOP			0.7
		REVPAR			87.5
		ROOMS			355
		DAYS			365
			Total		$11,337,800
	Food & Bev				$3,808,505
	Other				$300,000
				TOTAL	$15,446,305
LESS					
Department Expenses					
	Guest Rooms				$2,834,450
	Food & Bev				$3,237,229
	Other				$126,000
				TOTAL	$6,197,679
Undistributed Operating Expenses					
				TOTAL	$4,633,892
Fixed Charges					
	Franchise Fee				$617,852
	Insurance				$175,000
				TOTAL	$792,852
NET INCOME					$3,821,882
	Management Expense				$386,157.63
	Return OF FF&E/Reserves				$308,926.10
	Reutrn ON FF&E				
		RCN			9,000
		depreciation			50%
		cap rate			0.079
		# of rooms			355
			Total		$126,203.50
				Total	$821,287.23
NET INCOME to Real Property					$3,000,594.58
Cap Rate					0.079
Effective Cap Rate (Cap + 2.11)					0.1001
Value					$29,975,969.78
Rounded					**$29,975,970.00**

Tax Year 2011					
Revenue					
	Rooms				
		ADR			125
		AOP			0.7
		REVPAR			87.5
		ROOMS			355
		DAYS			365
			Total		$11,337,800
	Food & Bev				$3,808,505
	Other				$300,000
				TOTAL	$15,446,305
LESS					
Department Expenses					
	Guest Rooms				$2,834,450
	Food & Bev				$3,237,229
	Other				$126,000
				TOTAL	$6,197,679
Undistributed Operating Expenses					
				TOTAL	$4,633,892
Fixed Charges					
	Franchise Fee				$617,852
	Insurance				$175,000
				TOTAL	$792,852
NET INCOME					$3,821,882
	Management Expense				$386,157.63
	Return OF FF&E/Reserves				$308,926.10
	Reutrn ON FF&E				
		RCN			9,000
		depreciation			50%
		cap rate			0.0725
		# of rooms			355
			Total		$115,818.75
				Total	$810,902.48
NET INCOME to Real Property					$3,010,979.33
Cap Rate					0.0725
Effective Cap Rate (Cap + 2.24)					0.0949
Value					$31,727,917.02
Rounded					**$31,727,920.00**

Pursuant to N.J.S.A. 54:51A-6a, in a non-revaluation year an assessment must be reduced when the ratio of the assessed value of the property to its true value exceeds the upper limit of the common level range. The common level range is defined by N.J.S.A. 54:1-35a(b) as "that range which is plus or minus 15% of the average ratio" for the municipality in which the subject property is located. The formula for determining the subject property's ratio is:

Assessment divided by True Value = Ratio.

The ratio for the subject property in tax year 2010, therefore, is determined as follows:

$38,003,000 divided by $29,975,970 = 1.27 %

The chapter 123 ratio for defendant in tax year 2010 was .9735 with an upper limit of 1.00 and a lower limit of .8275. The ratio for the subject property exceeds the common level range. Pursuant to N.J.S.A. 54:51A-6(b), if the average ratio is below the county percentage level (1.00) and the ratio of the assessed value of the subject property to its true value exceeds the county percentage level, the tax court shall enter judgment revising the taxable value of the property by applying the average ratio to the true value of the property.

For tax year 2010, the Tax Court Clerk is directed to enter judgment, in accordance with this opinion, as follows[12]:

Land	3,685,800
Improvements	25,495,800
Total	29,181,600

[12] The final assessment is rounded and the allocation between land and improvements is the same as the allocation in the original assessment.

The ratio for the subject property in tax year 2011, therefore, is determined as follows:

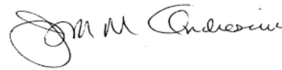
$38,003,000 divided by $31,727,920 = 1.20 %

The chapter 123 ratio for defendant in tax year 2011 was 1.0176 with an upper limit of 1.00 and a lower limit of .85. The ratio for the subject property exceeds the common level range. Pursuant to N.J.S.A. 54:51A-6(c), if both the average ratio and the ratio of the assessed value of the subject property to its true value exceed the county percentage level, the tax court shall enter judgment revising the taxable value of the property by applying the county percentage level (1.00) to the true value of the property.

For tax year 2011, the Tax Court Clerk is directed to enter judgment, in accordance with this opinion, as follows:

Land	4,007,420
Improvements	27,720,500
Total	31,727,920

Very truly yours,



Hon. Joseph M. Andresini, J.T.C.