BOARD OF ASSESSMENT APPEALS, STATE OF COLORADO 1313 Sherman Street, Room 315 Denver, Colorado 80203	Docket No.: 78792
Petitioner: **AURORA CONVENTION CENTER HOTEL, LLC,** v. Respondent: **ADAMS COUNTY BOARD OF EQUALIZATION.**	

FINAL AGENCY ORDER

THIS MATTER was heard by the Board of Assessment Appeals ("Board") on September 1 and 2, 2020, Debra A. Baumbach, Sondra W. Mercier, and Louesa Maricle presiding. Petitioner was represented by H. Michael Miller, Esq. and Larry R. Martinez, Esq., of Spencer Fane LLP. Respondent was represented by Meredith P. Van Horn, Esq., of the Adams County Attorney's Office. Petitioner appeals the actual value of the subject property for tax year 2019.

EXHIBITS

The parties submitted a joint, written "Stipulation of Facts," which the Board approved. The parties stipulated to the admission of expert witness testimony from David Lennhoff and Mary O'Connor for Petitioner, and Patrick Hallman for Respondent. The parties also stipulated to facts regarding the subject property characteristics, the admission of Petitioner's Exhibit 1 (Mr. Lennhoff's appraisal report), Petitioner's Exhibit 2 (Ms. O'Connor's valuation report), and Respondent's Exhibit A (Mr. Hallman's appraisal report). At hearing, the Board admitted into evidence Petitioner's Exhibits 1, 2, 3, 4, 5, 6, 7, 8, 10, 11, and 12; and Respondent's Exhibits A, B, D, and E. Petitioner and Respondent each provided Closing Arguments in writing.

DESCRIPTION OF THE SUBJECT PROPERTY

Gaylord of the Rockies Resort and Convention Center
6700 N. Gaylord Rockies Boulevard
Aurora, Colorado
Adams County Parcel No.: 0182-1023-01-002
Account Nos.: R0201354, R0201355, and R0201356

The parties' Stipulation of Facts contains a description of the subject property relied upon by the Board. The Gaylord of the Rockies Resort and Convention Center ("Gaylord Rockies") is a 15-story, 1,501-room full-service convention hotel, owned by Aurora Convention Center Hotel, LLC. Construction of this commercially classified property was completed in 2018, and the property opened for business in late December 2018, just before the January 1, 2019 assessment date. Gaylord Rockies is situated on an 84.57-acre site in northeast Aurora, near the Denver International Airport. Gaylord Rockies primarily serves the group meetings and conventions market. Adams County records state the total gross building area of the subject improvements is 1,996,111 square feet. The facilities include indoor and outdoor function space, a large exhibit hall, indoor function space including 3 ballrooms, 66 breakout rooms, and pre-function space, as well as 109,000 square feet of outdoor space. Hotel amenities include eight food and beverage outlets, a full-service spa with 18 treatment rooms, a fitness center, a retail market shop, and a business center. In addition to the function facilities, the property includes recreational water amenities featuring two indoor swimming pools, an outdoor pool, three waterslides, a lazy river, indoor and outdoor spas, a large deck with lounge seating, 12 private cabanas, and large outdoor gas firepits. A large surface parking lot with approximately 2,700 spaces serves the property.

The Adams County Assessor ("Assessor") assigned a value of $676,459,415 to Gaylord Rockies for tax year 2019. Petitioner appealed this value to the County Board of Equalization ("CBOE"), who denied the petition. This appeal followed. Petitioner asserts the correct value for the property is $270,000,000. For purposes of this appeal, Respondent's appraiser prepared an appraisal report finding the value of the subject property to be $695,500,000 (after deductions for personal property and intangible business value), which supported the Assessor's and CBOE's value.

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 or CBOE'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 Cnty. Bd. of Equalization*, 851 P.2d 307, 310 (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, the 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 CBOE proceeding may be presented to this 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.

ISSUES BEFORE THE BOARD

In support of its contention that the Assessor's value is incorrect, Petitioner relied on an appraisal report and resulting value reached using an income approach within which an income residual technique (also known as the business enterprise approach) is applied. Respondent countered that the Assessor's value is correct, and relies on an appraisal report and resulting value reached using an income approach applying the management fee method (sometimes referred to as the Rushmore approach, after appraiser Stephen Rushmore) and applying cost and sales comparison approaches as tests of reasonableness. Both the income residual technique and the management fee method are performed within the income capitalization approach and aim to isolate the intangible elements of property value, as well as personal property value, in order to remove this value from the calculation of the taxable real estate component of the subject property. Both approaches deduct certain elements of business value and a personal property component. However, the income residual technique results in the attribution of significantly more value to intangible and personal property, and thus applied to any property would result in a lower taxable value. As a result, the parties' contentions of taxable value differ greatly.

Petitioner's appraiser, Mr. David Lennhoff, relied on the income residual technique for removing intangible assets from the market value of the property. (Exhibit 1, p. 66.) Petitioner claimed that through the application of this approach it values only the real estate component of the taxpayer's property, while Respondent incorrectly valued the total "going concern" market value of the subject property (as an operating business), thereby improperly including intangible assets in the taxable value. Petitioner contended the only reliable method of determining market value for the subject property is the income approach. Petitioner argued in support of its position that courts in Florida and California found the methodology used by Respondent's appraiser inappropriate and inadequate to account for the intangible business value of complex hotels.

Respondent's appraiser, Mr. Patrick Hallman, relied on the management fee methodology, which he contended more accurately deducts intangible value not attributable to the real estate. (Exhibit A, p. 154.) Respondent claimed Petitioner's income residual technique improperly removes revenue that is attributable to the real estate, resulting in an artificially low value. Respondent further claimed the Rushmore methodology has been upheld by courts across the country as the correct way for accounting for the value of intangible assets for hotels for *ad valorem* purposes. Respondent argued that only one state, California, has rejected the management fee methodology, and did so because California's Assessor's Handbook specifically excludes it as a way to value properties for *ad valorem* purposes in California. Respondent asserts that this basis for rejecting the approach is not applicable in Colorado, where the Division of Property Taxation ("DPT") teaches the management fee method to county assessors and appraisers as the appropriate method for valuing a hotel.

In sum, the primary issue of dispute between the parties, and for the resolution of the Board, is whether Petitioner is correct that the business enterprise approach is the correct method to apply in valuing the subject property. This requires the Board to evaluate which items of value associated with this commercial property are properly attributed to the market value of the real estate, and which elements should be considered non-realty intangible assets that must be excluded.

APPLICABLE LAW AND AUTHORITATIVE SOURCES

"'Taxable property' means all property, real and personal, not expressly exempted from taxation by law. § 39-1-102(16), C.R.S. This appeal is concerned with the assessed value of real property.

As relevant to this appeal, there are three methods of valuing real property: the market approach, the cost approach, and the income capitalization approach.

The market approach relies on comparable sales, as required under section 39-1-103(8)(a)(I), C.R.S., which states:

> Use of the market approach shall require a representative body of sales, including sales by a lender or government, sufficient to set a pattern, and appraisals shall reflect due consideration of the degree of comparability of sales, including the extent of similarities and dissimilarities among properties that are compared for assessment purposes.

The cost approach involves estimating the cost of replacing the improvements to the property, less accrued depreciation. *Bd. of Assessment Appeals v. E.E. Sonnenberg & Sons, Inc.*, 797 P.2d 27 (Colo. 1990). Colorado law mandates that depreciation in the valuation of a taxpayer's personal business property be allowed annually from the base year to the date of assessment. *BQP Industries v. State Bd. of Equalization*, 694 P.2d 337 (Colo. App. 1984).

The income capitalization approach is a common method for calculating the value of commercial properties. *Sonnenberg*, 797 P.2d at 31 (fn.8). It generally involves calculating the income stream (rent) the property is capable of generating, capitalized to value at a rate typical within the relevant market. *Id.* Within an income approach to calculate real property value, it is necessary to remove all components of net operating income not attributable to the real estate and deduct them from the value.

It is also necessary to exclude all tangible and intangible personal property items from the valuation of real property for taxation. Tangible personal property is taxed through a separate procedure, and intangible personal property is exempt from taxation. § 39-3-118, C.R.S. ("Intangible personal property shall be exempt from the levy and collection of property tax"); *see also* § 39-22-611, C.R.S. "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* (6th ed. 2015), p. 119.

The standard appraisal methods for allocating value to intangible assets are presented in *The Appraisal of Real Estate*, *Chapter 37 - Valuation of Real Property with Related Non-Realty Items.* As this reference book explains,

> The appropriate method of valuing or allocating intangible assets has been highly controversial among real property appraisers. 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 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.

Appraisal Institute, *The Appraisal of Real Estate*, (15th ed. 2020), p. 670.

The International Association of Assessing Officers ("IAAO") also issues technical standards and other reference publications that are generally accepted in the appraisal community. The Assessors' Reference Library ("ARL") provides binding guidance for county assessors and 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 IAAO, *Property Appraisal and Assessment Administration*, (1990); ARL V.3 at 4.21 (citing IAAO for the practice of time trending); ARL V.5 at 3.4 (citing IAAO, *Property Assessment Valuation*, (2010); ARL V.2 at 8.16 and ARL V.5 at 3.4 (citing numerous technical standards published by IAAO). As relevant to this case, the IAAO Special Committee on Intangibles has published a guide titled *Understanding Intangible Assets and Real Estate: A Guide for Real Property Valuation Professionals*, which discusses various methods for allocating value to intangible assets. This article explains that the appraisal community recognizes the two approaches discussed above to removing intangible value for the purposes of the *ad valorem* appraisal of real estate: the management fee method (Rushmore approach) and the income residual technique (business enterprise approach).

The Rushmore approach is a method of valuing the real property portion of hotels and other lodging properties by excluding the value of intangible assets from the hotel's overall value. It does so by calculating the property's net operating income after deducting the hotel's management and franchise fees – fees that, under the Rushmore approach, account for the value of intangible assets. Following the deduction of the management fee from the income of the business, the remaining income is capitalized to reach the subject property's value. The Rushmore approach has never been addressed in a published opinion by Colorado courts, but its application has been extensively upheld by courts in other jurisdictions. *See, e.g.*, *Glenpointe Assoc. v. Teaneck Township*, 12 N.J. Tax 118 (N.J. Super. Ct. App. Div. 1990); *In re J.F.K. Acquisitions Group*, 166 B.R. 207, 209 (Bankr.E.D.N.Y.1994); *Marriott Corp. v. Bd. of Johnson Cnty. Comm'rs,* 972 P.2d 793 (Kan. Ct. App. 1999); *Chesapeake Hotel LP v. Saddle Brook Township*, 22 N.J. Tax 525 (2005); *Wolfchase Galleria Ltd. Partnership v. Tenn. Bd. Of Eq.* (Shelby Cty. TN, 2005); *Grand Haven Investment, LLC v. Spring Lake Township* MTT Docket No. 364917 (MI Tax Tribunal 2012); *CHH Capital Hotel Partners, LP, v. District of Columbia*, 152 A.3d 591 (D.C. 2017); *Switzerland Cnty Assessor v. Belterra Resort Indiana, LLC, 101 N.E.3d 895* (Ind. Tax Ct. 2018). "[T]he Rushmore approach has been widely accepted by the courts, has been embraced by most assessment jurisdictions, and reflects observable and verifiable market behavior in the transaction market. For lodging properties and casinos, the Rushmore approach is the recommended method for excluding intangible value from real property valuations." IAAO Special Committee on Intangibles, *Understanding Intangible Assets and Real Estate: A Guide for Real Property Valuation Professionals*, (Nov. 12, 2016), pp. 38-39.

The business enterprise approach deducts not only the management fee, but also business start-up costs and the return on any furniture, fixtures and equipment. This approach is often used

to value shopping centers and office buildings. Mr. Lennhoff is credited as the originator of the business enterprise approach to valuing hotels.

"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. 28 (6th ed. 2015). Going concern value can be thought of as the market value of the real estate plus the Business Enterprise Value. "Going concern value" is more expansively defined as:

> An outdated label for the market value of all the tangible and intangible assets of an established and operating business with an indefinite life, as if sold in aggregate; more accurately termed the *market value of the going concern or market value of the total assets of the business.*

Appraisal Institute, *The Dictionary of Real Estate Appraisal*, (6th ed. 2015), p. 102.

The market value of the going concern is defined as:

> The market value of an established and operating business including the real property, personal property, financial assets, and the intangible assets of the business.

Appraisal Institute, *The Dictionary of Real Estate Appraisal*, (6th ed. 2015), p. 143.

> Other methodologies have been used for market and ad valorem valuation, but it is our opinion that the Rushmore Method is the most reliable; this opinion is supported by market appraisers, case law, published appraisal articles, and the IAAO. By failing to deduct these expenses from the hotel's income stream, an appraiser would be valuing the subject based on income attributable to the realty and non-realty elements.

State of Colorado, Division of Property Taxation, Appraisal Standards, *APR 215: Hotel/ Motel Valuation Workshop (2019)*, *Course Materials*, p. 31.

FINDINGS AND CONCLUSIONS

After consideration of the testimony and exhibits presented, the Board finds that Petitioner presented insufficient probative evidence to meet its burden of proof to establish, by a preponderance of the evidence, that the Assessor's valuation of Gaylord Rockies is incorrect for tax year 2019. Moreover, the Board finds that Mr. Hallman's appraisal supported the value reached by the Adams County Assessor and affirmed by the Adams County Board of Equalization.

After consideration of all three approaches to value, Mr. Lennhoff relied solely on the income approach. Alternately, Mr. Hallman developed all three approaches, giving the greatest

weight to the cost and income approaches, and allocating value to intangible "business" elements via a reconciliation of the cost approach and management fee methods. After consideration of the parties' 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. The Board gives weight to Respondent's conclusions of value under the cost and sales comparison approach to the extent they provide a test of reasonableness of the actual value assigned to the subject by the Assessor. Within the cost approach, the Board also credits Mr. Hallman's calculation of intangible value as confirmation that the Assessor's value is correct.

I. Cost Approach

While the cost approach is not typically relied on by buyers and sellers in the marketplace, it can provide a reliable indication of the value of the real estate component in some instances. If performed correctly, the cost approach explicitly excludes any value of intangible assets.[1]

Mr. Hallman completed a cost approach that indicated a value of $766,000,000 for real and personal property. After deducting the allocated value of personal property, he identified the real property value of the subject as $696,800,000. He also eliminated $20,000,000 from the developer's estimate for pre-opening costs (referred to by Petitioner as "business start-up costs"), as those were determined to be intangible costs associated with establishing the business operation. Entrepreneurial Profit was also excluded, as Mr. Hallman determined the profit could be considered an intangible asset. (Exhibit A, p. 153.)

In the case of the subject, for which the costs were based on the developer's actual costs, construction was completed just prior to the assessment date. Because the project is new but has not yet reached stabilization, use of the cost approach was deemed relevant by the Board as a reliable indicator of market value for the real estate. Mr. Hallman also provided a test of reasonableness by comparing the subject's actual costs to budgeted costs for other convention hotels. (Exhibit A, p. 111.)

The Board finds Mr. Hallman's cost approach-derived value conclusion provided a reliable test of reasonableness of the actual value assigned to the subject, and a credible "check" of the intangible value that should be excluded from the subject's taxable value. His cost approach provided compelling support for the Assessor-assigned value of $676,459,415.

II. Sales Comparison Approach

In this case, the Board finds that the value of the sales comparison approach is limited to providing a test of reasonableness to the property value indicated by the income approach. The Board did not rely on Mr. Hallman's sales comparison approach-derived value conclusion as key evidence of the subject property's value.

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[1] *See* IAAO Special Committee on Intangibles, *Understanding Intangible Assets and Real Estate: A Guide for Real Property Valuation Professionals*, (Nov. 12, 2016), pp. 9-10; 26-27. Standard appraisal methods are also outlined in Appraisal Institute, *The Appraisal of Real Estate*, (15th ed. 2020).

Mr. Hallman's appraisal referred to the effective date of value as January 1, 2019, which is not consistent with Colorado statute. The date of appraisal is June 30 of the year preceding the year of general reappraisal. All applicable approaches to appraisal must be trended or adjusted to this date. Colorado Revised Statutes § 39-1-105 provides that the date of assessment is to be January 1 of each year and that all property is to be listed as it exists in the county where it is located on the assessment date. To distinguish between the two dates, the assessment date refers to the date upon which property situs (location), taxable status, and the property's physical characteristics are established for that assessment year, while the appraisal date refers to the date upon which the valuation of the property is based, otherwise adjusted, or trended. Accordingly, the effective date of value at issue in this case is June 30, 2018, not January 1, 2019. Mr. Hallman testified that in his opinion there would no difference in his $817,000,000 sales comparison approach conclusion of value for the subject property between June 30, 2018 and January 1, 2019. Regardless, the Board finds the sales comparison approach to have little value when applied to the subject property.

III. Income Approach

An appraisal should be representative of the actions of the marketplace. The Board was convinced by both parties that participants in the hotel marketplace depend primarily on the income-producing aspects of a property such as the subject when making purchase and sale decisions. The Board finds the income approach to be the most reliable indicator of value for the subject.

The Board is not persuaded by Mr. Lennhoff's income approach methodology, but finds Mr. Hallman's appraisal persuasive in terms of the methodology he used to remove intangible value in his income approach.

A. Removal of Revenue and Departmental Expense for Food and Beverage, Gift Shop and Spa

The subject's food and beverage, gift shop, and spa areas are not leased. 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 ("F&B") category, gift shop, and spa.

Mr. Lennhoff noted in his report that "as a practical matter…arm's length hotel real property leases were replaced many year ago by management contracts. Therefore, lacking sufficient quantity of meaningful "arms' length' leases to hotel operators, our opinion of value of the real property portion of the going concern is developed by an income residual technique." (Exhibit 1, p. 66.)

The Board finds that Mr. Lennhoff's income residual technique is similar to the "parsing income method." [2]

> In this method, the total revenue of the going-concern is allocated to real property, personal property, and any intangible assets. The steps in performing the parsing income method are as follows: 1. Allocate a going-concern's net income between real property, personal property, and intangible assets. 2. Apply separate capitalization rates to the net income of each component to arrive at a value estimate for each component, real property, personal property, intangible assets.

IAAO Special Committee on Intangibles, *Understanding Intangible Assets and Real Estate: A Guide for Real Property Valuation Professionals*, (Nov. 12, 2016), pp. 24-25.

Contained in both the parsing income method and the income residual technique is the assumption that the appropriate income allocation to real property is generally considered to be equal to absolute net rent. Further,

> In the use of the parsing income method, it is critical for appraisers to ensure that any allocation of the income and expenses correctly identifies the contribution of the income to the total assets from tangible and intangible personalty. If the allocation is not done properly, it is unlikely that the residual value for any asset class will be correct. Ideally, the estimate of real estate rent in this method is based on an analysis of direct rent comparables.

Appraisal Institute, *The Appraisal of Real Estate*, (14th ed. 2013).

However, Mr. Lennhoff conceded in his report that he lacked a sufficient quantity of meaningful arms' length leases to hotel operators. (Exhibit 1, p. 66.) This undermines the reliability of the value conclusion under his chosen method. Moreover, the food and beverage, gift shop, and spa spaces are not rented in the subject, and generate significant income to the subject.

An alternate method of estimating rent is "applying an appropriate rent-to-revenue ratio based on data from an industry association study, interviews with market participants, or other sources." Appraisal Institute, *The Appraisal of Real Estate*, (14th ed. 2013), p. 714. *The Appraisal of Real Estate* warns that, "[e]ach of the alternative methods of estimating real estate rent has potential weaknesses. By using more than one method, appraisers can make reasonably supported conclusions." *Id*., pp. 713-714.

Mr. Lennhoff asserted that, "the F&B outlets at the subject are tied to the hotel operation and contain a high intangible value in and of itself…." (Exhibit 1, p. 75.) He estimated the real estate value of this component under the assumption that the F&B space is leased to a typical restaurant operator. Mr. Lennhoff estimated leased space at 69,042 square feet. (Exhibit 1, p. 81.) Although he does not identify it as such, Mr. Lennhoff applied the equivalent of a hypothetical

[2] "The courts have generally rejected the parsing income method for property tax purposes." IAAO Special Committee on Intangibles, *Understanding Intangible Assets and Real Estate: A Guide for Real Property Valuation Professionals*, (Nov. 12, 2016), p. 25.

condition, assuming that the F&B space is rented to an outside user, and eliminating both the departmental revenue and expenses for the F&B component. To establish a rent under this hypothetical condition, he cited a spring 2014 journal article reporting the results of a national survey based on a stand-alone restaurant facility (incomparable to the subject) indicating that "[t]ypical rental rates for restaurants range from 6% to 9% of gross sales. Brock J. Rule, *Restaurant Valuation*, The Appraisal Journal (Spring 2014). (Exhibit 1, p. 75.) Mr. Lennhoff relied on an industry rate of rent equal to 9% of gross sales, assuming restaurant rent of $11,028,600. He supported the concluded F&B revenue through reference to F&B sales as a percent of room revenue derived from projections for the subject as well as performance at other Gaylord properties. However, he presented no specific rental data derived from the market in support of the 9% rate conclusion.

The subject was opened in late 2018, and so no operating history was available for consideration. A review of the subject's budget for 2019 indicated the F&B category would derive income well in excess of the attributed rent. As calculated by the Board, the F&B category was projected to generate department profit of $47 million in 2019. (*See* Exhibit 1, p. 71.)

The Board is convinced that the subject property had significant space contributing to a strong food and beverage operation, which, unlike a typical freestanding restaurant, is operated within multiple restaurant spaces, bar area, room service, and extensive interior and exterior conference spaces. The Board is convinced that the subject offered over 500,000 square feet of function space, including 115,000 square feet of exhibit hall space, 199,000 square feet of indoor ballroom and breakout room space, an 84,000 square foot pre-function space, and 109,000 square feet of outdoor space. (Exhibit A, pp. 62-63.) No revenue or expenses were directly attributed to the convention space. More importantly, testimony at hearing indicated that this is not typically the way a large hotel operates; as in most cases, the management company is paid based on total revenue to all departments and therefore requires control of the operation of all revenue generating departments.

Mr. Lennhoff applied the same methodology to derive rent for the gift shop and spa spaces. Rent for the gift shop was estimated at $136,200 based on a rate of 15% of gross sales. Rent for the spa was estimated at $295,000 based on a rate of 13% of gross sales. (Exhibit 1, p. 60.)

The Board finds that Petitioner incorrectly valued the subject based on an improper hypothetical condition, assuming that the restaurant space, gift shop, and spa spaces were rented, thereby neglecting to value the subject's actual space dedicated to generating F&B income and the performance of these departmental operations in the pro forma analysis of the subject. Further, Petitioner's method is not consistent with the actual practice of hotel operations in the marketplace.

B. Value of the Intangible Assets of the Business

Petitioner contended that Respondent's value includes intangible assets of the business, sometimes referred to as aspects of going concern value. Mr. Lennhoff'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.

Exhibit 1, p. 65, citing William N. Kinnard, *Intangible Assets in an Operating First-Class Downtown Hotel*, The Appraisal Journal (January 2001).

The relationship between the real estate and business aspect of a hotel operation was well stated by Mr. Lennhoff as follows:

> A hotel is best defined as a real estate-related investment because "rent" (to the investor) is completely dependent upon the *business* operated at the real estate. The investor, in effect, becomes a partner in the "tenant's" business by accepting residual hotel *business* income as "rent" for use of the real estate asset; that is, receipt of "rent" is wholly contingent upon success of the hotel business. Although a hotel franchise brand typically offers real estate owners varying degrees of competitive business advantage, it is neither a requirement nor a guarantee of success. Comparatively, a "pure" real estate investment involves rent that is *unrelated* to the tenant's business. Furthermore, because "rent" derived from a hotel investment is based solely on residual or *net* income (rather than gross revenue) from hotel operations, virtually all risk of the business – in addition to risk of the real estate – falls to the property owner.

(Exhibit 1, p. 65.)

The Board must evaluate how each party attempted to remove the value associated with intangible assets to produce a reliable indication of the value of the real property for tax purposes. As discussed above, the parties presented two methods that can be employed by appraisers to estimate and deduct value related to intangible assets – the management fee method (Rushmore approach) and the income residual technique (business enterprise approach). [3]

Mr. Lennhoff identified his approach as an income residual technique, which involves first estimating the income of the total assets of the business, then adjusting for the income to the tangible and intangible personal property remaining after deduction of real estate operating expenses. The steps in this process were identified by Mr. Lennhoff as follows:

> All non-realty items require adjustment for return *of* and return *on* investment, which may be handled by two methods. The most straightforward method is a

[3] The cost approach is an additional method indicated in both IAAO Special Committee on Intangibles, *Understanding Intangible Assets and Real Estate: A Guide for Real Property Valuation Professionals*, (Nov. 12, 2016), and The Appraisal of Real Estate, *Valuation of Real Property with Related Personal Property or Intangible Property*, (14th Edition, 2013), pp. 703-715. The cost approach to value explicitly excludes any value of intangible assets. As discussed above, Mr. Lennhoff did not apply the cost approach in the valuation of the subject, while Mr. Hallman's cost approach provided compelling support for the Assessor's assigned value.

> single deduction from income attributed to total assets of the business based on an annual amortization amount that combines return on *and* return of investment (conceptually similar to a mortgage payment, which includes both interest *and* recapture of principal). A second method involves two steps….We will apply the first method because it combines return *of* and return *on* investment in a single calculation.

(Exhibit 1, p. 90.)

Mr. Lennhoff concluded to total revenue to the going concern of $127,682,100, with the F&B, gift shop and spa revenue based on an imputed rent. (Exhibit 1, p. 77.) Total expenses were estimated at $91,987,580, resulting in net operating income to the going concern of $35,694,520. (Exhibit 1, p. 89.)

To determine the deduction from net operating income to the going concern for furniture, fixtures, and equipment ("FF&E"), Mr. Lennhoff analyzed the *2017 Franchise Offering Circular* for JW Marriott flagged hotels. He estimated total cost new to furnish and equip the subject hotel at $95,433,800. At an estimated percent good of 40%, the depreciated value of the FF&E was calculated as $38,173,500. (Exhibit 1, p. 92.)

Mr. Lennhoff's next step was to estimate a chattel mortgage rate. The report notes "*lacking sufficient chattel mortgage rate data,*" the rate can be estimated by starting with a hotel mortgage rate – the minimum required rate of return – then adding a premium of 200 to 500 basis points to reflect the risk of personal property versus real property. The hotel mortgage rate was reported as 4.11% based on the *ACLI Hotel Mortgage Rate 4th Quarter 2017* report. Mr. Lennhoff then added 250 basis points to the mortgage rate of 4.11%, which resulted in a derived chattel mortgage rate of 6.61%. (Exhibit 1, p. 91.)

Mr. Lennhoff concluded that an annual "payment" of $6,296,500 would be required to amortize the $38,173,500 in depreciated value over an estimated life of eight years at 6.61%. This payment was subsequently deducted from the indicated net income to the going concern. (Exhibit 1, p. 92.)

Conversely, Mr. Hallman relied on the actual costs for FF&E provided for the subject in the development budget and made a deduction of $69,500,000 from the estimated total value of the going concern. (Exhibit A, p. 154.)

Business start-up costs can include assemblage and training of staff, management, and administrative team; regulatory compliance; accounting and other business systems; pre-opening marketing; and initial operating losses. To estimate the deduction for business start-up costs, Mr. Lennhoff relied on the *JW Marriott 2017 Franchise Disclosure* document. Total business start-up costs were estimated at $15,239,300, which were 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 for the going concern for business start-up costs was estimated at $1,507,400 which includes return *of* and return *on* business start-up costs. (Exhibit 1, p. 94.)

Alternately, Mr. Hallman deducted the developer's estimate of $20,000,000 in "pre-opening" expenses in the cost approach. (Exhibit A, p. 153.)

Mr. Lennhoff also considered the existence of intangible value associated with the subject's brand name. To determine the amount of this adjustment, any RevPAR premium for the subject would be compared to that of comparable hotel operations. As the subject was not open as of the valuation date, RevPAR penetration indices were not available for comparison. No specific adjustment was made for brand or name recognition. (Exhibit 1, p. 95.)

After deducting return *on* and return *of* for the FF&E and the business start-up costs, Mr. Lennhoff's net operating income to the realty was reduced to $27,890,620. (Exhibit 1, p. 96.) Mr. Lennhoff next considered an adjustment for perceived remaining intangible personal property, which he described as "comparatively minor." The report notes that "because identification and quantification of market-typical intangibles is more difficult to isolate than brand-specific intangibles, their elimination is achieved by adjusting the overall capitalization rate [applicable to real property] upward to reflect its inclusion…." Additionally, "[c]ompeting commercial real estate property types are considered because they offer guidance into the magnitude for this adjustment, since they have minimal, if any, intangible personal property." (Exhibit 1, p. 96.)

Mr. Lennhoff relied on data from a *Hotel Investment Analysis: In Search of Business Value*, by Bernice T. Dowell, Assessment Journal (March/April 1997), which concluded, "Marriott Franchises resulted in revenue of 15-20% above other flags and 25% or more above "No Name" flags." An additional study indicated "[r]emoving the brand name and becoming an Independent dropped the revenue index by 39% or more….Furthermore, independent hotels generate RevPAR at only 74% of the rate generated by branded hotels." A. Scruggs Love, Bruce H. Walker, and Douglas W. Sutton, *New Option in Hotel Appraisals: Quantifying the Revenue Enhancement Value of Hotel Brands*, *The Appraisal Journal*, (Summer 2012). Mr. Lennhoff concluded to an adjustment of 10% to account for the subject not having any type of flag, which was equal to an upward adjustment of 80 basis points per his appraisal narrative, or 70 basis points per an included chart. (Exhibit 1, p. 97.)

Mr. Lennhoff concluded to a capitalization rate for the real estate of 6.00%, and then added 70 basis points to account for residual intangible assets. A rate of 3.7424% for the effective tax rate was reduced to account for taxes that would be passed through to the subject's hypothetical condition of leased space at 3.6753%, resulting in a tax load of 3.6044%. He applied a total capitalization rate of 10.3044%. Mr. Lennhoff then re-addressed residual intangibles not specifically quantified, reducing the capitalization rate to 9.92785%. (Exhibit 1, pp. 84-85.) This produced a future stabilized value to the real estate of $280,930,000.

To reach a value for the subject as of June 30, 2018, the Mr. Lennhoff applied a 10% annual discount rate over the three-year estimated time to reach stabilization to conclude to a value of $270,000,000.

The Board finds that Petitioner relied on a methodology that lacks qualitative factual data typically related to real estate transactions. The Board concludes that Petitioner's income residual methodology suffers from the problems related in the *Appraisal of Real Estate*, as follows, "Critics

state that this methodology is flawed because the identification of an appropriate capitalization rate to convert the residual income to different asset classes can be difficult." Appraisal Institute, *The Appraisal of Real Estate*, (15th ed. 2020), p. 676.

In fact, Mr. Lennhoff notes this issue in his report:

> 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.

(Exhibit 1, pp. 90-91.)

Mr. Lennhoff first applied an upward adjustment of 250 basis-points to a chattel mortgage rate of 4.11%. This rate was then reapplied and compounded with upward adjustment for subsequent deductions. His basis point adjustment was derived from a broad range of 200 to as much as 500 basis points depending on the perceived risk.

The Board is not persuaded that these adjustments were based on evidence from actual real estate transactions. Appraisers typically 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. Mr. Lennhoff's basis point adjustments were not supported by factual real estate data and therefore were not persuasive.

Petitioner's witness, appraiser Mary O'Connor, prepared and testified regarding her "Market Value of the Business Enterprise and the Non-Realty Business Intangible Assets" valuation report. (Exhibit 2.) The stated purposes of the report included "Application of the Discounted Cash Flow Method under the Income Approach to estimate the value of the Business Enterprise as of the Valuation Date." The discounted cash flow method aims to value a business based on its projected future cash flow. To arrive at a value for the subject property, Ms. O'Connor used projected income and expenses estimated over a future holding period, using "a discrete projection through 2022" and then applying "a terminal (or perpetual) growth rate to project cash flow beyond 2022." (Exhibit 2, p. 10.) Ms. O'Connor opined that the market value of the Business Enterprise of the subject, as of June 30, 2018, was $645,901,000, and that the market value of the identified "Intangible Assets" (consisting of Flag and Management, Food and Beverage Operations, Recreation Operations, and Business Start-up Costs) was $302,626,000. She allocated the remaining value to the real property.

Under Colorado law, valuations for property tax purposes must be determined using a base period methodology, which mandates the consideration of data from within the applicable base period, adjusted to the level of value on the final day of that base period. *See* §§ 39-1-104(10.2)(d); 39-1-104(10.2)(a), C.R.S. The base period at issue in this case is January 1, 2017 through June 30, 2018, and the date of value is June 30, 2018. Information on conditions outside of the base period may not be considered. *Padre Resort Inc. v. Jefferson Cnty. Bd. of Equalization*, 30 P.3d 813, 815

(Colo. App. 2001); *see Carrara Place, Ltd. v. Arapahoe Cnty. Bd. of Equalization*, 761 P.2d 197, 201 (Colo. 1988). The projected and estimated conditions used in the discounted cash flow method were beyond the base period, and are not to be considered in the *ad valorem* valuation of a property, even where the data underlying the projections was known during the base period. *Padre Resort Inc.*, 30 P.3d at 815. Because the discounted cash flow method was based on projections, estimates and future speculated income beyond the applicable 18-month base period, and did not value the subject property as of the June 30, 2018 level of value date, the Board cannot consider its conclusions. *Id.*; *see* State of Colorado, Division of Property Taxation, Appraisal Standards, *APR 215: Hotel/ Motel Valuation Workshop (2019)*, *Course Materials*, p. 11 ("The discounted cash flow procedure can be used to determine value and is often the income approach used in fee appraising, but for the purposes of ad valorem valuation use of the discounted cash flow methodology is not allowed by Colorado law.")

Additionally, the discounted cash flow method ignores the contribution of the taxable real estate toward value. For example, when applied to the subject's Food and Beverage Operation, all projected profit is applied toward the business enterprise, which ignores the contribution of the real estate. The same is true of Ms. O'Connor's valuation of the Recreation Operations using the discounted cash flow method. This is particularly significant given the notable space at the subject dedicated to food and beverage, and the many recreational amenities.

Ms. O'Connor's report also states that, "The opinions expressed in our valuation of Intangible Assets are based in part on [Mr. Lennhoff's appraisal]." (Exhibit 2, p. 6.) To the extent this is the case, the Board's critique of Mr. Lennhoff's appraisal also applies to Ms. O'Connor's report.

Despite Petitioner's contention to the contrary, the Board is convinced that Respondent accounted for intangible asset value, relying on the management fee method. This method relies on the deduction of a management and (if appropriate) franchise fee as an expense in the calculation of net operating income to account for intangible business value. It also requires a deduction of a reserve amount inclusive of replacement of FF&E, as well as deduction of the depreciated value of the personal property from the concluded value of the real property. (*See* Exhibit A, p. 154.)

This methodology is succinctly described below:

> For a hotel property, proponents of this approach would deduct the management fee and franchise fee (if it is a branded hotel affiliated with a chain) along with other operating expenses. 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…the value of any intangible assets is removed, and any remaining net income is attributed to the real property.

Appraisal Institute, *The Appraisal of Real Estate*, (15th ed. 2020), p. 677.

In his analysis, Mr. Hallman calculated net operating income based on the same pro forma for the subject that Petitioner relied on. The projected departmental revenue and departmental expenses were tested against that of four similarly sized hotel properties considered representative of the subject. Undistributed operating expenses, fixed charges and other expenses were also analyzed against the competitive hotel set.

Mr. Hallman testified that he deducted the base and incentive management fees, brand marketing fees, reservation fees, guest and royalty fees from his calculation of value as "business value." (*See* Exhibit A, p. 154.) When a management fee and incentive management fee are deducted, among other items, the expertise of the staff is accounted for (given the assumption that staffing stays with the management company and does not change with the owner), and any brand name value is accounted for. Mr. Hallman did not need to make a separate adjustment within the income approach for these attributes, as they are properly adjusted for by the management fee deductions. *Id*.

The Board finds that Mr. Hallman made a supported deduction for intangible assets by deducting a 3.0% management fee, equal to what was reported for the competitive set. An additional 0.3% was deducted as an incentive management fee. Mr. Hallman then selected a capitalization rate based on market data derived from five hotel sales, investor survey data, and a band of investment analysis. He reconciled to a real property value of $760,000,000, including personal property valued at $69.5 million based on the income approach. Deducting personal property valued at $69.5 million resulted in a value to only the real estate of $690,500,000, which exceeds and supports the actual value assigned by the Assessor.

The Board finds Respondent's use of the management fee technique compelling as an appraisal methodology to eliminate intangible asset value and determine the taxable value of real estate for hotel properties in general, and for the subject property in particular. Market data indicates a narrow and reliable range for this management fee.

As noted in the authoritative sources cited by the Board, use of the management fee method is widespread in the appraisal industry. As was testified to by Mr. Hallman, the DPT instructs that the Rushmore method should be used to value hotels in Colorado. Assessors are required by statute to attend DPT courses and to follow the DPT's published manuals. § 39-2-110, C.R.S.; *Huddleston v. Grand Cnty. Bd. of Equalization,* 913 P.2d 15 (Colo. 1996); *Jet Black, LLC v. Routt Cnty. Bd. of Cnty. Comm'rs*, 165 P.3d 744 (Colo. App. 2006). The Board is also mindful of the fact that the DPT's interpretation of how to value hotel properties is entitled to deference. *Huddleston,* 913 P.2d at 17.

Furthermore, the Board notes that the Rushmore approach has been upheld by courts across the country as the correct way for accounting for the value of intangible assets for hotels for *ad valorem* purposes, and is the preferred method within the appraisal industry. This Board is not bound by the decisions of courts in other states, where property tax law may contrast with Colorado's. For instance, the California decision cited by Petitioner, *SHC Half Moon Bay, LLC vs.*

County of San Mateo, discusses controlling California law requiring a specific method of valuing intangibles within a property's income stream that is nowhere found in Colorado law.

IV. Conclusion

In this appeal, Petitioner contended that Respondent incorrectly valued the total "going concern" market value of the subject property as a business, rather than arriving at a value for the taxable real property. Petitioner further claimed that the only reliable method of determining the value of the real estate is through an income residual technique. While Petitioner's methodology is one of several techniques that may be considered by appraisers, the Board was not convinced that it represented the most compelling or reliable approach to removal of intangible business value for the subject property.

In Colorado, property valuations are based on the actual value or market value of the property. *Bd. of Assessment Appeals v. Colo. Arlberg Club*, 762 P.2d 146, 148 (Colo. 1988). Market value is defined as "what a willing buyer would pay a willing seller under normal economic conditions." *Id.* at 151. Petitioner's approach did not rely on market data extracted from sales, investor surveys, and interviews with market participants, but relied on an appraiser's subjective assignment of a general percentage of gross sales as rental income, and the selection of a chattel mortgage rate (increased by a wide indicated range for perceived risk), which was then compounded and capitalized at a subjectively adjusted capitalization rate.

The Board was not convinced by Petitioner that the Assessor (or Respondent's appraiser in this appeal) assigned intangible, "business," or other value to the subject property that should have been exempted as non-taxable value. The Board agrees with Mr. Hallman's testimony that the Rushmore Method most closely aligns with what occurs in the actual market for hotels. This includes, in this case, concluding that the income from the subject's food and beverage, spa, retail, water park and activity center are not intangibles as opined by Mr. Lennhoff and Ms. O'Connor, but are in fact streams of income attributable to the Gaylord property, which are properly accounted for by Mr. Hallman in his income approach.

In addition, the Board was persuaded that Respondent's application of the management fee method, the approach Colorado assessors are required to use, resulted in a credible valuation of the subject that supported the Adams County Assessor's assigned value.

Pursuant to the findings and conclusions reached above, the Board finds that Petitioner presented insufficient probative evidence 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.

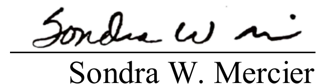
If the Board does not recommend its decision to be a matter of statewide concern or to have resulted in a significant decrease in the total valuation of the respondent county, Respondent may petition the Court of Appeals for judicial review of such questions within thirty days of such decision.

See § 39-8-108(2), C.R.S. (rights to appeal a tax protest petition); *see also* § 39-10-114.5(2), C.R.S. (rights to appeal on an abatement petition).

DATED and MAILED this 17th day of February, 2021.

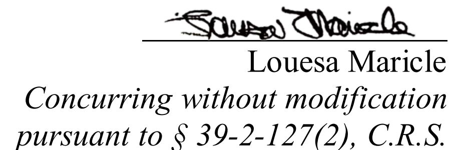
BOARD OF ASSESSMENT APPEALS:

Drafting Board Member:



Sondra W. Mercier

Concurring Board Member:



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

Concurring Board Member:

Debra Baumbach
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.

Yesenia Araujo