

BEFORE THE STATE TAX APPEAL BOARD  
OF THE STATE OF MONTANA

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ERCK INCORPORATED,	)	
d.b.a., RUBY-S RESERVE	)	
STREET INN,	)	
	)	DOCKET NO.: PT-1997-86
Appellant,	)	
	)	
-vs-	)	
	)	FINDINGS OF FACT,
THE DEPARTMENT OF REVENUE	)	CONCLUSIONS OF LAW,
OF THE STATE OF MONTANA,	)	ORDER and OPPORTUNITY
	)	<u>FOR JUDICIAL REVIEW</u>
Respondents.	)	

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The above-entitled appeal was heard on the 7th day of August, 1998 in the City of Missoula, Montana, in accordance with an order of the State Tax Appeal Board of the State of Montana (the Board). The notice of the hearing was given as required by law. Gregory A. Damico, CPA, representing the taxpayer, presented testimony in support of the appeal. The Department of Revenue (DOR), represented by appraiser Patrick McKenna and appraisal supervisor Jim Fairbanks, presented evidence in opposition to the appeal. Testimony was presented, exhibits were received, a post-hearing submission schedule was determined, post-hearing submissions were received, and the Board then took the cause under advisement; and the Board having fully considered the testimony, exhibits and all things and matters presented to it, finds and concludes as follows:

## FINDINGS OF FACT

1. Due, proper and sufficient notice was given of this matter, the hearing, and of the time and place of the hearing. All parties were afforded opportunity to present evidence, oral and documentary.

2. The subject property is Ruby's Reserve Street Inn and is described as follows:

Lots 2A & 3, Northgate Business Center, City of Missoula, Missoula County, State of Montana; Assessor Code #04-2200-05-3-01-09-0000.

3. The DOR appraised the subject property at a value of \$351,966 for the land and \$3,118,534 for the improvements.

4. On December 12, 1997, the taxpayer appealed to the Missoula County Tax Appeal Board (MCTAB) requesting values of \$217,800 for the land and \$1,950,800 for the improvements, stating: "Income approach to value is most heavily relied on method. Buyers & sellers of hotels use the income approach to establish market values. Per attached actual operating statement and income approach, market does not support re-appraised values."

5. In a decision dated January 23, 1998, the MCTAB denied the appeal, stating:

The appellant's burden to disprove the DOR's building valuation was not met. The \$3,118,534 value is hereby sustained (by split decision).

6. The taxpayer appealed that decision to this

Board on February 10, 1998, stating:

The 1997 re-appraised value of the subject property is not supported by the market; as indicated by the operating income of subject property. This is based on a capitalization of actual net operating income.

7. At the hearing before this Board the taxpayer revised the requested value for the improvements to \$2,325,034.

8. Ruby's Reserve Street Inn is a full service hotel and contains 127 rooms.

9. A post-hearing submission requested by the Board allowed each party an opportunity to provide additional evidence to support their respective capitalization rates.

10. Mr. Damico represents various motel/hotel operators in this series of appeals; therefore, the Board will take administrative notice of the evidence and testimony presented in PT-1997-82, PT-1997-83, PT-1997-84 & PT-1997-85.

**TAXPAYER'S CONTENTIONS**

Because this property has a stabilized operating history, the value determination for this property is based on the income approach to value.

Mr. Damico presented the Board with a value indication from the income approach (ex. 1, pg 1). Summarized, this exhibit illustrates the following:

<b><u>Income Approach (1996 Results):</u></b>	<b><u>Per Cent</u></b>
Total Revenues	\$1,830,755
Net Income or (Loss)	\$ 17,688
<u>Add:</u>	
Depreciation & Amortization	\$ 144,982

Property Taxes	\$ 66,417	
Interest	\$ 202,532	
Life Insurance - Owners	\$ 26,120	
<u>Less:</u>		
Reserve for Replacement	\$ (91,538)	
Net Operating Income	\$ 366,181	20.0%
<u>Cap Rate:</u>		
Base Rate		11.0%
Property Tax Load		<u>1.8%</u>
Total		12.8%

Indicated Value	\$2,860,791	Includes land, Buildings & Personal Property
Less: Assessed Pers. Prop	\$ (183,658)	
Real Estate Value	\$2,677,133	Includes Land & Building
Less: Land Value	\$ (351,966)	
Indicated Value - Buildings	\$2,325,167	

Mr. Damico testified the income of \$1,830,755 is revenue from all sources.

Taxpayer's exhibit #2 is support for the 20% ratio of net operating income to total income and illustrates the following:

**Analysis of Full Service Hotel Expense Ratios**

Based on 1996 HOST Report  
Prepared for State of Montana DOR - Missoula

<u>Economy Hotel Price Category</u>	<u>Holiday Inn Parkside</u>
Occupancy	67.2%
Avg. Daily Rate	\$ 56.98
REVPAR	\$ 38.29
	71.4%
	\$ 56.00
	\$ 39.98

**Expense Ratios:**

Net Operating Income	17.4%
<b><u>Add: (1)</u></b>	
Property Taxes	3.2%
Reserves for Replacement	1.4%
Franchise Fees	2.7%
Management Fees	2.5%
Total Adds	<u>9.8%</u>
Sub-Total	<u>27.2%</u>
<b><u>Less: (2)</u></b>	
Reserves for Replacement	-4.4%
Franchise Fees	-2.8%
Management Fees	-4.2%
Total Deducts	<u>-1.4%</u>
Avg. Net Oper. Income -	<u>15.8%</u>

Note: (1) Property taxes added to cap rate. Reserves, Franchise & Management Fees added, as not all hotels report these numbers.

(2) Based on expenses for only those hotels reporting these items. See page 12 of HOST Report.

Mr. Damico referenced PT-1997-84, exhibit #3, a one page excerpt from **A**Hospitality Investment Survey - PKF Consulting@ for the determination of the selected capitalization rate of 11% (base rate):

<b>Capitalization Rates</b>	<b>Average</b>	<b>High</b>	<b>Low</b>
Full-Service	10.9%	15.0%	8.3%
Limited-Service	11.7%	16.0%	9.0%
Resort	10.4%	13.5%	5.0%

In the taxpayer's analysis, 11.0% has been selected the most appropriate capitalization rate for the subject property.

Mr. Damico's post-hearing submission, with reference for support for the capitalization rate, is a four page document authored by Jinneman, Kennedy, & Associated, P.S., Hospitality Consultants & Appraisers and is summarized as follows:

At your request, we completed certain consulting services regarding the selection of an appropriate capitalization rate for valuing hotels in Montana as of January 1, 1996. For our analysis, we used actual sales activity in Montana and southeast Idaho as one means of estimating an appropriate capitalization rate. We augmented the regional data with the results of several national surveys of hotel investment criteria. A discussion of each data source and the indicated return requirements are presented in the following paragraphs.

#### **Hotel Industry Investment Surveys**

##### **Landauer Hotel Investment Outlook**

...The report for the first half of 1996 indicates an average overall capitalization rate for full-service hotels of 9.75 percent, with responses ranging from 7.00 to 13.00 percent. For Limited-service hotels, an average capitalization rate of 11.55 percent was reported, with responses ranging from 10.00 to 14.00 percent.

##### **Coopers & Lybrand/Korpacz Survey**

...The 1st quarter 1996 survey indicates an average overall capitalization rate for full service hotels of 10.4 percent, 25 basis points less than the rate indicated in the 4th Quarter 1995 report, and a capitalization rate for limited-service

hotels of 12.39 percent, 14 basis points less than the rate indicated in the 4th Quarter report.

**HMBA Hotel Financing Survey**

The hotel financing survey completed by HMBA lists regional hotel sales transactions by type of owner and hotel size. According to the year-end 1995 report, hotel sales in the Mountain and Pacific region indicated an average capitalization rate of 12.7 percent, ranging from 9.4 percent for hotels with 75 to 250 rooms to 14.5 percent for those hotels with less than 75 guestrooms.

**Hospitality Investment Survey - PKF Consulting**

The Hospitality Investment Survey, Published by PKF Consulting, provides investment trends based on the expectations of buyers and sellers in lodging industry. In the second quarter of 1996, PKF's survey indicated an average capitalization rate for full-service hotels of 10.88 percent, ranging from 8.0 percent to 11.3 percent. For limited-service hotels, responses ranged from 8.5 to 14.5 percent, indicating an average overall capitalization rate of 11.76 percent.

...On a more regional level, investment in Montana has historically been perceived to carry a somewhat greater degree of risk than would be associated with investment in other areas of the United States. This greater risk is primarily the result of lower investor interest in Montana, Montana's remote location, and overbuilding of hotel properties, including the Missoula market. Accordingly, we would consider an appropriate capitalization rate to be slightly greater than those indicated by national sales data.

**Comparable Hotel Sale Properties**

Comparable hotel sales in Montana and southeast Idaho were researched and analyzed to provide a more regional indication. All these sales were researched and analyzed while our firm was completing appraisals of hotels in Montana. These sales were confirmed with the broker, the seller, or the buyer. Capitalization rates were computed by dividing the net operating income, after deduction of an appropriate property management fee and capital replacement reserve, by the sale price. Additional details of these sales are available from our office. The overall capitalization rates derived from the unadjusted comparable sales are summarized in the following table.

<b>Table 2</b>				
<b>Summary Of Comparable Hotel Sale Indicators</b>				
Property	Location	Sale Date	Year Built	Cap Rate
<i>Full-Service Hotel Sales</i>				
Ponderosa Inn	Great Falls, Montana		1969	Jun-91 10.9%

Best Western Canyon Springs	Twin Falls, Idaho	1973/1984	Aug-95	14.4%
Townhouse Inn	Great Falls, Montana	1972/1984	Feb-92	13.3%
Best Western War Bonnet Inn	Butte, Montana	1973/1977	Mar-93	11.2%
Best Western Colonial Inn	Helena, Montana	1970/1986	Apr-96	11.3%
Quality Inn	Pocatello, Idaho	1978	Mar-94	16.0%
<i>Limited-Service Hotel Sales</i>				
Super 8 Motel	Miles City, Montana	1978	Feb-92	12.4%
Super 8 Motel	Glendive, Montana	1978/1986	Mar-93	11.8%
Super 8 Motel	Whitefish, Montana	1989	Aug-93	15.0%
Best Western AmeriTel Inn	Idaho Falls, Idaho	1991	Jun-96	13.7%

The overall capitalization rates extracted from the above sales data indicate a range of unadjusted capitalization rates from 10.9 to 16.9 percent. These sales include both limited and full-service hotels and do not include sales of distressed properties. These capitalization rates are supported by the industry surveys, which indicate average overall capitalization rates from 9.75 to 12.70 percent, but also reflect the greater risk associated with the hotel industry in Montana.

Hotels are a unique type of real estate investment that carry risks and benefits not found in many other types of real estate investment. Unique characteristics of hotels include:

- , A large amount of personal property (furniture, fixtures, and equipment) necessary for operation.
- , The retail nature of operation, including the need to re-sell rooms on a daily basis and the labor intensity of the business.
- , Rapid functional obsolescence due to increased market segmentation in the industry.
- , Susceptibility to external factors, such as changes in the market area conditions or modes of travel, which can immediately affect the operating performance of a hotel.
- , Specialized nature of a hotel, which limits the number of potential buyers.
- , Potential for large profits once fixed costs are covered.
- , Because guestrooms are re-sold on a daily basis, changes in market conditions affect the value of hotels more rapidly than most other types of real estate. Accordingly, more risk is associated with the hotel investment than with other real estate investments, and higher capitalization rates are required. Based on investment surveys completed by Cushman & Wakefield and Dupre & Scott, typical capitalization rates for office properties in January 1996 averaged 9.0 percent, while typical capitalization rates for apartment properties averaged 8.3% percent. These rates are approximately 200 to 850 basis points less than those indicated by the actual comparable hotel sale data, demonstrating the additional risk associated with hotel investments in Montana.

#### DOR-S CONTENTIONS

DOR exhibit A is a copy of the property record and illustrates the following with respect to the improvements:

Structure

, Year built - 1981  
, Number of units - 132  
, Quality grade - Average +  
, Building area  
Building #1  
    Basement - 1,602 square feet  
    1st floor - 25,591 square feet  
    2nd floor - 23,451 square feet  
Building #2  
    1st floor - 3,800 square feet  
    2nd floor - 3,920 square feet



Building #3  
1st floor - 5,328 square feet  
2nd floor - 5,328 square feet  
, Physical condition - 2 (fair) & 3 (average)  
, Functional utility - 2 (fair) & 3 (average)  
, Percent good - 75% & 79% (accumulated depreciation - 21% & 21%)  
, Economic Condition Factor (ECF) - 105%

Other Building and Yard Improvements

, Paving (asphalt) - 37,000 square feet - \$40,830  
, Paving (asphalt) - 12,400 square feet - \$12,610  
, Paving (concrete) - 7,500 square feet - \$12,080  
, Fence - 6' X 244' - \$1,290  
, Whirlpool/Hot Tub - 9 person - \$1,550

DOR exhibit B is a four page document which the DOR requested the  
in appeals PT-1997-82, 83, 84 and 85. Mr. Fairbanks stated this exhibit  
appraiser, Sue Hoell. In summary this exhibit illustrates the following:

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FIVE LARGE VERY GOOD QUALITY MOTELS - 1997				
Property	Holiday Inn Parkside	Best Western Grant Creek	<b>Ruby-s Reserve Street Inn</b>	Holiday Inn Express
Year Built	1984	1996	<b>1981</b>	1996
Building Area	136,960	81,208	<b>67,020</b>	42,724
# of Rooms	200	126	<b>127</b>	95
Room Rate	\$56	\$63	<b>?</b>	\$55
Occupancy	71%	60%	<b>?</b>	50%
Room Income	\$2,918,832	\$1,738,422	<b>\$1,752,563</b>	\$953,563
Telephone Income	\$17,479	\$6,419	<b>\$0</b>	\$3,923
Other	\$67,730	\$0	<b>\$0</b>	\$14,746
Total Income	\$3,004,041	\$1,744,841	<b>\$1,752,563</b>	\$972,232
Total Expenses	\$2,366,591	\$1,180,887	<b>\$1,430,583</b>	\$572,393
Net Income	\$637,450	\$563,954	<b>\$321,980</b>	\$399,839
Value @ 9.5%	\$6,710,000	\$5,936,358	<b>\$3,389,263</b>	\$4,208,826
Value @ 13%	\$4,553,214	\$4,338,108	<b>\$2,476,769</b>	\$3,075,681
Pers Property(PP)	\$317,862	\$682,521	<b>\$183,658</b>	
Value 1 Less PP	\$6,392,138	\$5,253,837	<b>\$3,205,605</b>	\$4,208,826
Value 2 Less PP	\$4,235,352	\$3,655,587	<b>\$2,293,111</b>	\$3,075,681
Estm Rpl Cst Less Depr	\$7,097,782	\$5,930,640	<b>\$3,570,166</b>	\$3,415,714

Assessed Value	I \$6,823,800	C \$5,930,640	<b>I \$3,470,500</b>	C \$3,415,71
Value Per Room	\$21,177	\$29,013	<b>\$18,056</b>	\$32,376

This exhibit states further, ...The tax rep provided the department with Income and Expense statements from each of the five hotels along with a summary sheet on which he attempted to identify the main income and expense items which he felt were important to address. I cannot explain the numbers on his summary but they differ from the numbers I derived from the information provided by the owners.

I believe Mr (sic) Damico said that the income on his summary came from actual income but the expense numbers came from industry standards. To use a different standard for income than is used for expenses I believe is an error. If we use actual income , (sic) we must also use actual expenses. That is the approach we used.

I found the industry standards to be unreliable, conflicting and usually unsupportable.

The hospitality trade materials don't provide detailed support for their ratios, but it is likely that they influence the market regardless of the quality of their methodology...

...The trade materials differentiate ratios by region - New England, Mountain, Pacific, etc. Their data is primarily derived from property management firms operating in large metropolitan areas rather than small communities like Missoula.

A 14% cap rate was used by the agent although an 11% cap rate was suggested in the industry literature he provide. We used his 11% cap rate assuming that these larger motels are likely to be marketed in a national rather than a local market. We added to the 11%, our 2% tax rate.

We disallowed some of the expenses listed on the Income and Expense statements where such expenses did not contribute to the generation of income, such as bank charges, loan amortization and interest, cost of food for the restaurants, and unidentifiable categories such as the one listed by Best Western called **Acollateral materials@**. Non-typical expenses were disallowed.

Both in our original appraisal process and in our review of values, we used only information gathered from the Missoula motel community. In the later analysis, we used only the information provided by these hotel owners.

Five Missoula motels sold during the time frame of our reappraisal period. Income and Expense ratios were normalized for the Missoula area. Market I&E ratios and market cap rates were applied to each hotel/motel in the county to arrive at a value using the income approach.

The five larger motels have lower expense ratios than the smaller motels from which we derived our ratios.

The local market capitalization rate for the smaller motels is 9.5%.

Because much of the information we originally used came from small motel owners, it was decided that we would build a new model using the local information provided by the tax rep for the larger hotels....

The Hampton Inn, the smallest of the five, is of a higher quality construction than the Holiday Inn Express and Ruby's. It is next door to Ruby's and under the same ownership. There is a symbiotic relationship between the two facilities enhancing income for both. The Hampton Inn may have been slightly undervalued by the department. The value arrived at using the Income approach was used whereas the intent was to assess all the new motels using the cost approach.

The cost approach is the most appropriate approach for new commercial uses. It is clear that the developers were persuaded to invest the money required to build these hotels. They felt the cost was a fair representation of value when they made the decision to build which was just prior to our date of appraisal.

Furthermore, in the first year of operation, occupancy rates and room rates are unstable. There are extra set-up costs, and advertising has not had a chance to take effect. That is why the cost approach is felt to represent the most accurate approach to value for new commercial properties.

The income approach on the Hampton Inn using the 13% cap rate, supports the income value arrived at earlier using the original set of market information. An upward adjustment may be made next year for equity reasons if the legislative and administrative rules allow us to make such a correction...

Because of the strong hospitality market in Missoula, 2 more large new motels are being built for '98.

Mr. McKenna testified **A**One of the reasons why Ms. Hoell developed this presentation was because she wanted to look at the reasonableness of our numbers versus the reasonableness of the numbers that Mr. Damico supplied us. And as you have noticed in many cases they are very similar, the net operating incomes are very similar, so Sue drew the conclusions that since that wasn't a vast difference we should stick with our numbers.**@**

The DOR's market value of \$3,118,534 for the improvements was determined by the income approach to value.

DOR=s page 4 of exhibit A is the value determination from the income approach and in summary illustrates the following:

Income Portion

Base Rate	=	\$55.00
Market Type (Commer)	x	1.00
Quality Type (Average)	x	1.00
Adjusted Base Rate	=	\$55.00
x number units	x	132
x number days	x	365
Potential Gross Income=		\$2,649,900
Occupancy Predictedx		60%
Effective Gross Income=		\$1,589,940
Expenses 75% of Gross Income	=	\$1,192,455
Total Expenses	=	\$1,192,455
<b>Net Income</b>	<b>=</b>	<b>\$397,485</b>
Multi Use Storage	For Use Type Group 17	
Gross Leasable 1,602 X 3.15	=	\$ 5,046
Percent Occupancy	=	70%
Effective Gross Income=		\$ 3,532
Total Expenses	=	\$ 1,041
Management	=	\$ 177
Total	=	\$ 1,218
<b>Net Income</b>	<b>=</b>	<b>\$ 3,314</b>
Add Hotel	=	\$399,799
Income Capitalization		
Equity Ratio 1.00 x cash on cash	0.095 =	0.095
Effective Tax Rate		= 0.0202
Total Capitalization Rate		0.1152
Net Income 399,799 @ 0.1152		
Value, Income Approach		\$3,470,500
Cost		\$3,570,166
Income		\$3,470,500
Ratio		-3%

The DOR, in the development of a value from the income approach for the subject property, did not recognize income or expenses for the restaurant and lounge. The \$55.00 daily rate is the average rate within the motel model. Mr. Fairbanks testified

A...unless we add income it is a little hard to argue for an expense.

In this particular case there is no added income for the income generated by the restaurant, and that I find to be an error and apparently it was difficult, since the restaurant is in just part of the hotel and isn't a easily identifiable restaurant addition...@ Mr Fairbanks indicated that, within the cost and income approaches to value, the restaurant and lounge have not been identified.

Mr. Fairbanks testified (PT-1997-84) when establishing the capitalization rate, the DOR had a sufficient number of motel sales to develop an acceptable capitalization rate. Based on that confidence in this rate, the band-of-investment theory was not utilized as defined in 42.20.109.

Mr. Fairbanks indicated (PT-1997-84) when the income models were created, the income was adjusted to reflect that portion which would be attributable to personal property, (i.e. beds, televisions, etc.). He stated the nightly rent or room rate was discounted to reflect this amount.

DOR's exhibit B in PT-1997-84, which has been made a part of the record, is a compilation of motel/hotel properties which have sold along with the DOR's market value indications for this series of appeals. This exhibit is summarized as follows:

Comparable Sales						
	Yr. Built	Grade	# Units	Sale Date	Sale Amount	Per Unit

Sale #1	1982	A+	115	9/95	\$3,488,077	\$30,331
Sale #2	1981	A	117	4/94	\$3,740,000	\$31,966
Sale #3	1995	A+	52	9/95	\$1,900,000	\$36,538
Sale #4 *	1978	G	220	4/98	\$9,000,000	\$40,909
Sale #5 *	1972	A+	124	2/98	\$7,140,000	\$57,581
Sale #6 *	1970	G	149	4/96	\$9,150,350	\$61,412

Properties Under Appeal

	Yr. Built	Grade	# Units		Appraised Value	Per Unit
<b>Ruby-s (97-86)</b>	<b>1988</b>	<b>A+</b>	<b>132</b>	<b>N/A</b>	<b>\$3,470,500</b>	<b>\$26,292</b>
Holiday Inn Parkside (97-82)	1984	G+	200	N/A	\$6,823,800	\$34,119
Holiday Inn Express (97-83)	1996	G-	97	N/A	\$3,415,714	\$35,214
Grant Creek Inn (97-84)	1996	G	130	N/A	\$5,930,640	\$45,620
Hampton Inn (97-85)	1996	G	60	N/A	\$2,760,300	\$46,005

\* full service facility

Mr. Fairbanks testified (PT-1997-84) the DOR does not market model commercial properties to determine market value.

Exhibit B was presented to illustrate the comparison of sold properties on a price per unit (sale price/number of rooms) with the DOR's per unit value of the properties under appeal (DOR market value/number of rooms).



Mr Fairbanks testified (PT-1997-84) daily rates and occupancy rates are not difficult to obtain, but net operating income from properties which have sold is not so easily ascertained; therefore, the DOR will create or normalize the income and expenses in order to establish the net operating income. This net operating income is then used to develop a capitalization rate.

The DOR's post-hearing submission illustrates the following in support of the 9.5% capitalization rate before applying the effective tax rate:

MARKET-BASED CAP RATES FOR MISSOULA COUNTY MOTELS					
Taken from RTCs and income/expense reports					
Sale #	Sale #1	Sale #2	Sale #3	Sale #4	Sale #5
Sale Date	September >95	April >95	April >93	May >93	February :
Sale Price	\$1,900,000	\$325,000	\$500,000	\$347,500	\$170,000
Net Income	\$180,500	\$29,920	\$47,158	\$35,000	\$16,660
Cap Rate	9.50%	9.21%	9.43%	10.00%	9.80%

### DISCUSSION

The Administrative Rules of Montana (ARM) provides that the DOR establish market value from the income approach.

ARM, 42.20.107 Valuation Methods For Commercial Properties .

(1) When determining the market value of commercial properties, other than industrial properties, department appraisers will consider, if the necessary information is

available, an income approach valuation.

(2) If the department is not able to develop an income model with a valid capitalization rate based on the stratified direct market analysis method, the band-of-investment method or collect sound income and expense data, the final value chosen for ad valorem tax purposes will be based on the cost approach or; if appropriate, the market approach to value. The final valuation is that which most accurately estimates market value. (emphasis added)

ARM, 42.20.108 Income Approach.

(1) The income approach is based on the theory that the market value of income producing property is related to the amount, duration, and certainty of its income producing capacity. The formula used by the department to estimate the market value of income producing property through application of the income approach to value is  $V = I/R$  where:

(a) AV@ is the value of the property to be determined by the department;

(b) AI@ is the typical property net income for the type of properties being appraised; and

(c) AR@ is the capitalization rate determined by the department as provided in ARM 42.20.109.(emphasis supplied)

ARM, 42.20.109 Capitalization Rates.

(1) When using the income approach, the department will develop overall capitalization rates which may be according to use type, location, and age of improvements. Rates will be determined by dividing the net operating income of each property in the group by its corresponding valid sale price.

The overall rate chosen for each group is the median of the rates in that group. The final rate must include an effective tax rate. (emphasis added)

(2)(a) If there are insufficient sales to implement the provisions of ARM 42.20.109 (1), the department will consider using a yield capitalization rate. The rate shall include a return of investment (recapture), a return on investment (discount), and an effective tax rate. The discount is developed using a band-of-investment for types of commercial property. The band-of-investment method considers the interest rate that financial institutions lend on mortgages and the expected rate of return an average investor expects to receive on their equity. This method considers the actual mortgage rates and terms prevailing for individual types of property.

(b) A straight-line recapture rate and effective tax rate will be added to the discount rate to determine the yield capitalization rate.

The taxpayer's net operating income (NOI) from exhibit #1 is \$366,181 and the DOR's NOI from exhibit A is \$399,799. The major disparity between the party's income approaches lies with the determination of an appropriate capitalization rate. The taxpayer capitalized the NOI at 12.8% (11.0% - base rate + 1.8% - effective tax rate) and the DOR capitalized the NOI at 11.52% (9.5% + 2.02% effective tax rate). The Board requested that each party provide additional support for their respective capitalization rates through post-hearing submissions. The taxpayer's support for its capitalization rate was provided by JK & Associates, Hospitality Consultants & Appraisers. The DOR's support for its capitalization rate was provided by five additional motel sales. The post-hearing submissions have been submitted for the immediate appeal and appeals PT-1997-82, 83, 84 & 85. The appeals are for limited-service motels as well as full service motels. The Board notes that capitalization rates may vary depending upon the type of motel property along with all the additional components that affect value, i.e. age, condition, location, etc.

The DOR testified (PT-1997-84), when determining the capitalization rate from properties that have sold, the NOI's for those sales were created rather than using properties' actual NOI's at the time of sale. It is the Board's opinion

that an actual NOI should be used if possible when establishing a capitalization rate. The Board realizes that adjustments may need to be made to the reported NOI, i.e. taxes, management, reserves for replacement, etc. It is the Board's opinion that simply creating an NOI does not reflect an actual capitalization rate for the various sales. In addition, the Board was not presented evidence explaining how the various NOI's were created.

The DOR adjusts the value of the improvements as determined by the cost approach by an ~~A~~Economic Condition Factor<sup>@</sup> (ECF). The ECF is a market adjustment factor. The International Association of Assessing Officers (IAAO) states:

Market adjustment factors are often required to adjust values obtained from the cost approach to the market. These adjustments should be applied by type of property and area based on sales ratio studies or other market analyses. Accurate cost schedules, condition ratings, and depreciation schedules will minimize the need for market adjustment factors. (IAAO, 1990, Property Appraisal and Assessment Administration, pages 311-312)(Emphasis applied)

An ECF for a neighborhood is derived from sales; but there was no evidence or testimony from the DOR to indicate the ECF of 105% that was applied was developed from sales of properties of the same type as the subject property. It was testified that the ECF was determined from sales of all commercial property.

Mr. Fairbanks testified **A**...it might be much more appropriate to specifically identify an ECF for specific occupancy.<sup>@</sup> Mr.

Fairbanks further testified, AI don't think we had enough sales to identify an ECF for occupancy.@"

The DOR in PT-1997-84, exhibit B presented the Board with six motel property sales. This exhibit compares the DOR's value indications for the five motel properties represented by Mr. Damico with six motel property sales. The properties vary in comparability (i.e., full-service, limited service, age, size, location, etc). The DOR presented this exhibit to illustrate what motel properties are selling for on a price per motel room.

Motel properties can be viewed as having a ~~A~~going-concern value@, defined in the Appraisal of Real Estate, 11th Edition, as:

*Going-concern value is the value of a proven property operation. It includes the incremental value associated with the business concern, which is distinct from the value of the real estate. Going-concern value includes an intangible enhancement of the value of the operating business enterprise, which is produced by the assemblage of the land, buildings, labor, equipment, and the marketing operation. This assemblage creates an economically viable business that is expected to continue. Going-concern value refers to the total value of a property, including both real property and intangible personal property attributed to business value.*

Going-concern appraisals are commonly conducted for hotels and motels, restaurants, bowling alleys, industrial enterprises, retail stores, shopping centers, and similar properties. For these properties, the physical real estate assets are integral parts of an ongoing business. It may be difficult to separate the market value of the land and the improvements from the total value of the business, but such division of reality and nonreality

components of value is often required by federal regulations. (emphasis added)

The Board realizes the sales illustrated and used by the DOR for comparison purposes may, in fact, reflect the inclusion of **Going-concern** values and the DOR is appraising for ad valorem purposes. The DOR did not establish the market value for the subject property by the sales comparison approach to value, but the sales illustrated would need to be adjusted for the inclusion of personal property, excess land, business inventory, liquor/gaming license and intangibles that may have been included in the transaction.

Mr. Damico developed the requested market value from the income approach to value. The income statement for year-end 1996 was used for the development of the market value. Mr. Damico stated he used the operating statement for year 1996 because it was the closest year to the DOR appraisal date. The subject property has an operating history and it is typical appraisal practice to analyze the operating history.

Mr. Damico added back the nonapplicable expenses (depreciation, interest, property taxes and owner's life insurance) to the income to arrive at the NOI for ad valorem purposes. In addition, Mr. Damico recognized a reserve for replacement expense of \$91,538 or 5% of the total revenue.

The International Association of Assessing Officers (IAAO), Property Assessment Valuation states, **The following**

categories are proper expenses related to the operation of a property: (1)management, (2)salaries, (3)utilities, (4)supplies and materials, (5)repairs and maintenance, (6)property taxes, (7)insurance, (8)miscellaneous, and (9)reserves for replacement.(emphasis added) The Dictionary of Real Estate, 3rd Edition defines reserves for replacement as **A**An allowance that provides for the periodic replacement of building components that wear out more rapidly than the building itself and must be replaced during the buildings economic life@.

As previously mentioned, the operating statement presented by Mr. Damico contained numerous expense categories.

There is not an expense category identified for capital expenditures. In addition, nothing was presented to the Board to indicate that capital expenditures were not incurred during 1996. A motel property the size of the subject should have an ongoing maintenance program. For 1996 the repairs and maintenance expense totaled \$93,203.18. It is impossible to derive whether or not replacement allowance items are included in the 1996 operating statement. It is the Board's opinion that without a more detailed breakdown there is the possibility of an overstatement of expenses by applying what may be considered an appropriate reserves for replacement allowance of 5% and not knowing if capital expenditures for year 1996 are included in the 1996 operating statement.

Mr. Fairbanks indicated (PT-1997-84) that when the income models were created, the income was adjusted to reflect the portion that would be attributable to personal property, (i.e. beds, televisions, etc.). He stated that the nightly rent or room rate was discounted to reflect this amount. The Board was not presented anything to support the DOR's position to indicate that, when the motel/hotel income model was developed, the room rate was adjusted to reflect the personal property.

It is the Board's opinion there was sufficient data presented by both parties to establish the market value for the subject property by means of the income approach. By recognizing the evidence and testimony presented, it is the Board's opinion the value for the subject improvements should be calculated as follows:

<b><u>INCOME</u></b>	
Number of rooms	127
Room Rate	\$55.00
Number of Days	365
Potential Gross Income (PGI)	\$2,549,525
Occupancy	60%
Effective Gross Income (EGI)	\$1,529,715
<b><u>EXPENSES</u></b>	
Expenses (75% of EGI)	\$1,147,282
Net Operating Income (NOI)	\$382,429
Overall Capitalization Rate	12.8%
Total Value Indication	
\$382,429/.128 =	\$2,987,725
Less: Personal Property	(\$183,658)
Land	(\$351,966)
Improvement Value	\$2,452,101

Mr. McKenna stated in the post-hearing submission:

The courts have ruled (Western Airlines Versus Michonovich 149



Montana, page 347 (1967) that the burden of disproving the DOR's valuation rests with the appellant, and that there is a presumption of correctness in the DOR's appraisal.® This statement is correct but incomplete. The court's decision further stated **A...**the taxing agency should bear a certain burden of showing the propriety of their action.®

Mr. McKenna also stated in his post-hearing submission: **A**Indeed, Mr. Damico testified under oath before the Missoula County Tax Appeals Board that, after considerable review, the properties were not properly appraised and should be valued at one level, and then testified under oath to STAB that, after considerable review, the properties were not properly appraised and should be valued at a higher value. The DOR's valuation has never wavered.®

This Board has always dealt with and allowed a modification of the values requested by the taxpayers. There are any number of reasons that could warrant such a modification following an appearance before a local tax appeal board. A change in the requested value does not constitute an inconsistency or a contradiction of prior testimony that could be seen as an unfair surprise to the DOR, particularly in this case since the requested value was increased from that requested by the taxpayer before the local tax appeal board.

Mr. McKenna was provided the opportunity of examination of Mr.

Damico and his exhibits and to draw from those the inconsistencies Mr. McKenna may have believed existed. It is unclear why that issue was raised in a post-hearing submission.

In Department of Revenue v. BN Inc., 169 Mont. 202, A..while STAB reviewed the assessment (as it may under section 84-708(3), R.C.M. 1947), augmenting the record so it might better perform its duty, as stated in section 84-709:

A \*\*\* to affirm, reverse or modify any decision appealable to the state tax appeal board \*\*\*@.

To perform this function, STAB may have a completede novo hearing, for the infrequent case in which the board is of the opinion that it should examine all of the record of the Department, and additional evidence, on a firsthand basis, so as to reach a fair, just and equitable holding..@ (emphasis added)

Based on the evidence and testimony presented to the Board, the market value for the subject improvements, Ruby's Reserve Street Inn, is \$2,452,101 as determined by the Board.

#### CONCLUSIONS OF LAW

1. The State Tax Appeal Board has jurisdiction over this matter. '15-2-301 MCA.

2. '15-8-111, MCA. **Assessment - market value standard - exceptions.** (1) All taxable property must be assessed at 100% of its market value except as otherwise

provided.

3. **15-2-301, MCA, Appeal of county tax appeal board decisions.** (4) In connection with any appeal under this section, the state board is not bound by common law and statutory rules of evidence or rules of discovery and may affirm, reverse, or modify any decision.

4. **Western Airlines, Inc. v. Catherine J. Michunovich, et al, 149 Mont. 347.428 P.2d 3.(1967).**

5. **Department of Revenue v. BN Inc., 169 Mont. 202.**

6. Evidence and testimony in PT-1997-82, PT-1997-83, PT-1997-84 & PT-1997-86.

7. The appeal of the taxpayer is hereby granted in part and denied in part decision of the Missoula County Tax Appeal Board is modified.

**ORDER**

IT IS THEREFORE ORDERED by the State Tax Appeal Board of the State of Montana that the subject improvements shall be entered on the tax rolls of Missoula County by the County Assessor at the 1997 tax year value of \$2,452,101.

Dated this 23rd of December, 1998.

BY ORDER OF THE  
STATE TAX APPEAL BOARD

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PATRICK E. MCKELVEY, Chairman

( S E A L )

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GREGORY A. THORNQUIST, Member

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LINDA L. VAUGHEY, Member

NOTICE: You are entitled to judicial review of this Order in accordance with Section 15-2-303(2), MCA. Judicial review may be obtained by filing a petition in district court within 60 days following the service of this Order.