STATE OF MINNESOTA

IN SUPREME COURT

A22-1201

Tax Court Thissen, J.

Bloomington Hotel Investors, LLC,

Relator,

vs.

Filed: August 9, 2023
Office of Appellate Courts

County of Hennepin,

Respondent.

Thomas R. Wilhelmy, Gauri S. Samant, Fredrikson & Byron, P.A., Minneapolis, Minnesota, for relator.

Mary F. Moriarty, Hennepin County Attorney, Sara L. Bruggeman, Steven R. Gershone, Assistant County Attorneys, Minneapolis, Minnesota, for respondent.

S Y L L A B U S

1. The tax court's assessment of the market value of a full-service hotel using the income capitalization approach, including its use of the management fee method, was not erroneous.

2. The tax court's assessment of the value of a full-service hotel under the sales comparison approach was generally not erroneous. The tax court, however, erred to the

extent that nothing in the record shows that it correctly adjusted its percentage reduction in the total value of a comparator hotel used in the sales comparison approach.

Affirmed in part, vacated in part, and remanded.

O P I N I O N

THISSEN, Justice.

Relator Bloomington Hotel Investors, LLC (Bloomington Investors), the owner of a DoubleTree in Bloomington, (the DoubleTree), challenges the value that the Minnesota Tax Court placed on the DoubleTree for tax assessment purposes. The tax court determined that the taxable 2018 market value of the DoubleTree was $25,500,000, an amount that exceeded the valuations offered by Bloomington Investors and respondent County of Hennepin (the County). We vacate and remand to the tax court on a single issue: the tax court is directed to revisit and explain its adoption of the percentage reduction to the sales price of one of the comparator hotels that it used in its sales comparison analysis to account for non-taxable assets included in the sales price. To the extent doing so requires any recalculation or adjustment to the taxable 2018 market value it placed on the DoubleTree, we further direct the tax court to do so. We otherwise affirm the decision of the tax court.

FACTS

Background

On January 2, 2018, the assessment date, Bloomington Investors owned the DoubleTree. Bloomington Investors operated the DoubleTree under a franchise agreement with Hilton Franchise Holding, LLC (Hilton). Hilton owns the hotel brand. The property has a full-service hotel with 564 rooms and approximately 71,957 square feet of conference and meeting space. The DoubleTree has an onsite restaurant, bar, and café, as well as a gift store. The DoubleTree operates each of these services itself.

On September 3, 2019, Hilton sent Bloomington Investors a notice of default under the franchise agreement. The stated event of default was the DoubleTree's 12 consecutively failed quality assurance evaluations over 6 years. Under the notice of default, the DoubleTree was required to obtain an overall score of "Acceptable" or better by January 30, 2020, or its DoubleTree franchise was subject to termination. As part of the process, Hilton issued a formal Product Improvement Plan for the DoubleTree.

The Product Improvement Plan explained the items "earmarked for improvement" at the DoubleTree. The improvements are those that are relevant to the Hilton brand and "are based on conditions at the hotel." Bloomington Investors did not undertake performance of the Product Improvement Plan items. This failure was not only a default under the franchise agreement with Hilton, but also a default under the mortgage with its lender, Colony Capital (Colony).

In November 2019, Vinakom, Inc. (Vinakom) provided to Bloomington Investors a $26 million letter of intent to purchase the DoubleTree. Bloomington Investors did not accept the offer at that time. A few months later, on May 19, 2020, the parties signed a purchase order for $26 million, the amount of the offer.

Before Bloomington Investors accepted the offer, Colony engaged an engineering firm to inspect the DoubleTree and prepare a Property Condition Report. The Property Condition Report provided an opinion concerning the overall property condition, options of cost for immediate and short-term repairs, and an opinion of the costs for capital replacement reserve items anticipated to occur. The report stated that "[b]ased on the systems and components observed during the site visit, the subject property appeared to be in good condition. The overall level of preventative maintenance appeared to be good." The report was dated December 16, 2019. The sale closed on July 30, 2020. The tax court found that the "sale was subject to the [Product Improvement Plan]."

Valuation of the DoubleTree Real Property and the Trial

The central question in this case is the proper value of the DoubleTree on the assessment date, January 2, 2018. The County initially assessed the value of the DoubleTree real property at $31,586,400. Bloomington Investors appealed the valuation to the tax court. *See* Minn. Stat. § 278.01, subd. 1 (2022) (providing for appeals of assessed value to the tax court).

At trial, Bloomington Investors and the County presented expert appraisals and testimony in support of their proposed valuations. Bloomington Investors' expert, Daniel Boris, used two assessment approaches to value the DoubleTree: the income capitalization approach (which resulted in an estimated value of $14,925,000) and the sales comparison approach (which resulted in an estimated value of $15,645,000). After weighing the probative value of the two approaches, Boris settled on a valuation of $15,000,000. The County's expert, Donald Palmer, also used two assessment approaches to value the DoubleTree: his income capitalization approach at trial resulted in a valuation of $23,095,140, and his sales comparison approach resulted in a valuation of $26,775,000. At trial, Palmer settled on a final valuation of $23,500,000.

After trial, the tax court determined that the taxable 2018 market value of the DoubleTree was $25,500,000. This valuation reflected an equal weighting of the tax court's $24,500,000 valuation using the income capitalization approach and its $26,500,000 valuation (rounded) using the sales comparison approach. Bloomington Investors challenges that determination in this appeal.

ANALYSIS

Minnesota statutes direct that "all property shall be valued at its market value." Minn. Stat. § 273.11, subd. 1 (2022). Market value is "the usual selling price at the place where the property to which the term is applied shall be at the time of assessment; being the price which could be obtained at a private sale or an auction sale." Minn. Stat. § 272.03, subd. 8 (2022).

With certain exceptions not relevant here, only real property is subject to property tax; personal property, including personal intangible assets, are not subject to property tax and should not be included when valuing real property for tax purposes. Minn. Stat. § 272.02, subd. 9 (2022) (providing that personal property is generally exempt from tax); Minn. Stat. § 272.03, subds. 1–2 (2022) (defining real and personal property). Accordingly, when an entity owns real property to operate a business that generates income from personal goods and services, the value of the taxable real property must be separated from the value of non-real property assets (like personal property assets and intangible business assets). *See The Appraisal of Real Estate* 663 (15th ed. 2020); *see 1300 Nicollet, LLC v. County of Hennepin*, 990 N.W.2d 422, 435 (Minn. 2023).

For instance, the value of a full-service hotel consists of both the value of the real property assets (like the land on which the hotel stands and the building in which the hotel operates) and the value of non-real property assets like income generated from services, such as a restaurant or conference center, furniture and trade fixtures, and the value of the hotel brand. When assessing the real estate value of a full-service hotel, the appraiser must separate out the value of non-real property assets. *See The Appraisal of Real Estate*, *supra*, at 663 (citing The Appraisal Foundation, *Uniform Standards of Professional Appraisal Practice* (*USPAP*), Standards Rule 1-4(g) (2020-2021)). One of the central disputes here is over the proper method for differentiating the value of the taxable real property assets and the value of non-taxable non-real property assets of the DoubleTree.

We recognize three approaches for valuing real property: the cost approach, the income capitalization approach, and the sales comparison approach. *Inland Edinburgh Festival, LLC v. County of Hennepin*, 938 N.W.2d 821, 825 (Minn. 2020). Appraisers often use multiple approaches to valuing real estate and then assign a proportionate weight to the estimated value derived from each method to settle on the final estimated value of the property. The parties and the tax court agreed that the cost approach was not useful as an approach to valuing the DoubleTree.

In this case, both experts used, and the tax court relied upon, the income capitalization approach and the sales comparison approach in their valuations but each differed in their respective applications of those approaches. On appeal, Bloomington Investors challenges the tax court's application of both the income capitalization approach and the sales comparison approach.

Our review of a tax court's valuation decision is limited and deferential. *See Eden Prairie Mall, LLC v. County of Hennepin*, 797 N.W.2d 186, 192 (Minn. 2011). We review the tax court's application of law de novo. *KCP Hastings, LLC v. County of Dakota*, 931 N.W.2d 773, 778 (Minn. 2019). We review for clear error the tax court's valuation of property. *1300 Nicollet, LLC v. County of Hennepin*, 990 N.W.2d at 434. An error is clear if the decision is not reasonably supported by the evidence as a whole and we are left with a "definite and firm conviction that a mistake has been committed." *Hansen v. County of Hennepin*, 527 N.W.2d 89, 93 (Minn. 1995) (citation omitted) (internal quotation marks omitted). "The inexact nature of property assessment necessitates that this court defer to the decision of the tax court unless the tax court has either clearly overvalued or undervalued the subject property, or has completely failed to explain its reasoning." *Id.* The tax court "brings its own expertise and judgment to the hearing, and its valuation need not be the same as that of any particular expert as long as it is within permissible limits and has meaningful and adequate evidentiary support." *Montgomery Ward & Co. v. County of Hennepin*, 482 N.W.2d 785, 791 (Minn. 1992). We will not reweigh the evidence or assess the credibility of witnesses. *Medline Indus., Inc. v. County of Hennepin*, 941 N.W.2d 127, 131 (Minn. 2020).

I.

We turn first to Bloomington Investor's challenges to the tax court's income capitalization approach analysis. The income capitalization approach analyzes the value of real property by assessing the capacity of the property to generate income to the owner of the real property. To make that determination, the appraiser must estimate the annual net income the real property will generate (at its most basic level, the gross market rent the owner of the real property could charge minus relevant expenses). *See Inland Edinburgh Festival, LLC*, 938 N.W.2d at 825–26. The appraiser must then project that annual net income into the future subject to a discount rate to determine the total present value of those income streams. *Cont'l Retail, LLC v. County of Hennepin*, 801 N.W.2d 395, 402 (Minn. 2011) ("The income capitalization approach determines the value of income-producing property by capitalizing the income the property is expected to generate over a specific period of time at a specified capitalization yield rate.").

A significant dispute relating to the tax court's income capitalization analysis in this case arises out of the first step—estimating the annual net income generated from the real property of the DoubleTree. As discussed above, only real property assets are taxable. In the context of the income capitalization approach to valuing property, that means only the income generated from real property assets may be used to estimate the taxable value of the hotel property. That analysis requires the appraiser to distinguish between two sources of income: income generated to the full-service hotel through real property assets, and income generated through non-real property assets (such as business income from restaurants and other retail services, personal property like furniture and fixtures, and the value associated with a brand name).

The Income Capitalization Method of Daniel Boris for Bloomington Investors

The parties' experts disagreed over the proper method for identifying and excluding the income generated from non-real property assets of the DoubleTree. Bloomington Investors' expert, Daniel Boris, used the parsing income method and the proxy rent method to separate real property value from business and other intangible value. *See The Appraisal of Real Estate*, *supra*, at 676.

The parsing income method "involves estimating the business entity's total value . . . and then removing the value of income and expenses that are not attributable to the real estate itself." *1300 Nicollet, LLC*, 990 N.W.2d at 428–29. Accordingly, Boris started with the DoubleTree's actual financial reports that divided the hotel's total revenues and expenses into three broad categories: gross revenues from room rental, gross revenues from food and beverage sales, and gross revenues from other and miscellaneous sources, like gift shop sales and sales of internet packages and other hotel "amenities."

Boris attributed all the room rental gross income to the real estate assets of the DoubleTree. But he took a more nuanced approach to the net income derived from food and beverage sales and other miscellaneous sources. For instance, Boris recognized that a portion of the income from the hotel restaurant business should be allocated to the real property on and in which the restaurant operated. He also recognized that other income generated by the hotel restaurant business derived from non-real property sources, like the sale of food and beverages, the ambience and service in the restaurant and effective restaurant management, should not be allocated to the real property.

The portion of the income to the hotel owner generated by the real property on and in which a hotel restaurant is operated is easier to identify where a third-party leases space to operate a restaurant. When the hotel owner (or owner of property on which a stand-alone restaurant operates) leases space to a restaurant operator, the restaurant operator will use part of the restaurant income to pay rent to the property owner—and rent is precisely the income to the property owner derived from the value of the real property. *See The Appraisal of Real Estate*, *supra*, at 663.

The task of identifying the portion of income generated by the DoubleTree real property to Bloomington Investors is more complicated because the hotel itself operated the restaurant space. There was no lease with a third-party operator and thus no lease with a rent amount to use to calculate the income from the real property. Accordingly, a proxy for an actual rent was employed to properly value the real property. Boris used the proxy rent technique to separate the income generated by sales of food and beverage within the hotel (the restaurant operations) from the income generated by the real property in which the restaurant operated. *See 1300 Nicollet, LLC*, 990 N.W.2d at 429 ("The proxy rent technique seeks to establish what the rent *would* be, had the spaces been leased to a third party.").

Boris concluded that it was appropriate to assume that had the restaurant in the hotel been leased to an independent operator, that operator reasonably would have paid 10 percent of its gross food and beverage sales in rent to the hotel. He based this determination on conversations with a Twin Cities restaurant broker who informed him that "most restaurant and bar properties can support Real Estate Rent of 6.0% of Gross Sales for 'stand alone' facilities" (facilities not inside a hotel).[1] Boris also based this percentage on appraisal treatises admitted into evidence, including a text by Stephen Rushmore (the progenitor of the management fee method that we will discuss shortly). Boris increased his estimate of percentage of gross sales that an independent restaurant located in the DoubleTree would pay as rent to 10 percent because "room guests (and conference attendees) will spend money on Food and Beverage services as part of their stay." Essentially, Boris increased his estimate of food and beverage income related to the real property (thereby *increasing* his estimate of the value of the hotel real property) because hotel guests and conference attendees were a somewhat captive audience; the guests and conference attendees would buy more food and beverages and perhaps pay more because they were on that specific property.[2]

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[1] Boris noted that he did not specifically consider restaurants in hotels in making his determination. At trial, Boris stated that the restaurant broker he spoke with brokered stand-alone restaurants but also "all forms of restaurants whether they are part of a larger package of real estate or not. Boris also stated, "I'm not sure if you would single out just restaurants that are stand-alone."

[2] Boris made a similar calculation to determine the income generated by the real estate on and in which Bloomington Investors operated gift and sundry shops. There, Boris applied a 7 percent proxy rent to the 4-year average of each of the other and miscellaneous revenue streams.

In summary, Boris calculated gross revenues derived from the DoubleTree real property as follows:

Revenue Source	**Gross Revenue Amount Derived from Real Estate**	**Basis for Calculation**	**Percentage of Total Gross Revenue**
Room Revenue	$15,811,750	Actual Room Rental Revenues Over Previous Four Years	93.7%
Food & Beverage Revenue	$1,019,675	10% of Total Food & Beverage Sales	6%
Other/Miscellaneous	$48,913	7% of Total Other/Miscellaneous Sales	.3%
TOTAL	$16,880,338		100%

From the total gross revenues, Boris deducted expenses associated with operating the DoubleTree: fixed expenses and variable expenses (management fees; utilities; repairs and maintenance; furniture, fixtures, and equipment; and reserves for replacement). The expenses totaled $10,178,375. Boris also deducted the hotel franchise fee which totaled $1,343,999. Accordingly, Boris calculated that the DoubleTree annual net income derived from real property was $5,357,964. Boris then applied a combined capitalization rate and effective tax rate of 13.42 percent to the net income figure[3] and estimated that an arms-length buyer would value the DoubleTree real estate at $14,925,000—a figure that Boris rounded to $15,000,000.

[3] The tax court used a capitalization rate of 9.3 percent in its calculation and an effective tax rate of 3.59 percent or a combined rate of 12.89 percent. Those decisions are not challenged on appeal.

The Income Capitalization Approach of Donald Palmer for the County

In his analysis of the income-producing capacity of the Doubletree, the County's expert, Donald Palmer, used a different method—the management fee method (also known as the "Rushmore" method)—to separate the real property value of the DoubleTree from the business or intangible value of the hotel. Under this method, management fees and franchise fees represent the value of expert management services and access to hotel brands and, accordingly, those fees provide a sufficient stand-in for the intangible non-real property assets of a hotel. *See generally The Appraisal of Real Estate*, *supra*, at 676–77. Accordingly, under the management fee approach, a management fee and/or a franchise fee (as well as other operating expenses) are deducted from total hotel revenues from all sources, and the result of that calculation represents the value of a hotel's real property assets. *Id.* at 677. Palmer stated that the management fee approach is "commonly used to value hotel properties for ad valorem tax purposes" and "has been embraced by the International Association of Assessing Officers [] for the valuation of lodging facilities."

In accordance with the management fee method, Palmer started his income capitalization analysis by calculating the total hotel revenues, including income from all sources (room rentals, food and beverage, and other income), and then subtracted all expenses specific to each of the income sources, as well as general operating expenses and reserves for replacement. Notably for this appeal, one of the expenses that Palmer deducted as an "undistributed operating expense" in this part of his calculation was the DoubleTree franchise fee.

Another notable expense for purposes of this appeal was a reduction to address the need for an arms-length buyer of the DoubleTree to spend money to upgrade the hotel. The buyer will anticipate lower net income from the hotel to the extent it has to invest money earned from hotel operations to upgrade the hotel after purchase. To determine the amount of that expense for purposes of his income capitalization approach analysis,[4] Palmer created a hypothetical reserve for replacement fund based on 6 percent of room revenue. Palmer acknowledged that 3–5 percent of room revenues would be a typical reserve for replacement fund but concluded that 6 percent would "better represent what current management and any possible investor would prudently use."[5]

From these calculations, Palmer derived a total net annual revenue amount of $5,263,532. This amount included all revenues—those derived from taxable real property assets and those derived from non-taxable non-real property assets like intangible business assets and personal property. He then applied a loaded capitalization rate (including a percentage for estimated property taxes) of 12.89 percent to set the total (or "going

[4] In his sales comparison analysis, Palmer approached the issue of the amount an arms-length buyer would set aside for future upgrades differently: He deducted $19,880,000 to account for the investments "required to bring [the DoubleTree] to competitive status, which would help [it] attain higher revenues in line with similar upscale hotels." In contrast, Palmer's estimated reserve for replacement fund in his income capitalization approach amounted to a deduction of $7,293,685 (the annual reserve for replacement amount of 6 percent of total room revenue capitalized at the combined capitalization rate and effective tax rate of 12.89 percent used by Palmer). Palmer testified that the income replacement adjustment did not require the same deduction used in his sales comparison analysis. Of course, a smaller deduction means a higher total taxable value.

[5] A higher deduction for a reserve for replacement fund decreased Palmer's estimate of the total value of the DoubleTree.

concern"[6]) value of the hotel, all sources of income included. The result was a total value for the hotel including all assets (real property and non-real property) of $40,834,229.

Palmer then made two deductions to eliminate value related to non-real property assets. First, he deducted the portion of the total capitalized net income (and thus value) associated with the personal property used in the hotel such as room furnishings, furniture, and fixtures, as well as equipment used in the restaurant, kitchen, and other public spaces in the hotel. The total personal property deduction was $6,716,350. This specific deduction as used as part of Palmer's approach is not challenged on appeal.

Second, Palmer deducted the capitalized value of the franchise fee to account for income derived from non-real property and non-personal property assets, including income related to the businesses run on the property. This franchise fee deduction is Palmer's version of the "management fee" required as part of the management fee approach to distinguishing value attributable to real property assets from value attributable to intangible and other business assets. *See The Appraisal of Real Estate*, *supra*, at 676 ("The management fee approach has been used by some appraisers as a variant of overall capitalization analysis. From that viewpoint, deduction of franchise fees and management fees accounts for returns to the business."). Under Palmer's calculation, the value of the business component for the hotel operations was $8,192,723. Importantly, this franchise fee deduction duplicated the previously discussed deduction for the franchise fee that

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[6] A business entity's "going concern" can include "real property, tangible personal property (such as furniture, fixtures, and equipment) and intangible assets." *The Appraisal of Real Estate*, *supra*, at 663.

Palmer made when determining total operating expenses as part of his initial calculation of the total net operating income of the DoubleTree.

After completing these calculations, Palmer initially concluded that the value of the real property assets of the DoubleTree under the income capitalization approach was $25,990,000.

Palmer's income capitalization analysis was complicated at trial because Palmer acknowledged that he erroneously used the wrong number for the franchise fee expense. Rather than $1,056,042 (which he used in his report), Palmer explained that the franchise fee was, in fact, $1,402,831. Applying the capitalization rate to the correct franchise fee, Palmer explained that the correct capitalized value of the franchise fee should be $11,022,739. After making that adjustment, Palmer concluded that the final value of the DoubleTree under the income capitalization approach was $23,095,140.

Palmer's final income approach analysis may be summarized as follows:

Going Concern Value (including all sources of net income)	$40,834,229	Total revenues (all income less all expenses) multiplied by capitalization rate
Less Franchise Fee (corrected amount at trial) to account for business income	($11,022,739)	Calculated by multiplying franchise fee by capitalization rate
Less Personal Property	($6,716,350)	Calculated by applying a depreciation rate of 67% to industry standard cost of replacing furniture, fixtures, and equipment and adding 20% as reasonable rate of return on balance after depreciation
Value of Real Property	$23,095,140	

In short, like Boris, Palmer recognized that the taxable value of the property could only be based on the net income derived from the real property. Applying a management fee approach, Palmer calculated the total net income from all sources of income and then subtracted income related to (1) personal property (the furniture, fixtures, and equipment calculation) and (2) intangible business expenses using the capitalized franchise fee calculation as an approximation.

In its order, the tax court adopted Palmer's income capitalization analysis with some significant adjustments. Relevant to this appeal, the tax court used the management fee method to exclude income related to non-real property business assets and rejected Boris's application of the parsing income/proxy rent method, addressed concerns about Palmer's decision to use a reserve for replacement fund in an amount of 6 percent of room revenue (as opposed to total revenue) to account for the cost of needed hotel upgrades, and eliminated the second deduction of the capitalized franchise fee that Palmer had included in his analysis. After making these adjustments and other adjustments not relevant to this appeal, the tax court assessed the value of the DoubleTree using the income capitalization approach at $24,500,000, an amount greater than the income capitalization approach valuations of either Boris or Palmer.

On appeal, Bloomington Investors challenges the tax court's income capitalization analysis. Bloomington Investors asserts that (1) use of the management fee method is always improper as a matter of law when assessing the value of a full-service hotel; (2) the tax court clearly erred in adopting Palmer's 6 percent reserve for replacement to account for investments that an arms-length buyer would consider necessary to upgrade the condition of the DoubleTree; and (3) the tax court clearly erred when it rejected Palmer's second deduction for the franchise fee. We address each argument in turn.

A.

Bloomington Investors argues that the tax court erred as a matter of law when it used the management fee method under the income analysis approach. We disagree.

The tax court determined that Palmer's use of the management fee method was appropriate: "The court agrees with the County that, on the record in this case, [net operating income] is properly calculated by including all hotel revenue in full regardless of source. . . . and then deducting expenses . . . ." The tax court cited Palmer's testimony, as well as some appraisal authorities and cases from other jurisdictions.

Bloomington Investors argues that the management fee method is never appropriate when valuing full-service hotels. It asserts that the management fee method cannot effectively separate the business value of food and beverage and other retail or service operations from real property assets in the context of full-service hotels and, accordingly, use of the management fee method is always improper as a matter of law when assessing the value of a full-service hotel.

We refuse to adopt a rule that absolutely precludes the use of the management fee method when valuing full-service hotels. We have repeatedly acknowledged that assessing the value of properties, although necessarily based on meaningful and adequate evidentiary support, is an inexact science—it is an estimate of value based on assumptions and projections offered by professional appraisers. *Hansen*, 527 N.W.2d at 93. Our review of the record and the literature shows us that there is no clear current consensus among appraisal authorities that the management fee method fails to exclude income effectively and reliably from food and beverage and other business value in every case. *See The Appraisal of Real Estate*, *supra*, at 675–77; *see also 1300 Nicollet, L.L.C. v. County of Hennepin*, Nos. 27-CV-17-06284, 27-CV-18-06407, 27-CV-18-12727, 2022 WL 829605, at *10 (Minn. T.C. Mar. 16, 2022) (explaining that even though the management fee method and parsing income method "have been competing for approximately 20 years," there is not a "clear preference for one or the other") *aff'd* 990 N.W.2d 422 (Minn. 2023). Consequently, we hold that the parties and the tax court may continue to use the management fee method when valuing full-service hotels when appropriate.[7]

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[7] The tax court also offered reasons why it did not adopt the parsing income/proxy rent method of Boris, explaining that Bloomington Investors "has not supported the proposition that, *on this record*, the 'proxy rent' method is an appropriate method for calculating the [effective gross income] of the subject hotel or that hotels should be valued using the same methodology as stand-alone restaurants." The tax court raised case-specific concerns about the way Boris used the parsing income/proxy rent method in this case. We defer to the tax court's analysis of those case-specific reasons for rejecting Boris's income capitalization analysis. *See Eden Prairie Mall*, 797 N.W.2d at 192.

The tax court also used language that suggested that the parsing income/proxy rent method is never appropriate when valuing full-service hotels. For the same reasons we reject Bloomington Investors' argument that the management fee method, as a matter of law, is never appropriate for assessing the value of a full-service hotel, we also reject the suggestion that it is never appropriate to use the parsing income/proxy rent method when valuing a full-service hotel.

Indeed, we recently affirmed the decision of the tax court in *1300 Nicollet*, 2022 WL 829605. In *1300 Nicollet*, a case that the tax court decided before it issued its decision in the present case, the tax court used the parsing income/proxy rent method rather than the management fee method in its income capitalization analysis of a different full-service hotel. The tax court spent several paragraphs in the opinion detailing the advantages of the parsing income/proxy rent method. *Id.* at *13. But the tax court also explained that courts have been divided historically on whether the management fee method or the parsing income/proxy rent method should be used for valuing hotels. *Id.* at *11–12. In the end, the tax court did not conclude that the management fee method was never appropriate as a matter of law, but rather explained why it *preferred* to use the parsing income/proxy rent

Further, and for the same reasons, we reject Bloomington Investors' argument that the use of the management fee method is unconstitutional. The United States and Minnesota constitutions require that similarly situated properties be taxed uniformly. U.S. Const. art. I, § 8; Minn. Const. art X, § 1. And as stated above, one rule that must be applied uniformly is that non-taxable non-real property value must not be included in the taxable assessed value of property. Accordingly, if the management fee method failed to effectively separate the value of taxable real estate assets from non-taxable assets while the parsing income/proxy rent method much more effectively distinguished the value of taxable real estate assets from non-taxable assets, then use of the ineffective method may present a constitutional uniformity problem. But because we conclude that the management fee method is not so flawed that it is ineffective as a matter of law for use in separating the value of taxable real estate assets from non-taxable assets, Bloomington Investors' constitutional uniformity argument fails.

B.

Bloomington Investors challenges the tax court's adoption of Palmer's reserve for replacement deduction figure. We conclude that the tax court did not clearly err in doing so.

As discussed above, Palmer accounted for the expenses that a buyer of the DoubleTree would have to invest in upgrading the condition of the hotel by creating a hypothetical reserve for replacement fund equaling 6 percent of room rental revenues.

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method in the *1300 Nicollet* case. *Id.* at *12. We disagree with Bloomington Investors that the tax court's decisions in *1300 Nicollet* and in this case are in unreconcilable conflict.

Under Palmer's analysis, the amount of the reserve for replacement fund was $940,156 per year, which amounts to $7,293,685 on a capitalized basis. Bloomington Investors observes that amount is significantly lower than the $19,880,000 that Palmer used to account for needed upgrades in his sales comparison analysis.

The tax court adopted Palmer's use of a 6 percent reserve for replacement fund in its order.[8] The tax court rejected Bloomington Investors' assertion that the substantial discrepancy between a deduction of $19,880,000 for hotel upgrades in Palmer's sales comparison analysis and $7,293,685 in Palmer's income capitalization analysis undermined the reliability of Palmer's calculation. The tax court explained that a Property Condition Report prepared for the ultimate buyers of the DoubleTree in 2019 stated that there were *no* planned property improvements and that the property appeared to be in good condition. Further, citing *Macy's Retail Holdings, Inc. v. County of Hennepin*, Nos. 27-CV-15-6881, 27-CV-16-4588, 2019 WL 7176742 at *10–11 (Minn. T.C. Dec. 17, 2019), the tax court observed that the *income approach* requires that the subject property

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[8] As noted above, the tax court adjusted Palmer's calculation of the total replacement for reserve amount "to be consistent" by calculating it based on all hotel revenue rather than merely room revenue. Accordingly, the tax court increased the amount of the deduction from income from $940,156 (6 percent of total room gross revenues of $15,669,264) to $1,602,435 (6 percent of total gross revenues of $26,707,250). The capitalized value of the updated replacement for reserve amount is $12,431,614. Because this change increased expenses/deductions, it reduced the total net operating income. The result was that the tax court's income capitalization valuation estimate was lower than it would otherwise have been had it not made this specific adjustment. Stated another way, this specific adjustment by the tax court favored Bloomington Investors.

is valued in its current condition and, under Minnesota law, only items fully deteriorated and in need of immediate repair should be categorized as deferred maintenance.[9]

The tax court did not clearly err when it adopted Palmer's 6 percent reserve for replacement fund. It explained its reasons for its decision and those reasons are supported in the record. *See 1300 Nicollet*, 990 N.W.2d at 435.

C.

Bloomington Investors also takes issue with the tax court's decision to eliminate the second, duplicate deduction of the franchise fee. Again, we conclude that the tax court did not clearly err in doing so.

As discussed above, Palmer made two deductions from his total capitalized net income estimate to eliminate the value of business and personal property assets: a deduction for business value that he estimated by deducting the capitalized franchise fee and a deduction for the value of personal property. In its order, the tax court refused to adopt the capitalized franchise fee deduction from capitalized total net income. The tax court reasoned that Palmer deducted the same amount twice: once when he deducted the

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9 By using the $19,880,000 figure in his sales comparison analysis, Palmer was doing something quite different than he was when using the reserve for replacement fund in his income capitalization analysis. In his sales comparison analysis, Palmer was attempting to adjust the sales price of the two comparator hotels (which were in better, more recently renovated shape) to match the condition of the DoubleTree. To do so, he had to reduce the value of the two comparator hotels to account for the cost of upgrades needed to bring the DoubleTree up to the condition of the two comparator hotels. Stated another way, the two comparator hotels essentially had already "spent" the money needed to upgrade; reducing the actual sales price of the comparator hotels by the amount that the DoubleTree would need to spend to upgrade to the condition of the comparator hotels (using $19,880,000 as a proxy) allowed for an apples-to-apples comparison.

franchise fee from total gross revenues as an undistributed operating expense to arrive at annual net income, and again when he deducted the franchise fee from the capitalized net income. The tax court concluded that the second franchise fee deduction double-counted the franchise fee expense. The tax court noted that Palmer did not provide any rationale or authority for deducting the capitalizing franchise fee *twice*. The result was that the tax court's final valuation using the income capitalization approach was $11,022,739 higher than it would otherwise have been using Palmer's valuation. We conclude that this was not clearly erroneous.

The capitalized amount of the annual franchise fee was deducted twice. The tax court explained its reasoning for rejecting the duplicate franchise fee deduction (Palmer did not explain why he did it) and the tax court's explanation is supported by the record. *See 1300 Nicollet*, 990 N.W.2d at 435. Bloomington Investors' only argument on this issue is the observation that Palmer deducted the franchise fee twice; tellingly, Bloomington Investors does not offer a reason why deducting the capitalized franchise fee twice is necessary or legitimate.

In summary, we hold that the tax court's analysis of the value of the DoubleTree using the income capitalization approach, including its use of the management fee method, was not clearly erroneous.

II.

We now consider Bloomington Investors' challenges to the tax court's sales comparison analysis. A sales comparison analysis measures the market value of real estate by looking at the price at which comparable properties sold. "In the sales comparison approach, appraisers develop opinions of value by analyzing closed sales, pending sales, active listings, and cancelled or expired listings of properties that are similar to the property being appraised." *The Appraisal of Real Estate*, *supra*, at 351. In short, the sales comparison approach "involves valuing property based on the price paid in actual market transactions of comparable properties, and then [making] an adjustment to those sales prices . . . to reflect differences [like location, size, and time of sale] between the sold property and the subject property." *Menard, Inc. v. County of Clay*, 886 N.W.2d 804, 817 (Minn. 2016) (first and second alterations in original) (citations omitted) (internal quotation marks omitted); *Carson Pirie Scott & Co. (Ridgedale) v. County of Hennepin*, 576 N.W.2d 445, 447 (Minn. 1998) (stating that adjustments should be made for differences, "such as location, size and time of sale," between the properties).

Palmer relied on two hotel property sales, both of which were fee simple properties sold in arm's length transactions. The first hotel, located in Bloomington, sold for $33,000,000 in April 2017 (Comparator Hotel A). Comparator Hotel A, which was built in 1999 and was in "above average" condition at the time of sale, had 200 rooms. The second hotel, located in Brooklyn Park, sold for $29,250,000 in March 2017 (Comparator Hotel B). Comparator Hotel B, which was built in 1987 and was in "average" condition at the time of sale, had 230 rooms. Based on the attributes of the two properties, Palmer made several adjustments to the sales prices to estimate the DoubleTree's value. He made adjustments to account for the different conditions of the two comparator hotels compared to the DoubleTree. He also adjusted the value of Comparator Hotel B upward by 5 percent because Comparator Hotel B was located a greater distance from the airport and the central downtown Minneapolis business district than the DoubleTree. (Comparator Hotel B has a lower value than the DoubleTree because it is further from downtown Minneapolis and the airport and so the appraiser must adjust upward the arms-length sales price of the lower-valued Comparator Hotel B to properly approximate the relatively higher value of the DoubleTree.)

Recognizing that the sales price of the two comparator hotels reflected both the value of real property assets and non-taxable personal property and non-tangible business assets, Palmer took steps to adjust the sales prices of the two comparator hotels to eliminate the value of non-real property assets included in the sales price. He appears to have taken different approaches to accomplish this task for each of the two comparator hotels.

For Comparator Hotel B, the only information Palmer considered was that Comparator Hotel B is a full-service hotel like the DoubleTree with personal property of roughly the same vintage as the DoubleTree. Consequently, in the absence of any other information, Palmer relied solely on his income capitalization analysis of the DoubleTree as a reference point. Recall that in that analysis, Palmer deducted from the total capitalized net income of the hotel (including all real property and non-real property assets) amounts equal to the capitalized income derived from furniture, fixtures, and equipment to reflect the value of non-taxable personal property and the capitalized annual franchise fee to reflect the value of non-taxable intangible business value. *Supra* at 14. More specifically, in his report, the capitalized income derived from furniture, fixtures, and equipment was $6,716,350, or approximately 17 percent of the $40,834,229 total capitalized net income of the DoubleTree, and the capitalized annual franchise fee was $8,192,723, or about

20 percent of total capitalized net income.[10] In other words, the total value of non-taxable personal property assets and non-taxable business assets in Palmer's report rounds to 37 percent of total net income.

In his sales comparison analysis of Comparator Hotel B, Palmer simply used that same 37 percent figure to account for the portion of the total sales price Comparator Hotel B derived from the value of non-taxable personal property assets and business assets. In short, he simply reduced the sales price by 37 percent.

Palmer took a different approach to Comparator Hotel A. He did so for several reasons. Palmer noted that, unlike the dated furniture, fixtures, and equipment in the DoubleTree, the furniture, fixtures, and equipment in the recently renovated Comparator Hotel A was almost new. Consequently, those personal property assets would make up a higher percentage of the total sales price in Comparator Hotel A as compared to the DoubleTree. On the other hand, Palmer also noted the complexity added by the fact that Comparator Hotel A had fewer personal property assets associated with meeting and other public spaces which suggests that those assets may make up a lower percentage of the total

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[10] As a bit of foreshadowing for our later discussion of Palmer's analysis adopted by the tax court, it is important to remember that, at trial, Palmer stated that he used the wrong franchise fee amount in his report and acknowledged that the capitalized franchise fee amounted to $11,022,739 rather than the $8,192,723 used in his report. Consequently, the business asset value accounted for around 27 percent of the total value of the DoubleTree assets ($11,022,739 / $40,834,229), not 20 percent as calculated in Palmer's expert appraisal report ($8,192,723 / $40,834,229). *Supra* at 15. That further means that under Palmer's income capitalization approach, non-taxable personal property and business assets made up around 43 percent (or the total of $11,022,350 and $6,716,350 divided by $40,834,229 and then rounded down to the nearest whole percent) of the DoubleTree's total value.

sales price in Comparator Hotel A as compared with the DoubleTree. Palmer further observed that because Comparator Hotel A was a select service rather than full-service hotel, the food and beverage services offered by Comparator Hotel A were substantially more limited than those offered by the DoubleTree, meaning that the intangible business value attributable to such sources would be a lower portion of the total sales price if the DoubleTree was sold. Accordingly, and in consideration of these factors, Palmer adopted a different approach from that he used for Comparator Hotel B. He did not use in his valuation of Comparator Hotel A the percent reduction figure calculated for the DoubleTree in his income capitalization analysis. Palmer instead estimated that the value of non-taxable personal property assets and business assets made up 40 percent of the total sales price for Comparator Hotel A. To reach this conclusion, Palmer referred to a variety of other sources of information.

In his report, Palmer referred to the Assessor's ACE Sales Report for Comparator Hotel A. The ACE Report describes the terms of the sale of Comparator Hotel A as follows: The Cash Equivalent Sales Price of $33,000,000 is reduced by an amount attributable to "Personal Property" valued at $8,286,252 and by an amount attributable to "Other Terms Amount" valued at $4,968,423 leaving a "Cash Equivalent of Real Estate" amount of $19,745,325. $8,286,252 plus $4,968,423 equals $13,254,675 or 40 percent of the total sales price of $33,000,000.

A few things are worth noting about this information. First, according to the ACE Report, the value of the personal property for Comparator Hotel A amounts to approximately 25 percent of the total sales price of the hotel. In comparison, Palmer's income capitalization approach had calculated the personal property for the Double Tree at approximately 17 percent. This increased percentage for Comparator Hotel A is consistent with the fact that, as earlier noted, the furniture, fixtures, and equipment in Comparator Hotel A was newer than the DoubleTree's furniture, fixtures, and equipment. Second, Palmer nowhere explains what is included in the category of "Other Terms Amount" in the ACE Report. Finally, at trial, Palmer seemingly backed away from reliance on the ACE Report in determining that a reasonable deduction for non-taxable personal property and business assets is 40 percent.

At trial, Palmer pointed to other bases for his decision (not explicitly mentioned in his report) to reduce the sales price of Comparator Hotel A by 40 percent to account for the value of non-taxable personal property and business assets included in the sales price. He said that he relied upon his experience preparing tax assessments for other hotel properties in the area where he found that the value attributable to non-taxable business assets of the hotels ranged from 30 percent to a bit more than 40 percent of total value of the hotels. He also testified that, because Comparator Hotel A was recently renovated, he had in his thoughts a survey of hotel development costs for select service and full-service hotels.

In summary, in his sales comparison approach, Palmer started with the total sales price for each comparable hotel. He then adjusted for location and the physical condition of the hotels. He also made a 40 percent and 37 percent deduction respectively to separate the value related to the non-taxable, non-real property assets included in the total sales price of Comparator Hotels A and B and deducted that amount. The result was an Adjusted Taxable Sale Price for each comparable hotel that Palmer then converted (by dividing by the number of hotel rooms) to a Per Room Adjusted Taxable Sale Price.

After arriving at the Per Room Adjusted Taxable Sale Price, Palmer made an additional adjustment to reflect the need to make renovations to the DoubleTree that were (in Palmer's words) "required to bring [the DoubleTree] to competitive status, which would help them attain higher revenues in line with similar upscale hotels." Palmer estimated that the cost of necessary renovations to the DoubleTree was $19,880,000, or about $35,000 per room. He testified that he made this adjustment because his two comparable hotels "had already had extensive work done in the form of a [Property Improvement Plan] to get to a very good condition." Accordingly, he reduced the Per Room Adjusted Taxable Sales Price by $35,000. No one contests the legitimacy of this part of the analysis. The resulting amount was Palmer's Adjusted Sales Price Per Room, which he used to arrive at his sales comparison approach value for the DoubleTree.

The chart below summarizes Palmer's analysis of the value of the comparator hotels.

Adjustment	**Comparator Hotel A**	**Comparator Hotel B**	**Average**
Sale Price	$33,000,000	$29,250,000	
Location/Market	N/A	+5%	
Physical Condition/Facilities	(15%)	(5%)	
Business/Intangible Value	(40%)	(37%)	
Adjusted Taxable Sale Price	$16,830,000	$18,427,500	
Per Room Adjusted Taxable Sale Price	$84,150	$80,120	
Capital Outlay Per Room to Bring to Competitive Level	($35,000)	($35,000)	
Adjusted Sales Price Per Room	$49,150	$45,120	
Weighted Average Per Room			$47,135
Total Value of DoubleTree (Average per Room Multiplied by 568 Total Rooms)			$26,772,680 (rounded to $26,775,000)

Palmer testified that he did not adjust the value of either of the comparator hotels based on its size relative to the DoubleTree, even though Comparator Hotel A has 200 rooms and substantially less (approximately 2,000) square feet of meeting space, and Comparator Hotel B has 230 rooms with "dedicated meeting space," compared to DoubleTree's 564 rooms and 70,000 square feet of meeting space. He also explained that he did not make market conditions adjustments to either comparable sale because both sales occurred within 8 months of the valuation date.[11]

The tax court accepted Palmer's sales comparison approach with one adjustment to correct a small error that concerned the number of rooms in the DoubleTree. The tax court explained, "[B]oth [comparator] hotels in Hennepin County . . . sold within one year before the valuation date and required substantial recent capital expenditure of a similar nature to a [Product Improvement Plan]." Bloomington Investors contends that the tax court clearly erred when it adopted Palmer's sales comparison analysis because Palmer's estimate of value based on those sales is unreliable. With one exception, we reject Bloomington Investors' position because the tax court explained its reasoning and that reasoning is supported in the record.

A.

Bloomington Investors first argues that the tax court clearly erred when it did not adjust Palmer's sales comparison approach to account for certain differences between the DoubleTree and the comparator hotels. The tax court further found that no adjustment

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[11] Boris took an entirely different approach to the sales comparison analysis. Boris provided information about 20 potential comparable sales in his report, but he concluded that the DoubleTree has "no good comparables" and that the data generated by these comparisons were not a reliable basis for valuation for two reasons. First, he observed that the deviation among the various sales was too wide, thus suggesting a less reliable final result. Second, he concluded the sales data for the comparator hotels did not provide "ample information" to determine the allocation of the total sales price between "going concern" and "real estate only" value. Consequently, the only "comparable sale" Boris considered in his sales comparison analysis was the 2019 sale of the DoubleTree itself. He conducted a retrospective analysis of the sale of the subject property to reach a determination of value. Because Bloomington Investors does not challenge the tax court's rejection of Boris's sales comparison analysis, we do not describe Boris's analysis further.

based on the differences in size and number of rooms was necessary. The tax court reasoned that the fact that the DoubleTree is larger than Comparator Hotel A and Comparator Hotel B in terms of gross building area and the number of rooms did not matter because the price per guest room—not the number of rooms or square footage of the comparable properties—is the "typical unit" of comparison when comparing sales of hotel properties. *The Appraisal of Real Estate*, *supra*, at 359. We conclude that the tax court did not err because it explained its reasoning and the reasoning is supported in the record. *1300 Nicollet*, 990 N.W.2d at 435.

B.

Bloomington Investors also argues that the tax court's adoption of Palmer's 37 percent and 40 percent reduction in sales price of the two comparator hotels to account for the portion of the sales prices derived from non-taxable personal property and business assets was clearly erroneous because Palmer's analysis lacked foundation.

Regarding the foundation for Palmer's percentage reductions, we conclude that the tax court's assessment of Palmer's sales comparison analysis—that it "is not as strong as it could be"—is a kind understatement. Nonetheless, with one exception, we hold that the tax court did not clearly err in adopting Palmer's analysis because, as the tax court said, "the record is not devoid of evidentiary support for his calculation of the percentage reduction for business intangible value."

Although it is true that Palmer's justifications for the 40 percent reduction in the sales price of Comparator Hotel A shifted over time, Palmer did point to his experience in estimating the value attributable to the business assets of hotels as well as documentation like surveys of typical hotel development costs and the ACE Report for the sale of Comparator Hotel A. *Supra* at 27. The tax court found these sources to provide sufficient foundation for Palmer's analysis. Under our deferential standard of review and in recognition that estimating property values is an inexact science, we do not find the tax court's decision regarding Comparator Hotel A to be clear error. *See 1300 Nicollet*, 990 N.W.2d at 435.

We reach a different conclusion for Comparator Hotel B. For that hotel, Palmer relied exclusively on his income capitalization analysis of the DoubleTree as the sole justification for his 37 percent reduction in the total sales price to account for the value of non-taxable personal property and business assets included in that total sales price.

As discussed above, in his income capitalization analysis, Palmer estimated in his report that the value of non-taxable personal property and business assets accounted for approximately 37 percent of the total value of the DoubleTree. We have no quibble with the tax court's decision to adopt Palmer's method of transporting his percentage reductions for the value of non-taxable personal property and business assets from his income capitalization analysis of the DoubleTree to use in his sales comparison analysis of Comparator Hotel B. As Palmer noted, the two hotels are both full-service hotels of relatively similar vintage. That decision of the tax court is not clearly erroneous.

However, we agree with one criticism lodged by Bloomington Investors. The rounded 37 percent figure is the sum of the 17 percent reduction for the value of furniture, fixtures, and equipment and the 20 percent reduction for the capitalized franchise fee as set forth in Palmer's written report. Turning to the capitalized franchise fee, in his income capitalization analysis in his report, Palmer calculated the reduction to exclude the value of non-taxable business assets by capitalizing the annual franchise fee for the DoubleTree. In his initial report, Palmer used the wrong franchise fee amount of $1,056,042. At trial, Palmer acknowledged (as did the tax court in its order) that the actual franchise fee was $1,402,831. As a result, the capitalized franchise fee in the report was $8,192,723, compared to the capitalized franchise fee derived if the actual franchise fee had been used of $11,022,739. *Supra* at 25, n.10.

The determination that the capitalized franchise fee constituted 20 percent of the total value of the DoubleTree was based on the numbers in the initial report and calculated by dividing the total value attributed to the DoubleTree's non-taxable business assets (based on the incorrect franchise fee amount) by the total value of the DoubleTree: ($8,192,381 / $40,834,229) = 20%. If the correct, actual capitalized franchise fee to which Palmer testified at trial had been used, the percentage of total value attributable to the capitalized franchise fee would increase to slightly less than 27 percent: $11,022,739 / 40,834,229 = 26.99%. That is a material difference. And when added to the deduction for furniture, fixtures, and equipment, the total reduction in value for non-taxable personal property and business assets in the income capitalization approach would be approximately 43 percent of total value, not 37 percent.

Nothing in the record shows that the tax court adjusted the percentage deduction from 37 percent to 43 percent in the sales comparison analysis of Comparator Hotel B. The tax court offered no explanation about this apparent discrepancy and we cannot discern one from the tax court's order. Consequently, we remand to the tax court to account for and explain its reasons for adopting Palmer's base reduction percentage of total value to account for the value of non-taxable personal property and business assets of Comparator Hotel B.[12] To the extent doing so requires any recalculation or adjustment by the tax court to its analysis, we further direct the tax court to do so.

CONCLUSION

For the foregoing reasons, we affirm in part, vacate in part, and remand the decision of the tax court. We remand on a single issue. The tax court is directed to the percentage reduction to the sales price for Comparator Hotel B that it used in its sales comparison analysis to account for the value of non-taxable personal property and business assets included in the sales prices of comparator hotels and conduct any recalculation or revised analysis that may be required. We otherwise affirm the tax court's order.

Affirmed in part, vacated in part, and remanded.

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[12] Bloomington Investors also suggests that the tax court clearly erred when it concluded that the DoubleTree's final value of the taxable real property was greater than either of the expert appraisals. We disagree. For the reasons discussed above, we conclude that the tax court "carefully explain[ed] its reasoning for rejecting the appraisal testimony and the grounds for adopting a . . . higher value, and adequately describe[d] the factual support in the record for its determination." *See Eden Prairie Mall*, 797 N.W.2d at 194. Accordingly, the mere fact that the tax court settled on a value greater than those offered by both of the parties is not error. *Id.*