

No. 2018-119438-A

IN THE COURT OF APPEALS OF THE STATE OF KANSAS

IN THE MATTER OF THE EQUALIZATION APPEAL OF KANSAS STAR CASINO,
L.L.C. FOR THE YEAR 2016 IN SUMNER COUNTY, KANSAS

IN THE MATTER OF THE EQUALIZATION APPEAL OF KANSAS STAR CASINO,
L.L.C. FOR THE YEAR 2017 IN SUMNER COUNTY, KANSAS

BRIEF OF APPELLANT

APPEAL FROM THE KANSAS BOARD OF TAX APPEALS
DOCKET NOS. 2016-2148-EQ, 2016-2149-EQ, 2017-3172-EQ,
AND 2017-3173-EQ

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L.L.C.*

Oral Argument: 30 minutes

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TABLE OF CONTENTS

STATEMENT OF THE CASE..... 1

ISSUE ON APPEAL..... 2

STATEMENT OF FACTS..... 2

 The Subject Property..... 2

 K.S.A. 74-8733, *et seq.* 2

 The Improvements 6

Casino and Arena Operations..... 7

 The Arena..... 8

 Overall Operations (Arena and Casino)..... 10

The Experts 13

 Bliss’s Appraisal 13

In re Equalization Appeal of Kansas Star Casino for the Year
 2015,
 No. 116,782 (Kan. Ct. App. July 20, 2018) 15

 Jortberg’s Appraisal 19

In re Equalization Appeal of Kansas Star Casino, LLC for
 the Years 2016 and 2017,
 Docket Nos. 2016-2148-EQ, 2016-2149-EQ, 2017-3172-
 EQ, and 2017-3173-EQ (Kan. Bd. Tax App., May 1,
 2018)..... 20

 Cory Morowitz 20

 Dwight Percy..... 24

 Leslie Sellers 25

 Scott Schroeder 25

ARGUMENTS AND AUTHORITIES..... 29

I.	BOTA erred in reducing Bliss’s arena depreciation conclusion by one-third because it incorrectly interpreted one step in Morowitz’s analysis for an opinion that the arena was only two-thirds overbuilt	29
A.	Standard of review	29
	<i>Adams v. Bd. of Sedgwick Cnty. Comm’rs</i> , 289 Kan. 577, 214 P.3d 1173 (2009)	29
	K.S.A. 79-503a.....	30
	K.S.A. 79-505	30
	<i>In re Protests of City of Hutchinson/Dillon Stores for Taxes Paid in 2001 and 2002</i> , 42 Kan. App. 2d 881, 221 P.3d 598 (Kan. App. 2009).....	30
B.	Test for Reversibility	29
	K.S.A. 77-621(c)(4), (7), and (8)	30
C.	BOTA erred by reducing Bliss’s arena depreciation by one-third	30
	K.S.A. 79-503a.....	32
	K.S.A. 79-505	32
	<i>In re Equalization Appeal of Kansas Star Casino for the Year 2015</i> , (Kan. Bd. Tax App. Sept. 15, 2016).....	33
	<i>In re Equalization Appeal of Kansas Star Casino for the Year 2015</i> , No. 116,782 (Kan. Ct. App. July 20, 2018)	33
	CONCLUSION	36

STATEMENT OF THE CASE

Before the Court is the consolidated equalization appeals of Kansas Star Casino, L.L.C. (“Kansas Star” or “Taxpayer”) concerning its real property in Sumner County, Kansas for the tax years 2016 and 2017. The subject property is a casino and arena events center situated on approximately 195.5 acres located in Mulvane, Kansas (the “Subject Property”). The valuation dates in issue are January 1, 2016 and January 1, 2017. The parties agreed that the County bore the burden of proof.

Sumner County (the “County”) classified the entire parcel as commercial and industrial real estate and valued the Subject Property at \$168.3 million for 2016 and \$172 million for 2017, based upon “mass appraisals” performed by Richard Jortberg (“Jortberg”). R. Vol. 17, Exs. 671, 672. Jortberg valued the Subject Property at \$170 million for 2016 and \$171 million for 2017. R. Vol. 60, Exs. 326, 327, R. Vol. 1 (part 1) p. 162, Joint Stipulated Facts ¶¶ 39, 40. The County also called Leslie Sellers, a review appraiser, and Dwight Percy, a business advising consultant, as expert witnesses.

Taxpayer called Robin Marx (“Marx”) and Robert Jackson (“Jackson”) of Bliss Associates appraisal firm (collectively “Bliss” or “Bliss Appraisers”) to appraise the Subject Property. Bliss valued the Subject Property at \$77,650,000 for 2016 and \$77,600,000 for 2017. Bliss prepared a combined appraisal report for both tax years. R. Vol. 60, Ex. 356. The value of the remaining agricultural area (assuming proper classification as land devoted to agricultural use) is stipulated to have a property tax value of \$9,000, for a total value of \$77,659,000 for 2016 and \$77,609,000 for 2017. R. Vol. 1 (part 1) p. 163, Joint Stipulated Facts ¶ 47.

Additional testifying witnesses included Scott Schroeder (“Schroeder”), the Director of Finance for the Kansas Star Casino, and Cory Morowitz (“Morowitz”), a casino gaming industry expert and consultant.

BOTA essentially adopted the Bliss cost approach, except that it reduced the depreciation associated with the arena by one-third and determined that only 63.5 acres, rather than 76.13 acres, were devoted to agricultural use. BOTA valued the Subject Property at \$102,659,000 for tax year 2016 and \$102,609,000 for tax year 2017.

ISSUE ON APPEAL

Morowitz opined that the arena was 100% obsolete. He arrived at this opinion, in part, because the ratio of arena seats to gaming positions is three times higher than the average of similar casinos. BOTA incorrectly interpreted that step in his analysis for an opinion that the arena was only two-thirds overbuilt. Did BOTA err by reducing Bliss’s arena depreciation by one-third based only on this fact?

STATEMENT OF FACTS

The Subject Property

Kansas Star is the lottery gaming facility manager for the south central gaming zone pursuant to the Kansas Expanded Lottery Act (“KELA”). *See* K.S.A. 74-8733, *et seq.* Kansas Star owns the Subject Property and operates it as the Kansas Star Casino and Arena Events Center. The Subject Property consists of a combination of two land tracts, known as the Wyant and Gerlach Tracts. (R. Vol. 60, Ex. 356, pp. 24-25.) The tracts are outlined in this aerial photograph:



(Id.)

The Subject Property is located in the city of Mulvane, which is in Sumner County. While the land is in Mulvane's city limits, this is only because the underlying land was annexed during the casino proposal process. In reality, the land is in a rural, undeveloped area twenty minutes south of Wichita and eight miles west of Mulvane. (R. Vol. 1 (part 1) pp. 159-160, Joint Stipulated Facts, ¶ 23.) The area around the Land is sparsely populated and is largely used for farming. The improved property is depicted in this aerial photograph:



(R. Vol. 48, p. 8651, Ex. 28.)

The original combined size of the Wyant and Gerlach tracts was 201.2 acres. Upon re-platting of the property for purposes of the planned use development (“PUD”), the size of the combined tract was measured at approximately 197.5 acres. The remaining 197.5 acres was divided by the County into two parcels: 195.31 acres for the main parcel, and approximately 2 acres for an EMS station. Both parties agree that the two acres devoted to the EMS station do not contribute value to the Subject Property. (R. Vol. 1 (part 1) p. 160, Joint Stipulated Facts, ¶ 24; R. Vol. 3, Ex. 327, p. 54; R. Vol. 60, Ex. 356, p. BLISS_0023.)

Of the 195.31 acre main parcel subject to valuation, approximately 63.5 acres was directly used for the production of agricultural crops during the calendar years 2016 and

2017. (R. Vol. 48, Ex. 26.) The remaining acreage is utilized for commercial purposes (either directly or as drainage area supporting the commercial-use acreage).

Other than the two driveways depicted in Ex. 28, above, the Wyant tract is entirely unimproved. R. Vol. 48, p. 8651, Ex. 28. The 195.31 acres held by Kansas Star is more than is necessary for operation of a casino, including all potentially-profitable amenities and ancillary developments. At the time Kansas Star acquired the total site, Kansas Star planned to utilize the excess land (land not needed for direct support of the casino) for RV park(s), a maintenance building, livestock feed and supply improvements, and other commercial development. (R. Vol. 3, Ex. 327, p. 12; R. Vol. 60, Ex. 356, pp. BLISS_41, 114.) As it turns out, the anticipated additional commercial development never became reality. There remains no commercial development in the area other than the casino and the next-door winery (Brewer Tract), which pre-dated the construction of the casino.

Despite the availability of ample vacant land for development on and around the casino site, the casino operation has spurred no additional commercial development. Neither the RV park, nor the maintenance and livestock buildings were ever constructed in the future development areas. (R. Vol. 60, Ex. 356, pp. BLISS_36, 40, 44.) In fact, the original arena and equine event center plan proved to be unprofitable, and Kansas Star negotiated with the Kansas Lottery to amend its management contract to allow for the Phase 2 funds to be shifted away from additional arena investment. (R. Vol. 1 (part 1) pp. 160-161, Joint Stipulated Facts, ¶ 28.) Instead, Kansas Star used those committed funds to build conference space, which was ultimately constructed before the valuation date in

issue. (*Id.*) All of the land that was purchased for planned future development is currently leased for farming. (R. Vol. 48, Ex. 26.)

The Improvements

The Subject Property's casino and arena improvements are located entirely on the Gerlach Tract.



(R. Vol. 3, Ex. 327, p. 14.)

The arena is shown in the aerial photo as the brown-roofed building on the south end of the improved building area. The white-roofed building to the north and west of the arena is the permanent casino.¹ The smaller white-roofed area on the east side of the

¹ The brown-roofed structure to the east of the permanent casino is a hotel, which is part of a separate tax parcel and not in issue in this matter.

improvements between the arena and casino is the conference center. (R. Vol. 3, Ex. 327, p. 15.)

The arena building is 162,622 square feet with a maximum seating capacity in concert mode of 6,596. (R. Vol. 60, Ex. 356, p. BLISS_23; R. Vol. 1 (part 1) p. 161, Joint Stipulated Facts, ¶ 33.) The casino is 164,790 square feet. (R. Vol. 60, Ex. 356, p. BLISS_23.) The remaining buildings consist of the conference center (22,772 sf), the equine stall/riding arena building (57,640 sf), and the maintenance building (6,000 sf). (R. Vol. 60, Ex. 356, p. BLISS_23.)

The Subject Property improvements were constructed in three phases. Phase 1a was the construction of the arena with the temporary casino finishes; Phase 1b was the construction of the permanent casino and conversion of the arena from the temporary casino to the permanent arena; and Phase 2 was the downsized equestrian facilities and conference center. (R. Vol. 1 (part 1) pp. 160-161, Joint Stipulated Facts ¶¶ 27-28; R. Vol. 60, Ex. 356, pp. BLISS_25-26.)

Casino and Arena Operations

The arena was originally built and outfitted as a temporary casino. The temporary casino operated on the arena floor beginning on December 26, 2011. (R. Vol. 1 (part 1) p. 160, Joint Stipulated Facts, ¶ 27; R. Vol. 48, Exs. 74-77.) The temporary casino operated in the arena for, essentially, the calendar year 2012. (R. Vol. 1 (part 1) p. 160, Joint Stipulated Facts, ¶ 27.)

Construction of the permanent casino building was completed at the end of 2012, and the casino operations moved into the permanent casino building by January 2013. (R.

Vol. 1 (part 1) p. 160, Joint Stipulated Facts, ¶ 27.) The arena was converted from the temporary casino set-up to the permanent arena configuration during the first half of 2013. The first event, a Daughtry concert, was held on June 29, 2013. (R. Vol. 1 (part 1) p. 160, Joint Stipulated Facts, ¶ 27.)

Modified Phase 2 construction was completed in January 1, 2015. (R. Vol. 1 (part 1) p. 161, Joint Stipulated Facts ¶ 29.)

The Arena

The arena component of the Subject Property is not profitable. (R. Vol. 62, pp. 369-377.) Overall, the arena suffered a \$160,063 *operating* loss (not including additional losses from comped tickets) in calendar year 2015 and a \$211,943 *operating* loss in 2016. (R. Vol. 60, Ex. 348.) The *operating* loss is simply the total of the losses on the individual events held. It does not account for fixed overhead expenses, such as general advertising, maintenance, utilities, etc. (R. Vol. 62, pp. 372-373, 397-398.) The total losses associated with the arena, including fixed overhead expenses, were substantially more than the operating losses. (R. Vol. 62, pp. 390-391.)

The arena is fundamentally incompatible with Kansas Star's gaming operations. While the full capacity of the arena is 6,596, Kansas Star now only markets half-house shows (3,446 seats) and smaller. (R. Vol. 62, pp. 393-394.) Large events deterred high-end players from visiting the casino because it caused full parking lots, long lines, and big crowds. (R. Vol. 62, pp. 394, 520-521, 535.) Use of the full capacity of the arena not only results in operating losses for the arena; it also detracts from the profitability of the casino.

This causes the arena to be underutilized, sitting vacant approximately 90 percent of the time. (R. Vol. 60, Ex. 353, p. 36.)

The original equine events focus for the arena has also borne no fruit. Equine events are even bigger money-losers than concerts and other entertainment events. (R. Vol. 62, p. 381.) As a result, Kansas Star negotiated a repurposing of its Phase 2 construction spending with the Kansas Lottery. In short, Kansas Star remained obligated to spend the same amount of money, but scaled back its permanent equine facilities (practice arenas and permanent stalls) in favor of conference spaces to promote smaller events. Kansas Star is open to hosting more equine events, but has not had success attracting such events. (R. Vol. 62, pp. 376, 378, 381-382.)

Further still, the Kansas Star Arena is competing in a saturated arena market and at a major competitive disadvantage with respect to its location. The Kansas Star Arena is one of four arenas in the Wichita area, which includes the Intrust Bank Arena, the Century II Convention Center in downtown Wichita, and Hartman Arena just north of Wichita. (R. Vol. 62, pp. 391-392.) All of the other arenas in the area are closer to the Wichita population base than Kansas Star. Schroeder explained that this competition for entertainment dollars puts Kansas Star's arena in a difficult competitive position. For example, Schroeder described a Wynona Judd event that was scheduled for December 21, 2015. (R. Vol. 62, p. 392.) He stated that ticket sales were strong initially, but then Intrust Bank Arena announced Garth Brooks concerts for early December 2015. (*Id.*) That event soaked up the entertainment dollars from the area, and stifled Wynona Judd ticket sales.

(*Id.*) The Intrust Bank Arena is the premier event venue in the area, making it very difficult for the Kansas Star Arena to compete on a stand-alone basis.

Schroeder testified that he would not build the arena in order to maximize profits.

(R. Vol. 62, p. 411.)

Overall Operations (Arena and Casino)

Revenue and expense information for the total facility (casino and arena) for 2012 through 2016 is provided in this table:

	2012	2013	2014	2015	2016
Revenues					
Gaming	\$182,923,000	\$192,391,000	\$178,283,000	\$183,146,000	\$179,893,000
Food & Beverage	\$5,745,000	\$11,441,000	\$11,628,000	\$11,766,000	\$11,822,000
Other	\$1,979,000	\$3,628,000	\$4,157,000	\$4,750,000	\$4,753,000
Gross Revenues	\$190,647,000	\$207,460,000	\$194,068,000	\$199,662,000	\$196,468,000
Less Promotional allowances	\$2,685,000	\$4,606,000	\$5,273,000	\$3,994,000	\$4,060,000
Net Revenues	\$187,962,000	\$202,854,000	\$188,795,000	\$195,668,000	\$192,408,000
Cost and Expenses					
Operating Costs & Expenses					
Gaming	\$70,398,000	\$77,943,000	\$72,863,000	\$74,318,000	\$74,465,000
Food & Beverage	\$3,984,000	\$8,813,000	\$7,922,000	\$8,228,000	\$8,516,000
Other	\$267,000	\$1,912,000	\$2,189,000	\$1,396,000	\$1,337,000
Selling, General & Admin.	\$15,526,000	\$22,892,000	\$18,681,000	\$19,977,000	\$19,629,000
Maintenance & Utilities	\$2,132,000	\$3,344,000	\$3,400,000	\$3,523,000	\$3,705,000
Affiliate Management Fee	\$3,071,000	\$8,357,000	\$7,914,000	\$8,264,000	\$8,057,000
Preopening Expense	\$1,086,000	\$91,000	\$168,000	\$280,000	\$244,000
Asset Transaction Cost	\$5,000	\$1,601,000	\$211,000	\$0	\$0
Other Operating Items	\$0	-\$95,000	-\$325,000	\$192,000	\$273,000
Total Operating Costs & Expenses	\$96,469,000	\$124,858,000	\$113,023,000	\$116,178,000	\$116,226,000
Net Income	\$91,493,000	\$77,996,000	\$75,772,000	\$79,490,000	\$76,182,000

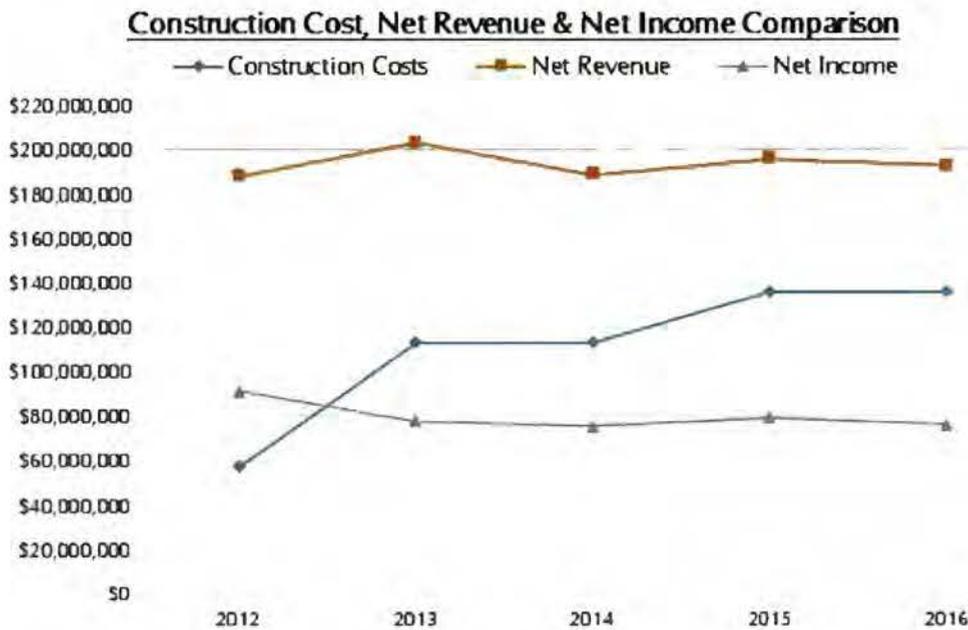
(R. Vol. 60, Ex. 356, p. BLISS_120.) Revenues were relatively flat from 2012 through 2014. However, during that time period, real estate construction spending increased dramatically. This table reflects the construction costs for the in-place real estate assets for each year:

Year	Total Net Revenue	% Change	Total Net Income	% Change	Construction Cost (1)	% Change
2012	\$187,962,000		\$91,493,000		\$57,386,537	
2013	\$202,854,000	7.9%	\$77,996,000	-14.8%	\$113,245,831	97.3%
2014	\$188,795,000	-6.9%	\$75,772,000	-2.9%	\$113,245,831	0.0%
2015	\$195,668,000	3.6%	\$79,490,000	4.9%	\$135,622,576	19.8%
2016	\$192,408,000	-1.7%	\$76,182,000	-4.2%	\$135,622,576	0.0%

(1) The Construction cost shown represents the cost of the existing improvements that were in operation during the year, which includes the "Temporary" casino improvements present in 2012 but not present for 2013 and 2014, as they were removed at that time, with the building converted to its current Arena use in June of 2013.

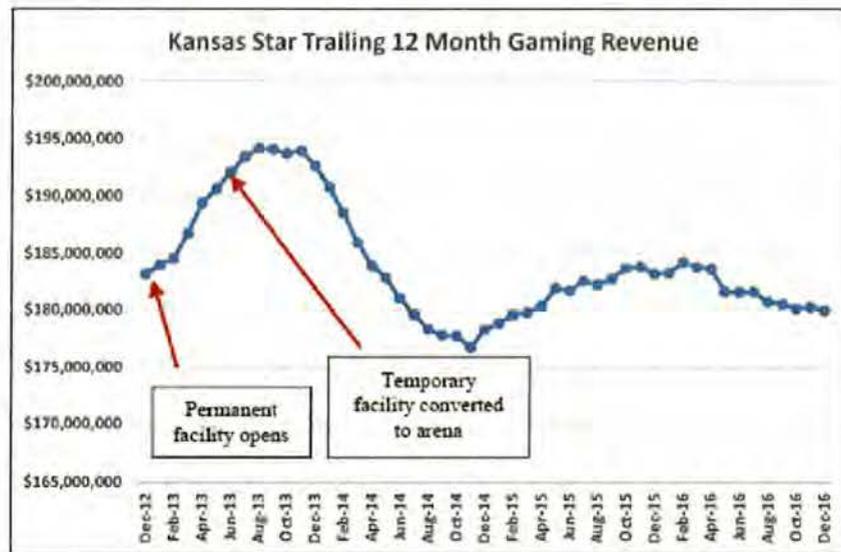
(R. Vol. 60, Ex. 356, p. BLISS_108.)

This chart shows the rising construction costs alongside essentially flat revenues from when the temporary casino opened through 2016, which includes about two full years of operation with the full buildout Phase 2 improvements in place:



(R. Vol. 60, Ex. 356, p. BLISS_115.) Market demand was effectively satiated by the temporary casino, and additional construction resulted in no revenue gain. In fact, to the extent that any trends can be discerned, there appears to be an inverse relationship between

revenue and real estate construction. This chart shows monthly gaming revenue on a rolling 12-month basis for the property:



Source: Kansas Racing and Gaming Commission/Morowitz Gaming Advisors

(R. Vol. 60, Ex. 356, p. BLISS_110.) Revenue peaked about the time that the arena opened in the summer of 2013, then fell steadily after that, and leveled off in 2015. While it seems counterintuitive that additional amenities would cause a loss of revenue, both Morowitz and Schroeder testified that large arena event days tended to crowd out the most lucrative, high-end gamers in favor of casual gamers. This resulted in lower revenue on event days versus non-event days. (R. Vol. 62, pp. 394, 520-521, 535.)

Even worse, profitability, measured in EBITDA, fell as a result of the real estate overbuilding. Even though revenues were relatively flat, the construction of the permanent casino effectively doubled the square footage of the total facility, resulting in higher overhead costs. This increased expense caused EBITDA to fall from \$91.5 million in 2012 to \$79.5 million in 2015 and \$76.2 million in 2016. (R. Vol. 60, Ex. 356, p. BLISS_120.)

Kansas Star's business operations were more profitable while operating the temporary casino in the arena than operating both the arena and the permanent casino. Even though revenues were relatively flat in the permanent casino, profitability declined due to increased costs associated with operating a larger than necessary facility. The presence of, and costs associated with, the arena were a drain on profitability. Kansas Star would have been more successful if the arena had never been built.

The Experts

Bliss's Appraisal

Robin Marx, MAI, and Robert Jackson have appraised properties for property tax purposes and appeared before BOTA in the past. Working for both taxpayers and taxing jurisdictions, they have developed an excellent track record of unbiased and credible appraisals. They have appraised many special purpose properties in the past. (R. Vol. 63, pp. 611-614.) Bliss performed cost and income approaches to value. However, BOTA adopted the Bliss cost approach, with modifications, so only that approach is detailed here.

Bliss's cost approaches for both tax years included a replacement cost analysis, land value analysis, and an obsolescence/depreciation analysis. (R. Vol. 60, Ex. 356, pp. BLISS_97-118, 130-151.)

For their land value analyses, the Bliss appraisers looked at the five available casino-site land transactions in Kansas, consisting of sales of the two tracts comprising the subject, the two tracts comprising the Boot Hill Casino site, and the Hollywood Casino site. (R. Vol. 60, Ex. 356, pp. BLISS_97-102, 130-135.) The unadjusted sale prices ranged from \$10,391 to \$215,919 per acre with a median of \$77,042. After adjusting for various market

factors, Bliss's adjusted sales range was \$73,190 to \$78,995 with a median of \$75,572. (R. Vol. 60, Ex. 356, pp. BLISS_101-102, 134-135.) Bliss concluded to a land value for the 121.18 commercial-use acres of \$76,600 per acre, or \$9.3 million total for both tax years. (R. Vol. 60, Ex. 356, pp. BLISS_102, 135.) Jackson testified that this value was reasonable in light of the Gerlach tract purchase price at \$8.9 million (inclusive of the Foxwoods option payment) because the improved commercial area is essentially within the boundaries of the former Gerlach Tract. (R. Vol. 63, pp. 636-640.) The stipulated value of the remaining agricultural-use acreage is \$9,000. (R. Vol. 1 (part 1) p. 163, Joint Stipulated Facts ¶ 47.)

For the Subject Property's improvements, Bliss estimated reproduction costs, using actual construction costs from Kansas Star. (R. Vol. 60, Ex. 356, pp. BLISS_103-104; R. Vol. 63, pp. 640-645.) Bliss totaled the relevant construction costs, then adjusted those costs for inflation to estimate reproduction costs as of each valuation date. (R. Vol. 60, Ex. 356, pp. BLISS_105-106, 117, 136-137, 151.) Bliss did not add entrepreneurial profit or incentive to the construction costs because

[t]ypically, with build to suit, owner-occupied properties that are reliant upon the operation of the associated business located with the real estate for the generation of revenue/income, entrepreneurial profit is not considered part of the overall development costs. This is due to the "profit" component typically being considered part of the business operation, but not the real estate itself. Therefore, for the purposes of analyzing the fee simple real estate component of the subject's gaming and entertainment development, no separate entrepreneurial profit is considered applicable and none has been included.

(R. Vol. 60, Ex. 356, p. BLISS_105.) (*See also* R. Vol. 60, Ex. 356, p. BLISS_138; R. Vol. 63, pp. 645-647.) This is consistent with the Court's most recent decision concerning this

property. *In re Equalization Appeal of Kansas Star Casino for the Year 2015*, No. 116,782, Memorandum Opinion (Kan. Ct. App. July 20, 2018).

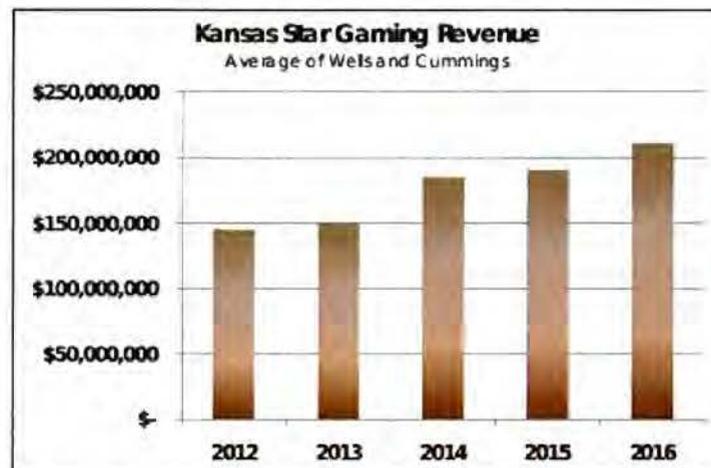
The Bliss appraisers used the well-recognized breakdown method of estimating depreciation and obsolescence for the Subject Property. (R. Vol. 60, Ex. 356, pp. BLISS_106, 139.) The breakdown method is one of the “three principal methods for estimating depreciation.” *The Appraisal of Real Estate*, 14th ed., p. 597, Appendix 1. “The breakdown method is the most comprehensive and detailed way to measure depreciation because it segregates total depreciation into individual component parts.” *Id.* at p. 614.

Bliss utilized straight line depreciation over a 50 year life to estimate physical depreciation. (R. Vol. 60, Ex. 356, p. BLISS_61.) This resulted in depreciation of 6% for 2016 (3/50) and 8% for 2017 (4/50). (R. Vol. 60, Ex. 356, pp. BLISS_106, 139.)

Bliss performed a combined functional and external obsolescence analysis, concluding that 52 percent of the real estate is obsolete due to superadequacy. (R. Vol. 60, Ex. 356, pp. BLISS_110-111, 117, 150-151; R. Vol. 63, pp. 660-661.) Bliss cited voluminous market evidence to support its obsolescence conclusion. First, Bliss noted the “misconception” that “a property...designed and built by experienced developers” suffers from no functional or external obsolescence. (R. Vol. 60, Ex. 356, p. BLISS_108.) Bliss cited three examples where relatively new properties suffered from significant obsolescence, including the renovated Heartland Park racetrack in Topeka, the Revel Hotel and Casino in Atlantic City, and the M Resort in Las Vegas. (R. Vol. 60, Ex. 356, pp. BLISS_108-109.) Jackson noted that even newly-built properties developed by experienced developers can suffer from obsolescence because “a particular design, size,

and layout may be highly successful and functional in one market, but not successful or functional in a different market.” (R. Vol. 60, Ex. 356, p. BLISS_109.)

Bliss further evaluated the pre-opening projections for the Subject Property, noting that three different expert consulting groups, including two independent consultants, concluded that the overall revenues at the Subject Property would increase with additional buildout of amenities from Phase 1a through Phase 2. As shown in this chart, the average gaming revenue estimates from Wells Gaming Research and Cummings Research Associates projected that the Subject Property would increase revenues from less than \$150 million in 2012 (Phase 1a, temporary casino only) to over \$200 million in 2016 (Phase 2, full buildout).



(R. Vol. 60, Ex. 356, p. BLISS_109.)

Kansas Star's parent company itself estimated that gross revenues would rise from \$123,370,043 in 2012 to \$225,944,173 in 2016, as shown in the table below:

Year	2012	2013	2014	2015	2016
Gaming	\$ 118,907,922	\$ 147,529,372	\$ 165,812,555	\$ 190,727,438	\$ 202,342,739
Non-Gaming	\$ 4,462,121	\$ 15,431,307	\$ 17,296,026	\$ 21,906,553	\$ 23,601,434
Gross Revenue	\$ 123,370,043	\$ 162,960,679	\$ 183,108,581	\$ 212,633,991	\$ 225,944,173

(R. Vol. 60, Ex. 356, p. BLISS_109.) Bliss concluded, accordingly, that the experts believed that the non-gaming amenities, including the arena and equine events center, would “drive attendance, admissions, and subsequently revenue at the subject.” (R. Vol. 60, Ex. 356, p. BLISS_109.) “In reality, the casino operation did not require years to achieve stabilized gaming revenue levels,” and the Subject Property “effectively achieved stabilized gaming revenues in its first year of operation...with no support from ancillary buildings, which were not existent in 2012.” (R. Vol. 60, Ex. 356, p. BLISS_110.) As such, Bliss concluded that Kansas Star Casino’s revenues “were not materially increased, nor do they significantly benefit from the presence of the completed existing indoor-arena, conference center and events pavilion.” (R. Vol. 60, Ex. 356, p. BLISS_112.)

Bliss further analyzed the impact of the ancillary improvements on expenses and net income. This table reflects the income and expense history of the Subject Property.

	2012	2013	2014	2015	2016
Revenues					
Gaming	\$182,923,000	\$192,391,000	\$178,283,000	\$183,146,000	\$179,893,000
Food & Beverage	\$5,745,000	\$11,441,000	\$11,628,000	\$11,766,000	\$11,822,000
Other	\$1,979,000	\$3,628,000	\$4,157,000	\$4,750,000	\$4,753,000
Gross Revenues	\$190,647,000	\$207,460,000	\$194,068,000	\$199,662,000	\$196,468,000
Less Promotional allowances	\$2,685,000	\$4,606,000	\$5,273,000	\$3,994,000	\$4,060,000
Net Revenues	\$187,962,000	\$202,854,000	\$188,795,000	\$195,668,000	\$192,408,000
Cost and Expenses					
Operating Costs & Expenses					
Gaming	\$70,398,000	\$77,943,000	\$72,863,000	\$74,318,000	\$74,465,000
Food & Beverage	\$3,984,000	\$8,813,000	\$7,922,000	\$8,228,000	\$8,516,000
Other	\$267,000	\$1,912,000	\$2,189,000	\$1,396,000	\$1,337,000
Selling, General & Admin.	\$15,526,000	\$22,892,000	\$18,681,000	\$19,977,000	\$19,629,000
Maintenance & Utilities	\$2,132,000	\$3,344,000	\$3,400,000	\$3,523,000	\$3,705,000
Affiliate Management Fee	\$3,071,000	\$8,357,000	\$7,914,000	\$8,264,000	\$8,057,000
Preopening Expense	\$1,086,000	\$91,000	\$168,000	\$280,000	\$244,000
Asset Transaction Cost	\$5,000	\$1,601,000	\$211,000	\$0	\$0
Other Operating Items	\$0	-\$95,000	-\$325,000	\$192,000	\$273,000
Total Operating Costs & Expenses	\$96,469,000	\$124,858,000	\$113,023,000	\$116,178,000	\$116,226,000
Net Income	\$91,493,000	\$77,996,000	\$75,772,000	\$79,490,000	\$76,182,000
Net Income Decrease From 2012		-14.8%	-17.2%	-13.1%	-16.7%

(R. Vol. 60, Ex. 356, p. BLISS_112.) From this data, Bliss concluded that the Subject Property’s “ancillary improvements had a negative effect upon the overall net income of

the existing Kansas Star Development.” (R. Vol. 60, Ex. 356, p. BLISS_113.) “The actual increased expenses associated with the presence of the ancillary improvements, along with the relatively flat historical revenues, resulted in a decrease in the net income at the subject of the past four years, as compared to 2012.” (R. Vol. 60, Ex. 356, p. BLISS_113.)

Based upon this information, Bliss carefully extracted the costs that were not supportive of value and deducted them as obsolescence. (R. Vol. 60, Ex. 356, p. BLISS_117; R. Vol. 63, pp. 654-658.) This methodology is recognized as “the functional obsolescence procedure” in the Appraisal of Real Estate, 14th ed. Specifically, it states that “Figure 29.6 diagrams a systematic procedure that can be used to calculate all forms of functional obsolescence caused by a deficiency or a superadequacy, whether the functional issue is curable or incurable.” The Appraisal of Real Estate, 14th ed., p. 627, Appendix 1. Figure 29.6 is presented as follows:

Figure 29.6 Procedure for Estimating All Forms of Functional Obsolescence

Step 1. <i>Estimate</i> Cost of Existing Item	\$xxx,xxx
Step 2. <i>Subtract</i> Depreciation Previously Charged	-\$xxx,xxx
Step 3. <i>If curable</i> , add Cost to Cure (All Costs)	+\$xxx,xxx
Or	
<i>If incurable</i> , add Value of the Loss	+\$xxx,xxx
Step 4. <i>If curable</i> , subtract Cost of the Proper Items if Included in New Construction	-\$xxx,xxx
Or	
<i>If incurable</i> , subtract Depreciated Cost of the Proper Item if Included in New Construction	-\$xxx,xxx
<i>or subtract</i> Depreciated Value*	-\$xxx,xxx
Step 5. Equals Depreciation for Functional Obsolescence	\$xxx,xxx

*Sometimes an existing item has value unrelated to cost.

(*Id.*)

Bliss complied with Steps 1 and 2 by determining the depreciated cost of the superadequate assets as indicated above. (R. Vol. 60, Ex. 356, p. BLISS_117.) Step 3 requires that cost to cure (if curable) or capitalization of the loss (if incurable) be added to the depreciation. In this case, the additional depreciation would be the cost to demolish the

arena or the capitalized income loss (*i.e.*, the difference in EBITDA from 2012 to 2015 and 2016) of keeping the asset in place. Bliss has conservatively determined that the stabilized arena is of no value (rather than negative value), eliminating further adjustment at this step and avoiding even greater depreciation. Step 4 requires that the cost or value of the correct item be deducted (assuming that the asset would be replaced with something more appropriate). For example, if the superadequacy in a house were gold faucets, one would subtract the cost of typical bronze or brushed nickel faucets from the depreciation because faucets are necessary to prevent a functional deficiency in the real estate. No adjustment is necessary here because no additional improvements are necessary to maximize profitability. Step 5 indicates that the total of the first four steps is the total of functional obsolescence. Bliss performed this analysis, as indicated by the 14th Edition.

Ultimately, Bliss concluded to a total value conclusion via the cost approach of \$77,650,000 for 2016 and \$77,600,000 for 2017. (R. Vol. 60, Ex. 356, pp. BLISS_118, 151.)

Jortberg's Appraisal

Jortberg has little to no experience in the gaming industry. He has never operated a casino nor worked in the casino industry. (R. Vol. 61, p. 258.) In the State of Colorado, Jortberg is essentially a contract appraiser for two county appraisers' offices, handling the counties' mass casino appraisals. (R. Vol. 61, pp. 149, 257.) For both the 2016 and 2017 appraisals, Jortberg performed two approaches to value: a cost approach and an income approach. Jortberg ultimately relied upon the cost approach for his value conclusion. (R.

Vol. 3, Ex. 327, p. 153²; R. Vol. 61, p. 259.) BOTA found Bliss’s cost approach to be more persuasive than Jortberg’s cost approach for a variety of stated reasons. *See Full and Complete Opinion, In re Equalization Appeal of Kansas Star Casino, LLC for the Years 2016 and 2017*, Docket Nos. 2016-2148-EQ, 2016-2149-EQ, 2017-3172-EQ, and 2017-3173-EQ, **10-11, (Kan. Bd. Tax App., May 1, 2018) [hereinafter referred to as the “BOTA Full and Complete Opinion”, R. Vol. 1 (part 2), pp. 168-182].

Cory Morowitz

Morowitz is a gaming consultant with twenty-two years of experience in the gaming industry. (R. Vol. 60, Ex. 354.) Morowitz is the Chairman and Managing Partner of Morowitz Gaming Advisors, LLC and a partner in Global Gaming & Hospitality, LLC. Morowitz has a business economics degree from State University of New York, and a Master of Business Administration degree from the Wharton School at the University of Pennsylvania. (*Id.*) Morowitz has taught gaming industry courses at Drexel University and for the Wharton School. (R. Vol. 60, Ex. 354; R. Vol. 62, p. 454.)

Morowitz Gaming Advisors engages in three gaming-related functions: mergers and acquisitions, consulting, and asset management. With respect to mergers and acquisitions, Morowitz represents buyers and sellers in the purchase or sale of casino properties. In that role, Morowitz identifies properties for acquisition or investors to purchase casino properties, assists with financing and valuation of properties and property components, and identifies profitability drivers and measures. (R. Vol. 62, pp. 455-456.)

² Jortberg prepared separate appraisal reports for 2016 (Ex. 326) and 2017 (Ex. 327). The reports are largely identical, so the references herein are to the 2017 report. (R. Vol. 2)

With respect to his consulting work, Morowitz performs a wide range of tasks, including feasibility studies and market assessments. Morowitz prepares pro formas for new and existing casinos, assists clients with developing the correct mix of assets, and assesses non-gaming amenities. (R. Vol. 62, pp. 456-457.)

With respect to the asset management component, Morowitz Gaming Advisors assists with casino operations, either as an overseer of management, direct management, or, in one case, owner of the casino. (R. Vol. 62, pp. 456-457, 505.) As part of this asset management, Morowitz assists with marketing and non-gaming amenities, as well. (R. Vol. 60, Ex. 354.)

Morowitz prepared two reports, which concluded, among other things, that the arena and conference center suffer from significant obsolescence in the form of superadequacy.

Morowitz analyzed various aspects of the Kansas Star Arena and conference center for indications of obsolescence. To determine whether Kansas Star's arena was properly sized, Morowitz first evaluated the Wichita arena market. He concluded that the Wichita market was already served by the other arenas and event centers in the area, which were all closer to the population base than the Kansas Star. (R. Vol. 60, Ex. 353, p. 19.) Because the Kansas Star Arena was not needed to serve the market in general, then its only remaining purpose was to serve the casino (*i.e.*, to drive casino revenue). (*Id.*) Morowitz determined that, for its intended purpose, the Kansas Star Arena is unnecessary and unprofitable.

Morowitz next analyzed the Kansas Star Arena's impact on overall performance of the Subject Property. In short, he found that the arena events failed to generate additional

gaming revenue. (R. Vol. 60, Ex. 353, pp. 19-36.) On a macro level, overall revenue for the Subject Property peaked just before the opening of the arena, then fell off steadily thereafter. (R. Vol. 60, Ex. 353, pp. 19-21; R. Vol. 62, p. 497.)

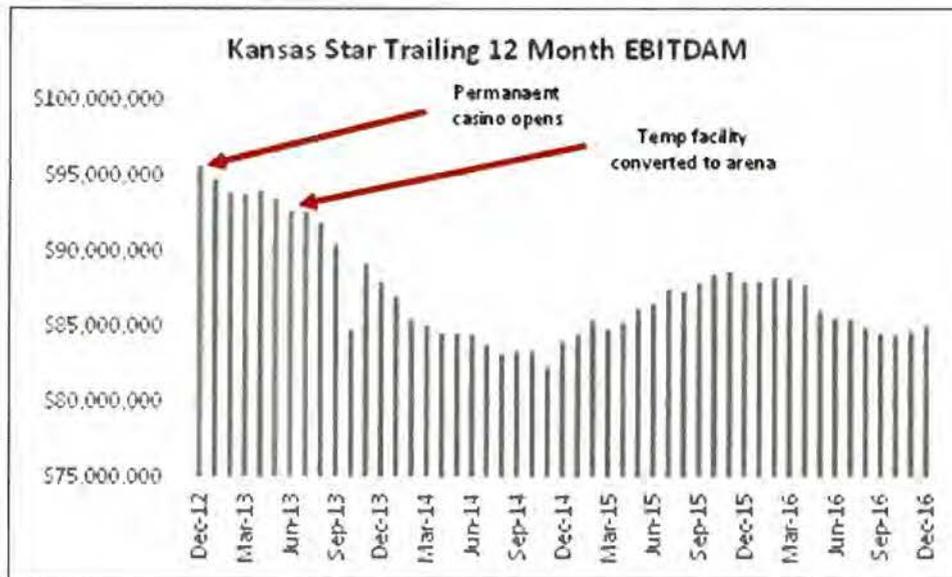
On a micro level, Morowitz also compared revenues on arena event days to revenues on non-event days. In doing so, he discovered that the casino generated, across seventy-four event days over two years, just \$541,168 of additional gaming revenue over non-event days. R. Vol. 60, Ex. 363, p. 34. And \$300,000 of that lift came from one day – July 4th – which is typically among the two highest grossing days at any casino. (R. Vol. 60, Ex. 353, p. 34.) Considering that Kansas Star’s total gaming revenue over that two year period was close to \$360 million, the additional gaming revenue associated with event days was about 0.15% -- a small fraction of one percent, a statistically insignificant rounding error. Morowitz explained that the data indicated that arena events tended to crowd out more lucrative gamers in favor of casual, less lucrative gamers, resulting in a net loss in gaming revenue. (R. Vol. 62, pp. 520-521, 535.)

So when you’re bringing some incremental visitors who are not normal gamers, and you see it in the numbers, that \$172,000 there of incremental gaming revenue on a Saturday divided by 62,000 admissions is \$3 per admission which comports with everything I know about when you bring people who aren’t normal gamers into a property. Some of them come in, they crowd around -- five people crowd around one machine, they pull the lever once every, you know, 30 seconds instead of once every six seconds like a core gamer and they create havoc on the floor. Your best customers can’t get their machine and it’s an issue. And to me it almost explains what’s happened to this property since they opened the arena.

(R. Vol. 62, pp. 520-521.)

Morowitz further determined that the Subject Property was underutilized relative to other arenas and that it typically operated at half capacity or less. (R. Vol. 60, Ex. 353, pp. 19, 33, 52.; R. Vol. 62, pp. 577-578.)

Finally, Morowitz determined that the Kansas Star Arena operated at a loss and contributed nothing to its overhead expenses. (R. Vol. 60, Ex. 353, pp. 32-33; R. Vol. 62, pp. 542, 551.) As shown in this chart, the arena contributed to an overall reduction in adjusted EBITDA (excluding management fees) of \$95.7 million in 2012 to roughly \$85.0 million by 2016.



(R. Vol. 60, Ex. 353, p. 21.)

Morowitz also explained that casino operators, in evaluating the performance of their arenas, expect to see significant additional gaming revenue on event days as compared to non-event days.

I've been part of an ownership group that owned a casino. I've advised casinos on operational issues. I've worked very recently with casinos who run arenas and are trying to figure out why their arenas aren't doing well, and

the one best practice that casinos employ when they're looking at the performance of their arena is they look at how their arena does versus how it would do if there was no arena event. So they look at how do we do when we didn't have an event in the casino, because they can measure the profit or loss of the arena, right? That's easy. But to figure out how the casino did versus the arena is another matter.

(R. Vol. 62, pp. 505-506.)

Morowitz determined that the arena loses money operationally -- *i.e.*, the cost of the events exceeds revenue from the events, not including overhead. (R. Vol. 60, Ex. 353, p. 32.) Adding overhead expenses associated with maintaining the arena, equine pavilion, and conference center increases the magnitude of the losses. (R. Vol. 62, p. 542.)

Dwight Percy

Percy is a business consultant. He has never been involved with or appraised a casino operation. He has never worked in the gaming industry. (R. Vol. 61, p. 126.)

Percy prepared four reports for this matter: (1) a value report, in which Percy estimated the value of the total enterprise of the Kansas Star Casino, LLC, (2) an arena report, analyzing whether arena events drive incremental gaming revenue, and (3 & 4) responses to Morowitz's rebuttal to the first two reports.

Percy's value report (R. Vol. 18, Ex. 675), while riddled with errors, is irrelevant. The issue here is not the value of the taxpayer's total enterprise. Rather, the issue is the value of the subject real estate. None of the appraisers relied upon Percy's valuation work as any component of his real estate value, and BOTA did not consider it either.

With respect to Percy's arena and rebuttal reports, the Board questioned "the efficacy" of Percy's analysis because of his "varied machinations and exclusions of

possibly relevant financial data.” (R. Vol. 1 (part 2), p. 178, BOTA Full and Complete Opinion, p. 11.) The Board credited the analysis and testimony of Morowitz and Schroeder to conclude that the arena and conference centers do not contribute to the overall enterprise and suffer from obsolescence as a result. (*Id.*)

Leslie Sellers

Sellers performed a review appraisal without a value conclusion. (R. Vol. 43, Ex. 697.) As such, Sellers did not perform the work necessary to opine on whether the Bliss appraised value conclusion was too low, too high, or just right. In fact, Sellers certified in his scope of work that he was authorized by the Kansas Real Estate Appraisal Board to only perform a “desk” review “so long as no opinion of value is being proffered.” (R. Vol. 43, Ex. 697, p. 000007.) While Sellers does repeatedly state that certain claimed errors “inappropriately reduce the value” in the Bliss report, Sellers explained that he was merely stating that certain downward adjustments were made in error. (R. Vol. 63, p. 786.) The Board did not credit any of Sellers’ opinions in reaching its value conclusions.

Scott Schroeder

Schroeder is the Director of Finance at the Kansas Star Casino, and has been employed by Boyd Gaming for 17 years. (R. Vol. 62, pp. 354-355.)

Overhead expenses, such as utilities, management salaries, human resources, security, surveillance, maintenance, marketing, and valet, and property taxes, legal, housekeeping, and general administrative expenses are not assigned to individual revenue departments. (R. Vol. 62, pp. 362-364, 369-370, 378-379.) With any reasonable amount of

overhead charged to the arena, it loses a significant amount of money. (R. Vol. 62, pp. 390-391.)

Kansas Star makes every effort to earn a profit with the arena – maximize its revenues and minimize its expenses. (R. Vol. 62, pp. 376-377.) If Kansas Star could profitably use the arena more often, it would. (R. Vol. 62, p. 391.)

However, there are challenges to using the arena – which already loses money – more than it is currently being utilized. Schroeder testified that the arena, unlike the casino, is not a monopoly. (R. Vol. 62, p. 405.) The arena is outside the main Wichita-area population base and has to compete with arenas and conference centers in Wichita. (R. Vol. 62, p. 405.) Schroeder further explained:

So if you're looking at like concerts, you have to look at who's available, what acts are available, and not only what acts are available but which acts fit our customers in our demographic in our market. Their availability, the cost of them, where they've performed recently. If they've performed in Wichita recently we don't want to have the same act again.

...

We have to look at Intrust Bank [arena], so that's right downtown Wichita, if they have an event on the same night obviously we don't want to have one to compete with them, or if they had one the weekend before, depends on what they have, we might not want because we're trying to fight over the same customer.

(R. Vol. 62, pp. 391-392.) Schroeder explained that Kansas Star Arena booked Wynona Judd for a concert, and shortly thereafter, Intrust Bank Arena announced Garth Brooks on the same weekend, which caused ticket sales to tank. (R. Vol. 62, p. 392.) Furthermore, Kansas Star has learned through experience that booking full-house shows is even more unprofitable than smaller shows because the influx of people creates overcrowding and a

poor guest experience without generating additional revenue. (R. Vol. 62, pp. 394-395.) Kansas Star no longer markets full-house shows. Instead, Kansas Star restricts its acts to half house. (R. Vol. 62, p. 394.) Schroeder testified that Kansas Star does not experience any spike in gaming revenues after events; although, Kansas Star expected and hoped that would happen. (R. Vol. 62, p. 395.)

Equine events are especially unprofitable. Kansas Star makes every effort to utilize the equine events capabilities of Kansas Star Arena, and, if it were possible, Kansas Star would book good equine events “[a]ll day long.” (R. Vol. 62, p. 382.) Schroeder testified that none of the equine events held at the Subject Property have been moneymakers. (R. Vol. 62, p. 381.) “We see low attendance at these events.” (R. Vol. 62, p. 381.) Equine events are also very expensive. In addition to typical expenses of hosting a show (ushers, ticket takers, security, utilities, management, set up, etc.), equine events require that dirt be moved into the arena at a cost of \$14,000 per show. (R. Vol. 62, pp. 383-384, 388-389.) Furthermore, the dust generated by the dirt-floor events has to be cleaned from the seats and other surfaces, and the entire arena floor has to be cleaned after the dirt is removed. (R. Vol. 62, pp. 383-384.)

Kansas Star recently charged \$25,000 for a four-day rodeo event. Kansas Star has never been able to charge \$40,000 to \$50,000 for an equine event. According to Schroeder, the market has not supported such prices, and “[w]e don’t have the interest.” (R. Vol. 62, p. 390.)

The conference center component of the Subject Property also loses money. Operationally, the conference center, at best, breaks even. However, with any reasonable

amount of overhead allocated to it, the conference center loses money. (R. Vol. 62, pp. 397-398.)

Schroeder testified that the management fee charged by Boyd Gaming to Kansas Star pays for the support that Kansas Star receives from Boyd, such as senior leadership, information technology, human resources, purchasing, legal, internal audit, payroll, emergency management, safety, marketing, and risk management. (R. Vol. 62, pp. 398-400.) Without those services, Kansas Star would have to acquire those services, either through additional staff or outsourcing, which would be a significant expense. (R. Vol. 62, pp. 400-402.)

Schroeder testified that the Subject Property maximized its profitability while operating out of temporary casino facility. (R. Vol. 62, p. 402.) Once the arena and event center portions of the property were constructed, it was “[v]ery obvious” that the Kansas Star incurred more expenses.” (R. Vol. 62, pp. 402-403.) This increase in expenses did not have offsetting gains in revenue, resulting in reduced EBITDA. (R. Vol. 62, p. 403.) Schroeder testified that there was a causal connection between the extra expenses associated with the arena and events center and the decline in EBITDA. (R. Vol. 62, p. 403.) “More expenses, less EBITDA.” (R. Vol. 62, p. 403.) In order to maximize profitability, Kansas Star would not rebuild the arena/equine complex or the conference center. (R. Vol. 62, p. 412.)

Schroeder testified that the Subject Property drains from the northwest to the southeast, where a pumping station removes water from the site. (R. Vol. 62, pp. 413-414.)

Schroeder testified that the Tin Lizard live music venue was a remodeling of previously existing space in the casino building. (R. Vol. 62, p. 415.) Tin Lizard is an expansion of a previously existing bar/restaurant, which was formerly called the Shark Bar. (R. Vol. 62, p. 441.) Kansas Star did not add any restaurants or kitchens in transforming Shark Bar into Tin Lizard and relocating the poker room. The materials used in the remodel were of similar quality to what is used elsewhere in the property. (R. Vol. 62, p. 415.)

ARGUMENTS AND AUTHORITIES

I. BOTA erred in reducing Bliss’s arena depreciation conclusion by one-third because it incorrectly interpreted one step in Morowitz’s analysis for an opinion that the arena was only two-thirds overbuilt.

A. Standard of review.

Factual and legal findings based upon uncontroverted facts are reviewed *de novo*. *Adams v. Bd. of Sedgwick Cnty. Comm’rs*, 289 Kan. 577, 584, 214 P.3d 1173, 1179 (2009) (“When material facts are uncontroverted, as they are in this case, an appellate court reviews summary judgment *de novo*.”). Whether an appraisal methodology estimates fair market value in compliance with USPAP, as required by K.S.A. 79-503a and 79-505, is an issue of law, which is subject to *de novo* review. *In re Protests of City of Hutchinson/Dillon Stores for Taxes Paid in 2001 and 2002*, 42 Kan. App. 2d 881, 891-92, 221 P.3d 598, *605 (Kan. App. 2009).

B. Test for Reversibility.

BOTA’s reduction of Bliss’s arena depreciation conclusion warrants relief. This Court must grant relief when: (1) BOTA “erroneously interpreted or applied the law”; (2) BOTA’s order is based on a determination of fact that is not supported to the appropriate

standard of proof by evidence that is substantial when viewed in light of the record as a whole; or (3) BOTA's decision is "otherwise, unreasonable, arbitrary or capricious." K.S.A. 77-621(c)(4), (7), and (8). Here, all three apply.

BOTA's reduction mistakenly relies on its incorrect interpretation of Morowitz's opinion from a prior-year appeal. In the 2015 appeal of the Kansas Star Casino, Morowitz concluded that the Subject Property's ratio of gaming positions to arena seats was three times higher than the average of similar casinos. This analysis and conclusion was (1) not part of the record for this 2016-2017 appeal year, and (2) not synonymous with an opinion that the arena is only two-thirds overbuilt. And this was the only "evidence" BOTA relied upon when reducing Bliss's depreciation. BOTA's faulty conclusion is not supported by the evidence in the record, is not compliant with USPAP, and is arbitrary, thus warranting reversal.

C. BOTA erred by reducing Bliss's arena depreciation by one-third.

This Court heard and ruled on this exact issue in the 2015 tax-year appeal of the Kansas Star Casino. In that case, the parties used the same appraisers who used the same appraisal methodologies, and the Board ruled the same way. Specifically, for the 2015 tax year, the Board ruled that the Bliss appraisal was the most persuasive, but the Board reduced Bliss's depreciation from 52% to 35%. BOTA's Full and Complete Opinion for the 2016-2017 tax years states that "[f]ollowing our derivation of economic obsolescence in the prior tax year's decision, the Board finds that a total economic obsolescence of 35% is proper for the tax years in issue." (R. Vol. 1 (part 2), p. 179, BOTA's Full and Complete

Opinion, p. 12.) Said another way, the Board's obsolescence ruling in the 2016-2017 consolidated hearing was based on the same rationale as the 2015 tax year.

With respect to the 2015 appeal, this Court held that the Board's "conclusion that Jackson's 52% economic obsolescence figure should be reduced by one-third is not supported by evidence that is substantial when considering the record as a whole." The Court then remanded the matter to BOTA for further proceedings. The same result is appropriate in this matter and for the same reasons.

BOTA's recitation of the law in Kansas concerning "fair market value" is generally correct. (R. Vol. 1 (part 2), pp. 176-177, BOTA Full and Complete Opinion, pp. 9-10.) In summary, all real property, with the exception of agricultural-use property, in Kansas must be valued at "fair market value." Fair market value is defined as the "amount in terms of money that a well-informed buyer is justified in paying and a well-informed seller is justified in accepting for property in an open and competitive market, assuming the parties are acting without undue compulsion." K.S.A. 79-503a. Furthermore, property tax appraisals must "be performed in accordance with generally accepted appraisal standards as evidenced by the appraisal standards promulgated by the appraisal standards board of the appraisal foundation." K.S.A. 79-505. These standards are the Uniform Standards of Professional Appraisal Practice, commonly known as USPAP. USPAP requires that an appraiser "be aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal." 2014-2015 USPAP, Standard 1-1(a).

The cost approach is one of the three recognized approaches of determining fair market value. The cost approach consists of three components: land value, replacement or reproduction cost, and depreciation. Here, BOTA generally agreed with Bliss about the value of the land (with the exception of the classification of certain drainage areas) and replacement cost. Furthermore, BOTA mostly agreed with Bliss on the existence and quantity of depreciation. However, BOTA reduced Bliss's functional and external obsolescence determination by one-third. The difference between Bliss's obsolescence analysis and BOTA's obsolescence analysis is that Bliss determined that the arena was 100% obsolete because it contributes no value to the overall property and never should have been built. BOTA, on the other hand, held (in 2015, incorporated by reference into 2016-2017) that "Mr. Jackson's report indicated that the arena was overbuilt by two-thirds; consequently, the 52% economic obsolescence figure used by Mr. Jackson should be reduced by a third to 35%." *In re Equalization Appeal of Kansas Star Casino for the Year 2015*, Full and Complete Opinion at p. 5 (BOTA, Sep. 15, 2016), Appendix 2. In the 2015 appeal, the reference to "Mr. Jackson's report" appears to be a mistake. Jackson, who co-authored the Bliss appraisal, did not suggest in any manner that the arena was two-thirds overbuilt. Rather, the Bliss appraisers determined that the arena was 100% obsolete and did not contribute any value to the overall property. The only possible suggestion of the arena being two-thirds overbuilt came from Morowitz, who stated in his 2015 tax-year report that the size of the Kansas Star Arena "is inappropriate relative to its casino and hotel operations" and "as much as two-thirds of the arena seats may not be needed or are

functionally obsolete.” *In re Equalization Appeal of Kansas Star Casino for the Year 2015*, No. 116,782, Memorandum Opinion, *28 (Kan. Ct. App. July 20, 2018).

The question for the Court in 2015 was whether BOTA’s conclusion that the arena was two-thirds overbuilt, rather than 100 percent overbuilt, was supported by the evidence. The Court concluded that it was not, for reasons stated below. However, the deficiency in the BOTA opinion goes even further in 2016-2017 because, for these years in issue, Morowitz never said that the arena “is inappropriate relative to its casino and hotel operations” and “as much as two-thirds of the arena seats may not be needed or are functionally obsolete” in his 2016-2017 report. As such, not only was that information insufficient to support BOTA’s depreciation conclusion in the 2015 tax-year appeal, but such information was not even in the record for the 2016-2017 appeals at issue here.

Even if the record did reflect those statements from Morowitz in the 2016-2017 appeals, as was the case in the 2015 tax-year appeal, such statements are not sufficient to support a USPAP-compliant appraisal analysis. To understand the difference between Bliss’s opinion that the arena was 100 percent obsolete and contributes no value to the overall Subject Property and BOTA’s opinion that the arena was one-third useful and two-thirds overbuilt, one must understand the concept of superadequacy and how it impacts value.

The Appraisal of Real Estate, 14th ed. describes superadequacy as follows:

A superadequacy is a type of functional obsolescence caused by something in the subject property that exceeds market requirements but does not contribute to value an amount equal to its cost. The superadequacy may have a cost to carry (*i.e.*, higher operating costs) that must be considered. A

superadequacy is only curable if it can be removed and value is added (or costs reduced) to the property . . . by its removal.

Appraisal of Real Estate, 14th ed., p. 624, Appendix 1.

The textbook notes several methods of quantifying such superadequacy, including this example involving a swimming pool:

[S]uppose that the presence of a swimming pool in an apartment building does not add any rental value to the units. The swimming pool would be an over-improvement and thus an item of functional obsolescence. If this swimming pool costs \$5,000 per year to operate, that \$5,000 would be an expense deducted from the income generated by the property. At a market-derived overall capitalization of 8%, the loss of \$5,000 in net income results in a \$62,500 ($\$5,000/.08$) penalty to the value of the property. In other words, curing the functional problem of the unnecessary swimming pool would increase the market value of the apartment building by \$62,500.

Appraisal of Real Estate, 14th ed., p. 625, Appendix 1.

The textbook also describes “the functional obsolescence procedure” as a method for estimating functional superadequacy. Specifically, the Appraisal of Real Estate textbook provides that “Figure 29.6 diagrams a mathematical procedure that can be used to calculate all forms of functional obsolescence caused by a deficiency or a superadequacy, whether the functional issue is curable or incurable.” The Appraisal of Real Estate, 14th ed., p. 627-632, Appendix 1. Figure 29.6 is presented as follows:

Figure 29.6 Procedure for Estimating All Forms of Functional Obsolescence

Step 1. <i>Estimate</i> Cost of Existing Item	\$xxx,xxx
Step 2. <i>Subtract</i> Depreciation Previously Charged	-\$xxx,xxx
Step 3. <i>If curable</i> , add Cost to Cure (All Costs)	
or	
<i>If incurable</i> , add Value of the Loss	+\$xxx,xxx
Step 4. <i>If curable</i> , subtract Cost of the Proper Items if Included in New Construction	-\$xxx,xxx
or	
<i>If incurable</i> , subtract Depreciated Cost of the Proper Item if Included in New Construction	-\$xxx,xxx
or <i>subtract</i> Depreciated Value*	-\$xxx,xxx
Step 5. Equals Depreciation for Functional Obsolescence	\$xxx,xxx

*Sometimes an existing item has value unrelated to cost.

(*Id.*) The textbook provides several examples of how to perform the calculation, but the bottom line is that an item's functional superadequacy for income-producing properties is depreciated cost, plus value of expenses, offset by the value of any income contributions.

(*Id.*)

Here, Bliss reduced the value of the overall property by the cost of the non-productive assets (the arena and conference center), which amounted to 52% overall depreciation. (R. Vol. 60, Ex. 356, pp. 117-118.) The additional overhead costs of the excess construction from Phase 1a (temporary casino) to Phase 1b (permanent casino and arena) were approximately \$16 million to \$20 million. 2014 expenses, which reflect full-year operations for the permanent casino and six months of operation of the arena (\$113,023,000), exceeded 2012 expenses, which reflect Phase 1a only (\$96,469,000) by \$16,554,000. (R. Vol. 60, Ex. 356, p. BLISS_112.) Expenses for 2015 and 2016, in which the casino, arena, and later the conference center were operated, were just over \$116 million, reflecting an increase in stabilized expenses of about \$20 million due to the addition of the arena and conference center amenities. *Id.* The "value" of a \$20 million annual loss is estimated by multiplying it by the EBITDA multiplier of 7.5, or \$150 million. The additional revenue generated by the arena to offset such expenses was \$2,344,346 in 2015 and \$2,257,032 in 2016. (R. Vol. 60, Ex. 353, p. 32.) Even using the highest revenue stream available, calendar year 2015, the value of the arena and conference center revenue is \$17,582,595 ($\$2,344,346 \times 7.5$). Accordingly, strict application of the functional obsolescence procedure would result in the following estimate of functional obsolescence:

$$\$72,946,477 + \$150,000,000 - \$17,582,595 = \$205,363,882 \text{ (functional obsolescence)}$$

In effect, Bliss, in concluding functional obsolescence of only \$74,010,860, assumed that the arena was a break-even asset, adding no value, but not detracting from the value of the property either. This was a very conservative estimate because the arena does not break even. Rather, it is a massive money-losing asset that detracts from the overall value of the property. This is not controverted. The profitability of the property has declined by over \$15 million from 2012 to 2014. (R. Vol. 60, Ex. 356, p. 111.) That decline in profitability is not due to decrease in revenue – revenues have been flat over that time. (*Id.*) Rather, the decline in profitability is entirely the result of having twice as much real estate as is necessary to satisfy the available demand.

No factual basis exists for BOTA's 35% obsolescence conclusion, and even if the supposed facts relied upon were in the record, such facts are not sufficient for a USPAP compliant depreciation analysis. For these reasons BOTA's reduction of the Bliss obsolescence estimate is contrary to Kansas law and not supported by the record. The Court should reverse that decision and conclude that the Subject Property suffers from obsolescence of 52%, consistent with the Bliss appraisal, or remand the matter to BOTA for further findings.

CONCLUSION

For the above reasons, the Court should overturn BOTA's Full and Complete Opinion and either adopt the Bliss appraised values (\$77,659,000 for 2016 and \$77,609,000 for 2017) or remand the matter for further proceedings at BOTA with instructions to adopt a USPAP-compliant obsolescence analysis that is supported by the record.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that on the 3rd day of April, 2019, a true and correct copy of the above and foregoing was e-mailed to the following:

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APPENDIX

- 1 The Appraisal of Real Estate, 14th ed., pp. 597, 614, 624, 625, 627-632
- 2 *In re Equalization Appeal of Kansas Star Casino for the Year 2015*, Full and Complete Opinion (BOTA, Sep. 15, 2016)

Appendix 1

The Appraisal of Real Estate

14th Edition

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The Appraisal Institute advances global standards, methodologies, and practices through the professional development of property economics worldwide.

29



Depreciation Estimates

Appraisers have several methods available for estimating depreciation. Each is acceptable and should result in roughly the same value as long as appraisers apply the methods consistently and logically. The method (or methods) used in a particular assignment should reflect how an informed and prudent buyer would react to the condition and quality of the property and the market in which the property is found.

The primary goals in the analysis of depreciation are to identify all forms of depreciation recognized by the market, to treat all these forms of depreciation, and to charge only once for each form of depreciation (i.e., to avoid double-counting items of depreciation).¹ The three principal methods for estimating depreciation are

- the market extraction method
- the economic age-life method
- the breakdown method

The various methods may be combined to solve specific problems, or each method may be applied separately to test the reasonableness of the estimates derived from other methods.

The three methods used to estimate depreciation are the market extraction, economic age-life, and breakdown methods.

1. Additional discussion of the estimation of depreciation and numerous examples can be found in *In Defense of the Cost Approach: A Journey into Commercial Depreciation* (Chicago: Appraisal Institute, 2011) by E. Nelson Bowes.

Or the economic life would have to be 33.33 years:

$$10/33.33 = 30\%$$

There would be no justification for either number.

Note that the external obsolescence is caused by an oversupply in the market, and it is unlikely that such a situation will be permanent. As supply and demand again approach equilibrium, the oversupply should disappear.

Now suppose that the 10% loss in value due to external influences includes a decline in land value estimated at \$25,000. The losses in value to the land and the improvements would be accounted for as follows:

Total Losses Due to External Influences	\$69,600
Less Loss in Land Value	– \$25,000
External Obsolescence	\$44,600
Replacement Cost	\$696,000
Less Physical Deterioration	– \$139,200
Less External Obsolescence	– \$44,600
Value of Improvements	\$512,200
Plus Land Value	+ \$175,000
Indicated Value by Cost Approach	\$687,200

The modified economic age-life techniques work best when relatively few adjustments need to be made to the economic age-life method of estimating total depreciation. Usually, relatively nominal adjustments are made for curable physical items or for a functional or external influence. If more than one atypical element exists in a property, it may be advisable to use the more detailed breakdown method.

Breakdown Method

The breakdown method is the most comprehensive and detailed way to measure depreciation because it segregates total depreciation into individual component parts:

- physical deterioration
- functional obsolescence
- external obsolescence

Each step of the breakdown method calculates one type of depreciation. The process is cumulative, with each step building on the results of the prior step until all forms of depreciation have been considered. Alternatively, the depreciation calculation may begin with the estimation of total depreciation by the market extraction or economic age-life method and then apply the breakdown method to allocate total depreciation into more precise components. In other words, appraisers can start from either the top or the bottom of the flowchart shown in Figure 29.2 and use the breakdown method to work toward the other end for a more complete understanding of all the forms of depreciation present in a property.

Characteristics of the different types of functional obsolescence are illustrated in Table 29.4. Elements of depreciation not identified as physical deterioration or functional obsolescence must be external obsolescence, which is discussed later in this chapter.

Like the curability of physical deterioration, there are two major tests of curability for functional obsolescence caused by a deficiency or superadequacy:

- If spending the money to cure the item will result in a value increment equal to or greater than the expenditure, the item is normally curable.
- If spending the money to cure the item will not result in a value increment equal to or greater than the expenditure but will allow existing items to maintain their value, the item is again curable.

Table 29.4 Types of Functional Obsolescence

Type	Characteristics/Measure
Curable deficiency requiring an addition	The subject property has functional obsolescence because it does not have something that other properties in the market do have. Because the item is not present, the property cannot be penalized for any deterioration that the item would have incurred if it had been included in the original construction. However, because it usually costs more to add an item to an existing property than to include it when the property was originally built, the excess cost to cure is the appropriate measure of functional obsolescence.
Curable deficiency requiring substitution or modernization	A curable deficiency requiring substitution or modernization is caused by something that is present in the subject property but is either substandard compared to other properties on the market or is defective and thereby prevents some other component or system in the property from working properly. The measure is the excess cost to cure. In addition, the depreciated or remaining cost of the existing item, which is now worthless, must be deducted.
Curable superadequacy	A superadequacy is a type of functional obsolescence caused by something in the subject property that exceeds market requirements but does not contribute to value an amount equal to its cost. The superadequacy may have a cost to carry (i.e., higher operating costs) that must be considered. A superadequacy is only curable if it can be removed and value is added (or costs reduced) to the property—including any salvage value—by its removal.
Incurable deficiency	The subject property has functional obsolescence because it is missing a building component or design feature (e.g., a warehouse with unusually low ceilings) that is not economically feasible to correct.
Incurable superadequacy	An item of incurable functional obsolescence caused by a superadequacy is a property component that exceeds market requirements. It represents a cost without any corresponding increment in value or a cost that the increment in value does not meet. Note that in some applications of the cost approach, the need to estimate the functional obsolescence attributable to an incurable superadequacy is eliminated by using replacement cost instead of reproduction cost because superadequacies are not replicated in a replacement cost estimate. Nevertheless, whether replacement or reproduction cost is used, any extraordinary expense of ownership associated with the superadequacy is quantified and deducted as a penalty from the value of the property. Essentially, the property loses value through the added costs of ownership over time because the component is incurable. However, if the cost of ownership increases over time, the obsolescence may become curable.

If the cost to cure the item will not result in a value increment greater than the loss in value caused by the item or building component, then the item is incurable. Functional obsolescence can be corrected in two ways:

- The functional obsolescence is cured by the property owner when this is economically feasible.
- or
- Market norms change, eliminating the cause of the functional obsolescence. In other words, the functional obsolescence no longer exists.

Problem-Solving for Functional Obsolescence

Estimating the effect of functional obsolescence is rarely as straightforward as estimating the effect of physical deterioration because judging the relative utility of building improvements is more difficult

The Curability and Incurability of Functional Issues

The test of curability is simply a comparison of the value added to the improvement if the functional problem is corrected with the cost to cure the functional problem of that improvement. If the value added is greater than the cost to cure, the functional problem is curable. If the value added is less than the cost to cure, the functional problem is incurable.

In the simplest terms, the value added is the amount that the market value of the real estate increases if a specific item is fixed. The value added is not the value of the item but rather the value that will be added to the property if the functional problem is fixed. As an example, suppose a recently built home was designed with a standard forced-air heating system with a natural gas furnace. In the five years since the house was built, high-efficiency gas furnaces have begun to replace less-efficient standard models in new homes in the subject property's neighborhood. Paired data analysis of a large pool of data comparing the recent sale prices of houses with high-efficiency furnaces and those with standard heating systems indicates a \$3,000 premium for houses with a high-efficiency heating system in place. That \$3,000 premium would be the value added for the subject property if the standard heating system were to be replaced with a more modern system.

The cost to cure is the amount that must be spent to correct the functional problem. In this case, estimates for the removal of a slightly depreciated heating system and replacement with a high-efficiency system average around \$3,500, including all direct costs, indirect costs, and profit. The cost to cure of \$3,500 is greater than the \$3,000 value added, so the functional issue would be incurable. However, suppose that the existing heating system had a salvage value of \$500 and a governmental incentive program promoting the installation of high-efficiency heating systems offered a \$500 rebate on the installation cost of a new system. Then the total cost to cure would be \$2,500 ($\$3,500 - \$500 - \500), which would be less than the value added, making the functional problem curable.

Most curable functional obsolescence is caused by some form of deficiency like the heating system of the house that is currently below the emerging standard for energy efficiency, but some superadequacies can be treated as curable depreciation. As an example, suppose that the presence of a swimming pool in an apartment building does not add any rental value to the units. The swimming pool would be an overimprovement and thus an item of functional obsolescence. If this swimming pool costs \$5,000 per year to operate, that \$5,000 would be an expense deducted from the income generated by the property. At a market-derived overall capitalization rate of 8%, the loss of \$5,000 in net income results in a \$62,500 ($\$5,000/0.08$) penalty to the value of the property. In other words, curing the functional problem of the unnecessary swimming pool would increase the market value of the apartment building by \$62,500.

Now assume the problem of the unwanted swimming pool can be corrected for \$10,000 by filling the pool and landscaping the area, with maintenance expenses reduced from the \$5,000 to \$500. The \$500 loss in net income would only penalize the value of the property \$6,250 (at the same 8% capitalization rate), so the total benefit to the property of removing the swimming pool would be \$56,250 ($\$62,500 - \$6,250$). Clearly, the value added of \$56,250 is greater than the cost to cure of \$10,000, so the functional problem of a swimming pool amenity that does not make apartment units more desirable to potential tenants is a curable issue.

loss cured will equal the value added once the cure is accomplished. Note that the *value added* is not the same as the value referred to in the fourth step of the functional obsolescence procedure (Figure 29.6).

Now the cost to cure is compared with the quantified loss. If the value added (once the cure is accomplished) is greater than the cost to cure, then the functional problem is curable. Otherwise, the functional problem is incurable. The next step is to solve for the dollar amount of depreciation using the functional obsolescence procedure.

Using the Functional Obsolescence Procedure

Figure 29.6 diagrams a systematic procedure that can be used to calculate all forms of functional obsolescence caused by a deficiency or a superadequacy, whether the functional issue is curable or incurable. Use of this model helps ensure that all components of functional obsolescence will be treated in a consistent manner, that none of the items will be treated more than once, and that no double charges will be made for items that have already been depreciated (i.e., charged under physical deterioration), which is particularly important for superadequacies.

First, the cost of the existing item is identified. If the item is a form of functional obsolescence caused by a deficiency requiring an addition, there will be no cost for the item and zero will be entered on this line. If the item is a deficiency requiring rehabilitation or retrofit, there will be a cost for the item. Also, when replacement cost, rather than reproduction cost, is used as the cost basis, typically there will be no cost allotted for any superadequate items. As stated earlier in the text, all forms of functional obsolescence present in the subject property would be included in a reproduction of that property, whereas a replacement structure is built to contemporary standards and would not have certain forms of obsolescence present in the subject improvement.

In the second step, any depreciation that has already been charged for the item is deducted. In nearly

The functional obsolescence procedure ensures that all items of functional obsolescence will be treated consistently, that none will be considered more than once, and that double depreciation charges will not be made.

Figure 29.6 Procedure for Estimating All Forms of Functional Obsolescence

Step 1.	Estimate Cost of Existing Item	\$100,000
Step 2.	Subtract Depreciation Previously Charged	- \$100,000
Step 3.	If curable, add Cost to Cure (All Costs)	+ \$100,000
	or	
	If incurable, add Value of the Loss	+ \$100,000
Step 4.	If curable, subtract Cost of the Proper Item if Included in New Construction	- \$100,000
	or	
	If incurable, subtract Depreciated Cost of the Proper Item if Included in New Construction	- \$100,000
	or subtract Depreciated Value*	- \$100,000
Step 5.	Equals Depreciation for Functional Obsolescence	\$100,000

* Sometimes an existing item has value unrelated to cost.

all instances, this depreciation will be physical deterioration. As in the first step, if the item does not already exist in the building, no depreciation will have been charged and zero will be entered on this line.

Regardless of the type of functional obsolescence, appraisers always investigate a cost to cure to determine whether an item is curable or not. If the functional obsolescence is curable, the third step is to add up all the costs associated with curing the item. This includes the cost of purchasing and installing a new item (including entrepreneurial incentive) and the cost of removing the old item, less any salvage value. If the functional obsolescence is incurable, the third step is to add the value of the loss attributable to the obsolescence. This value can be obtained by capitalizing an income loss (using an income multiplier or a capitalization rate) or through analysis of market data such as paired sales.

The fourth step involves the cost of the item if it were included as part of new construction, i.e., the proper item's contribution to the replacement cost (or reproduction cost) if it had been part of the original design rather than being the source of a functional problem. That cost is essentially deducted from the cost to cure in the third step to calculate the excess cost to cure a curable item. If the item is incurable, the depreciated cost listed in the fourth step is deducted from the value of the loss in the third step to yield the value of the loss over and above the cost of the item if installed in new construction.

In the final step, the appraiser adds up all of the entries to derive the total functional obsolescence attributable to each factor. The model described here works for all types of functional obsolescence.

Examples of a Deficiency

Some examples of deficiencies include

- inadequate HVAC
- interior finish that is lower quality than the exterior
- no landscaping where the market requires it
- hallways that are too narrow
- access points that are not ADA-compliant

Consider a small office building without air-conditioning in a market where this feature is standard. Because of retrofit requirements, it is more costly to install the air-conditioning now than it would have been as a part of the original construction. The current cost to install the air-conditioning is \$12,000. If the work had been done as a part of new construction, the cost would have been only \$10,000. Installing air-conditioning would allow the property owner to raise rents, and effective gross income would increase an estimated \$2,000 per year. The current effective gross income multiplier (EGIM) is 7.0. The functional obsolescence is *curable* because the value increase ($\$2,000 \times 7.0 = \$14,000$) is greater than the cost to cure (\$12,000).

1. Cost of Existing Item	\$0
2. Less Depreciation Previously Charged	\$0
3. Plus Cost to Cure (All Costs)	\$12,000
4. Less Depreciated Cost of the Proper Item if Included in New Construction	-\$10,000
5. Equals Depreciation for Functional Obsolescence	\$2,000

Note that because the air-conditioning is not present in the existing improvement, no cost is shown as the cost of the existing item and no depreciation was charged (Steps 1 and 2). The cost to install the air-conditioning as a part of new construction on the date of the opinion of value is \$10,000 (Step 4), but the actual cost to retrofit and install the air-conditioning is \$12,000 (Step 3). The curable functional obsolescence is the excess cost to cure, or \$2,000 (Step 5).

Now suppose that installing an air-conditioning system in the office is not economically feasible—e.g., the current cost of the necessary renovations (say, \$20,000) is greater than the value gained by adding the item (\$14,000). In the analysis of functional obsolescence, two elements must be identified for each building component:

- the cost to cure
- the amount of loss caused by the component or the lack of the component

When the loss is cured, the amount of the loss essentially becomes the value added. In this case, the cost to cure is \$20,000. If the item is cured, the value added (or reduction in loss) is only \$14,000, which means the item is incurable. The depreciation charged is the amount of the loss, over and above the cost if installed new. In the previous example, the item was curable and the measure of depreciation was the excess cost to cure.

1. Cost of Existing Item	\$0
2. Less Depreciation Previously Charged	\$0
3. Plus Value of Loss	\$14,000
4. Less Depreciated Cost of the Proper Item if Included in New Construction	-\$10,000
5. Equals Depreciation for Incurable Functional Obsolescence	\$4,000

Again, because the air-conditioning is not present in the existing improvement, no deterioration was charged. The value of the loss is equivalent to the lost income attributable to the deficiency. The effect of this loss is partially offset by the \$10,000 that would have been expended to install air-conditioning as part of new construction. In other words, this building is losing \$14,000 but it saved the \$10,000 expense. The incurable functional obsolescence is \$4,000.

Now suppose that the value added is \$7,000 instead of \$14,000. The item is still incurable.

1. Cost of Existing Item	\$0
2. Less Depreciation Previously Charged	\$0
3. Plus Value of Loss	\$7,000
4. Less Depreciated Cost of the Proper Item if Included in New Construction	-\$10,000
5. Equals Depreciation for Functional Obsolescence	-\$3,000

The inclusion of air-conditioning is not financially feasible in this case.

Costs to cure and losses sustained by a component can and do change over time. Items identified as incurable at one point in time can become curable and vice versa over the life of the property.

Now suppose that the office building has an outdated air-conditioning system that does not meet market standards and needs to be retrofitted. The reproduction cost of the existing air-conditioning system is \$8,000, and the item is 25% physically deteriorated ($\$8,000 \times 0.25 = \$2,000$). The cost to remove the existing air-conditioning is \$4,500, the salvage value of that equipment is \$3,000, and the current cost of installing an appropriate air-conditioning system is \$12,000 (\$10,000 to install the correct component plus \$2,000 to retrofit the space). The property can still be expected to increase effective gross income by \$2,000 per year (with an *EGIM* of 7.0) if an appropriate air-conditioning system is installed, so the extra income generated (\$14,000) would exceed the cost to cure ($\$4,500 - \$3,000 + \$12,000 = \$13,500$) and the item is therefore *curable*. If the correct air-conditioning system had been installed as part of new construction, the cost would have been \$10,000 and it would be 25% depreciated. The depreciated cost is \$7,500.

1. Cost of Existing Item	\$8,000
2. Less Depreciation Previously Charged	- \$2,000
3. Plus Cost to Cure (All Costs)	+ \$13,500
4. Less Depreciated Cost of the Proper Item if Included in New Construction	- \$10,000
5. Equals Depreciation for Incurable Functional Obsolescence	\$9,500

In this case, application of the formula essentially removes the existing component from cost (the \$8,000 cost of the existing equipment less physical depreciation of \$2,000 already charged) in the first two steps and penalizes cost by the excess cost to cure of \$3,500 ($\$13,500 - \$10,000$) in the third and fourth steps.

Suppose that the existing equipment had no salvage value. The cost to cure the deficiency (\$4,500 for removal of existing equipment plus \$12,000 for installation of the new system, or \$16,500) would exceed the value gained by replacing the air-conditioning system (\$14,000), and the item of functional obsolescence would be *incurable*. If the \$10,000 item had been installed originally, it would be 25% depreciated, i.e., with a current depreciated cost of \$7,500.

1. Cost of Existing Item	\$8,000
2. Less Depreciation Previously Charged	- \$2,000
3. Plus Value of Loss	+ \$14,000
4. Less Depreciated Cost of the Proper Item if Included in New Construction	- \$7,500
5. Equals Depreciation for Incurable Functional Obsolescence	\$12,500

Examples of a Superadequacy

Some examples of superadequacies include

- excess ceiling height
- high-end finish in a Class C office building

- a warehouse with 60% office space in a market that prefers 25% office space

A superadequacy is often difficult to cure. Consider an industrial building with 24-ft. ceiling heights where the market norm is 18-ft. ceilings. The cost of a building with 24-ft. ceilings is \$1.2 million, whereas the cost of a building with 18-ft. ceilings is \$1.0 million. The subject building costs \$5,000 more per year to heat and cool than comparable properties with 18-ft. ceilings in the subject's market. The extra \$200,000 spent in the original construction on the extra six feet of ceiling height adds no value to the property and there is no reasonable cost to cure, so the superadequacy is incurable.

In this instance, the higher ceiling has no value to be recorded in Step 4. In the calculation of functional obsolescence, the amount entered as cost if installed new is zero. Note also that if replacement cost is used, the \$200,000 cost of the superadequacy will be eliminated and the measure of functional obsolescence would be only the capitalized additional costs of ownership. The extra ceiling height costs the subject property \$5,000 more per year than the costs incurred by competitive buildings, and analysis of income and expense data for comparable buildings yields a building capitalization rate of 12.5% in this market. The incurable functional obsolescence is \$40,000 ($\$5,000/0.125$). Because the item is superadequate, it does not belong in the structure and there is no correct replacement component, so there is no entry in Step 4. The replacement cost calculation is as follows:

1. Replacement Cost of Existing Item	\$0
2. Less Depreciation Previously Charged	\$0
3. Plus Value of the Loss	+ \$40,000
4. Less Depreciated Value	\$0
5. Equals Depreciation from Functional Obsolescence	<u>\$40,000</u>

If reproduction cost is used, the additional \$200,000 cost of the superadequacy will not be eliminated, and \$200,000 would be entered in Step 1 and the 10% depreciation already charged in Step 2.

1. Reproduction Cost of Existing Item	\$200,000
2. Less Depreciation Previously Charged	- \$20,000
3. Plus Value of the Loss	+ \$40,000
4. Less Depreciated Value	\$0
5. Equals Depreciation from Functional Obsolescence	<u>\$220,000</u>

If the extra ceiling height does earn some income in the market, the calculations would be affected by that value increment unrelated to cost. Suppose the six feet of extra ceiling height yields an extra \$7,000 in income. At the 12.5% building capitalization rate, the value attributable to the extra ceiling height would be \$56,000 ($\$7,000/0.125$), which would be accounted for in Step 4 of the calculations:

1. Reproduction Cost of Existing Item	\$200,000
2. Less Depreciation Previously Charged	- \$20,000
3. Plus Value of the Loss	+ \$40,000
4. Less Depreciated Value	- \$56,000
5. Equals Depreciation from Incurable Functional Obsolescence	\$164,000

In this case, the extra ceiling height still costs too much and creates additional operating expenses, but it does add \$56,000 in value and thus reduces the functional obsolescence charged to that functional problem.

Now suppose that market research supports an income increase of \$27,500 for the extra 6 feet of ceiling height. At the 12.5% building capitalization rate, the 6-ft. height advantage has a value of \$220,000 ($\$27,500/0.125$).

1. Reproduction Cost of Existing Item	\$200,000
2. Less Depreciation Previously Charged	- \$20,000
3. Plus Value of the Loss	+ \$40,000
4. Less Depreciated Value	- \$220,000
5. Equals Depreciation from Functional Obsolescence	\$0

The market norm may be 18 feet, but according to the data this market wants, and will pay for, 24 feet.

When estimating functional obsolescence caused by a superadequacy, the appraiser must remember whether the cost basis in the calculations is reproduction cost or replacement cost. A superadequacy in an existing improvement would not be installed in a replacement structure, so the cost of that item would not be included in the estimation of functional obsolescence when replacement cost figures are used.

External Obsolescence

External obsolescence is a loss in value caused by negative externalities, i.e., factors outside a property. It is almost always incurable. External obsolescence can be temporary or permanent. For example, value loss due to an oversupplied market may be regained when the excess supply is absorbed and the market works its way back to equilibrium. In contrast, the value loss due to proximity to an environmental disaster may be permanent.

In the aftermath of the financial crisis of 2008, external obsolescence in oversupplied real estate markets was significant, but those losses in value were not expected to be permanent in areas where the economic base was sufficiently diverse to eventually recover. External obsolescence is sometimes called *economic obsolescence* because economic factors outside the control of property owners, like mortgage interest rates and changing employment levels, can have large effects on the value of real estate.

External obsolescence usually has a marketwide effect and influences a whole class of properties, rather than just a single property. However, external obsolescence may affect only one property when its

Appendix 2

**BEFORE THE BOARD OF TAX APPEALS
STATE OF KANSAS**

IN THE MATTER OF THE
EQUALIZATION APPEALS OF KANSAS
STAR CASINO, L.L.C. FOR THE YEAR
2015 IN SUMNER COUNTY, KANSAS

Docket Nos. 2015-3737-EQ
and 2015-3738-EQ

FULL AND COMPLETE OPINION

Now the above-captioned matters come on for consideration and decision by the Board of Tax Appeals of the State of Kansas. The Board conducted a hearing in these matters on May 4 and 5, 2016. The Taxpayer, Kansas Star Casino, L.L.C., appeared by Jarrod Kieffer, Frank Basgall, and Lynn Preheim, Attorneys. The County of Sumner appeared by David Cooper and Andrew Holder, Attorneys. The tax year in issue is 2015.

This matter was fully submitted with the receipt of the County's proposed findings of fact and conclusions of law on June 6, 2016. The Taxpayer made its submission on June 3, 2016. The Board issued its Summary Decision on June 15, 2016 and the Taxpayer requested that the Board issue a Full and Complete Opinion on June 17, 2016.

The subject matters of these tax appeals are two tracts of real estate in Mulvane, Sumner County, Kansas described as follows:

Docket Number 2015-3737-EQ

777 Kansas Star Drive, also known as Parcel Identification
Number 096-022-04-0-00-00-002.00-0

Docket Number 2015-3738-EQ

A tract on East 140th Avenue North known as Parcel
Identification Number 096-022-04-0-00-00-003.01-0

Facts

The subject properties are classified as "Commercial" and appraised as follows:

Docket Number	Land	Building	Total
2015-3737-EQ	\$18,497,500	\$157,900,000	\$176,397,500
2015-3738-EQ	202,500	0	202,500
TOTAL	\$18,700,000	157,900,000	\$176,600,000

The parcel in Docket Number 2015-3738-EQ is a two-acre tract of land that is leased to the City of Mulvane for a fire and ambulance station.

The subject property in Docket Number 2015-3737-EQ is a casino, convention center, and equine show ring located on 195.31 acres of land.

The casino operates under a license from the State of Kansas and pursuant to that license, is required to have the ancillary items such as equine center and convention center. The evidence shows that these ancillary items do not increase the subject property's net operating income.

Mr. Richard Jortberg, appeared for Sumner County and testified on the County's behalf. Mr. Jortberg is a commercial real estate appraiser and has appraised casinos in two Colorado counties. He has a MAI designation from the Appraisal Institute.

Mr. Jortberg has appraised the subject property from 2012 through 2015. For the current tax year, 2015, Mr. Jortberg found that the subject property's appraised value is \$167,000,000, based on the cost approach. The highest and best use of the subject property is the current use.

As for the arena area, Mr. Jortberg characterized it as a loss-leader to attract potential gamblers and to provide goodwill.

For a replacement cost new, Mr. Jortberg estimated an amount of \$155,577,719. That figure is based on the subject property's actual construction costs, adjusted for inflation, and includes a 12½% entrepreneurial incentive amount.

A 1.11% allowance for physical depreciation was applied. The functional/economic obsolescence amounted to \$3,813,000.

Based on Mr. Jortberg's cost approach, the replacement cost new less depreciation of the subject property is \$150,035,680.

For the land value, Mr. Jortberg valued 195½ acres of it at \$86,957 per acre. That value is based primarily on the adjusted sales prices of the subject property, although it sold for \$84,151 per acre. Three other land sales were considered. Two properties in the immediate vicinity of the subject property were optioned for \$55,000 per acre. The fifth sale is the sale of the casino property in Dodge City that sold for \$10,000 per acre.

As noted above, Mr. Jortberg's cost approach concludes with a value of \$167,000,000, for the subject property.

Mr. Cory Morowitz, a consultant and not an appraiser, appeared for the Taxpayer and testified on the Taxpayer's behalf. Mr. Morowitz has a Masters in Business Administration

degree from the Wharton School and has taught classes on and advised potential investors in purchasing a casino operation.

Mr. Morowitz testified that the subject property is the only casino in the Wichita market and that the market in neighboring areas is either saturated or that the population density would not support a casino.

Mr. Dan Ihm, Vice-President and General Manager of the casino, testified that he has worked in the casino industry since 1994 in numerous locations. He testified that profit is made from the gambling income and that the equine center and convention center loses money for the Taxpayer. The Wichita-area market for convention center/concert space is competitive. Only because of the licensing requirements did the Taxpayer construct the equine space and the convention center/concert space.

Mr. Ihm also testified that there are 63½ acres of land leased to Mr. Mark Hardison, a farmer. As of the time of the hearing, Mr. Hardison was growing wheat and soybeans on this land. This land is not necessary to the operation of the casino or any of its ancillary structures.

Mr. Robert Jackson, a Kansas certified general appraiser, appeared for the Taxpayer and testified that he and Mr. Robert (Robin) Marx, MAI, SRA, performed a fee appraisal of the subject property that concluded with a value of \$76,000,000.

Mr. Jackson's appraisal is also based on the cost approach. For a replacement cost new, Mr. Jackson used an inflation-adjusted reproduction cost of the improvements to the subject property. This amounts to \$348.90 per square foot or \$146,126,757. That amount is inclusive of any entrepreneurial incentives.

A 4% allowance for physical depreciation was applied. The subject property is two years old and it is estimated to have a 50-year economic life.

Functional or economic obsolescence in the amount of \$72,946,477, or 52% of the replacement cost new less physical depreciation, was applied to account for the requirements of the Taxpayer's license to operate the casino. As noted above, having the convention center, pavilion, and equine center are requirements to operate but do not provide a profit for the Taxpayer or a return on its investment. In addition, due to market conditions, the net operating income achieved at the subject property has declined after the subject property initially opened and is now rather flat.

Based on Mr. Jackson's cost approach, the replacement cost new less depreciation of the subject property is \$67,335,210.

For the land value, Mr. Jackson valued 119.8 acres of it at \$76,500 per acre. That value is based on the adjusted sales prices of the subject property as well as other casino site sales—one being in Dodge City and the other in suburban Kansas City, Kansas.

Mr. Jackson then included a deduction of \$497,839 as an anticipated cost to complete. As noted above, Mr. Jackson's cost approach concludes with a value of \$76,000,000, for the subject property.

The Taxpayer requests that the portion of the subject properties leased to the farmer be classified as agricultural and appraised at its agricultural use value. The Taxpayer called the Sumner County Appraiser, Ms. Cindy Magill to testify. She testified that the predominant use of the subject property is a commercial, casino use and that the 63½ acres being farmed provides minimal, if any, income to the Taxpayer. Since the predominant use is commercial, the County feels that the entirety of the subject property is properly classified as commercial.

The lease to Mr. Hardison is dated December 20, 2013, and is an automatically renewing annual lease. The lessee is required to mow the drainage areas of land and may plant grain crops on tillable portions of the subject property. In return, the lessee is allowed to keep the entire proceeds from the fields of grain. See Exhibit 26.

Applicable Law and Board Conclusions

All real and personal property in Kansas is subject to taxation on a uniform and equal basis unless specifically exempted. Kan. Const. Art. XI, § 1(a); K.S.A. 79-101. It is the duty of the legislature to provide for a uniform and equal rate of assessment and taxation. See *id.* Pursuant to its constitutional dictate, the legislature has enacted a statutory scheme to ensure property is appraised for ad valorem tax purposes in a uniform and equal manner. Central to this statutory scheme is the requirement that property be appraised at fair market value as of January 1 of each taxable year. See K.S.A. 79-1455.

Each parcel of non-agricultural real property in Kansas is appraised at its fair market value. K.S.A. 79-501. The term "fair market value" is defined as that "amount in terms of money that a well-informed buyer is justified in paying and a well-informed seller is justified in accepting for property in an open and competitive market, assuming the parties are acting without undue compulsion." K.S.A. 2015 Supp. 79-503a.

K.S.A. 79-102 defines "real property" and "real estate" to "include not only the land itself, but all buildings, fixtures, improvements, mines, minerals, quarries, mineral springs and wells, *rights and privileges appertaining thereto.*" (Emphasis added.) Because real property is defined to include all rights and privileges appertaining thereto, it is the "fee simple interest" that is valued for purposes of *ad valorem* taxation in the State of Kansas. See also *In re Prieb Properties, L.L.C.*, 47 Kan. App. 2d 122, 130-31, 275 P.3d 56 (2012). The "fee simple interest" denotes "absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by governmental powers of taxation, eminent domain, police power, and escheat." *The Appraisal of Real Estate*, Appraisal Institute, at 111-112 (13th ed. 2008). "Stated another way, '[o]wnership of the fee simple interest is equivalent to ownership of the complete bundle of sticks [property rights] that can be privately owned.'" *Prieb*, 47 Kan. App. 2d at 130 citing *The Appraisal of Real Estate*, p.112.

In Kansas, the fair market value of real property for ad valorem taxation purposes is based upon the highest and best use of the property. PVD Directive #99-038. "Highest and best use" is the reasonably probable and legal use of vacant land or an improved property which is physically possible, appropriately supported, financially feasible, and that results in the highest value. The highest and best use must meet four criteria: legal permissibility, physical possibility, financial feasibility, and maximum productivity. *The Appraisal of Real Estate*, Appraisal Institute, at 278-279 (13th ed. 2008); *Yellow Freight System, Inc., et al. v. Johnson County Board of Co. Comm'rs*, 36 Kan. App. 2d 210, 217, 137 P.3d 1051, rev. denied (2006).

In comparing the two appraisals submitted by the parties, the Board finds that Mr. Jackson's appraisal for the Taxpayer carries more weight than Mr. Jortberg's appraisal done for the County.

Mr. Jortberg used a 12½% entrepreneurial incentive amount in calculating the replacement cost new. However, the evidence does not show that if it were appropriate to include one in the first place, 12½% would be the proper figure. In this case, due to the circumstances of the subject property being a build-to-suit, owner-occupied property, any development costs are a part of the business rather than the real estate.

For physical depreciation, the subject property was built in various phases between 2011 and 2014. Mr. Jortberg used a physical depreciation figure of 1.11%. In contrast, Mr. Jackson used 4% that better accounts for the age of the subject property and its economic life.

For the functional economic depreciation Mr. Jortberg uses 2.47% while Mr. Jackson uses 52%. Mr. Jackson's figure is based on the super-adequacy of the arena, convention center, and equine facility that do not provide an economic advantage to the subject property aside from them being a licensing requirement. Mr. Jortberg disregards any super-adequacy.

The evidence shows that the arena, convention center, and equine center do not contribute to the overall profit of the subject property. In fact, they detract from it. Therefore, some allowance should be given to account for this economic obsolescence. Mr. Jackson's report indicated that the arena was over built by two-thirds; consequently, the 52% economic obsolescence figure used by Mr. Jackson, should be reduced by a third to 35%.

For the land value, Mr. Jortberg used the sale of the subject property in 2011, and the sale of the site for the Dodge City casino in 2007. Two other properties that had options to purchase were also considered. These two properties are in the immediate vicinity of the subject property.

The subject property's land sold in two transactions for almost \$87,000 per acre. The option on the two properties cited by Mr. Jortberg comes to \$55,000 per acre. The Dodge City sale sold for \$10,393 per acre. Inasmuch as the Dodge City market is dissimilar to the subject property's market, Mr. Jortberg rightly determined that the Dodge City sale is not relevant for valuation of the subject property. Mr. Jortberg relied on \$87,000 per acre for the land value without making any adjustment for time.

Mr. Jackson also considered the same sales as Mr. Jortberg but also considered a second Dodge City sale and the sale of the property for the Hollywood Casino in Kansas City, Kansas. These sales all adjust to \$76,500 per acre. The Board finds that Mr. Jackson's land value is more persuasive as it considers the sales of those properties besides the subject property and makes proper adjustments to account for differences in time, size, amenities, and location.

One issue raised by the Taxpayer involves the proper classification of portions of the land. In regard to 63½ acres of this land, the Taxpayer challenges the commercial use classification and asserts that this area consists of land devoted to agricultural purposes.

As of the appraisal date, January 1, 2015, K.S.A. 2015 Supp. 79-1476 provided a definition for agricultural use land in Kansas, stating, in pertinent part, as follows:

“For the purpose of the foregoing provisions of this section the phrase “land devoted to agricultural use” shall mean and include land, regardless of whether it is located in the unincorporated area of the county or within the corporate limits of a city, which is devoted to the production of plants, animals or horticultural products, including, but not limited to: Forages; grains and feed crops; dairy animals and dairy products; poultry and poultry products; beef cattle, sheep, swine and horses; bees and apiary products; trees and forest products; fruits, nuts and berries; vegetables; nursery, floral, ornamental and greenhouse products. Land devoted to agricultural use shall not include those lands which are used for recreational purposes, other than that land established as a controlled shooting area pursuant to K.S.A. 32-943, and amendments thereto, which shall be deemed to be land devoted to agricultural use, suburban residential acreages, rural home sites or farm home sites and yard plots whose primary function is for residential or recreational purposes even though such properties may produce or maintain some of those plants or animals listed in the foregoing definition.”

There is no evidence that any recreational use is being made of the portions that are farmed. Mr. Hardison is farming the property by growing grain crops. The evidence does not show that it is being done for personal purposes. Therefore, the 63 ½ acres should be classified as “Agricultural” and appraised at its agricultural use value of \$11,970, as stipulated to by the parties.

There are also areas that include drainage and storm water retention. The Board finds that the need for these drainage areas is due to the commercial activities on the subject property, namely the buildings and parking lots. Furthermore, no agricultural activities take place on these areas. Therefore, those properties should remain classified as “Commercial.”

Based on the evidence presented at the hearing, duly weighing such evidence, the Board determines that the appraised value of the subject properties for tax year 2015 totals \$101,500,000, as set forth below.

IT IS THEREFORE ORDERED that the subject properties shall be classified and appraised as follows:

Docket Number	Classification	Land	Building	Total
2015-3737-EQ	Commercial	\$10,100,000	\$91,185,530	\$101,285,530
2015-3737-EQ	Agricultural	11,970	---	11,970
2015-3738-EQ	Commercial	202,500	---	202,500
TOTAL		\$10,314,470	\$91,185,530	\$101,500,000

IT IS FURTHER ORDERED that the appropriate Sumner County officials shall correct their records to comply with this order, re-compute the taxes owed by the Taxpayer, and issue a refund for any overpayment.

Any party who is aggrieved by this order may file a written petition for reconsideration with this Board as provided in K.S.A. 77-529, and amendments thereto. See K.S.A. 74-2426(b), and amendments thereto. The written petition for reconsideration shall set forth specifically and in adequate detail the particular and specific respects in which it is alleged that the Board's order is unlawful, unreasonable, capricious, improper or unfair. Any petition for reconsideration shall be mailed to the Secretary of the Board of Tax Appeals. The written petition must be received by the Board within 15 days of the certification date of this order (allowing an additional three days for mailing pursuant to statute).

Rather than filing a petition for reconsideration, any aggrieved person has the right to appeal this order of the Board by filing a petition with the court of appeals or the district court pursuant to K.S.A. 74-2426(c)(4)(A), and amendments thereto. Any person choosing to petition for judicial review of this order must file the petition with the appropriate court within 30 days from the date of certification of this order. See K.S.A. 77-613(b) and (c) and K.S.A. 74-2426(c), and amendments thereto. Pursuant to K.S.A. 77-529(d), and amendments thereto, any party choosing to petition for judicial review of this order is hereby notified that the Secretary of the Board of Tax Appeals is to receive service of a copy of the petition for judicial review. Please note, however, that the Board would not be a party to any judicial review because the Board does not have the capacity or power to sue or be sued. See K.S.A. 74-2433(f), and amendments thereto.

If both parties are aggrieved by this order, and one party timely appeals this order to the district court (which necessitates a trial de novo pursuant to K.S.A. 74-2426(c)(4)(A)) and amendments thereto, then this order will be deemed final and will render moot any pending petition for reconsideration or request for a full and complete opinion filed by the other party. If both parties are aggrieved by this order, one party timely appeals this order to the court of appeals (which would involve appellate review under the Kansas judicial review act), and the other party timely files a petition for reconsideration or request for a full and complete opinion,

then this order will be deemed non-final and the Board will proceed to render an order regarding reconsideration or a full and complete opinion, as applicable.

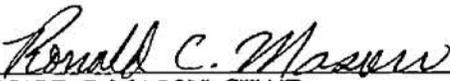
Unless an aggrieved party files a timely petition for reconsideration as set forth herein, this order will be appealable by that party only by timely appeal to the district court or the court of appeals as set forth above.

The address for the Secretary of the Board of Tax Appeals is Board of Tax Appeals, Eisenhower State Office Building, 700 SW Harrison St., Suite 1022, Topeka, KS 66603. A party filing any written request or petition shall also serve a complete copy of any written request or petition on all other parties. Please be advised that the administrative appeal process is governed by statutes enacted by the legislature and no further appeal will be available beyond the statutory time frames.

IT IS SO ORDERED

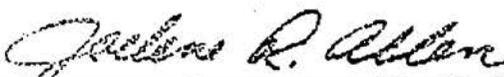


THE KANSAS BOARD OF TAX APPEALS


RONALD C. MASON, CHAIR


JAMES D. COOPER, BOARD MEMBER

DEVIN SPRECKER, BOARD MEMBER


JOYLENE R. ALLEN, SECRETARY

Docket Nos. 2015-3737-EQ and 2015-3738-EQ
Sumner County, Kansas
Page 9

CERTIFICATION

I, Joeline R. Allen, Secretary of the Board of Tax Appeals of the State of Kansas, do hereby certify that a true and correct copy of this order in Docket Nos. 2015-3737-EQ and 2015-3738-EQ and any attachments thereto, was placed in the United States Mail, on this 15th day of September 2016, addressed to:

David Krasn, Vice President of Corporate Tax
Kansas Star Casino, L.L.C.
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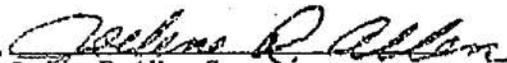
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IN TESTIMONY WHEREOF, I have hereunto subscribed my name at Topeka, Kansas.


Joeline R. Allen, Secretary