Hotel Valuation Myths and Misconceptions Revisited

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This discussion summarizes the “whats and whys” of hotel intangible property allocations. And, this discussion reviews some of the recent judicial precedent related to the topic. This discussion will also clarify some of the misunderstandings that have developed about the withdrawal of the Appraisal Institute continuing professional education course, Separating Real and Personal Property from Intangible Business Assets (Course 800). Additionally, this discussion describes the importance of understanding the relationship between real estate and personal property (both tangible and intangible personal property) for a valuation engagement that concludes the market value of the hotel real estate only. Such a valuation engagement typically starts with the income (or the value) of the total operating assets of the hotel going concern business.

INTRODUCTION

Although the topic of separating hotel intangible assets and tangible assets has been around for much longer, this topic has received considerable intense attention in the past 10 to 15 years. This attention was aided by the introduction and presentation of the Appraisal Institute continuing professional education (CPE) course, Separating Real and Personal Property from Intangible Business Assets (course 800). That CPE course premiered around 2001.

With the Appraisal Institute withdrawal of course 800 in 2005, some observers may conclude that the issue has diminished in importance and has somehow lost its relevance. However, that conclusion could not be further from the truth.

If anything, there is now a greater awareness on the part of hotel valuation clients of the need to allocate the hotel total operating assets in situations where only the value of the real estate is sought. This client awareness extends to valuation engagements related to secured lending, property tax assessment, and eminent domain and condemnation. Now more than ever, hotel owners, taxing jurisdictions, secured lenders, and valuation analysts should understand the composition of these business operating assets. This way, these interested parties can assure themselves that the hotel total assets have been properly parsed when that allocation is necessary in the valuation engagement. The evidence of this continued interest in the operating assets allocation process is ample. For example, in 2009, the Appraisal Foundation released an exposure draft related to the best practices for valuing intangible assets.1 In addition, some of the federal banking agencies appear to be moving toward a formal position regarding the valuation of intangible assets.2

This discussion considers the “whats and whys” of these tangible asset versus intangible asset allocations. And, this discussion will review some of the recent judicial precedent regarding the allocation of total operating assets. This discussion also clarifies some of the misunderstandings regarding the Appraisal Institute decision to withdraw CPE course 800.

RENTING A HOTEL ROOM

While this may be all too familiar to frequent travelers, it is worth taking a moment to describe the various services that are provided to a guest at a full service hotel. Due to “amenity creep,” many of
these services are also provided in limited service hotels. If a guest is entering a luxury or resort hotel, there are even more services. As these hotel services are listed below, let’s contrast these services to the “services” (or lack thereof) that are provided when someone walks into an office building or a warehouse.

- Bellman helps carry luggage to the front desk.
- Valet parks the car.
- Front desk associate checks in the guest and provides keys to the guest room.
- Housekeeping staff has made a clean room available for the guest even if there was someone occupying the room hours before.
- Security personnel are doing their jobs, often unnoticed.
- Comfortable furniture and linens have been provided to sit/sleep on.
- Television and radio are provided for use while the guest is in the room.
- Possibly a mini-refrigerator is provided in the room (could be stocked with grocery items available for purchase).
- Lounge area is provided to watch television and meet with the other guests.
- Fitness room with equipment may be available for use.

- Swimming pool may be available (could be indoors in an area with inhospitable climate) for relaxation and recreation.

The daily room charge typically covers all the services listed above. True, there may be separate charges for some services provided in the hotel, such as phone and internet service, food and beverage service, resort/spa activities, and so on. But, there remains an inherent cost in establishing and managing these services in the hotel for the immediate and ongoing availability to the hotel guests.

There are few, if any, “services” provided to the office or warehouse tenant (other than building maintenance and possibly cleaning) when he/she rents this sort of space. The tenant gains the right to occupy an otherwise vacant office or warehouse bay. If the daily hotel room rate was simply conveying the right to occupy a vacant room, the experience would be akin to indoor camping. In that case, the hotel guest would need to provide all of the furniture, fixtures, equipment, and other services.

### Operating the Hotel Business

The five unique elements of a stabilized hotel business operation are described in Exhibit 1.

Valuation analysts should understand that any viable, operating, profitable hotel creates intangible asset value by providing some level of service above and beyond that of renting a vacant guest room. It is an error for valuation analysts to conclude that only nationally or internationally recognized hotel brands can create intangible asset value by providing services or allowing the use of their brand name(s).

Hotel developers invest in a certain number of non-realty items that are considered standard for a viable hotel to operate. Figure 1 demonstrates the breakdown of the “total assets of the operating business” between tangible assets and intangible assets. This list of intangible assets is not intended to be all-inclusive.

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**Exhibit 1
Unique Hotel Characteristics**

| 1. Hotels are operating businesses | Aside from the component of leasing real estate, hotels conduct many other businesses such as restaurants, equipment rentals, business services, and so on. |
| 2. Hotel leases are only 24 hours in duration | Hotel room nights are perishable, and countless transactions are involved in leasing hotel rooms during the course of a year. |
| 3. Hotels are labor intensive | In order to accomplish the goals of (1) executing 24-hour leases and (2) operating other related businesses, hotels are very labor intensive. |
| 4. Hotels are capital intensive | The excessive wear and tear on hotel real estate due to the public nature of the facilities requires annual expenditures for property renovation and improvements that other real estate types do not require. (emphasis added) |
| 5. Hotels are typically “branded” with a chain affiliation | In essence, the chain affiliation partially replaces the real estate broker as a leasing agent. |

RETURN “ON” INTANGIBLE PERSONAL PROPERTY

One component of the issue of the appropriate value allocation to intangible assets is the procedure of a return “on” this investment—that is, on any/all of the intangible assets listed above under the Intangible Property listing. In order to thoroughly explore this issue, it may be helpful to provide a definition and explanation of just what this return “on” calculation represents.

The Appraisal of Real Estate (13th edition) defines and explains the return “on” and return “of” calculations as follows:

The notion that an investor anticipates a complete recovery of invested capital-plus a payment for the use of capital-prevails in the real estate market just as it does in other markets. The term “return of capital” refers to the recovery of invested capital. The term “return on capital” refers to the additional amount received as compensation for use of the investor’s capital until it is recaptured.3

A more practical explanation of the concept of “return on” an investment is provided by Smith and Parr, in the Preface section of their 2000 textbook, Valuation of Intellectual Property and Intangible Assets.

. . . the structure around which we value intangible assets and intellectual property is not without firm foundation. That rock is one of the immutable laws of business—“return on investment.” Yes, large business transactions are sometimes made to feed egos, thwart competition, and in haste. But, in the main and in the long run, businesspeople base those decisions on a careful (and correct) evaluation of the potential for earning a return on investment. Dollars are not committed for idle amusement. They are planted in order to grow—businesspeople are simply farmers with their own unique seeds and implements, trying to employ the classic agents of production in their own way.4

In the context of the hotel valuation and total asset allocation—in the situation where the value of just the real property is sought—this issue manifests itself in the appropriate value allocations to such assets as a franchise agreements, working capital balance, business start-up costs, and potentially, unidentified intangible assets (as those represented in Figure 1). These intangible assets, as well as other intangible assets not mentioned here, are invested in the expectation of (1) a return of the investment and (2) a fair return on the investment. To quote Smith and Parr again, “We cannot emphasize enough the importance of the relationship of value and earnings. The raison d’être of business assets is to provide a return on the investment required to obtain them.”5

Franchise agreements and related franchise rights are a good example of an intangible asset

Figure 1 Components of Total Assets of the Business

often found in the hotel valuation. With a franchise, the franchisee receives the right to use the name/flag of the franchisor. Accordingly, the franchisee will enjoy the instant image, the in-place reservations/referral system, the rewards program, the advertising and sales benefits, well developed and proven operating procedures, and the like. In exchange, the franchisor receives the payment of an initial fee plus regular royalty payments.

Some valuation analysts contend that, by deducting the annual royalty fee, the value of the franchise is removed from the subject hotel income stream. This procedure, however, fails to address the issue of an appropriate return on this intangible asset investment. Why, for example, would a hotel owner enter into a franchise agreement if the sum total of its franchise value is represented by the periodic license fee that the hotel owner pays to the franchisor?

A royalty rate rule of thumb, often called the 25 percent rule, illustrates this point. This rule of thumb suggests that the licensee will pay a royalty rate equivalent to 25 percent of its expected profits for the product/service that uses the subject intellectual property. Stated differently, the royalty rate represents only a fraction of the value of the intellectual property (e.g., franchise agreement) license.

The licensee enters into such a franchise arrangement expecting (1) to recover the royalty rate that he/she pays to the licensor and (2) to earn a suitable return on the payment of that royalty fee. If the licensee only expected to recover the franchise license fee, then he/she would never enter into the franchise agreement. “The theory underlying this rule of thumb is that the licensor and licensee should share in the profitability of products embodying the patented technology. The a priori assumption is that the licensee should retain a majority (e.g., 75 percent) of the profits because it has undertaken substantial development, operational, and commercialization risks, contributed other technology/intellectual property, and/or brought to bear its own development, operational, and commercialization contributions.”

This procedure is analogous to the hotel franchisor/franchisee relationship. And, this procedure illustrates that there should be a profit incentive for a licensee to pay royalties for the franchise license. This is not to suggest that this procedure is an appropriate method to value a franchise agreement. Rather, this discussion is presented simply to illustrate (1) the concept of the fair return “on and of” components of any intangible asset investment, and (2) the fact that, one way or another, if the value sought is just the real estate, then both the return of and the return on intangible asset should be accounted for.

**Specific Intangible Asset Investments—Hotel Development**

To develop a hotel with a nationally recognized franchise (Marriott, Sheraton, Hilton, Westin, etc.), the hotel developer invests in a number of non-realty items that are clearly described in the typical Uniform Franchise Offering Circular (UFOC). The UFOC, also commonly known as a Franchise Disclosure Document, is a legally registered document provided to prospective franchisees setting out in detail all of the requirements necessary to qualify for a franchise from that particular franchisor. Including the addenda, a UFOC can be well over 400 pages long.

As mentioned above, each franchisor has spent significant resources to develop its proprietary operating systems and its current level of brand recognition. The franchisor is not going to license a franchise to a hotel operator who does not agree to use all of the franchisor processes, procedures, and systems. Such processes, procedures, and systems presumably have been proven to make franchises profitable and to preserve the brand standard. And, a new franchisee would not expect to pay a franchise fee for only the right to use the franchisor’s name with no access to the appropriate resources, systems, etc., that will, presumably, ensure a profitable hotel project.

Exhibit 2 presents a list of the representative items that a hotel franchisor will typically
require the franchisee to procure, either directly from the franchisor or indirectly from another approved source. Additionally, Exhibit 2 includes several requirements for hiring, training, and the like. These expenditures may not represent physical items to be procured, per se. However, these expenditures are investments that are made as part of the overall hotel development project.

Exhibit 2 does not include the cost of every single item or fee that a new hotel franchisee, developing a new full service, chain-affiliated hotel, would incur in the process of completing the project. However, the Exhibit 2 items are unique in their inclusion in the overall investment for a hotel project versus an office or warehouse project.

Obviously, an office or a warehouse developer may or may not incur some of these expenses, such as advertising or working capital. However, most of these items are absolutely necessary for the final hotel product, that is, for the hotel business to start out on a successful footing. Therefore, if the valuation analyst is estimating the business enterprise value of an operating hotel property, then these items should be included in the valuation. However, if the valuation analyst is estimating the value of just the hotel real estate, then these items should be excluded from the valuation.

### Intangible Asset Valuation Issues

The business start-up costs component of going concern value is a commonly misunderstood intangible asset. This is especially true when the subject property is an older hotel.

This misunderstanding has two facets. The first misunderstanding is that these start-up costs are simply ongoing costs in a hotel operation, expenses that are incurred repeatedly. The second misunderstanding is that these start-up costs were incurred initially at the time of opening—many years ago. Therefore, such start-up costs were amortized long ago and are no longer an appropriate deduction.

With respect to the former misunderstanding, it is true that these costs occur repeatedly. For instance, a portion of the hotel assembled workforce is periodically turned over and personnel costs are incurred annually. However, this does not diminish the requirement of assembling the hotel workforce in the first place (e.g., preopening interviews, hiring and training). This misunderstanding is much like confusing the initial installation of a hotel roof with the requirement to continually maintain the hotel roof. Both sets of costs are necessary.

With respect to the second misunderstanding, it is true that the original hotel owner incurred the initial costs. With each transfer (or hypothetical transfer) of the subject hotel, the costs are passed

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**Exhibit 2**

**Selected Nonrealty Franchise Development Costs**

<table>
<thead>
<tr>
<th>Required Hotel Franchise Item</th>
<th>Approximate Cost</th>
<th>Provider</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial franchise fee</td>
<td>$200/room or $60,000, whichever is greater</td>
<td>Franchisor</td>
</tr>
<tr>
<td>Property management and reservations systems &amp; in-person training</td>
<td>$163,000-$168,000</td>
<td>Franchisor/equipment suppliers</td>
</tr>
<tr>
<td>Other systems/training</td>
<td>$215,500 - $233,500</td>
<td>Franchisor/equipment suppliers</td>
</tr>
<tr>
<td>Pre-opening training &amp; services</td>
<td>$82,500 - $102,000</td>
<td>Franchisor</td>
</tr>
<tr>
<td>Feasibility study</td>
<td>Up to $50,000</td>
<td>3rd party supplier</td>
</tr>
<tr>
<td>Kitchen/laundry equipment</td>
<td>Up to $4,700/room</td>
<td>3rd party supplier</td>
</tr>
<tr>
<td>Start-up costs (wages, prepaid expenses, licenses, deposits, etc.)</td>
<td>Up to $4,200/room</td>
<td>Suppliers, franchisee</td>
</tr>
<tr>
<td>Pre-opening local advertising</td>
<td>Up to $170,000</td>
<td>Suppliers</td>
</tr>
<tr>
<td>3 months operating funds (i.e., working capital)</td>
<td>Up to $4,200/room</td>
<td>Suppliers, franchisee</td>
</tr>
<tr>
<td>Furniture &amp; fixtures</td>
<td>Up to $22,000/room</td>
<td>3rd party supplier</td>
</tr>
<tr>
<td>Professional interior design services</td>
<td>Up to $9,300/room</td>
<td>3rd party supplier</td>
</tr>
</tbody>
</table>

along to the new hotel buyer. Accordingly, these costs are never “amortized.”

An easy way to keep this concept straight is to consider how the valuation analyst would value the subject total assets—that is, (1) real property and (2) tangible and intangible personal property—using the cost approach. If the valuation analyst wants to conclude the value of a stabilized hotel operation, the analyst would have to add both tangible personal property (FF&E and inventory) and intangible personal property (business start-up costs, for example) to the cost new of the real property. This is true even if the subject hotel was 50 years old.

Figure 2 illustrates the flow of the start-up costs from hotel development through a subsequent hotel purchase. Unless the building is dark at the time of the transaction, the initial investment in the start-up costs would be recaptured by the hotel seller. And, the hotel buyer does not have to re-invest in all the start-up costs initially incurred. These going concern value start-up costs remain with the property.

Let’s assume that the valuation analyst is estimating the value of the hotel real property only but doing so using sales or income for the hotel total operating assets. In that case, the start-up costs that are necessarily added in the cost approach valuation analysis would have to be removed from the operating sales and income streams used in the income approach valuation analysis.

**Tangible Personal Property Allocation Issues**

The most common source of confusion regarding tangible personal property is handling the allocation to FF&E in order to remove the FF&E from the overall hotel going concern value. Most valuation analysts recognize that, in order to accomplish this, both a return “on” and a return “of” this FF&E asset must be deducted from the hotel income stream. The misunderstanding comes from the relationship of (1) the deduction for the return “of” the FF&E and (2) the deduction of a replacement allowance as a standard, expected, and necessary operating expense. If the hotel total operating assets are being valued, then a deduction for an FF&E replacement allowance is made. Few valuation analysts would argue with this procedure. Somehow, however, when just the hotel real property component...
is being valued, then the deduction of the FF&E represents the removal or separation of the FF&E from the real property. How is this allocation possible? If this procedure doesn’t allocate FF&E value when the analyst is valuing the hotel total operating assets, then why would this procedure become an FF&E allocation when just the real property is being valued? The answer is, of course, it wouldn’t.

In the case of the hotel real estate only valuation, the tangible personal property deduction has to be made twice. First, the FF&E replacement allowance operating expense deduction has to be made. Second, a deduction—representing both a return on and a return of this FF&E asset—is needed to remove the FF&E value from the hotel total operating assets value.9

**Survey of Recent Judicial Precedent**

Probably the best known recent decision relating to this topic involved the Saddle Brook Marriott Hotel in Saddle Brook, New Jersey. This property tax assessment appeal case was tried in 2002. However, the decision wasn’t handed down until 2005. The concepts taught in Appraisal Institute course 800 were prominent in this judicial decision.10

Despite the fact that the assessor’s valuation expert made a material mathematical error with which the court was clearly aware (to quote the judge from the transcript, “So that—it is a big difference. That’s a difference of more than $5 million in ultimate final value conclusion.”), the court ruled to uphold the property tax assessment.

It is important to note, however, the trial judge qualified the significance of the decision by emphasizing, “this decision is based upon the consideration of the reasoning and supporting data addressed in the record of this case for the particular adjustments proposed. It should not be understood as a definitive pronouncement on appraisal practices designed to extract real estate value from the assets of a business or as binding precedent with respect to adjustments of the kind proposed here, should they be offered in other cases with different records.”

A similar result was reached in the Maryland Tax Court in 2006 in a case involving a Red Roof Inn.11 In that case, similar arguments were advanced. Ultimately, the court could not bring itself to appreciate that intangible assets could exist in a limited service hotel, and the court ruled to uphold the property tax assessment.

Several other cases, however, resulted in conflicting judicial opinions. For example, in the 2004 WXII/Oxford-DTC Real Estate case,12 the Loudoun County Circuit Court’s decision in Virginia was diametrically opposite to the Saddle Brook decision. And, the Loudoun County Circuit Court decision centered on the Appraisal Institute course 800 concepts. In this matter, the judge found the Appraisal Institute course 800 concepts to be more accepted in valuing the real estate connected with, or part of, a going concern business.

Similar conclusions were found in three Marriott hotel cases in 2003 and 2004 by the Tennessee State Board of Equalization. The same Tennessee administrative law judge presided in all three decisions. However, in a subsequent case in 2005, in a matter involving a regional shopping mall, that judge reversed himself. The Tennessee administrative law judge appeared to be uncomfortable about whether there was broad acceptance of the Appraisal Institute course 800 concepts.

Several other judicial decisions were also relevant. In Canada, a 2005 decision involving the Fairmont Empress Hotel in Victoria ruled in favor of the valuation concepts with respect to the allocation of tangible personal property (FF&E), but against the valuation concepts with respect to business intangible assets.13 And, in the Superior Court of California, County of Los Angeles, the judge in a 2009 case involving the Glendale Hilton
granted a motion for summary judgment. The judge concluded that “the assessor’s methodology necessarily failed to exclude from his valuation certain intangible assets, such as a return on the franchise and management expenses, from his going concern valuation methodology. The Los Angeles County Assessment Appeals Board’s subsequent adoption of the assessor’s income approach valuation method is contrary to California law.”

There are two noteworthy California Assessment Appeals Board decisions—one involving the Coronado Marriott Hotel (2009) and the second involving the La Jolla Marriott (2006), both in San Diego, California. The Board found deductions for a RevPAR premium due to flag/franchise and for business start-up costs were appropriate and necessary above and beyond a deduction for just the hotel franchise fees and management costs. These fees and costs were recognized to be simply operating expenses. (One of the two Board decisions recognized all intangible assets except the RevPAR premium; the other Board decision accepted all intangible assets except for the business start-up costs.)

This discussion does not represent an exhaustive presentation of court cases involving intangible asset allocation issues. It is obvious from the decisions mentioned, however, that the courts have not reached consensus on this topic. As awareness of all sides of the intangible asset allocation issues intensifies, progress will undoubtedly be seen in the courts.

**Course 800 Misconceptions**

Some valuation analysts have inferred that course 800 was removed from the Appraisal Institute curriculum because of the Institute recognition that the concepts were not valid. Other valuation analysts inferred that the course 800 concepts were counter to the *Uniform Standards of Professional Appraisal Practice*. In fact, these assertions are nothing more than “old husbands’ tales.”

A 2008 “Fact Sheet” authored by the Appraisal Institute noted, “The Business Enterprise Value seminar was offered under the title ‘Course 800’ for approximately three years and then was withdrawn in 2005 for review and evaluation. The Appraisal Institute frequently does this with many courses and seminars, especially one that is a cutting edge and advanced educational offering.”

This 2008 Fact Sheet continues, “The AI did not receive any communications, threats or otherwise . . . related to this advanced educational offering. The Appraisal Institute did not receive any such complaints about the seminar from such entities or persons. There were some complaints and some praise about the course from appraisers, as would be expected for any cutting edge educational offering.” In 2005, a motion was passed unanimously by the Appraisal Institute Board of Directors adopting, among other positive course-related initiatives, “that the educational offering be revised and updated as soon as practical.”

**Summary and Conclusion**

Many valuation analysts do not give sufficient consideration to defining what it is that they are appraising. These valuation analysts don’t carefully define the appraisal problem before they go about trying to solve it. The result is a value estimate that does not properly respond to the appraisal problem. In other words, best case, these valuation analysts end up providing the right answer to the wrong question.

Hotel valuations are particularly susceptible to this. This is because the valuation conclusion will be significantly different depending on whether the valuation analyst is estimating the value of the hotel total operating assets or of just the hotel real property. Many valuation analysts simply begin the valuation report by stating, “the market value of the hotel is . . .” This statement is clearly not definitive enough to reveal exactly what bundle of assets it is that is really being valued. Neither the valuation analyst nor the valuation report reader seems to know the answer to this question.

When the valuation engagement calls for the value of just the hotel real property—such as in eminent domain/condemnation, secured lending, and property tax assessment—then the valuation analyst should carefully remove the value of the tangible personal property and the intangible personal property. This is where the valuation misunderstandings manifest themselves.
First, with the removal of the tangible personal property—for example, the FF&E and the inventory—the confusion centers on a perceived double counting. The valuation analyst inexperienced with hotel valuations may confuse the deduction of a replacement allowance with the removal of the tangible personal property.

This error is analogous to suggesting that when an analyst values an apartment building and deducts a replacement allowance for a roof, then the conclusion indicates the value of the apartment building without a roof. Clearly the tangible personal property adjustment still remains to be made even after the replacement allowance expense has been deducted. Not to perform this procedure would result in a hotel total assets valuation that still includes the value of the hotel FF&E.

The allocation to the hotel intangible assets is even a more misunderstood valuation procedure. Some valuation analysts incorrectly suggest that the deduction of a management fee and a franchise fee removes the operating business element from the hotel valuation. Actually, this procedure removes none of the operating business element (or the business-related intangible assets) from the hotel valuation.

Management fees and franchise fees are simply operating expenses. They do not create an intangible asset. Such operating expenses would necessarily be deducted even if the intended valuation subject was of the value of the total assets of the hotel business enterprise.

Often, the valuation analyst’s problem relates to a lack of education. The very first Standard in the Uniform Standards of Professional Appraisal Practice includes the statement, “In developing a real property appraisal, an appraiser must be aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal.”

The comment to that Standard continues, “it is not sufficient for appraisers to simply maintain the skills and the knowledge they possess when they become appraisers. Each appraiser must continuously improve his or her skills to remain proficient in real property appraisal.”

Sometimes, the resistance to accepting methodological advances relates to an entrenched position on the topic. Maybe not even a premeditated consideration, the valuation analyst simply fails to consider methodology different from what he/she has been practicing for years. Regardless, the issue of allocating value between tangible personal property and intangible personal property is a real one. And, as more and more attention is given to this value allocation issue, it will become more important for hotel valuation analysts and their hotel clients (and other interested parties) to have an adequate understanding of the related value allocation concepts and methodologies.

Notes:
5. Ibid., p. 66.
7. Ibid., p. 412.

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