

The 2010 Hospitality Law Conference

February 3-5, 2010

What Lawyers & Operators Need to Know About Hotel Operations Part II

Presented By:

**Morris Ellison,
Buist Moore Smythe McGee**

**John Keeling,
The Keeling Consultancy**



Morris A. Ellison
Buist Moore Smythe McGee P.A.
5 Exchange Street
Charleston, SC 29401
Principal
Phone (843) 720-4164
Fax (843) 723-7398
Email: mellison@buistmoore.com

Morris A. Ellison is a principal in the South Carolina law firm of Buist Moore Smythe McGee PA where his practice includes commercial real estate transactions, commercial litigation and banking law. He represents local, national and international investors, lenders, and real estate developers in the development, financing and disposition of commercial properties and other assets. Mr. Ellison has experience in a variety of complex real estate and business related issues including the development of hotels, several mixed use projects, real property tax appeals, entity disputes and structuring and complex foreclosures and workouts.

He is a fellow of the American College of Real Estate Lawyers, American College of Mortgage Attorneys and the American Property Tax Counsel. He is a past chair of the Hotels, Resorts and Tourism Committee of the American Bar Association.

Mr. Ellison received his B.A. degree *magna cum laude* from Yale University in 1979 and his J.D. degree from Duke University in 1982 where he served as a member of the Editorial Board of the *Duke Law Journal*. After graduation, Mr. Ellison served as a law clerk to the Honorable James C. Hill, Judge of the United States Court of Appeals for the Eleventh Circuit from 1982 to 1983.

Honors

- *Best Lawyers in America*, Commercial Litigation and Real Estate Law
- *Chambers USA: America's Leading Lawyers for Business*, Real Estate Law
- *South Carolina Super Lawyers*, Real Estate Law
- *International Who's Who of Real Estate Lawyers*

Recent Selected Papers and Publications

- Contributor to *Sale of Goods/Uniform Commercial Code, South Carolina Damages*, published by the South Carolina Bar, 2009, 2004
- Contributor to *Foreclosure Law & Related Remedies, A State-by-State Digest*, published by the Section of Real Property, Probate and Trust Law of the American Bar Association, 2009, 1995
- 'Tis Better to Receive – The Use of a Receiver in Managing Distressed Real Estate*, American College of Real Estate Lawyers, Washington, D.C., October 2009
- Shell Games Tenants Play: Guaranties, Letters of Credit and Special Purpose Entities*, American College of Real Estate Lawyers San Diego, California, March 2007
- South Carolina Property Tax Update*, AMERICAN PROPERTY TAX COUNSEL NATIONAL PROPERTY TAX UPDATE, September 2009
- Legal Issues for Receiverships: An Annotated Sample Order*, Hospitality Law Conference, Houston, Texas, February, 2009
- Dockominium Development and Structuring*, Hospitality Law Conference, Houston, Texas, February 2007

JOHN M. KEELING CPA CRE MAI

Present Principal – The Keeling Consultancy, LLC

Mr. Keeling is an expert in the field of hotel and resort market research, feasibility analysis, and appraisal. He has been providing expert testimony, development consulting, appraisals, asset management, brokerage and contract negotiation for hotels for 35 years. The firm was founded in May of 2009 following his departure from PKF Consulting. Due to his non-compete agreement, any engagements performed by Mr. Keeling through April, 2012 are as a subcontractor to PKF Consulting.

Executive Vice President – Valencia Group

Valencia Group specializes in the development and operation of full-service, independent hotels. In addition to management the company provides development, branding and repositioning services. Mr. Keeling and the Valencia development team are currently developing hotel projects in Philadelphia, New York and San Francisco. Existing properties are located in Austin, Houston, San Antonio and San Jose, CA.

Prior Senior Vice President – PKF Consulting

Managing Director – PKF Capital

Regional Managing Partner – Laventhol & Horwath

Manager – Marriott Hotels & Resorts (Washington, DC; Chicago, IL; Dallas, TX)

AREAS OF SPECIAL COMPETENCE

During his 35 years of hotel brokerage, appraisal and consulting practice, Mr. Keeling has provided hotel development consulting services and managed a diverse assortment of projects including hotel market studies, highest and best use studies and project financing. He currently develops upscale full-service hotels. Mr. Keeling's areas of specialization and relevant experience include the following:

- Appraisals of hotels, resorts, and conference centers;
- Assistance in the development of hotels and resorts;
- Workouts and repositioning of troubled hospitality assets;
- Hotel brokerage;
- Assistance to owners in the selection of management companies and the negotiation of hotel management contracts;
- Market studies for hotels and resorts;
- Assistance in the financial structuring of complex real estate projects; and
- Hotel asset management

EDUCATION

University of California at Los Angeles, CA – BA, History (Cum Laude)

Michigan State University, East Lansing, MI – MBA, Hotel Restaurant & Institutional Management.

PUBLICATIONS

Contributing author to *Real Estate Market Analysis: Methods and Case Studies* and the *Downtown Development Handbook*, both published by the Urban Land Institute.

IMPROVING THE BOTTOM LINE:
TAX REASSESSMENT APPEALS FOR HOTELS®

Prepared for the Hospitality Law Conference

February, 2010

Morris A. Ellison, Esq.

Buist Moore Smythe McGee PA

5 Exchange Street

Charleston, South Carolina 29401

mellison@buistmoore.com

(843) 720-4614¹

John M. Keeling, CPA CRE MAI

The Keeling Consultancy, LLC

4400 Post Oak Parkway, Suite 1640

Houston, Texas 77027

john@keelingconsultancy.com

(713) 871-0221²

Introduction

Suggesting that the current economic downturn has dramatically impacted the financial performance of hotels would obviously be a gross understatement. While revenues of many properties have declined, expenses have not. The current economic climate has led many hotel owners and operators to scrutinize expenses even more closely than in the past. Furthermore, the current economic downturn differs fundamentally from those of the past quarter century in that we are currently in an economic environment where not only are hotels experiencing reduced revenues but the values of the underlying real estate have experienced significant declines.

Property taxes continue to be one of the least understood expenses incurred by hotel owners.³ With the general decline in real estate values, many hotel owners are examining reduced property taxes as a means of reducing operating expenses. However, while real estate values have declined, the pressure on local assessors to maintain tax revenue has increased.⁴

¹ Mr. Ellison, a magna cum laude graduate of Yale University and Duke University Law School, is a principal in the Charleston, South Carolina law firm of Buist Moore Smythe McGee PA. He is a past chair of the Real Estate Section of the South Carolina Bar and a fellow of both the American College of Real Estate Lawyers and the American College of Mortgage Attorneys. He is the South Carolina member of the American Property Tax Counsel and is listed in Chambers and Partners, Best Lawyers in America and the South Carolina edition of Super Lawyers. He can be reached at 843-720-4614 and/or mellison@buistmoore.com.

² Mr. Keeling is a principal of the Houston, Texas hotel consulting firm of The Keeling Consultancy, LLC. He is also Executive Vice President of Valencia Group, a developer and operator of upscale full-service hotels. He has 35 years experience as a consultant, appraiser and asset manager with PKF Consulting and Laventhol & Horwath. He is a CPA, MAI, licensed real estate broker and a member of the Counselors of Real Estate. He can be reached at 713-871-0221 and/or john@keelingconsultancy.com.

³ Daniel H. Lesser and Karen E. Rubin, *Understanding the Unique Aspects of Hotel Property Tax Valuation*, THE APPRAISAL JOURNAL 9 (1993).

⁴ Conor Daugherty, *State, Local Tax Revenues Decline 7%*, WALL STREET JOURNAL, Dec. 30, 2009 at A3 (reporting that according to Census Bureau data, sales taxes and income taxes declined 9% and 12% © Copyright 2010 – Morris A. Ellison. All rights reserved. {01655585.7})

Appeals are state specific, generally complicated and require knowledge of detailed statutes and regulations. However, a successful tax appeal can often save a hotel owner hundreds of thousands of dollars.

Calculating underlying real estate value for hotel properties is complicated by the dependence of these revenues on factors in addition to the real estate value. The monies generated by a hotel's operations are income not rent and must be treated differently for purposes of computing a hotel's value for ad valorem real property tax purposes.

Consequently, calculating real estate value requires an appraiser to extract the business value of the hotel. While there is general consensus that assessors should extract the "business value" of a hotel from the real estate value, the methodology for making this complicated calculation has been the subject of substantial argument and disagreement, even in the world of appraisers.

Most state procedures do not require lawyers to file initial appeals, negotiate with local assessors or appear before local assessment boards. However, only lawyers can take the appeal to the next step, generally a *de novo* trial before a trial court. The relaxed rules for initial appeals have historically led many hotel owners to use tax valuation services to appeal valuations. The major disadvantage in using these consultants stems from their inability to pursue any appeal beyond the local assessment board. Secure in the knowledge that appeals will end before local boards, which are usually more favorably disposed to local government revenue needs, assessors tend to be less willing to negotiate the steeper reductions which the current economic climate suggest are appropriate.

The purpose of this paper is to outline the general procedures and technical pitfalls involved in ad valorem tax appeals generally and hotels specifically. This article will provide an overview of various methods proposed to separate Business Enterprise Value (BEV) from the realty in a hotel. The article includes a sample calculation for valuing the BEV of a hotel franchise affiliation. Finally, the article concludes with a summary of some of the current difficulties which a declining real estate market for hotels and difficulty in obtaining credit presents to assessors as they attempt to calculate the value of the hotel's real estate.

Calculation of Taxes Generally

Methods of calculating ad valorem real property taxes are jurisdiction specific but the basic methodology is similar to that employed by South Carolina. Most jurisdictions separately tax both a hotel's real property and business property. This article focuses on ad valorem real property taxation and the basic methodology is the same. In South Carolina, the assessor is responsible for assessing or appraising the fair market value of the property.⁵ The amount of taxes depends on the appraised value of the real estate. This value is termed the "appraised

respectively in the third quarter of 2009) (while property taxes increased 3.6% in the third quarter, "as property assessments catch up with falling residential and commercial real estate values, property tax revenues are expected to be weak."). "At a minimum, cities will be working through the catastrophic drops in revenues for the next 18 months to two years," said Mark Muro of the Brookings Institution's Metropolitan Policy Program" *Id.*

⁵ See S.C. CODE ANN. § 12-37-3140 (Supp. 2009).

value.” The appraised value of the property is then divided by the taxing ratio applicable to properties of that type. Hotels are taxed at a six (6%) percent rate.⁶ The dividend of this calculation is defined as the “assessment ratio.”⁷ The assessment ratio is then multiplied by the tax rate, the “millage,” applicable in the taxing jurisdiction to determine the amount of the taxes. This ratio is referred to as one mill equals 1/1000th of a dollar or 1/10th of a cent.⁸ For example, if the tax rate is 256 mills, the treasurer multiplies .256 by the assessed value to determine the base amount of real property tax due.⁹ The product of this calculation is the amount of taxes owed on the hotel property.

The hotel owner has no ability to change the assessment or the millage. The appeal focuses on the first component of this calculation, the appraised value of the hotel property.

The Tax Appeal Process Generally

All ad valorem real property tax procedures are creations of state and local law. Consequently, any hotel property owner looking to appeal his taxes must engage someone who knows and understands the intricate requirements of the governing jurisdiction.¹⁰ Nearly all jurisdictions use a similar definition of “value” for ad valorem tax purposes. Under South Carolina law, real property must be valued as follows:

All property must be valued for taxation at its true value in money which in all cases is the price which the property would bring following reasonable exposure to the market, where both the seller and buyer are willing, are not acting under compulsion, and are reasonably well informed of the uses and purposes for which it is adapted and for which it is capable of being used.¹¹

This definition illustrates several current issues. First, like the Appraisal Institute’s definition of value,¹² the statutory scheme assumes the existence of (i) a willing seller; (ii) a

⁶ S.C. CODE ANN. § 12-43-220 (2000 & Supp. 2009).

⁷ See S.C. CODE ANN. § 12-60-30(20) (2000 & Supp. 2009) and 12-43-220.

⁸ BLACK’S LAW DICTIONARY 1009 (7th ed. 1999).

⁹ Assessment ratios often differ for different types of properties within a jurisdiction. Some sample South Carolina assessment ratios include: (a) home (legal residence), 4%; (b) second home (non-legal residence), 6%; (c) agricultural real property (privately owned), 4%; (d) agricultural real property (corporate owned), 6%; (e) commercial real property (which includes all operating hotels) 6%; and (f) manufacturing real and personal property, 10.5%. See S.C. CODE § 12-43-220. In addition, for residential real property, a credit is applied to the base tax thereby reducing the taxes owed by the taxpayer.

¹⁰ For purposes of this paper, the South Carolina ad valorem property tax procedures are primarily cited.

¹¹ S. C. CODE ANN. § 12-37-930 (2000 & Supp. 2009).

¹² The Appraisal Institute’s Standards of Professional Appraisal Practice and the Federal Deposit and Insurance Commission define market value as “[t]he most probable price which a property should bring in a competitive and open market under all condition requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby: (1) Buyer and seller are typically motivated; (2) Both parties are well informed or well advised, and acting in what they consider their own best interest; (3) a reasonable time is allowed for exposure in the open market; (4) Payment is made in terms of cash in United States dollars or in terms of financial arrangements comparable thereto; and (5) {01655585.7}

willing buyer; and (iii) the absence of compulsion. The statutory scheme also assumes a fixed valuation date.¹³ Second, the statutory scheme assumes that the exposure to the market resulted in a fictional sale on the specific valuation date.¹⁴ Finally, the local assessor is charged with assessing the value of real estate, not the value of the personal property used in the hotel's operations nor the value of a business operating on a piece of real property. As complicated operating businesses, a hotel's revenues derive from sources in addition to the real estate, such as the personal property, a "flag," and a complex, often national, reservation system.

The fundamental assumptions in the definition of "value" are being challenged by the reduced real estate valuations and absence of credit in the current economic downturn. With the nearly complete collapse of the credit markets in mid-September 2008, a historic devaluation of real estate values and a tepid, at best, recovery in the credit markets, there are few willing sellers or buyers. The absence of financing has increased the returns demanded by potential buyers to levels which are generally unacceptable to would-be sellers. There are few comparable sales under the current conditions, though these seem to be increasing in recent months. Further, the statutory models assume a sale as of the valuation date even though many markets are experiencing few, if any, sales of hotel properties.

Some jurisdictions reassess properties each year. Other jurisdictions do not reassess every year, though taxpayers generally retain the right to appeal valuations each year. In South Carolina, each county is required to reassess all properties in its jurisdiction once every five years.¹⁵ The South Carolina Department of Revenue has divided the state's forty-six (46) counties so that different counties implement countywide reassessment each year. The goal is to insure "uniformity and equity" in valuations of properties within each county.¹⁶

The requirement of countywide reassessment forces the Assessor to use "mass appraisal techniques" even though these techniques are clearly inappropriate in valuing hotel properties.¹⁷ In other words, as part of the general countywide reassessment program, assessors do not appraise each property individually. Furthermore, many county assessors do not have appraisal licenses outside of their work for the assessor's office. As a direct consequence, many assessors are not familiar with the complicated methodologies used to extract a hotel's business value in determining the real estate's value for tax purposes.

the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale." See 12 C.F.R. § 34.42(g); APPRAISAL INSTITUTE, UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE 2008-2009 (2008).

¹³ See note 21 *infra* and accompanying text.

¹⁴ See note 21 *infra* and accompanying text.

¹⁵ S.C. CODE ANN. § 12-43-217 (2008 & Supp. 2009). However, a county by ordinance may postpone reassessment for not more than one tax year. *Id.*

¹⁶ S.C. CODE ANN. § 12-43-210 (2000 & Supp. 2009) ("all property must be assessed uniformly and equitably throughout the state . . . and [n]o reassessment program may be implemented in a county unless all real property in the county . . . is reassessed in the same year") (emphasis added). S.C. CODE ANN. § 12-43-210(B) provides that no reassessment program may be implemented "unless all real property in the county is reassessed in the same year."

¹⁷ "Mass appraisal" is the process of valuing a universe of properties as of a given date using standard methodology, employing common data, and allowing for statistical testing. S.C. CODE ANN. §40-60-20(15) (2001 & Supp. 2009).
{01655585.7}

In 2006, the South Carolina General Assembly passed the South Carolina Real Property Valuation Reform Act (the “**Reform Act**”).¹⁸ The Reform Act limits the increase in the fair market value of real property attributable to the countywide appraisal and equalization program to fifteen (15%) percent within a five (5) year period.¹⁹ However, this limit does not apply to the fair market value of additions or improvements to real property or to the fair market value of real property when an assessable transfer of interest occurs in the year that the transfer value is first subject to tax.²⁰

¹⁸ S.C. CODE ANN. §§ 12-37-3110 – 3170 (2000 & Supp. 2009).

¹⁹ S.C. CODE ANN. § 12-37-3140 (Supp. 2009). The 15% value limitation increase does not apply to the fair market value of any “additions” and “improvements” to the property and the fair market value of those additions or improvements must be added to the fair market value of the property as determined above in the year in which the additions or improvements are subject to property tax. S.C. Code Ann. §12-37-3140(B). For purposes of the Reform Act, an “addition” or “improvement” means an increase in the value of an existing parcel of real property because of either:

- (i) new construction; S.C. CODE ANN. § 12-37-3130 (1)(a);
- (ii) reconstruction; S.C. CODE ANN. § 12-37-3130 (1)(b);
- (iii) major additions to the boundaries of the property or a structure on the property; S.C. CODE ANN. § 12-37-3130 (1)(c);
- (iv) remodeling; S.C. CODE ANN. § 12-37-3130 (1)(d); or
- (v) renovation and rehabilitation, including installation. S.C. CODE ANN. §12-37-3130 (1)(e).

“Additions” or “improvements” do not include minor construction or ongoing maintenance or repair of existing structures. Special rules are provided for repair or reconstruction necessary as a result of certain natural disasters, construction defects or defective materials, or to make a structure handicap assessable. S.C. CODE ANN. § 12-37-3130 (1)(i).

²⁰ S.C. CODE ANN. § 12-37-3140 (B). The Reform Act defines an “Assessable Transfers of Interest” as (i) An assessable transfer of interest is a transfer of an existing interest in real property that subjects the real property to an appraisal. S.C. CODE ANN. §12-37-3150; (ii) an existing interest in real property includes life estate interests and the beneficial use of property when the fair market value of the beneficial use is substantially equal to the fair market value of the real property or the fee interest. S.C. Code Ann. §12-37-3130(4); and (iii) Beneficial use means the right to possession, use and enjoyment of property, limited only by encumbrances, easements and restrictions of record.

Transfers that constitute an “assessable transfer of interest,” under South Carolina Code section 12-37-3150 include: (i) Conveyance by deed; S.C. CODE ANN. §12-37-3150 (A)(1); (ii) Conveyance by land contract; S.C. CODE ANN. §12-37-3150 (A)(2); (iii) Conveyance to a trust, unless the settlor or settlor’s spouse convey to the trust and the sole present beneficiaries are the settlor, the settlor’s spouse or both. S.C. CODE ANN. § 12-37-3150 (A)(3); (iv) Conveyance by distribution from a trust, unless the distributee is the sole present beneficiary, spouse of the sole present beneficiary or both. S.C. CODE ANN. § 12-37-3150 (A)(4); (v) A change in the sole present trust beneficiary or beneficiaries, unless the change adds or substitutes the spouse of the sole present beneficiary. S.C. CODE ANN. § 12-37-3150 (A)(5); (vi) A deed of distribution, unless the distributee is the decedent’s spouse. S.C. CODE ANN. § 12-37-3150 (A)(6); (vii) A lease if the total duration, including the initial terms and all renewal options exceed twenty (20) years or the lease includes an option to purchase for not more than 80% of the property’s value at the termination of the lease. S.C. CODE ANN. § 12-37-3150 (A)(7).(viii) A transfer of an ownership interest in a single transaction or as part of a series of related transactions within a twenty-five (25) year period in a: (a) corporation; (b) partnership; (c) sole proprietorship; (d) limited liability company; (e) limited liability partnership; (f) or other legal entity if: if the ownership interest is more than 50% of the corporation, partnership, sole proprietorship, limited liability company, limited liability partnership or other legal entity; each entity named above must notify the tax assessor on a form provided by the Department of Revenue not more than forty-five (45) days after a conveyance or an ownership interest that constitutes an assessable transfer of interest or transfer of ownership. S.C. CODE ANN. § 12-37-3150 (A)(8).

Transfers that do not constitute an assessable transfer of interest under South Carolina Code section 12-37-3150(B) include: (i) Transfers not subject to federal income tax in the following circumstances: (a) 1033 {01655585.7}

In view of the rather dramatic demarcation in the “freezing” of the credit markets, a determining of the valuation date for tax purposes is critical. Most experts generally agree that the credit markets essentially froze in September 2008. Consequently, appraisals and valuations of hotels based on pre-September 2008 valuations are arguably of limited probative value. Under current South Carolina law, the valuation date has four different possibilities: (i) December 31st of the prior year;. (ii) December 31st of the year in which an “assessable transfer of interest” has occurred; (iii) as determined on appeal; or (iv) after an adjustment has been made to the value due to a countywide reassessment program but limited by the 15% cap discussed above.²¹ As becomes apparent, mid-cycle appeals can lead to inequities when properties are appraised using different valuation dates.

Definition of “Highest and Best Use.”

In valuing the real property, the assessor considers the property’s highest and best use. “Highest and best use” is generally defined as “the reasonable, probable and legal use of vacant land or improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value.”²²

Three Approaches to Value

Any one familiar with the concept of appraisals of real property readily recognizes three basic approaches to value. In estimating the value of property, all of the factors which affect market value or would influence the purchaser’s mind should be considered, such as location, quality, condition and use.²³ The three general approaches are:

- (i) Replacement Cost approach;
- (ii) Sales comparable approach; and

(Conversions-Fire and Insurance Proceeds to Rebuild) S.C. CODE ANN. § 12-37-3150 (B)(1)(a); (b) 1041 (Transfers of Property Between Spouses or Incident to Divorce) S.C. CODE ANN. § 12-37-3150 (B)(1)(b); (c) 351 (Transfers to a Corporation Controlled by Transferor) S.C. CODE ANN. § 12-37-3150 (B)(1)(c); (d) 355 (Distributions by a Controlled Corporation) S.C. CODE ANN. § 12-37-3150 (B)(1)(d); (e) 368 (corporate reorganization) .S.C. CODE ANN. § 12-37-3150 (B)(1)(e); or (f) 721 (Non-recognition of Gain or Loss on a Contribution to a Partnership) S.C. CODE ANN. § 12-37-3150 (B)(1)(f); (ii) Transfer of property in which the grantor retains a life estate or a life lease; (iii) A transfer through foreclosures or forfeiture of a recorded instrument or through deed or conveyance in lieu of a foreclosure or forfeiture, until the redemption period has expired. S.C. CODE ANN. § 12-37-3150 (B)(3); (iv) A redemption by the defaulting taxpayer of property sold at a tax sale. S.C. CODE ANN. § 12-37-3150 (B)(4); (v) conveyance to a trust if the settlor or settlor’s spouse or both convey the property to a trust and the sole present beneficiary is the settlor, settlor’s spouse or both. S.C. CODE ANN. § 12-37-3150 (B)(5); (vi) transfer for security or an assignment or discharge of a security interest. S.C. CODE ANN. § 12-37-3150 (B)(6); (vii) transfer of real property or other ownership interests among members of an affiliated group as defined in § 1504 of the Internal Revenue Code and S.C. CODE ANN. § 12-6-40, S.C. CODE ANN. § 12-37-3150 (B)(7); (viii) transfer of real property or other ownership interests among corporations, partnerships, limited liability companies, limited liability partnerships, or other legal interests in the entities involved are commonly controlled, S.C. CODE ANN. § 12-37-3150 (B)(8); or (ix) a transfer of an interest in a time share unit by deed or lease. S.C. CODE ANN. § 12-37-3150 (B)(9).

²¹ S.C. CODE ANN. § 12-37-3140 (A)(1)(d).

²² See *Sea Pines Plantation Co., 2002 WL 148696*, at *6 citing APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 409 (10th ed. 1992).

²³ See 84 C.J.S. *Taxation* § 511 (2001).

(iii) Income approach.

In jurisdictions where the assessor is charged with attempting to equalize value during periodic reassessments, there is a fourth approach which is not recognized by the Appraisal Institute. This approach is usually called the “equity value” approach. The income approach is the approach most frequently relied upon in valuing hotels for ad valorem real property tax purposes.

Cost Approach

The cost approach values property based on how much money would it take, using current material and labor costs, to replace the property with similar property. The usefulness of the cost approach is limited to special-purpose properties and properties not frequently exchanged in the market; in addition, its usefulness is questionable when valuing older property.²⁴

Sales Comparison Approach

The sales comparison approach involves the examination of sales of similar properties and comparing the values realized in these sales. Put simply, this approach compares the value of all property in the same area/neighborhood to other properties with special emphasis on the prices of properties that have recently sold.

Proper application of the sales comparison approach requires an investigation into all pertinent information that influenced the reported sales prices to be used for comparison purposes. The correct application of the sales comparison approach is an essential part of the valuation process, as it provides a probable range of market value for the subject property. In the sales comparison approach, the geographic limits of the appraiser’s search for sales data depend on the nature and type of real estate being valued. Certain types of properties have regional, national and even international markets.²⁵

To determine a fair market value for property, a comparison of the sales price for properties with similar characteristics may be utilized. While not conclusive, the sales price for comparable properties presents probative evidence of the fair market value of the property at issue.²⁶ While most assessors make the blanket statement that “the sales comparison approach usually is the most reliable way of determining value of residential property,” hotels are usually considered to have regional or national markets.

Untrained appraisers often fail to analyze the data underlying reported sales to determine whether the sales are in fact comparable. Mistakes associated with the sales comparison approach include using bulk sales of properties or properties involved in Section 1031

²⁴ See *Myrtle Beach Hospital, Inc.*, 1998 WL 574179, at *7 citing APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 409 (10th ed. 1992).

²⁵ See *Myrtle Beach Hospital, Inc.*, 1998 WL 574179 (SC ALJ Aug. 17, 1998) citing APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 409 (10th ed. 1992).

²⁶ See *Sea Pines Plantation Co.*, 2002 WL 148696, at *6; *South Carolina Nat’l Bank (Wachovia Bank of South Carolina) v. Anderson County Assessor*, 1996 WL 909127, Docket No. 95-ALJ-17-0271-CC (SC ALJ Feb. 13, 1996).
{01655585.7}

exchanges. These types of sales fail to demonstrate what a willing buyer would pay a willing seller for the property looking at the property individually.

The fundamental problem in the current market is how to analyze comparable sales after September 2008 when there are few such sales. All statutory taxing schemes assume that a fictional sale has taken place on the valuation date. However, most properties changing hands in the past eighteen (18) months have not involved willing sellers and willing buyers due primarily to the absence of available financing for hotel purchases. Most hotel sales which have occurred after this time have not involved the traditional willing buyer and willing seller with neither being under coercion, though current data suggests that the market is beginning to rebound. Many reported sales are distressed sales. Use of these sales is inappropriate in calculating value.

Income Approach:

The income approach to real estate value converts the anticipated future benefits of property ownership into an estimate of present value.²⁷ The income approach requires:

- (i) a calculation of the net income being generated for a property before debt service; and
- (ii) a determination of a capitalization rate for such net income.

The net income is divided by a capitalization rate to determine the property's appropriate value.

If there are errors with either (i) the capitalization rate; or (ii) the calculation of the net income being generated by a property, the calculated value of a property using the income approach will be flawed.

Determination of net income of a hotel for real estate tax purposes poses unique challenges. Net operating income is the actual or anticipated net income of the real estate, as opposed to the business, remaining after the deduction of operating expenses but prior to deducting mortgage debt service and book depreciation.²⁸ In the current economic downturn, many valuation professionals are being asked to value hotels with negative income for the year preceding the valuation date.

However, the real challenge is the determining the appropriate capitalization rate. The term capitalization rate is generally defined as "any rate used to convert income into value."²⁹ "From an investor's perspective, the earning power of a real estate investment is the critical element affecting its value."³⁰ An investment in income generating property represents the exchange of present dollars for the right to receive future dollars.³¹ A capitalization rate includes

²⁷ See Stephen Rushmore & Erich Baum, *Hotels & Motels: Valuations and Market Studies* 318 (Appraisal Inst. 2001).

²⁸ See *Myrtle Beach Hospital, Inc.*, 1998 WL 574179, at *6 citing APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 409 (10th ed. 1992).

²⁹ APPRAISAL INSTITUTE, THE DICTIONARY OF REAL ESTATE APPRAISAL (4th ed. 2002).

³⁰ APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 424 (10th ed. 1992).

³¹ APPRAISAL INSTITUTE, THE DICTIONARY OF REAL ESTATE APPRAISAL (4th ed. 2002).

a component for financing as well as a component reflecting what an investor would require for a return on the investment into the real estate.

On its face, the income approach would seemingly not depend on the existence of comparable sales. However, this is not the case. The appraisal profession recognizes seven (7) methods for determining the appropriate capitalization rate to apply to property:

- (i) Derivation from comparable sales;
- (ii) Derivation from effective gross income multipliers;
- (iii) Derivation by band of investment – mortgage and equity;
- (iv) Derivation by band of investment – land and building;
- (v) Debt coverage formula;
- (vi) Yield capitalization techniques; and
- (vii) Surveys based on market expectations.³²

Concept of “Equity value”

In jurisdictions such as South Carolina, where the assessor is charged with trying to achieve “equity” between valuations of properties,³³ the concept of “equity value” can become relevant. The standard for a claim based on the inequitable valuation of property is the intentional and systematic undervaluation of certain properties while other properties in the same class are valued at fair market value.³⁴ Using this concept, a taxpayer challenges the value of his property based inequitable values when compared to similar properties. The taxpayer can also contend that the assessor has engaged in a systemic and intentional undervaluation of property in the county.

Challenges based on equity value arguments are rarely successful. As assessors frequently note, complete equity and uniformity are not practically attainable when valuing property.

Timeline for Appeals

Every state has its own procedure for filing and prosecuting tax appeals. The taxpayer and its counsel must be very familiar with the intricacies and the deadlines imposed by the appeals process. However, most jurisdictions have the same basic procedure. The procedure

³² APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 501 – 508 (13th ed. 2008).

³³ S.C. CODE ANN. § 12-43-210 (2000 & Supp. 2009) (“all property must be assessed uniformly and equitably throughout the state . . . and [n]o reassessment program may be implemented in a county unless all real property in the county . . . is reassessed in the same year”) (emphasis added).

³⁴ See *Joe W. Hiller, Architect, Inc. v. Colleton County Assessor*, 1996 WL 909131, Docket No. 95-ALJ-17-0231-CC (ALJ Feb. 16, 1996).
{01655585.7}

usually involves: (i) the filing of an appeal; (ii) meetings and negotiations with the local assessor; (iii) an appeal to a county board which usually consists of laypeople and professionals; (iv) a de novo appeal to a trial court which can be located either locally or at the state level; and (v) an appeal through the court system.

A striking aspect of tax appeals is the dearth of reported decisions throughout the United States. The absence of reported decisions can be explained by the general absence of a requirement of the use of counsel prior to step (iv) in the process outlined in the paragraph above.³⁵ Consequently, many tax appeals are handled by various consulting firms and appraisers who do not have a license to practice law. Most taxing jurisdictions permit non-lawyers to represent property owners through the first three stages of the appeal described in the paragraph above.³⁶ However, the fundamental problem in using this approach is that assessors tend not to be as willing to negotiate value when the assessor recognizes the property owner will need to employ counsel to prosecute the appeal beyond the local board.

In South Carolina, the South Carolina Revenue Procedures Act³⁷ establishes appeal procedures for all real and personal property tax assessments. In a reassessment year, the issuance of the reassessment notice begins the process.³⁸ The assessor must send the property owner a notice of property tax assessment³⁹ by July 1st or as soon as after as is practical,⁴⁰ and serve it on the taxpayer personally or by mail.⁴¹

Historically, the taxpayer would need to ask whether he would sell the real property for the assessed value if a potential purchaser made an offer for that amount. Until the recent economic downturn, the answer was often “no” since tax valuations typically trailed the market value of properties in many jurisdictions. Second, the taxpayer would need to determine whether the appeal made economic sense. In other words, would potential tax savings exceed the costs of the appeal.

³⁵ South Carolina Code section 12-60-90(C)(e) provides that representative of the taxpayers must comply with the duties and restrictions of United States Treasury Department Circular No. 230 including, among other things, providing a power of attorney to the taxing authority.

³⁶ The North Carolina Tax Commission only accepts appeals signed by the taxpayer or the taxpayer’s attorney. See generally North Carolina Tax Commission Rules and Procedures, N.C.A.C. T17: 11 TOC-1.

³⁷ S.C. CODE ANN. § 12-60-10, *et seq.* (2000 & Supp. 2009). The assessment notice must be in writing and include: (i) Fair Market Value, S.C. CODE ANN. § 12-60-2510(A)(1)(a); the value as listed by the Reform Act (iii) Special Use Value (if applicable), S.C. CODE ANN. § 12-60-2510(A)(1)(c); (iv) Assessment Ratio, S.C. CODE ANN. § 12-60-2510(A)(1)(d); (v) Property Tax Assessment, S.C. CODE ANN. § 12-60-2510(A)(1)(e); (vi) Number of Acres or Lots, S.C. CODE ANN. § 12-60-2510(A)(1)(f); (vii) Location of Property, S.C. CODE ANN. § 12-60-2510(A)(1)(g); (viii) Tax Map Number, S.C. CODE ANN. § 12-60-2510(A)(1)(g); and (viii) the appeal procedure, S.C. CODE ANN. § 12-60-2510(A)(1)(j).

³⁸ The deadlines for appeals in non-reassessment years in South Carolina are quite different. *

³⁹ S.C. CODE ANN. § 12-60-2510 (A)(1) (2000 & Supp. 2009).

⁴⁰ S.C. CODE ANN. § 12-60-2510 (A)(1).

⁴¹ S.C. CODE ANN. § 12-60-2510(A)(2).

Conference with the Assessor

The “initial appeal” of an assessment notice usually involves the filing of a written protest with the local assessor.⁴² Real estate owners in South Carolina have ninety (90) days “after the Assessor mails the property tax assessment” to provide written notice of objection to the Assessor.⁴³

After receiving the taxpayer’s notice of objection, the Assessor is required to conduct a review of the market value within thirty (30) (*or as soon as practical*) to determine if a change is required.⁴⁴ If the Assessor agrees with Taxpayer, the Assessor will correct the error.⁴⁵ If the Assessor disagrees with taxpayer, the Assessor shall schedule a conference with the taxpayer.⁴⁶ If the matter is not resolved, the Assessor must advise the Taxpayer of his right to protest and provide a form by which to file the protest.⁴⁷

Appeals to the Local Board

If the matter is not resolved by the conference, the taxpayer has thirty (30) days after the date of the conference to file a written protest with the Assessor.⁴⁸ The written protest must contain: (i) the name, address and telephone number of taxpayer; (ii) a description of the property at issue; (iii) a statement of facts supporting the taxpayer’s position; (iv) a statement outlining reasons for appeal including law or other authority; and (v) a value and classification the taxpayer considers the fair market value or special use value (if applicable) and the proper classification.⁴⁹ The Assessor must respond to the taxpayer’s written protest within thirty (30) days. The Assessor’s response must (i) be in writing; (ii) be mailed via first class mail; (iii) be mailed within thirty (30) days of receipt of taxpayer’s written protest *or as soon thereafter as practical*; (iv) include a statement of the initial tax property tax assessment; (v) include the redetermined property tax assessment; and (vi) inform the taxpayer of procedure for all further appeals.⁵⁰

The next level of appeal in South Carolina is to a county Board of Assessment Appeals (the “**Board**”). This appeal must be made within thirty (30) days of the Assessor’s response to the taxpayer’s written protest.⁵¹ A conference on appeal (hearing) must be conducted by the

⁴² S.C. CODE ANN. § 12-60-1730 (2000 & Supp. 2009) provides a property taxpayer may appeal any property tax assessment if a written protest is filed. Appeals must be in writing. §§12-60-1730 & 12-60-2510. The County form reassessment notice usually contains a detachable “informal appeal form” which should be returned to the Assessor’s Office within ninety (90) days of the date of the notice.

⁴³ S.C. CODE ANN. § 12-60-2510(A)(3). Written Notice of Objection must be to one or more of the following: (i) fair market value, (most cases); (ii) special use value, (iii) assessment ratio; or property tax assessment. A representative of the taxpayer must also file a power of attorney. *Supra* note 33.

⁴⁴ S.C. CODE ANN. § 12-60-2520 (B) (emphasis added).

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ S.C. CODE ANN. § 12-60-2520(B).

⁴⁹ S.C. CODE ANN. § 12-60-2520(B).

⁵⁰ S.C. CODE ANN. § 12-60-2520(C).

⁵¹ S.C. CODE ANN. § 12-60-2530(A). The Assessor may extend this deadline so long as extension request is within the thirty (30) day period. *Id.*
{01655585.7}

Board within thirty (30) days after the date of receiving notice of appeal or as soon as thereafter practical.⁵² At least fifteen (15) days prior to the hearing, the Assessor must file the following with the Board and the taxpayer: (i) a copy of original property tax assessment; (ii) a copy of the written protest of the taxpayer; (iii) a written response to the taxpayer's protest; and (iv) copies of documents (appraisals, property sales comparable reports, and a brief description of any other evidence to be presented by the Assessor).⁵³ The taxpayer must file copies of documents (appraisals, property sales comparable reports, and a brief description of and other evidence to be presented) with the Board and the Assessor.⁵⁴ The Board may waive these requirements.⁵⁵ At least seven (7) days prior to the conference (hearing), each party may file a response to the materials submitted.⁵⁶ The responses must be sent to all parties. *Id.*

As noted above, the South Carolina taxpayer need not be represented by counsel at the hearing but any representative must file a Form SC2848 power of attorney in order for the taxing authority to recognize that person as the taxpayer's representative. An appraiser cannot serve as an advocate at the hearing.⁵⁷ The conference must be open to the public though the Board may meet privately to consider evidence. The Assessor must explain the property tax assessment and his response to the taxpayer's written protest and may provide evidence to support his assessment. The taxpayer must state his reasons for protesting the valuation and may provide evidence to support his valuation of the property. Both the Assessor and the taxpayer may rebut each other's arguments. The Board may ask questions of either party.⁵⁸ The Board may enter default judgment if either party fails to appear at the conference.⁵⁹ The appeal must be considered by all Board members present at a meeting.⁶⁰

The Board assumes that the Assessor's decision as to the valuation of property is correct until the taxpayer meets the burden of proving the case to the contrary.⁶¹ Ordinarily, this is done by proving the actual value of property. A taxpayer may, however, show by other evidence that

⁵² S.C. CODE ANN. § 12-60-2530(C)(emphasis added). The Board shall: (i) set the place, date, and time for the conference, S.C. CODE ANN. § 12-60-2530(C)(1); (ii) give the Assessor and the taxpayer thirty (30) days written notice of the conference, S.C. CODE ANN. § 12-60-2530(C)(2); and (iii) advise the taxpayer that all evidence must be presented at the conference, S.C. CODE ANN. § 12-60-2530(C)(3).

⁵³ S.C. CODE ANN. § 12-60-2530(F).

⁵⁴ S.C. CODE ANN. § 12-60-2530(G).

⁵⁵ *Id.*

⁵⁶ S.C. CODE ANN. § 12-60-2530(H).

⁵⁷ South Carolina Code section 12-60-90(C)(2) provides a taxpayer may be represented during the administrative tax process by a real estate appraiser . . . in matters limited to questions concerning the valuation of real property. According to the form power of attorney provided by the South Carolina Department of Revenue, the following professionals or individuals may represent a taxpayer before a taxing authority: attorneys, certified public accountants, enrolled agents pursuant to the United States Treasury Department Circular No. 230, an officer of the taxpayer entity, a full time employee of the taxpayer, a family member of the taxpayer, and the return preparer.

⁵⁸ S.C. CODE ANN. § 12-60-2530(I).

⁵⁹ S.C. CODE ANN. § 12-60-2530(C)(4).

⁶⁰ S.C. CODE ANN. § 12-60-2530(E).

⁶¹ *Cloyd v. Mabry*, 295 S.C. 86, 367 S.E.2d 171 (Ct. App. 1988); see *S. C. Tax Comm'n v. South Carolina Tax Bd. of Review*, 278 S.C. 556, 299 S.E.2d 489 (1983).
{01655585.7}

the assessing authority's valuation is incorrect. If the taxpayer does so, the presumption of correctness is removed and the taxpayer is entitled to appropriate relief.⁶²

After the hearing, the Board rules on the valuation by majority vote.⁶³ If the Board's vote is a tie, the Assessor's determination is upheld.⁶⁴ The Board must provide a written decision to both the Assessor and the taxpayer within fifteen (15) days of the date of the conference or as soon thereafter as practical.⁶⁵ The written decision must (i) explain the decision; (ii) state that if the decision is NOT appealed, it will be certified; and (iii) inform the parties of their right to appeal to the Administrative Law Judge Division.⁶⁶

Appeals from the Board to the Trial Court

The taxpayer or the Assessor has thirty (30) days to appeal the County Board of Assessment Appeals' decision.⁶⁷ While the forum for this appeal differs among jurisdictions, the appeal is almost always de novo. In South Carolina, the appeal must contain a request for Contested Case Hearing before the Administrative Law Judge Division ("**ALJD**") in accordance with ALJD Rules.⁶⁸ The appeal to the ALJD is a contested case if filed pursuant to the ALJD Rules.⁶⁹ This proceeding before the Administrative Law Judge Division is in the nature of a *de novo* hearing.⁷⁰

Importance of Expert Testimony

As noted above, many appraisers in assessor offices are not licensed to appraise hotels outside of their employment by the Assessor.⁷¹ Successfully appealing a real estate valuation often depends on the strength of expert testimony. While an appraiser's license is not generally required before local boards, a full license is critical when presenting testimony at the de novo hearing before the trial court.

⁶² See *Cloyd, supra*; *Richland County Assessor v. Sally Walker*, 1997 WL 725106, Docket No. 97-ALJ-17-0206-CC (SC ALJD Nov. 6, 1997).

⁶³ S.C. CODE ANN. § 12-60-2530(J)(1).

⁶⁴ *Id.*

⁶⁵ S.C. CODE ANN. § 12-60-2530(J)(2) (emphasis added).

⁶⁶ S.C. CODE ANN. § 12-60-2530(J)(2).

⁶⁷ S.C. CODE ANN. § 12-60-2540(A) (2000 & Supp. 2009).

⁶⁸ *Id.*

⁶⁹ S.C. CODE ANN. § 12-60-2540(A). The procedures are generally governed by S.C. Code Ann. § 12-60-3310 through § 12-60-3390 (2000 & Supp. 2008). A party permitted to request a contested case hearing must make the request by serving the request on opposing parties according to the rules of ALJD. *Id.*

⁷⁰ See *Sea Pines Plantation Co., Inc. v. Beaufort County Assessor*, 2002 WL 1486969, Docket No. 01-ALJ-17-0018-CC, at *6 (SC ALJ June 20, 2002).

⁷¹ South Carolina Code §12-37-90 (2000 & Supp. 2009) requires each county to have a full time assessor but does not set forth the requirements for the qualifications of the assessor. South Carolina Code §12-37-110 (2000 & Supp. 2009) requires only that assessor attend educational classes "required by the [South Carolina Department of Revenue.]" S.C. CODE ANN. § 12-37-11 {01655585.7}

“The qualification of a witness as an expert in a particular field is within the sound discretion of the trial judge.”⁷² Where the expert’s testimony is based upon facts sufficient to form the basis for an opinion, the trier of fact determines its probative weight.⁷³ A trier of fact is not compelled to accept an expert’s testimony, but may give it the weight and credibility he determines it deserves.⁷⁴

Importance of Appraisal Institute Standards

South Carolina courts, as well as other jurisdictions, generally rely on the Appraisal Institute’s standards for valuation.⁷⁵ Because of the nature of the cost/benefit analysis, many taxpayers prefer to hire appraisers/experts on a contingency basis. This type of fee poses substantial potential pitfalls both in terms of the expert’s credibility as well as the ethical standards of the Appraisal Institute.

In appeals to most trial courts, the court presumes that the assessor’s valuation is correct and that it was made in conformity with the law.⁷⁶ The property owner bears the burden of disproving the assessor’s determination.⁷⁷ Generally, the property owner meets its burden of proving the valuation of the property to the contrary of the Assessor’s determination of its value by proving the actual value of the property.⁷⁸ Even if the taxpayer fails to prove the actual value of the property, the taxpayer still meets its burden of proof when the taxpayer shows by other evidence that the assessing authority’s valuation is incorrect.⁷⁹

⁷² See *Sea Pines Plantation Co.*, 2002 WL 1486969, at *6; *Smoak v. Liebherr-Am., Inc.*, 281 S.C. 420, 315 S.E.2d 116, 118 (1984); *S.C. Dep’t of Highways & Public Transp. v. Manning*, 283 S.C. 394, 323 S.E.2d 775 (1984).

⁷³ See *Sea Pines Plantation Co.*, 2002 WL 1486969, at *6.

⁷⁴ *State v. Morris*, 376 S.C. 189, 656 S.E.2d 359 (2008) citing *State v. Myers*, 301 S.C. 251, 255, 391 S.E.2d 551, 554 (1990); *Florence County Dep’t of Social Serv. v. Ward*, 310 S.C. 69, 425 S.E.2d 61 (1992); *Greyhound Lines v. S.C. Public Serv. Comm’n*, 274 S.C. 161, 262 S.E.2d 18 (1980); see also *Morrow v. Martschink*, 922 F.Supp. 1093, 1097-98 (D.S.C. 1995) (assigning double weight to the real estate appraisal done by defendant’s expert where possible infirmities existed in the plaintiff’s appraisal). The trier of fact may also accept the testimony of one expert over another. *S.C. Cable Tel. Assn. v. Southern Bell Tel. & Tel. Co.*, 308 S.C. 216, 417 S.E. 2d 586 (1992)).

⁷⁵ See, e.g., *Myrtle Beach Hospital, Inc. v. Horry County Assessor*, 1998 WL 574179, Docket No. 97-ALJ-17-0449-CC (SC ALJ Aug. 17, 1998); *South Carolina Tax Commission v. South Carolina Tax Board of Review*, 287 S.C. 415, 339 S.E. 2d 131 (Ct. App. 1985); *Badische Corporation (BASF) v. Town of Kearney*, 288 N.J. Super. 171, 672 A. 2d 186, 189 (1996).

⁷⁶ See *Joe W. Hiller, Architect, Inc. v. Colleton County Assessor*, 1996 WL 909131, Docket No. 95-ALJ-17-0231-CC (S.C. A.L.J. Feb. 16, 1996); 84 C.J.S. Taxation § 410 (1954).

⁷⁷ See *Joe W. Hiller, Architect, Inc. v. Colleton County Assessor*, 1996 WL 909131, Docket No. 95-ALJ-17-0231-CC (ALJ Feb. 16, 1996).

⁷⁸ See *Richland County Assessor v. Walker*, 1997 WL 725106, Docket No. 97-ALJ-17-0206-CC, at *2 (SC ALJ Nov. 6, 1997); *Joe W. Hiller, Architect, Inc. v. Colleton County Assessor*, 1996 WL 909131, Docket No. 95-ALJ-17-0231-CC, at *4 (SC ALJ Feb. 16, 1996) (emphasis added).

⁷⁹ See *Joe W. Hiller, Architect, Inc. v. Colleton County Assessor*, 1996 WL 909131, Docket No. 95-ALJ-17-0231-CC (ALJ Feb. 16, 1996); and *Cloyd v. Mabry*, 295 S.C. 86, 367 S.E.2d 171 (S.C. App. 1988). [01655585.7]

Payment of Taxes while Appeal is Pending

If the appeal process proceeds beyond December 31 of the current tax year, South Carolina law requires the Assessor to notify the County Auditor to adjust the property tax assessment to eighty (80%) percent of the protested assessment.⁸⁰ The taxpayer must pay the taxes as in all other cases.⁸¹

After final review of the appeal, if the property tax assessment is *greater* than the adjusted property tax assessment, a corrected tax assessment will be entered and interest must be collected.⁸² If the property tax assessment is *less* than the adjusted property tax assessment, a corrected tax assessment will be entered and overpayment of tax must be refunded.⁸³

Hotels

Hotels differ from most real estate in that they are more than simply real estate; they are operating businesses. Unlike most other real estate, income from the property cannot simply be classified as rent. Terms are bandied around such as REVPAR, ADR, limited service, full service, flags, per key values, and other terms which have specific meanings in the context of the hotel industry.

- (i) **Revenue Per Available Room (RevPAR):** a measure of performance which considers both the occupancy percentage and average daily rate
- (ii) **Occupancy Rate** = A percentage based on the number of rooms occupied out of total available rooms
- (iii) **ADR** = Average Daily Rate
- (iv) **\$RevPAR = \$ADR X %Occupancy Rate**

The Components of Value in a Hotel

Hotels are generally sold not as real estate but as “going concerns.” According to *The Appraisal of Real Estate*:

A going concern is an established and operating business with an indefinite future life. For certain types of properties (e.g., hotels and motels, restaurants, bowling alleys, manufacturing enterprises, athletic clubs, landfills), the physical real estate assets are integral parts of an ongoing business. . . Going-concern value includes the incremental associated with the business concern, which is distinct from the value of the tangible real property and personal property.⁸⁴

⁸⁰ S.C. CODE ANN. § 12-60-2550(A) (2000 and Supp. 2009).

⁸¹ S.C. CODE ANN. § 12-60-2550 (4).

⁸² S.C. CODE ANN. § 12-60-2550(B) (emphasis added).

⁸³ S.C. CODE ANN. § 12-60-2550(C) (emphasis added).

⁸⁴ THE APPRAISAL INSTITUTE, THE APPRAISAL OF REAL ESTATE 29, (13th ed. 2008).

While the assessor is charged with appraising the value of the hotel's real estate, the components comprising the value elements of a hotel are not sold separately. Investors base purchases on the income stream generated by the hotel as an operating business, not on the value of its individual components. These components include:

- Land
- Improvements
- Furniture, Fixtures & Equipment (FF&E)
- Working Capital
- Business Enterprise Value

The first two items, land and improvements, constitute the real estate or realty which is subject to ad valorem real property taxation. FF&E and inventory would constitute the Tangible Personal Property (“**TPP**”) and typically be subject to personal property taxation. The components of inventory include supplies, uniforms, linens, silver, china, glassware, food, liquor, fuel, tools, etc. Working Capital and Business Enterprise Value (“**BEV**”) are considered Intangible Personal Property (“**IPP**”). Working capital includes cash, the net of accounts payable and receivable, and other cash equivalents. The business enterprise value components might include start up costs, an assembled workforce, business organization, non-realty leases and contracts, hotel franchise and residual intangible assets.

Some assessors contend that business enterprise value is an illusion conjured by disreputable appraisers and property owners as a strategy to reduce ad valorem taxes.⁸⁵ Daniel Lesser posits that the more aggressive approaches to value “are merely contrived academic constructs which have been developed to reduce hotel property tax burdens. Analysis of the actions of hotel investors proves that the purchase of a hotel property reflects the acquisition of real and personal property only. Hotel investors account for income attributable to the business through the expense deduction of management and, in some cases, franchise fees.”⁸⁶

While a consensus on the method for calculating BEV does not exist, there is a general agreement that it is a valid component of going concern value. Intangible assets are explicitly recognized by the Appraisal Institute, IRS, SEC and FASB pronouncements of the AICPA, to identify only the best known. “The business component of a hotel's income stream accounts for the fact that a lodging facility is a labor-intensive, retail type activity that depends upon customer acceptance and highly specialized management skills.”⁸⁷

While most professionals agree that a hotel's business enterprise value should be excluded for purposes of determining the proper assessment for real property tax purposes, the method for calculating the amount of this business enterprise value is subject to great

⁸⁵ Richard Marchitelli, *How Should Appraisers View Business Enterprise Value?*, THE APPRAISAL JOURNAL 64, 336 (July 1996).

⁸⁶ Daniel Lesser, *Total Assets of the Business' and Lodging Facilities: What Should be the Final Chapter*, 1 JOURNAL OF PROPERTY TAX ASSESSMENT AND ADMINISTRATION 4, 29-36 (2004).

⁸⁷ Bernice T. Dowell, *Hotel Investment Analysis: In Search of Business Value*, ASSESSMENT JOURNAL 46-51 (March/April 1977).
{01655585.7}

controversy.⁸⁸ This article does not intend to endorse any particular approach but does describe approaches commonly used by appraisers to extract business value from the operating hotel in appraising the real estate for tax purposes.

The Case for the “Rushmore Approach” of Valuing Hotel Business Enterprise Value

Both hotel chain affiliation and management, the level of the latter being often dictated by chain affiliation, add significant value to a hotel.⁸⁹ Of the three generally accepted approaches to valuing hotels (the cost approach, the market comparable approach, and the income capitalization approach), the income capitalization approach dominates.

One of the most commonly cited approaches for extracting the real estate value of an operating hotel is known as the “Rushmore Approach,” named for Stephen Rushmore, the founder of HVS International. By subtracting management fees and franchise fees from the cash flow of a hotel, the resulting cash flow when capitalized results in real estate value.⁹⁰ The Rushmore Approach is widely accepted by tax assessing entities, even those using “mass appraisal techniques.” Rushmore states:

The most appropriate theory for today’s environment is based on the premise that by employing a professional management agent to take over the day-to-day operation of the hotel – thereby allowing the owner to maintain only a passive interest – the income attributed to the business has been taken by the managing agent in the form of a management fee. Deducting a management fee from the stabilized net income thereby removes a portion of the business component from the income stream. An additional business value deduction must also be made if the property benefits from a chain affiliation.⁹¹

Under the Rushmore Approach, the valuation expert (i) starts with original income and expense statements; (ii) makes deduction for business value by analyzing (a) the property’s management fee and (b) the franchise fee, if any; (iii) deducts the value of the hotel’s personal property; (iv) calculates a value for return on the investment; and (v) calculates a value for return of the investment. The expert then makes adjustments for superior or inferior management usually by adjusting the property’s occupancy and average daily rate based on Smith Travel Research and Market Research. In doing so, the expert adjusts income and expense data based on comparable operating data considering factors such as (i) location; (ii) design and

⁸⁸ See generally, Stephen Rushmore, *Why the “Rushmore Approach” is a Better Method for Valuing the Real Property Component of a Hotel*, 1 JOURNAL OF PROPERTY TAX ASSESSMENT AND ADMINISTRATION 4, 15-27 (2004); Norm Miller, *The Land Residual Theory and Absence of Business Value for Real Estate as an Operating Business*, 1 JOURNAL OF PROPERTY TAX ASSESSMENT AND ADMINISTRATION 4, 29-36 (2004); Lesser, *supra* note 86 at 29-36; Heather J. Reichardt & David C. Lennhoff, *Hotel Asset Allocation: Separating Tangible Personality*, 10 ASSESSMENT JOURNAL 1, 25-31 (Winter 2003); Lesser and Rubin, *supra* note 3.

⁸⁹ Eric E. Balfrage, *Business Value Allocation in Lodging Valuation*, THE APPRAISAL JOURNAL 69, 277-282 (July 2001).

⁹⁰ Stephen Rushmore and Karen E. Rubin, *The Valuation of Hotels and Motels for Assessment Purposes*, THE APPRAISAL JOURNAL 50 (April 1984).

⁹¹ *Id.*
{01655585.7}

construction; (iii) market orientation (i.e. extended stay, select service, limited service, etc.); (iv) brand (i.e. Hilton, Marriott); and (v) age.

In adjusting the property's occupancy and daily rate, the expert generally divides hotel properties into classes such as (i) full service and (ii) limited service.

A typical problem is the assessor's inclusion in his calculation of income the business value of the Property as opposed to valuing the real estate itself.⁹² As noted above, there are extremely few reported decisions in the United States in this area. The leading reported decision regarding valuing hotels is that of the New Jersey Tax Court in *Glen Pointe Assocs. v. Township of Teaneck*.⁹³ The hotel involved in that case, the Lowe's Glen Pointe Hotel, contained 347 guest rooms, two restaurants, a lounge, a lobby bar and a health club known as "The Spa at Glenpointe."

The court concluded that the Township of Teaneck had inappropriately valued the hotel for ad valorem tax purposes.⁹⁴ Using the income method, the court held that to arrive at the "true value" of the real property itself, one must eliminate business value and the value of the personal property.⁹⁵ The court held that it was reasonable to extract the hotel's business value and the method used by the expert to be reasonable.⁹⁶ The court noted that a hotel, whose income depends on many factors other than the real estate itself, differs from other types of income producing real estate such as an apartment complex, whose value generally depends primarily on the real estate itself.⁹⁷ The taxpayer's expert opined that the business value is reflected in the compensation paid to the professional management agent to assume responsibility for daily operations of the hotel. That compensation is measured by a percentage of total hotel revenues.⁹⁸

An appraisal of real estate for ad valorem tax purposes which is based on the income derived from the hotel's operations must allow a deduction for the contribution to that income of the business' goodwill because that portion of the value of the property is not related to its real estate but instead to the hotel's reputation and the services it provides, in another words its goodwill or going concern value.⁹⁹ The attractiveness of the method includes the ready availability of the necessary data and the simplicity of the calculation. Rushmore further states that the deduction of the management fee in order to arrive at BEV is supported because third party management is widely practiced and in appraisals a management fee is routinely deducted.

Rushmore defends his approach against attacks by advocates of the "business enterprise" approach in an extensive article published in 2004.¹⁰⁰ Rushmore believes that while the business

⁹² E.g., S.C. CODE ANN. §12-37-930.

⁹³ 10 N.J. Tax 380, 1989 N.J. Tax LEXIS 5, at *11-12 (1989) *citing inter alia* Stephen Rushmore, HOTELS, MOTELS, AND RESTAURANTS: VALUATIONS AND MARKET STUDIES 105-06 (Appraisal Inst. 1983)).

⁹⁴ See generally, *Glen Pointe Assocs. v. Township of Teaneck*, 10 N.J. Tax 380.

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.* at 390-392.

⁹⁸ *Id.*

⁹⁹ *Sunwest Hotel Corp. v. Bd. of County Commissioners of Reno County, Kansas*, 1998 WL 982905, at *13 (U.S.D.C. – Kan 1998).

¹⁰⁰ Rushmore, *supra* note 88 at 15-27.
{01655585.7}

enterprise approach advocated by others significantly reduces a hotel's ad valorem tax assessment, the business enterprise approach also has the potential of reducing the mortgage asset security value relied upon by lenders in making hotel loans.¹⁰¹ Rushmore notes that there is no hard date pertaining to sales of a hotel business' different components. In essence, Rushmore argues that the results yielded by other more aggressive business enterprise approaches yield real estate values which are not reasonable in the context of an analysis of depreciation taken by most hotel owners.¹⁰²

Criticisms of the Rushmore Approach

While the Rushmore Approach is often preferred by tax assessors and is simple to calculate, it is subject to criticism from many appraisers. The Rushmore approach offers no support for the theory other than the notion that management fees can be characterized as income to the business. The assumption that the deduction of management and franchise fees effectively removes BEV is counter to market participant expectations that the costs of management and franchise affiliation should result in revenues that exceed cost. Many appraisers suggest that the idea that management and franchise companies capture all of the BEV is to say that a hotel has no business enterprise value. While a management fee may compensate the management company fairly, it does not compensate the owner for his investment in the hotel. From the owner's point of view it is only a cost, like payroll or advertising.

It is important to understand that cost is not the same thing as value. Not only is the management fee a normal cost of operating a hotel, it is already deducted from cash flows in order to arrive at going concern value. Further, the value of a franchise is measured by its ability to deliver customers. If the cost of the franchise only equals the business revenues generated by the franchise, why wouldn't all hotels be independent? The reason they are not is because successful hotel franchises have proven their ability to drive revenues in *excess* of their cost. If a hotel merely achieves RevPAR equal to the average of its competitive set of hotels, or even falls below, it does not necessarily mean the hotel has no BEV.

A hotel management company has been characterized as comparable to a tenant in a leased property. In a lease, the owner's income, except in the case of a tenant default or turnover, is secure at least to the extent of the base rent. In the case of a management contract, the owner has claim only to the residual after all operating expenses, including management and franchise fees have been deducted. The management fee, far from representing BEV, is an obligation and encumbrance on the owner. In a leased hotel, the lessee operator bears the risk while in a managed hotel the owner bears the risk. Risk demands compensation beyond the operating costs of the hotel. According to Paul Samuelson, "economic activities that involve much uncertainty and risk, which will fall on the people who engage in them, will be forced by competitive entry and exit of risk takers to pay, over the long run, a positive profit premium to compensate for aversion to risk."¹⁰³

¹⁰¹ *Id.* at 27.

¹⁰² *Id.* at 26 -27.

¹⁰³ Paul A. Samuelson, *ECONOMICS: AN INTRODUCTORY ANALYSIS* 564 (7th ed. McGraw Hill 1967).

Real Estate Lease Method

As noted above, a lease represents the purest form of real estate revenue. Ideally, the cleanest way to identify the value of the real estate component of a going concern would be to calculate the value of lease payments. This would have been fairly simple in the 1940s or 50s as the hotel lease was fairly common at that time. In 1947, Fred Eckert wrote:

A very considerable number of the hotels of this country, large and small, are operated under contracts of lease between investor owners and independent hotel operators. The practice of leasing is widespread and characteristic of the business in all sections of the country.¹⁰⁴

While true in 1947, it is no longer. For the past thirty years, the management contract has become the dominant form of operating a hotel and the standard hotel lease is the rare exception. The passive income requirements of Real Estate Investment Trusts (REIT) led to the development of a form of lease that swept virtually all of the taxable income from the related but taxable operating company to the tax free REIT. The REIT lease because of its tax avoidance purpose does not capture the pure real estate value of a hotel.

This method is more applicable to a hotel that has a food and beverage revenue disproportionate to its room revenue. Essentially, this was a very large and successful restaurant with a rooms component. In this case it is possible to structure the food and beverage component as a restaurant lease to derive the BEV from the food and beverage operation. Because it is common for restaurant facilities to be leased, finding market comparables is not an issue as it is for hotels.

Cost Method

One approach to separating the value of BEV from the going concern value is to calculate the value of the hotel by way of the cost approach. Once you have this value, subtracting both the cost value and the value of FF&E from the going concern value arrived at through the income approach should yield the BEV. While this approach is commendable for relatively new hotels, more depreciation has to be taken into account for older hotel. This can be subjective and unreliable.

Excess Profits Method

One way to measure the value of intangible assets such as management or chain affiliation is to evaluate the excess revenue per available room (RevPAR) that a hotel achieves relative to a set of similar competitors. For two nearly identical hotels with differing affiliations, the excess by which one hotel's RevPAR exceeds another may be attributed to a more competitive affiliation. Care must be taken, however, to allow or adjust for superior or inferior locations or facilities which would be attributes of the real estate and not affiliation. In the real

¹⁰⁴ Fred W. Eckert, *The Hotel Lease: A Study of the Business Element and Principles Involved in Making Leases That Are Equitable to Both Lessee and Lessor*, vii (The Hotel Monthly Press 1947). {01655585.7}

world, it is difficult to find properties that are not influenced by some difference in the real estate attributes. Nevertheless, the professional appraiser must also account for franchise requirements in the construction of the hotel. For example, improvements built to satisfy Clarion standards will generally need to be altered to satisfy Marriott standards if the property is reflagged from Clarion to Marriott.

Even if one determines that the difference is due to management and affiliation and not real estate, that is not the end of the story. Assume a Marriott and a DoubleTree hotel are identical in every way except affiliation. Neither has a location advantage over the other. If the Marriott, for example, had a higher RevPAR than the DoubleTree, the difference does not capture all the revenue associated with BEV since the DoubleTree would also have some level of BEV and it would have to be added to the amount identified by the difference.

In addition to RevPAR, a management company that consistently operates with lower expenses producing a higher net operating income (NOI) than its competitors, also generates BEV. The additional profit generated by the higher NOI is a component of BEV.

Franchise Revenue and Cost Method

The value of a franchise is its ability to generate revenue for the hotel owner in excess of the cost of the franchise. Because chain standards enforced on properties creates an expectation of a certain level of quality and service in the minds of hotel patrons, a body of brand loyal customers is built up.¹⁰⁵ This loyalty is reinforced by frequent traveler reward programs, the most successful of which include Marriott's "Rewards," Hilton's "HHonors," and Starwood's "Preferred Guest" programs. Customers who are loyal to a brand are less price-sensitive, tend to spend more and are positive sources of word of mouth advertising.¹⁰⁶ Peter Yesawich reported that 85% of business travelers and 76% of leisure travelers prefer chain hotels to non-branded hotels.¹⁰⁷

Chain reservation systems, frequent traveler programs, and group marketing bookings do not capture all of the demand generated by the franchisor. Often a guest will patronize a hotel because of a brand's reputation but will "walk in" or book outside the identified franchise distribution system. The franchise revenue and cost method does not capture these franchise generated guests and, to that extent, underestimates the value of the franchise.

In calculating the cost benefit premium created by a hotel's affiliation, the costs paid for the franchise affiliation are deducted from the quantifiable benefits received resulting in the net benefit of the affiliation. This methodology shows the cost versus benefit of the actual affiliation of a specific hotel. It employs the chain's own accounting of actual rooms attributed to their distribution channels. These channels provide guests through corporate internet sites, toll-free

¹⁰⁵ John W. O'Neill & Anna S. Mattila, *Hotel Branding Strategy: Its Relationship to Guest Satisfaction and Room Revenue*, JOURNAL OF HOSPITALITY & TOURISM RESEARCH 28, 156-165 (2004).

¹⁰⁶ John W. O'Neill & Qu Xiao, *The Role of Brand Affiliation in Hotel Market Value*, CORNELL HOTEL AND RESTAURANT ADMINISTRATION QUARTERLY 47, 1-14 (Aug. 2006).

¹⁰⁷ P. C. Yesawich, *So Many Brands, So Little Time*, LODGING HOSPITALITY 52, 16 (September 1996).
{01655585.7}

reservation telephone numbers, and travel agent relationships, as opposed to reasons relating to real estate such as location, physical characteristics, access, and exposure.

Below is a sample calculation of the benefit of a DoubleTree managed hotel using this method of calculating BEV. In evaluating the direct benefit of the DoubleTree affiliation, 37% of rooms revenue, or about \$1.6 million, is derived through the reservation and marketing system, based on its Hilton Reservations Worldwide (HRW) distribution report. The HRW system is DoubleTree’s proprietary central reservation system. The management fee amounts to 3.0% of total revenue. There is no franchise fee. Other fees paid to DoubleTree include a 0.8% allocation to the rooms department expense, accounting and/or reservation expenses, and travel agent commissions paid as a result of the global distribution system (GDS) relationships held by DoubleTree. Additional costs of affiliation are included in the marketing expense line item. This category includes chain advertising and Hilton HHonors guest loyalty program costs. The combined costs of affiliation paid by the hotel entity approximated 6.4% of total revenue (14.8% of rooms revenue). The cost to produce this DoubleTree derived revenue is broken down as follows:

	Amount	% Revenue	Total
Franchise Fee	\$0	0.0%	
Management Fee	320,655	3.0%	
Rooms Accounting	53,304	0.5%	
Reservations Fees	28,208	0.3%	
Marketing Assessment	162,141	1.5%	
Hilton HHonors	119,881	1.1%	
Total	\$684,189	6.4%	

The value of a franchise to a franchisee results from the brand’s ability to generate room revenues. The rooms department generates the highest contribution margin and typically constitutes the largest revenue contribution in a hotel. The hotel’s other departments would logically benefit from expenditures made by hotel guests attracted by the franchise but such revenue is not captured in this calculation. To the extent that some food and beverage and other revenue is derived from guests brought to the hotel by DoubleTree’s proprietary efforts, BEV is understated.

The following table presents the calculation of BEV attributable to the DoubleTree affiliation.

Cost Benefit Calculation	
Average Daily Rate	\$92.00
Occupancy	62.0%
RevPAR	\$57.00
Room Revenues	\$4,632,604
Total Revenue	\$10,684,602
Net Operating Income Ratio	12.4%
Net Operating Income	\$1,324,154
DCF Value	\$14,500,000
Value per Unit	\$65,022
Tangible Personal Property	\$4,300,000
% of Room Nights Attributed to Affiliation	30.2%
Revenues Attributed to Affiliation	\$1,744,401
80% Flow Through	\$1,395,521
Affiliation Cost %	39.2%
Amounts Included in Expenses for Affiliation Costs	\$684,189
BEV Revenue Residing in Cash Flow (before operating expenses)	\$711,332
Intangible Capitalization Rate	20.0%
BEV Value Indication	\$3,556,659
Rounded	\$3,600,000
BEV/Market Value	24.8%

The following proforma schedule more clearly allocates the benefits and cost of the DoubleTree affiliation on the subject hotel.

				Revenue from/ to Affiliation	Percent of Room Revenue
Revenues					
	Rooms		\$4,632,604	\$1,571,973	33.9%
	Food & Beverage		4,206,672	172,429	3.7%
	Telecommunications		79,381		
	Other Operated Departments		1,548,658		
	Rentals and Other Income		217,288		
		Total Revenues	10,684,603	1,744,401	
Departmental Expenses					
	Rooms		1,380,349	81,512	1.8%
	Food & Beverage		2,797,249		
	Telecommunications		75,502		
	Other Operated Departments		1,079,703		
	Other Income Expense		31,858		
		Total Departmental Expenses	5,364,661		
Undistributed Expenses					
	Administrative & General		1,086,581		
	Marketing		978,320	282,022	
	Property Operation and Maintenance		773,689		
	Utility costs		613,352		
		Total Undistributed Expenses	3,451,942		
Management Fee					
			320,655	320,655	6.9%
Taxes & Insurance					
			468,996		
Total Expenses					
			9,606,254	684,189	14.8%
Net Operating Income					
			\$1,078,349	\$1,060,212	22.9%
Net Identified Intangible Income (80% flow through)					
				\$711,332	15.4%

The incremental flow through of gross identified intangible income is subject to operating costs. Given that this incremental income is rooms revenue, this hypothetical applies an 80% flow through to achieve a BEV of \$711,332 or 15.4% of rooms revenue.

A difficulty in converting revenue identified as resulting from intangibles into BEV is the lack of market derived capitalization rates. Since BEV is not separated and sold independently of the underlying hotel, an appropriate capitalization rate would need to be derived by the band of investment method. In order to solve for the appropriate capitalization rate, one would need to know the overall capitalization rate for the hotel, the appropriate capitalization rate for a real estate only investment such as an apartment, the capitalization rate for tangible personal property and the percent of total value that each component represents.¹⁰⁸ The capitalization rate for BEV would necessarily be higher than for real estate or tangible personal property.

¹⁰⁸ John W. O'Neill & Eric E. Belfrage, *A Strategy for Estimating Identified Intangible Asset Value: Hotel Affiliation Contribution*, THE APPRAISAL JOURNAL 83 (Winter 2005) . {01655585.7}

Recognized sources for hotel capitalization rates include Real Estate Research Corporation's *Real Estate Report*, PKF Hospitality Research's *Hospitality Investment Survey*, and PriceWaterhouse Cooper's *Korpacz Real Estate Investor Survey*. This analysis utilizes the *Korpacz Real Estate Investor Survey*. Given the paucity of real estate transactions in 2008 and 2009, for purposes of this example, this example uses data from 2007. The average overall rate for a full-service hotel investment is 8.3% according to the third quarter 2007 *Korpacz* report. This rate applies to the total assets of the business.

In order to remove the real estate component, a real estate use with little or no intangible component, such as an apartment, can be used. The same *Korpacz* data indicate that the capitalization rate for institutional-grade apartments averaged 5.76% for the third quarter of 2007.

PriceWaterhouse Coopers
Korpacz Real Estate Investor Survey
Third Quarter 2007

	Range	Average
National Apartment Market	3.50% - 8.00%	5.76%
National Full-Service Lodging Segment	6.00% - 11.00%	8.98%

The capitalization rates for real estate or going-concern hotel values would be lower than that for tangible personal property. The life of hotel furniture, fixtures and equipment typically varies between seven to ten years. Properties with higher occupancies and therefore more wear and tear would tend to have shorter FF&E lives than properties with more gentle use patterns. The salvage value of FF&E is only cents on the dollar. A 12% capitalization rate for tangible personal property is used in this analysis.

The intangible personal property would demand an even higher capitalization rate. A 50% premium above the tangible personal property rate would be reasonable. As an added amount of conservatism, the example uses a 20% capitalization rate. Applying this rate to the net identified intangible income results in an implied BEV attributable to affiliation of \$3.6 million.

This approach quantifies the value of the DoubleTree affiliation and operations. It tends to understate BEV because it measures only the impact of incremental rooms revenue and ignores the other profit centers where DoubleTree's marketing and management have an impact. At \$3.6 million this represents \$16,143 per guestroom or 24.8% of appraised value. This level tends to fall in line with the expectation of the appraisal literature.

The Appraisal Institute's *Course 800* states: "Several recent studies have shown quite clearly that name recognition and good reputation for high quality service ('name brand'), plus affiliation ('flag'), can add as much as 20% to 25% to the value of a successfully operating

hotel.”¹⁰⁹ Eric Belfrage indicates that “...a business component of between 15% and 15% is reasonable in this case.”¹¹⁰

As noted previously, there is no single correct answer to the question of what approach is correct but rather a question as to what is the most reasonable approach to value by the assessor or by a court on appeal.¹¹¹ Hotels are not bought and sold on the basis of their individual components. However, a hotel is generally taxed at the local level on the basis of its components: real property is taxed for ad valorem real property taxes; personal property is subject to personal property taxes; the hotel’s income is subject to business license or similar fees. Most trial judges will have great difficulty distinguishing between the arguments presented by the various approaches described in this article. The real standard before most tribunals is one of reasonableness: “Transactions of lodging facilities, which occur in the fluid hotel real estate market, provide the true market evidence to support appropriate conclusions relative to the appropriate methodology for segregating hotel income attributable to real estate.”¹¹² Simply summarized, the problem in the current economic climate is the dearth of transactions from which a trial judge can extrapolate this market evidence.

Hotel owners can reasonably expect that the business enterprise value of a hotel will be extracted by some method but the method employed by the court will generally be the one which seems most reasonable in light of the trial judge’s perspective of reasonableness. With counties under substantial revenue pressures, more aggressive approaches probably may be relatively counterproductive. Again, there is no single correct answer as to which approach to employ in hotel real estate tax appeals.

Other Issues in the Current Market

The current economic decline and the dramatic contraction of credit have created substantial problems in valuing hotels for ad valorem real property taxes. The availability of financing has declined precipitously since approximately September 1, 2008. Yet, the number of properties requiring refinancing as loans have matured or gone into default has increased. Most realtors feel that the market has been overbuilt resulting in many unsold or unoccupied properties. Increased unemployment has resulted in reduced demand for goods thereby reducing the ability to handle existing financing. Most hotel properties have experienced serious declines in income in 2008 and 2009. Pressures for tax revenues have increased.

The theory underlying ad valorem property taxes assumes the existence of (i) a willing seller; (ii) a willing buyer; and (iii) the absence of compulsion. The statutory scheme also

¹⁰⁹ APPRAISAL INSTITUTE, *Course 800*, 9-17.

¹¹⁰ Eric E. Belfrage, *Business Value Allocation in Lodging Valuation*, THE APPRAISAL JOURNAL 277-282 (July 2001).

¹¹¹ For example, a Tennessee court specifically rejected the business enterprise approach advocated by Mr. Lennhoff, *see* Reichardt & Lennhoff, *supra* note 88 at 25-31, in the unreported decision of *In re Wolchase Galleria Ltd. Partnership*, (Shelby County, Tax Years 2001 and 2002).

¹¹² Lesser, *supra* note 86, at 42.
{01655585.7}

assumes a fixed valuation date.¹¹³ Second, the statutory scheme assumes that the exposure to the market resulted in a fictional sale on a specific valuation date.¹¹⁴

Valuation experts using the sales comparable approach face particular challenges in the absence of sales. If the valuation date is after September 1, 2008, there is a real problem with using sales from prior periods given the drastically changed market conditions.

Clearly, the date of valuation is critical in appraising the value of the hotel's real estate. One can make a very strong argument that most data predating mid-September 2008 is inapplicable since market conditions have so dramatically changed. Additionally, market data suggests a dearth of sales involving willing buyers, willing sellers and the absence of compulsion.

Finally, the absence of comparable sales during the past fifteen (15) months poses increased challenges for the determination of capitalization rates when applying the income approach to value. When sufficient data on sales of similar competitive properties is available, deriving capitalization rates from comparable sales is preferred.¹¹⁵ Without current sales of similar and competitive properties, this method cannot be applied. The remaining six methods¹¹⁶ are considered secondary sources but all except methods 5 and 7 require comparable sales as a source of a portion of the factors to be considered. When comparable sales are not available, only the debt coverage formula and surveys based on market expectations are available and therefore become the preferred methodologies for deriving an appropriate capitalization rate.

Many surveys of capitalization rates involved in hotel transactions depend on the availability of comparable sales. Surveys include *Korpacz Real Estate Investor Survey* and National Counsel of Real Estate Investment Fiduciaries (NCREIF): Capitalization rates spiked in fourth quarter of 2008 by approximately 150 basis points. Little market activity nationally with only nineteen (19) institutional grade properties (of all property types) transferring in the first quarter of 2009.

Conclusion

The purpose of this article is to show that assessing hotel values for ad valorem real property taxes requires a detailed knowledge of the particular taxing jurisdiction's statutes and regulations. Hotels pose a particular challenge since they are typically sold as going concerns rather than as real estate. While a consensus exists that the business enterprise value of a hotel must be extracted to determine the hotel's value as real estate, the methods for computing BEV differ. There is no consensus regarding which method for calculating BEV is preferred. However, current economic conditions present hotel owners with unique challenges in trying to achieve real cost savings by reducing valuations for tax purposes in an environment where inordinate pressure exists on assessors to maintain tax revenues from all sources including ad valorem real property taxes.

¹¹³ See notes 12-13 *supra* and accompanying text.

¹¹⁴ See note 14 *supra* and accompanying text.

¹¹⁵ THE APPRAISAL OF REAL ESTATE, APPRAISAL INSTITUTE, 501 – 08 (13th ed. 2008).

¹¹⁶ See pages 17-26 *supra*.