DISTINGUISHING MARKET SALES AND FINANCING TRANSACTIONS FROM MARKET VALUE FOR PROPERTY TAX PURPOSES

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Mr. Hutcheson is admitted to practice in Texas and before the United States District Court for the Western District of Texas. He has presented cases at trial and on appeal before several district and appellate courts, including the Supreme Court of Texas. Mr. Hutcheson received a BA from the University of Texas, and graduated *magna cum laude* from Baylor Law School in 1996. While in law school, he participated in a variety of trial and appellate advocacy competitions and served as Managing Editor of the Baylor Law Review.

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Mr. Hutcheson is a Registered Senior Property Tax Consultant and is an active member of IPT and has achieved the CMI designation. He serves on the IPT Property Tax Advanced Academy, and IPT's CMI Designation Committee.

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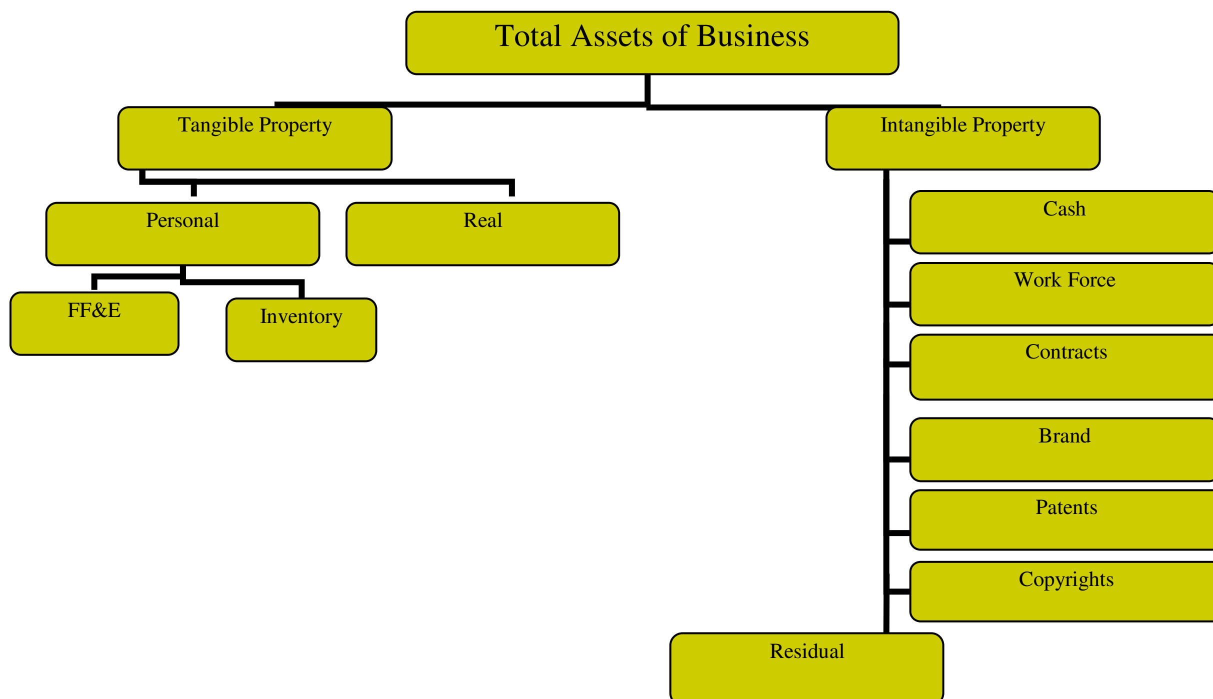
I. INTRODUCTION

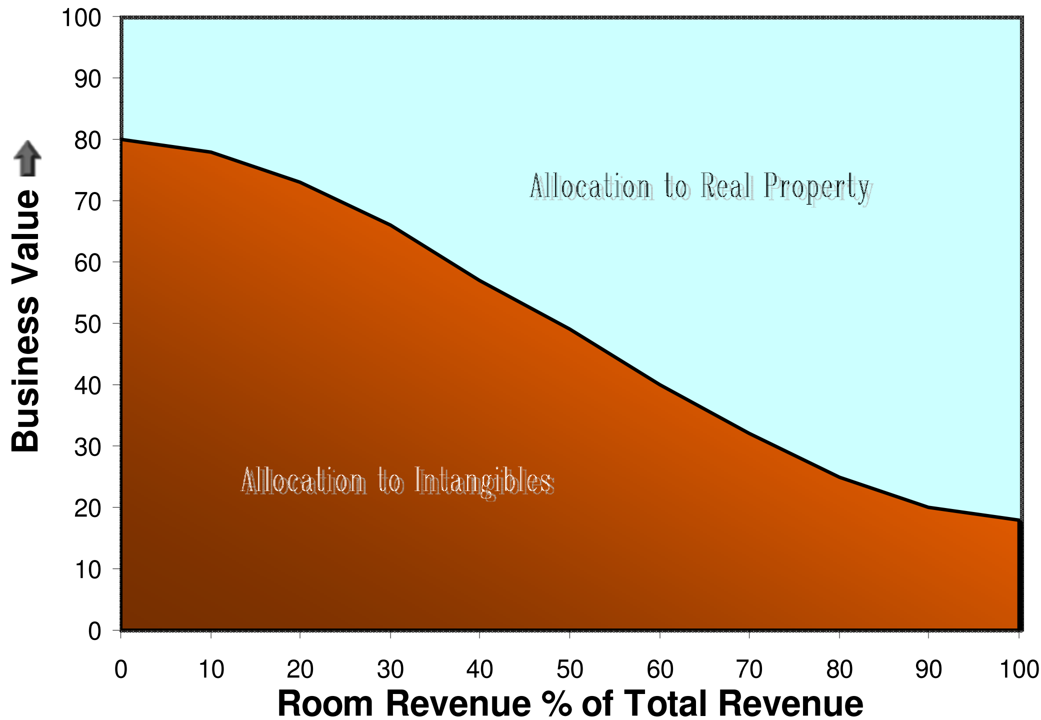
The valuation of hotels for property tax purposes continues to be an issue of great dispute and confusion. When hotels are transferred in the open market they typically sell as a business or going concern which includes both tangible and intangible assets. Intangible assets are generally exempt from taxation and must be excluded when valuing a hotel for property tax purposes. This paper will outline the components of value common to most hotel transactions and briefly outline how market sales must be distinguished from the value of just the taxable tangible assets.

II. COMPONENTS OF VALUE

Hotels are comprised of three fundamental components of value: tangible real property, tangible personal property, and intangible personal property. The real property includes the land and building, while the tangible personal property includes all furnishings used by the hotel. Intangible personal property incorporates virtually everything else, such as working capital, assembled and trained work force, contracts with vendors and customers, and, most significantly, the reputation and brand of the hotel's franchise. When these components are combined to create a hotel business, they are typically considered part of the "total assets of the business."



Usually, the value attributed to intangible personal property is related to the size and scope of the hotel operation. A limited service hotel with an independent flag should have a relatively small allocation to intangible personal property because almost all of its income can be attributed to the tangible real and personal property. On the other hand, a large convention hotel with significant banquet services, as well as restaurants, bars, and a spa, would have a relatively large allocation to intangibles because a significant portion of the hotel's income derives from services separate and apart from merely renting rooms. The graph below articulates this relationship (the figures provided are for demonstrative purposes only):



As illustrated, there is an inverse relationship between room revenue and business value. As the percentage of room revenue to total revenue decreases, the allocation to intangible business value will generally increase.

III. USE OF HOTEL SALES IN PROPERTY TAX VALUATION

For the most part, hotel appraisers do not rely upon sales when preparing a market valuation of just the tangible assets. Sales generally include both tangible and intangible assets and, because the income approach is necessary to allocated between the assets, most fee appraisers choose to streamline the analysis and go directly to the income approach. Assessors, on the other hand, often rely upon sales when creating mass appraisal grids and cap rates for hotel valuations. As such, it is important to know about the sales in your market and the underlying variables that impacted the value and reported cap rate.

IV. METHODS TO SEGREGATE INTANGIBLES

A. Start-Up Costs

In addition to the standard deductions for management and franchise fees (the "Rushmore Approach"), a hotel owner also incurs initial investment costs that are properly classified as components of intangible value. Below is an example of the quoted start-up costs for a Renaissance Hotel as of 2005:

Renaissance Full Service Hotel
Initial Business Start-Up Costs

Category	Fee Cost	Subject Rate	Subject Cost
Initial Franchise Fee	$200/key ($60,000 minimum)	$200	$ 104,200
Computers [a]	$1,148/key - $1,466/key	$1,300	$ 677,300
Feasibility Study	$15,000 - $50,000	$35,000	$ 35,000
Operating Supplies	$5,000/key - $5,600/key	$5,350	$2,787,350
Food Safety	$190/key	$190	$98,990
Opening Advertising [b]	$333/key - $500/key	$450	$234,450
Pre-Opening Costs [c]	$3,500/key - $4,000/key	$3,750	$1,953,750
Additional Funds [d]	$3,500/key - $4,000/key	$3,750	$1,953,750

[a] Includes computer systems, various training, and opening authorization process.
[b] In urban markets, advertising costs are most likely higher.
[c] Includes wages and other operating costs before opening, and prepaid expenses (business licenses, and security and utility deposits).
[d] Operating expenses during first three months. Not a breakeven amount. Additional expenses probable.

Source: *2005 Renaissance Hotels & Resorts Franchise Offering Circular*

As the above table reflects, as of 2005, the estimated start-up costs for a full-service Renaissance hotel (500 rooms) was approximately $8,000,000 or $16,000/key. These are real costs an owner of a Renaissance Hotel would be required to incur and are in addition to the tangible land, building, and furnishings. By investing these costs into the hotel business, the property owner reasonably anticipates both a return on and a return of these investment expenses.

To calculate the deduction for start-up costs in the income approach, the costs must be converted into an annual expense recapture. One technique that accomplishes this result is outlined below:

Return on and of Start Up Cost	
$ 8,000,000	Initial Investment
9.91%	Interest Rate (hotel mortgage interest rate + 300 basis points)
23 Years	Amortized Term
11.18%	Cap Rate / Mortgage Constant
$ 894,400	Annual Payment
	*source 4th Q 2008 ACLI of 6.91%

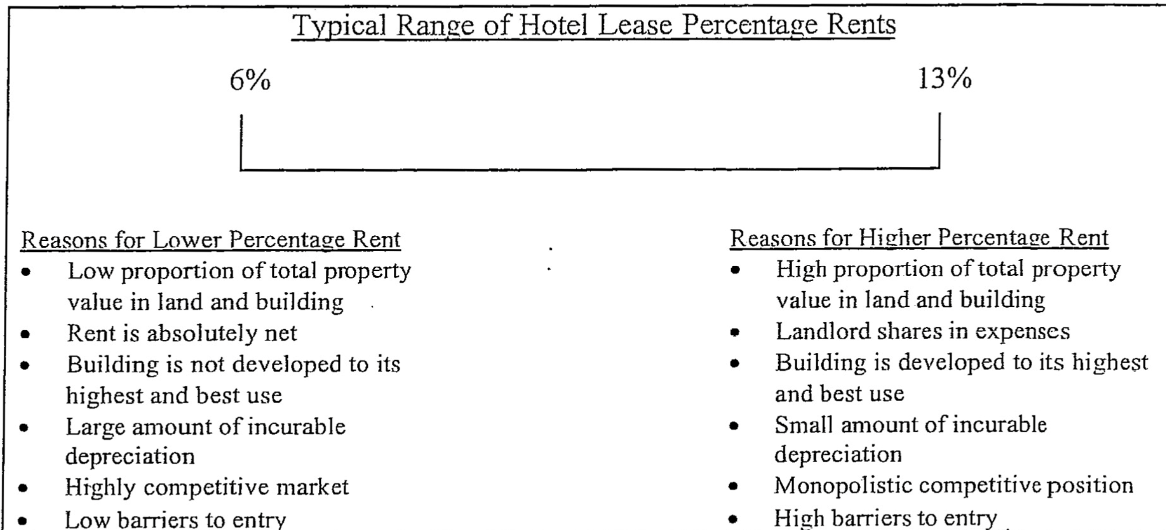
Here, the initial start-up costs (excluding tangible real and personal property) equal $8,000,000. We used a 23 year amortization period and increased the hotel mortgage interest rate by 300 basis points for the additional risk associated with the intangible nature of this investment. The resulting mortgage constant is 11.18%, which is then multiplied by the original $8,000,000 investment to render an annual recapture of $894,400. By deducting this amount from the income approach before capitalization, you allow for a return on and of this expense to the owner and exclude such value from the taxable value of the hotel.

The start-up cost deduction is only one of several necessary deductions for segregating the intangible from the tangible value of a hotel. Others include management and franchise fees, as well as performance based adjustments that relate to the hotel's ability to generate revenue when compared to competing brands and properties.

B. The Net Lease Approach

Unlike office buildings and commercial retail space, hotels typically do not rent. As a result, appraisers usually employ a residual technique that backs out intangible income streams from the net operating income and then capitalizes only that income which is attributable to the taxable assets. While rents are not common for hotels, they do exist and may be helpful as a cross-reference for value.

In 2003, several hotel owners in Austin, Texas engaged an expert to prepare a net lease analysis to determine if a "market rent" for hotels could be determined. The analysis noted that the number of pure hotel leases were somewhat limited and seemed to concentrate in major cities like New York and San Francisco. A study of the existing leases (over 50 were reviewed) revealed a range of rent expressed as a percentage of total revenue. The indicated range for the hotel leases considered was from 6% on the low end to 13% on the high end.



This lease range can be converted easily into a total revenue multiplier or a room revenue multiplier. If a 13% lease is divided by an 8% cap rate, the resulting total revenue multiplier equals 1.63. This can be further adjusted to reflect a room revenue multiplier by dividing the 1.63 by the room revenue percent of total revenue. For example, a full-service hotel's revenue stream may indicate 2/3 (67%) room revenue and 1/3 (33%) for food and beverage and other revenue. By dividing 1.63 by 67%, the resulting room revenue multiplier would be 2.43.

While this approach should not replace a more traditional income approach, it does provide some guidance regarding the relationship between the income of a hotel business and a proxy rent for its real property.

V. CONCLUSION

The brief discussion of hotel valuation presented herein is meant to touch on a few of the fundamental principles that must be addressed when appraising hotels for property tax purposes. When an income approach is prepared, care must be taken to ensure that all components of value are considered and properly allocated among the taxable and non-taxable assets.