Best Practices for Hospitality Property Tax Challenges and Selecting an Appraiser for Litigation

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"To begin with there is no such thing as 'value', except in the eyes of the beholder. And one must understand where the beholder is coming from."

- Bertram Lewis, "Do Syndicators Overpay," The Appraisal Journal (1985)

The property tax is one of the least avoidable, most sizeable, ongoing, fixed expenses of operating any hotel, anywhere, and has a direct impact on NOI and resulting market value. It is also, in order of magnitude, the one most controllable cost without slashing services or customer experience. In fact, while the property tax is generally considered a "fixed" expense in the Uniform System of Accounts for the Lodging Industry (USALI), conceptually it may be looked at alternatively as a hybrid fixed/variable expense, in contrast to some truly fixed line items, in the sense that it can grow and shrink based on a variety of factors such as RevPAR/occupancy and various micro- and macroeconomic variables.

U.S. hotels pay in excess of $10 billion in property taxes each year. In nearly every state, the law requires property taxes to be based on the value of the tangible assets, which means the real estate and, sometimes, FF&E, rather than the greater going business concern value that the tangible assets support. Understanding the common flaws that often occur in the assessor's valuation methodology allows owners to better evaluate and challenge the assessed value in order to lower their annual taxes. It is also common practice for such services to be carried out by attorneys with expertise in what is admittedly an arcane field and charged based on their success in reducing the tax such that there is no good reason to simply accept the tax each year without a closer look.

Based on a sample of 3,400 hotels from CBRE's Trends in the Hotel Industry Database, U.S. hotel property tax expenditures declined some 13.0% from 2020 to 2021, putting property

taxes 9.9% below 2019 levels. Initially, not so surprising considering the financial impact of the pandemic during that period, but when one compares this to the 41.3% decline in revenues and 57.4% falloff in profits overall during the same period, it is apparent that most hotels are not doing all they can to reduce their property tax expense. It also masks some of the complexities inherent in truly understanding how the property tax may vary from one jurisdiction to another in relation to hotel performance and local laws and rules that apply to tax valuations.

It is also important to recognize that with finite resources available to hospitality portfolio and asset managers, battles must be picked and chosen in those locations where they can do the most good overall. For instance, New York, my hometown, remains at the high end among other major markets with property taxes at some 30% of revenue (2020), according to the Hotel Association of New York City, and growing rapidly. This compares with property taxes at 8.2% in Chicago, 4.4% in Washington, D.C., 4.1% in Los Angeles, 4% in San Francisco, and 3.3% in Miami. A 10% tax reduction in one New York City property may equate to three properties reduced in another jurisdiction.

Methodology: The Big Debate

Generally, hotels are valued for assessment purposes using an income capitalization approach. And, because it's fairly rare to find a hotel built speculatively for rent to an operator, there are few arm's length leases of real estate that can be used to derive an estimate of market rent. Instead, the valuer begins with income generated by the total assets of the hotel business (the 'going concern'), and then deducts anything from income that is not tied to the real estate, which means anything representing both tangible and intangible personal property. What's left can be inferred as rent to the real estate, which can be capitalized into an indicated value using an overall capitalization rate.

While the above is conceptually agreed upon by both hotel operators and tax assessors, the problem arises in a disagreement over what constitutes "intangibles". Many assessors argue that all one needs to do is deduct from total annual net income the management fee and a franchise fee to account for the hotel business component. The implication of this is that when an owner obtains a franchise and hires a management company, the owner no longer has an interest in the business and is just a passive investor who benefits from the real estate proceeds alone.

But, this overlooks the fact that when franchising a hotel, an owner expects that the money paid to the hotel company will be returned (return "of" the investment) plus a return "on" the investment, usually through higher RevPAR as a result of the franchise. Why else would they pay the franchisor? Likewise, the money paid to a management company is for the purpose of generating a greater return than would occur without the management company.

Hotels are therefore an unusual valuation problem for most tax assessors. To value the real estate alone correctly, more than just the expenses for management and franchise must be deducted from total revenue. The tax appraiser must recognize the return on these investments that accrues from such contributions as the flag, an assembled and trained workforce, a developed reservations system, and any other items that derive from the various profit centers at the hotel that are not part of the real estate, as well as reserves for replacement and furniture, fixtures and equipment.

When this does not occur, which is the norm among tax assessors (and often goes unnoticed by many hotel operators), the assessor will be illegally taxing elements of the hotel that are not real estate and greatly inflating the amount the jurisdiction may legitimately collect as a fair tax. As one commentator observed, some 60% of properties are overvalued by some 25%; if you have a $4 or $5 million hotel, you are easily paying some $25,000+ annually you don't owe. And, doing the math, for larger hotels the expense increases proportionately.

And it almost goes without saying that in all of this there is a fair amount of subjectivity to fuel the debate. It is also true that every jurisdiction comes with its own nuances and hurdles that do not translate well to other locations, so that portfolio management can seem cumbersome and challenging. New York City is, for example, at both the high end of the tax burden and also presents one of the most intricate, convoluted, and mind-numbing tax systems imaginable.

Hiring the Right Appraiser

So, in the end, in most jurisdictions the hotel must submit some form of evidence to demonstrate to the local assessor that he or she has over-valued the real estate component of the hotel. For most instances this does not require a complete appraisal report, and in many situations a simple "internal" workup analysis of value - based on current financial operations and not necessarily created by a licensed appraiser – may suffice for the discussion. However, for

any significant tax reduction sought, or where reasonable minds differ about the value based on market assumptions or methodology, an appraiser will need to be engaged.

Hotels are a special asset class within real estate, and require a thorough understanding of the hospitality dynamic and business model. Moreover, valuation for property tax purposes is an even more specialized discipline that is beyond the skillset and experience of many commercial appraisers. Large sums of potentially-saved taxes can easily be left on the table if the wrong appraiser is selected.

As described earlier in this paper, for tax purposes the appraiser must be fully familiar with accepted approaches to separating realty value from the going concern value. Moreover, while most hotel-specific appraisers understand the methods used to distill realty value, some will be more aggressive than others, and this will affect the ultimate value – and tax burden.

Above all, the appraiser must be credible, both in their written report as well as when the need to present testimony arises. He or she must also be comfortable defending the appraised value under cross examination by the opposing attorney.

It is equally important that the appraiser recognizes the jurisdictional rules and practices. While it may be the job of the attorney to ensure that the appraiser is provided with this information, it is far better for your case when the appraiser comes armed with prior experience in the local area. Jurisdictional rules can vary widely – even when it comes to basic appraisal principles and practices relating to "market value", so it is important that the appraiser comes prepared to learn and adapt rather than arrive as a know-it-all.

These issues most often present themselves when it comes to a perennially difficult choice for the attorney: hire the "national reputation" appraiser who works all over the country with a laser focus on hotel valuation for property tax purposes but has never valued a property in this particular jurisdiction, or hire the local favorite appraiser who knows the county well, having appraised all kind of properties, but has limited hotel experience? There is no "right" answer, but it is rare to find an appraiser who is perfectly suited to the situation.

It is also important to determine at the outset what type of appraisal is really required. A "restricted" report, which is more useful for informal negotiations, may be less expensive, quicker to obtain, and fully sufficient to get to the desired result. On the other hand, a trial-ready

complete appraisal may be needed, and if so the attorney will need to know the local court requirements for a sufficient appraisal report. They often differ, and an appraisal that is sufficient for trial in one jurisdiction can be quickly dismissed (and game over for the tax appeal) in another.

Quite often, much work will lead up to the preparation of a final report, and the attorney must also be familiar with local discovery rules in order to ensure that drafts and documents that may be harmful to a client's case are not inadvertently created.

Looking Forward: The Market and Taxes

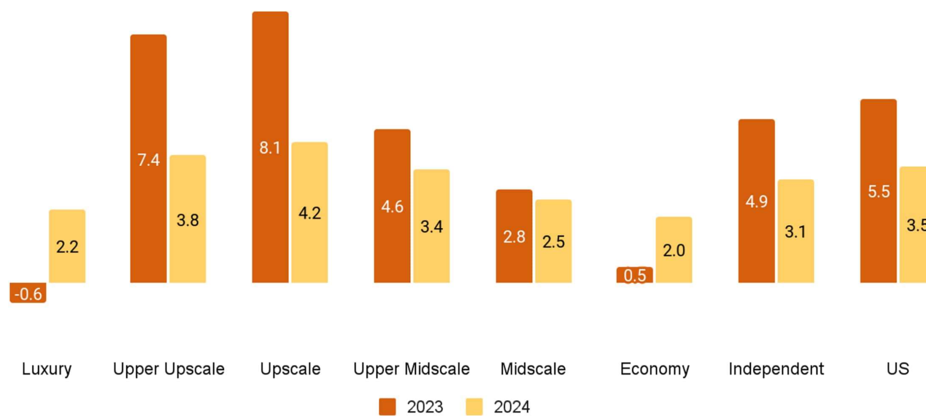
So, if it's all about performance, is the prospect of reducing the property tax burden diminishing in the face of a rosier outlook for hospitality as the pandemic recedes into the past? Hardly. Primarily, even in good times the property tax is a ripe area for improving NOI because assessors can be counted on to over-shoot the mark, raising assessments at the first hint of positive economic trends. The question is always whether the assessor got the value correct, and not necessarily whether the market has improved or declined. For additional reasons, as detailed above, assessors are also likely to assign far more of the value of a hotel property to intangible and going concern value than real estate and tangible personalty value, which always remains the only proper basis for taxation.

Moreover, the fact that U.S. hotels are outperforming expectations, assessors need to be reminded that it's not all good news. According to a recent PwC report, the Fed's monetary policy has resulted in continually elevated interest rates and an unexpected fallout of several larger regional banks, which have both contributed to limited debt availability. The tightening credit market has resulted in a slowing of new hotel construction.

Additionally, there is an expected softening in leisure demand (in New York City alone, leisure hotel stays account for some 79% of all hotel visits), and outbound international leisure travel outpacing inbound. Occupancy levels in 2024 are expected to be relatively flat, so that growth is expected to come almost entirely from ADR; continued high office space vacancy rates may also contribute to the outlook for hotels in the coming several years.

The PwC chart below, based on STR data, shows predicted RevPAR change between 2023 and 2024. While this is a generally pessimistic outlook for US hotels, it does lend further

support to the notion that controlling the property tax expense remains among an owner's most viable tools for maintaining value.



RevPAR percent change. PwC, Based on STR Data

What to Do

Portfolio owners and managers face a challenge in effectively managing the property tax across all assets. A few very large franchises maintain an in-house property tax department, but even these only handle a portion of the portfolio directly. Inevitably, portfolio owners either contract with one of a shrinking number of national "consulting" firms, or engage a local consultant or attorney in each market in which the company operates a hotel. Both approaches have merits and cons, largely as a result of the fact that managing property taxes requires both hyper-local knowledge and relationships but also the types of data and knowledge base resources most typically found in larger firms. Then, there is a hybrid approach.

Ultimately, one may say that managing property taxes can be done "bottom up", "top down", or a happy medium of the two. Bottom up means that the hotel home office relies on a large network of individual property tax practitioners, each located in the local market, who reports "up" to management as to the likelihood and means of achieving a tax reduction. The downside to this approach is that the home office has no centralized strategy or means by which to check the advice being received. It can be an effective approach, but is scattered and haphazard. Top-down, which is usually orchestrated by a national consulting firm, seems like an attractive version of "one-stop-shopping", but the reality is that these firms usually don't have the local expertise and have been known to assume they know best, only to find out that the local

tax assessor has little regard for their outsider views. Moreover, these firms rarely have the direct municipal relationships to get the job done efficiently and with the greatest level of success. Unfortunately, the hotel manager usually has no good way of knowing that the consulting firm's 10% reduction "success" should have been a 30% reduction, so was really a failure.

It's also true that the major consulting firms are not law firms, and in many jurisdictions lack the right to appeal on behalf of the owner; sometimes the consulting firm lacks authority from the inception, and sometimes at the point at which an unsuccessful administrative appeal must go to court. This makes for a cumbersome and often failure-ridden approach, with poor planning for the risks of trial and added costs to the hotel operator (not to mention less than stellar results).

The hybrid approach generally works best. In this method, the hotel's portfolio manager works directly with an attorney or law firm that serves as a quarterback for all property tax purposes across all jurisdictions. This attorney provides high-level strategic management for the entire portfolio's property tax, and advises on a tailor-made strategy for achieving the best result for each property in the portfolio. In some cases, that may mean the attorney will directly appeal the taxes, taking the case to trial if warranted. In other cases, the attorney leverages a national network of property tax specialist law firms as well as consultant specialists in which the attorneys collaborate and identify the optimal legal and valuation arguments as well as engage the appropriate experts needed to prove the case. The hotel company incurs no additional costs from this approach because all fees are charged based on success and divided among the attorneys as appropriate to the scope of work. The hotel gets the benefit of a combination of both high-level strategic advice that considers the resources of the *entire portfolio* as well as the best *local* know-how and relationships.

What About Avoiding Property Taxes Altogether?

Somewhat beyond this presentation, but always a part of the discussion, is obtaining tax incentives and abatements through what are often called "Payment in Lieu of Taxes" (PILOT) agreements. Generally, such agreements provide effectively a discount or even tax-free period to the applicant in exchange for some form of economic stimulus anticipated by the developer and community, usually in the form of increased jobs, etc. Especially in high-tax regions such as the Northeast, a PILOT agreement may be the only way that a property can go forward because

otherwise the level of property taxes would make the project economically unviable. PILOT agreements frequently also include other forms of financial incentives such as mortgage and sales tax breaks. Identifying opportunities for incentives, and then negotiating the optimal package, is also often highly relationship-driven and requires specialized knowledge of the local opportunities as well as political landscape, as incentive agreements can sometimes be controversial.