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Two Ways to Identify True Property Value

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Valuation Method of Choice May Spell Madness for Hotel Property Owner Taxpayer

The real property value component of a hotel can fluctuate significantly depending upon which valuation method is utilized by an appraisal expert. Such disparities are particularly significant in today's economic climate with hotel values so closely tied to the whims of the marketplace.

Simply put, the U.S. economy "has been downright inhospitable to the hospitality industry."⁽¹⁾ Recession, scarcity of credit, and shrinking demand have all contributed to the precipitous decline in the volume of annual hotel sales, dropping from an impressive \$77.4 billion in 2007, to a startling \$10.7 billion in 2008, and finally to a disconcerting \$2 billion in 2009.⁽²⁾ Moreover, "lodging values have dropped 17 percent [in 2009], with properties at the top and bottom of the segment's spectrum hit especially hard."⁽³⁾

Historically, hotel values dropped on average 32% during the 1991 recession. Although they slowly recovered through 2000, the September 11, 2001, events brought them crashing back down 25%. Their value then doubled through 2006. Recently, however, HVS Consulting & Valuation Services, a leading hotel consulting and valuation firm, reported that "the average value per room in the U.S. hotel sector has fallen 45% since peaking in 2006 (4)... and won't rebound until 2014."⁽⁵⁾

In light of the inherent susceptibility of hotel valuations to swings in the economy, the approach utilized to value hotels can have a significant impact upon ultimate value conclusions and upon the tax assessments fixed by local taxing authorities.

There are three methods of valuing real estate generally: the cost approach, the sales comparison approach, and the income capitalization approach (often referred to as the income approach). The cost approach is given minimal weight in the hotel valuation process because it does not reflect "economic factors such as projected net income and return on investment."⁽⁶⁾ These income-related considerations are critical to hotel buyers when making purchasing decisions and, therefore, must be accounted for in selecting the appropriate valuation methodology.

Likewise, the sales comparison approach is of little use because of the reduced number of hotel transactions currently being consummated.⁽⁷⁾ Moreover, even slight differences between parcels of land and/or buildings have a significant impact and make it difficult to fix the appropriate levels of adjustments. Consequently, use of this approach becomes overly subjective and is therefore wanting on the credibility front.⁽⁸⁾

The income approach, however, does give due weight to the realities of the hotel marketplace and to the considerations that active participants deem important (that is, income generation). As such, the income approach is recognized to be the best method and is usually given the greatest weight.⁽⁹⁾ Under this approach, revenues are calculated on the basis of average room rates over a period of time, adjusted for stabilized occupancy rates, which are predicated upon the hotel's recent operating history.⁽¹⁰⁾ Because a hotel's income is derived from the total assets of the business (including real property, tangible personalty, and intangible elements), when attempting to determine value for real property tax purposes, all components of net operating income not attributable to the real estate must be isolated and deducted.⁽¹¹⁾

This process requires two key steps. First, the business component must be separated from the real property interest. This is often accomplished by extracting the management fees paid by the owner pursuant to a management contract from the hotel's revenues.⁽¹²⁾ Second, as only real property is taxable, the value of the hotel's personal property (known as Furniture, Fixtures and Equipment, or "FF&E") must also be deducted.⁽¹³⁾

This last step is, however, the subject of much debate. There are two methods recognized and utilized by the appraisal community to perform this critical calculation: the "Rushmore method" and the "Business Enterprise Approach" ("BEA"). These methods differ in that the BEA is substantially more aggressive in attributing value to the non-taxable personal property components of the hotel, and therefore its application typically results in a lower value for tax assessment purposes.

In the first instance, the Rushmore method excludes the value of and the income derived from FF&E.⁽¹⁴⁾ In addition, "separate adjustments are made to provide for the periodic replacement of the personal property (the return of FF&E) and also for a yield on the investment in personal property (the return on FF&E)."⁽¹⁵⁾

The BEA, on the other hand, goes further by also excluding the value attributable to the hotel franchise, or "flag;" various residual intangibles, including goodwill and business and credit relationships; and developmental outlays associated with the start-up of the hotel business.⁽¹⁶⁾ Due to the aggressiveness of this approach, it has been criticized for "moving a disproportional share of the hotel's value out of the real property component and into the business and personal property components, thereby significantly reducing a hotel's property tax assessment."⁽¹⁷⁾

Alternatively, and much to the chagrin of hotel owners, the Rushmore method has been embraced by courts as the appropriate methodology for determining fair valuation in the real property tax context. For example, Stephen Rushmore, the brainchild of the self-titled method, was appointed by a Michigan bankruptcy court to appraise the hotel property in question.⁽¹⁸⁾ Additionally, a New York bankruptcy court expressly described Mr. Rushmore as "a well recognized and eminent expert in the field of hotel appraisers."⁽¹⁹⁾ Moreover, both parties' experts in a District of Columbia matter recognized Rushmore as a leading authority in the field of hotel valuation.⁽²⁰⁾ Furthermore, an appellate court in Kansas affirmed the trial court's finding that the Rushmore method was appropriate in arriving at a fair market value of the hotel property in question.⁽²¹⁾

New Jersey courts first adopted the Rushmore approach in 1989 in *Glenpointe Assocs. v. Teaneck Twp.* where Stephen Rushmore testified as an expert witness, and the court cited Rushmore's hotel valuation guide as authority on this very subject matter.⁽²²⁾ Since then, the Rushmore method has been accepted in a number of New Jersey matters. For example, in *Prudential Ins. Co. v. Twp. of Parsippany-Troy Hills*: While the parties disputed the appropriate stabilized room revenue, capitalization rates, and the value of the return on FF&E, both parties' appraisers agreed that the Rushmore method was appropriate to determine the relevant net operating income attributable to real property.⁽²³⁾

However, 'Chesapeake Hotel' perhaps best demonstrates the wide variance of value that can result from employing these different approaches. There the court recognized that the BEA method resulted in a final taxable value of 36% of the hotel's total value.⁽²⁴⁾ Alternatively, application of the Rushmore method yielded a valuation at approximately 60% of the total hotel value.⁽²⁵⁾ Although the 'Chesapeake Hotel' court recognized that its decision "should not be understood as a definitive pronouncement on appraisal practices designed to extract real estate value from the assets of a business or as binding precedent with respect to adjustments,"⁽²⁶⁾ it does echo a long line of cases which have found the Rushmore method preferable to the BEA in determining the "value" of a hotel for real property tax purposes.

The consistent utilization of the Rushmore method by appraisers and its widespread acceptance by the courts therefore signifies its established position as the leading methodology in the realm of hotel property tax valuation. While the BEA may be more useful in determining the real property component of certain kinds of structures (for example, multi-use properties,⁽²⁷⁾ supermarket chains,⁽²⁸⁾ and shopping malls⁽²⁹⁾), hotels appear to fall into a category of their own. While hotel owners should continue to attempt to employ elements of the BEA in their challenges to lower the value of the real property component of hotel income, they must be mindful that it may very well be an uphill battle considering the strong preference courts have afforded the Rushmore method.

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- (5) *Id.*
- (6) HOTEL INVESTMENTS ISSUES & PERSPECTIVES 1 (Rachel J. Roginsky & Lori E. Raleigh eds., 2006).
- (7) Watkins, *supra* note 3.
- (8) See e.g., *Westmount Plaza v. Twp. of Parsippany Troy Hills*, 11 N.J. Tax 127, 137 (N.J. Tax 1990) (rejecting a purported comparable sale due to its non-conformity with zoning requirements thereby necessitating variance relief deemed unlikely and concluding that the disparity prevented meaningful comparison and was thus fatal to the probative utility of the expert's comparable sale).
- (9) *Id.* at 133 (citing *Bostian v. Franklin State Bank*, 167 N.J. Super. 564 (App. Div. 1979); Hall & Benton, "Hotel and Motel Valuation," Friedman, *Encyclopedia of Real Estate Appraising* (3 ed. 1978) at 631, 642.)
- (10) See *Westmount Plaza*, 11 N.J. Tax at 135; see generally *Glenpointe Assocs. v. Teaneck Twp.*, 10 N.J. Tax 380 (Tax Ct. 1989); *In re St. Petersburg Harbourview Hotel Corp.*, 176 B.R. 611 (Bankr. M.D. Fla. 1994); *Analogic Corp. v. Bd. of Assessors*, 45 Mass. App. Ct. 605 (App. Ct. 1998).
- (11) *Chesapeake Hotel LP, v. Saddle Brook Twp.*, 22 N.J. Tax 525, 527 (Tax Ct. 2006) (citing *The Appraisal Institute, The Appraisal of Real Estate*, 643 (12th ed. 2001)).
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- (25) *Id.* at 530. See also Stephen Rushmore, Why the "Rushmore Approach" Is a Better Method for Valuing the Real Property Component of a Hotel, 1 J. PROP. TAX ASSESSMENT & ADMIN., Issue 4, p. 15 (discussing the case).
- (26) *Chesapeake Hotel*, 22 N.J. Tax at 536.
- (27) See *WXIII/Oxford-DTC Real Estate, LLC v. Bd. of Superv'rs*, 2004 WL 2848543, at 8, *5 (*Va. Cir. Ct. 2004*).</>
- (28) See *In re PWS Holding Corp.*, 228 F.3d 224 (3d Cir. Del. 2000).
- (29) See *Lawrence Assocs. v. Lawrence Twp.*, 5 N.J. Tax 481 (Tax 1983).

Carl Rizzo's broad and diverse practice includes concentration in commercial litigation matters and chancery practice relating to contractual disputes involving such matters as surety, construction and construction liens, real estate transactions, commercial tenancy, employment covenants and partnership/shareholder discord. He also concentrates his practice in tax court ad valorem proceedings, where he has successfully negotiated and litigated numerous matters involving millions of dollars in tax reductions for his commercial property owner clients. Mr. Rizzo can be contacted at 201-525-6350 or crizzo@coleschotz.com

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