Now Is the Time to Review Your Hotel's Property Taxes

by Stephen Rushmore

During periods of economic stress in the hotel industry, smart owners and operators carefully review their hotel's property tax assessment to determine whether there is sufficient justification to seek a reduction. In today's economic climate, such a review is extremely timely, and for those who understand the technicalities of how hotel properties are assessed, a well-executed appeal can often produce thousands of dollars of savings.

As with any type of real estate appraisal, municipal assessing departments generally utilize the three standard approaches to value: cost, sales comparison, and income capitalization. Since hotels are more than just real estate, special valuation techniques are required to separate from the total property value nonreality components such as personal property and the value of the going business, goodwill, franchise affiliation, and superior management.

The concept of a real estate tax is to allocate the municipal tax burden on the basis of real estate value. The higher the value of the real estate, the larger the share of the tax burden. To accomplish this objective, property tax assessments should bear a definite relationship to market value so that properties of equal market values will have similar assessments and properties of higher and lower values will have proportionately larger and smaller assessments.

Example. Assume a taxing jurisdiction has just three properties. According to local assessing procedures, the relationship between assessed value and market value is 60 percent. The following table shows the market values along with the remaining assessed values:

Property	*Estimated Market Value*	*Assessed Value*
1	$ 75,000	$ 45,000
2	100,000	60,000
3	125,000	75,000
Total		$180,000

The total assessed value of the taxing jurisdiction is known as the tax base and is used to calculate the local tax rate. If the annual municipal budget for this jurisdication is $9,000, the tax rate would be:

$$\frac{\$\ 9{,}000}{\$180{,}000} = \$50 \text{ per } \$1{,}000 \text{ of assessed value}$$

Based on these assessed values, the local tax burden would be allocated as follows:

Property	*Assessed Value*		*Tax Rate*		*Real Estate Tax Burden*
1	$45,000	×	$0.05	=	$2,250
2	60,000	×	0.05	=	3,000
3	75,000	×	0.05	=	3,750
Total					$9,000

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TABLE 1. OPERATING RESULTS OF 300-ROOM HOTEL OVER TWELVE MONTHS*

No. Rooms	300		
Occupancy	70%		
Average rate	$85		
Days open	365		
Rooms occupied	76,650		
	$(000)	**%**	**Gross Per Room**
Revenues			
Rooms	$ 6,515	61.1%	$21,717
Food	3,258	30.5	10,860
Beverages	652	6.1	2,173
Telephone	170	1.6	567
Other Income	75	0.7	250
Total	10,670	100.0	35,567
Department Expenses			
Rooms	1,498	23.0	4,993
Food and Beverage	2,971	76.0	9.903
Telephone	136	80.0	453
Other Income	34	45.3	113
Total Expenses	4,639	43.5	15,463
Department Income	6,031	56.5	20,103
Undistributed Operating Income			
Administrative and General	854	8.0	2,847
Marketing	213	2.0	710
Property Operations and Maintenance	427	4.0	1,423
Energy	320	3.0	1,067
Total Undistributed Operating Income	1,814	17.0	6,047
Income Before Fixed Charges	4,217	39.5	14,057
Fixed Charges			
Insurance	60	0.6	200
Total Fixed Charges	60	0.6	200
Net Income	$ 4,157	38.9%	$13,857

*Constructed in 1982, the property has maintained an occupancy rate of approximately 70 percent over the past several years.

This example demonstrates certain relationships. The relationship between market value and assessed value does not affect the allocation of the real estate tax burden. Should a fourth property be added to the taxing jurisdiction, the tax base would increase and the tax rate would decrease proportionately, assuming the municipal budget remains constant. A change in the municipal budget only affects the tax rate.

The key to a fair and equitable property tax system is achieving the uniform relationship between assessed value and market value so that all properties within a jurisdiction will have assessments that are proportional to each other based on market value. A hotel is improperly assessed when its assessed value is either significantly higher or lower than a comparable hotel having similar valuation attributes.

Monitoring Assessments. Hotel owners should monitor their property assessments on an ongoing basis to ensure that a favorable assessment relationship among the other hotels in the taxing jurisdiction is maintained. This can be accomplished by researching the assessed values of all comparable hotels situated within the local market area. Assessors generally provide separate values for the land and improvements. Since it is usually difficult to successfully appeal the land portion of the assessment, only the improvement value needs to be evaluated.

The evaluation starts by equalizing the improvement assessment using a common unit of comparison, which for a hotel is the assessed value per available room (i.e., divide the improvement assessment by the room count). The assessed values (per room) of all the comparable hotels are then compared to the subject's to determine whether the properties have been fairly assessed relative to each other. Adjustments related to differences such as quality of facilities, number and types of amenities, product class, and markets served should be considered. At this point in the analysis, the owner should be looking for glaring discrepancies between the assessed value

of the subject hotel and the assessments placed on the other hotels in the market.

Comparing the assessed values of the hotels within a taxing jurisdiction utilizing the described technique only pinpoints inequities between hotels. It does not verify that the assessed value placed on the subject property is fair relative to its market value or the value of other types of real estate. To evaluate the relationship between the subject property's market value and its assessed value, the hotel owner should use the income capitalization approach and determine what a fair assessment would be. This process is demonstrated in Table 1.

This statement of income and expense shows the net income before debt service of the subject property prior to deducting a management fee, a franchise fee, and a reserve for replacement. Because this analysis is being employed to evaluate the fairness of the real property tax assessment, the actual taxes are also excluded and the equalized tax rate will be incorporated (or loaded) into the capitalization rate when the actual valuation is performed. The net income represents the total income generated by the hotel and includes income attributed to the land, improvements, personal property, and the going business. Since real estate taxes are assessed only on the real property components, adjustments must be made to the net income to remove any income attributed to the personal property and going business components before the capitalization process can be completed.

Personal Property Adjustment. Two calculations are required to remove the income attributed to the personal property. The return of personal property must be deducted to account for the fact that hotel furniture and equipment have a relatively short useful life (eight to ten years on average) and a provision is needed for timely replacements. The industry accomplishes this objective by utilizing a reserve for replacement, which is generally calculated as a percentage of total revenue ranging from 3 percent to 5 percent. The following return of personal property deduction was calculated:

Total revenue	$10,670,000
Return of personal property	0.03
Return of personal property deduction	$ 320,000

In addition to the reserve for replacement calculation, which accounts for future refurbishments, the income attributed to the furniture and equipment currently in place must be deducted. This deduction is called the return on personal property. The subject property has been well maintained and the value of the personal property in place is estimated at $2.4 million. Assuming the appropriate return on personal property is 12 percent, the following return on personal property deduction was calculated:

Value of personal property in place	$2,400,000
Return on personal property	0.12
Return on personal property deduction	$ 288,000

Business Value Adjustment. The business component of a hotel accounts for the fact that a lodging facility is a retail business that often includes a restaurant and banquet operation, many amenities, a chain affiliation, and other similar factors that create income that is more than just real estate based. To deduct the income attributed to the going business, hotel appraisers often subtract a basic management fee (ranging from 3 percent to 4 percent of total revenue) plus a franchise fee (ranging from 3 percent to 5 percent of rooms revenue). The management fee accounts for the effort expended in supervising the operation of the business components, and the franchise fee recognizes the value of a national or regional chain affiliation that is not part of the real estate. The following calculations show the business value adjustments for the subject property:

Management fee deduction:	
Total revenue	$10,670,000
Basic management fee percentage	0.03
Management fee deduction	$ 320,000
Franchise fee deduction:	
Rooms revenue	$ 6,515,000
Franchise fee percentage	0.04
Franchise fee deduction	$ 261,000

Adjusting the Net Income. The previously described net income before debt service is adjusted for personal property and the going business components by making the following deductions:

Net income		$4,157,000
Less:	Return of personal property	320,000
	Return on personal property	288,000
	Management fee	320,000
	Franchise fee	261,000
Adjusted net income		$2,968,000

Capitalization of Adjusted Net Income. The capitalization process takes the adjusted net income and divides it by a capitalization rate representing the weighted cost of invested capital. In addition, the local tax rate expressed as a percentage of market value is added to the cap rate because the actual property taxes have not been included in the adjusted net income. Based on an analysis of hotel capitalization rates, along with local tax and equalization rates, the following loaded capitalization rate was developed by adding the equalized tax rate to the after-tax overall capitalization rate:

Data:	
After-tax overall capitalization rate	12%
Equalization rate (assessed value/ market value)	60%
Tax rate	5%
Equalized tax rate (0.60 × 0.05)	0.03%
Calculations:	
After-tax overall capitalization rate	0.12%
Plus: Equalized tax rate	0.03%
Loaded before-tax capitalization rate	0.15%

Dividing the adjusted net income by the loaded before-tax capitalization rate produces the market value of the subject property's real property component:

$$\frac{\$2{,}968{,}000}{0.15} = \$19{,}787{,}000$$

Proof of Value. The value of the real property can be proven by deducting the real estate taxes from the net income before real estate taxes and using the overall cap rate without the tax adjustment (0.12%) to verify the value of the real property component.

Market value of the real property	$19,787,000
Assessment ratio	0.60
Assessed value	$11,872,000
Tax rate	0.05
Real estate taxes	$ 594,000
Adjusted net income	$ 2,968,000
Less: Real estate taxes	594,000
Adjusted net income after real estate taxes	$ 2,374,000

Value of the real property

$$\frac{\$2{,}374{,}000}{0.12} = \$19{,}787{,}000$$

Using a market valuation of the subject's real property of $19.787 million, the calculation shows that the assessed value would be $11.872 million, and the tax burden amounts to $594,000. Deducting the tax burden from the adjusted net income attributed to real property reduces an adjusted net income after real estate taxes of $2.374 million. The market value is verified when the stabilized net income is capitalized by the unloaded rate of 12 percent.

Conclusion. After performing these calculations, the hotel owner can evaluate whether the assessment developed by the taxing jurisdiction is fair. The factors that impact the market and assessed value of a hotel are generally related to the property's actual net income and the current cost of capital. During periods of economic decline, net income is likely to decrease and capitalization rates are apt to escalate. Both factors tend to depress property values. By appealing property taxes at a time when a hotel is negatively affected by these factors, owners are in a better position to develop a supportable basis for an appeal. ■