HVS

Possessory Interests in Hotel Real Estate

January 16, 2019 / By Erich Baum

What is a Possessory Interest?

A possessory interest is created when a private-sector tenant is granted exclusive use of real property (land and/or building) that is owned by a tax-exempt entity, typically a municipality or a state or federal government agency. The right to occupy and use the land and/or building is usually conferred via a lease.

Examples Please?

Because of the federal and municipal government's extensive ownership interests in the nation's capital, many possessory interests have been created in Washington, D.C. Two examples involving hotels follow:

Marriott Marquis Washington, DC

Trump International Hotel Washington, DC

- The Trump International Hotel opened in September 2016 with 263 rooms and was adapted from the historic Old Post Office and Clock Tower. Trump Hotels leases the land and building from the General Services Administration (GSA), a tax-exempt independent agency of the United States government.
- The Marriott Marquis Washington, D.C. opened in May 2014 with 1,175 rooms, on land leased from the District of Columbia (and a related quasi-public agency). The District aggregated the land through multiple acquisitions for the express purpose of expediting the hotel's development. The property functions as the District's convention center headquarters hotel.

In the case of the Trump Hotel, the possessory interest includes both the land and the building. For the Marriott, the possessory interest includes only the land. As in a typical ground lease, the Marriott lease stipulates that ownership of any building improvements constructed by the tenant will revert to the landlord at the lease's termination. Thus, ownership of the Marriott includes both a possessory interest in the land and a leasehold interest in the building. In both the Trump and Marriott cases, the leases run for approximately 100 years, including extension options. Because of the long term and the high quality of the assets, each interest has an investment profile basically consistent with that of a fee simple interest, except for the property rent burden.

The Four Standards

To qualify as a possessory interest, four standards must be met. The tenancy must be ***independent***, ***durable***, and ***exclusive*** of the rights held by others, and it must provide ***private benefit to the possessor*** above that which is

Summary

Possessory interests result from unique circumstances. Understanding its origin and purpose is necessary when performing a possessory interest appraisal. This article describes possessory interest and provides valuation methodology guidance.

FILED UNDER CATEGORIES

Hotel Investments & Ownership
Development & Construction
Valuations & Market Studies
Property Tax
D.C., DC, United States
Washington, United States
United Arab Emirates
North America

granted to the public. Independence means that the tenant enjoys the freedom to use the property without the landlord's undue intervention. Durability is established by the contractual term over which the tenant will enjoy the use. And with exclusivity, the possessor can legally exclude others from interfering with its use of the property.

Sounds Like a Leasehold Interest, Right?

When appraising a possessory interest, the appraiser must exclude the value of any rights retained by the public owner/landlord, or any rights that will revert to the public owner/landlord when the lease expires. These same considerations hold true for any valuation of a typical leasehold interest. Furthermore, in a typical ground or property lease, the tenant is responsible for all property tax payments, land and building. The same is true of a possessory interest. Essentially, possessory interest is different from a leasehold interest in name only, the key distinction being that the landlord is a tax-exempt public entity.

Why Then Was Possessory Interest a Necessary Creation?

Possessory interest as a distinct form of taxable property was created to assure that private-sector tenants occupying public property were appropriately taxed for any enjoyment and/or economic benefits conferred to them by the lease. Because the landlord is exempt from property taxation, tenants have argued that it is unfair for them to have to pay taxes on property that hasn't been taxed previously and are only now taxed because of the fact of their tenancy. Tenants have asked, *why is paying rent to the government or other public agency not enough?*

The logic underlying the additional payment of property tax expense holds up upon further consideration. The tenant pays rent to occupy the land and/or building; that is the public's return on the value of the property. These rent payments are unrelated to ad valorem property taxation, which is levied to fund municipal services. In the case of a large-scale commercial hotel, the tenant's possessory interest tax payments compensate the municipality for the costs of providing infrastructure, fire and safety services, and public education. These burdens are funded through ad valorem taxation. Without a taxable possessory interest, the tenant's share of these expenses would be unfairly distributed to the municipality's other taxpayers.

How to Value?

The valuation methodology is basically the same as the methodology applied in a typical leasehold appraisal. A discounted-cash-flow (DCF) analysis is recommended; if the remaining lease term exceeds 50 years, then the standard ten-year DCF methodology typically applies, with reversionary proceeds from an assumed sale quantified at the end of the tenth year.
For leases with less than 40 remaining years, HVS typically employs a DCF analysis extending through to the year of expiration, with no reversion included.

Lease terms with 40 to 50 years remaining are open to interpretation. The appraiser can extend the DCF over the remaining life and exclude the reversion, or use a ten-year DCF and reversion, adjusting the terminal capitalization rate upward to reflect for the shorter lease life remaining.

In cases where the contractual rent fluctuates significantly in comparison to the assumed inflation rate, the appraiser is advised to extend the DCF to the full term, no matter how many years remain, and again exclude the reversion.

What if the Assignment is a Property Tax Appraisal?

When determining the property value for ad valorem taxation, the ground and/or building rent is excluded as an operating expense in the forecast of EBITDA Less Replacement Reserve. The rent represents the contractual return on the possessory interest component. Excluding it as an expense assures that the possessory interest value component is captured in the total real property valuation used to calculate property tax expense. If a single-year direct capitalization methodology is applied, the property tax rate can be loaded into the selected overall capitalization rate. If a DCF is used, the property tax expense should be iterated using the total property value and the Year One property tax expense as mutual unknowns. Appraisers sometimes avoid the iteration process by loading the tax rate into the discount rate instead, but the results are mathematically erroneous, with the error becoming more significant with the magnitude of the value. In a DCF, the tax rate can and should be loaded into the terminal capitalization rate in either case, however.

Conclusion

Possessory interest is less complicated than it sounds. It exists primarily as a means of ensuring fair distribution of ad valorem property tax expense across the population of taxpayers. For appraisals performed for bank or acquisition purposes, the same set of factors that are associated with typical leasehold valuations apply. For appraisals developed for property tax assessment purposes, the property rent is excluded from the income approach forecast so that the possessory interest's real property value component is appropriately captured.

About Erich Baum

Erich Baum is a Senior Vice President with the HVS Boston office and has performed and overseen thousands of hotel appraisal and consulting assignments throughout North America, including an extensive list of assignments involving residential components and property tax appeal cases. Erich co-authored the 2001 edition of the Appraisal Institute's hotel valuation textbook, has written numerous previous articles on issues related to hotel appraisal and consulting, and regularly serves as an expert witness. Erich holds the CRE designation, is a state-certified appraiser, and is a graduate of Cornell's School of Hotel Administration. For more information contact Erich at +1 (603) 502-6625, or .