Property Tax Assessments for Hotels and Motels

by Stephen Rushmore

One of the significant expense items incurred by a hotel is the property taxes paid to local municipalities. In some instances, hotels pay as much as 8 percent of total revenue in real estate taxes. Smart owners and operators constantly monitor their hotel assessments to ensure that their property tax burden is kept to a minimum.

Property taxes are levied by municipalities to generate revenues to pay for essential governmental services. The purpose of real estate taxes is the allocation of the municipal tax burden on the basis of real estate value. The higher the value of the real estate owned by a taxpayer, the larger the proportion of the tax burden the individual must assume. The concept of this tax is called "ad valorem" (i.e., in proportion to value). To establish the proper distribution of the tax burden, municipalities employ tax assessors to value all the taxable property within their jurisdiction. Theoretically, the assessed value should bear a definite relationship to market value, with properties of equal market values having similar assessments and properties of higher or lower values having proportionally larger or smaller assessments.

Determining Market Value. The key to the whole assessment process is an accurate estimate of market value. This goal is fairly easy to achieve for simple types of real estate, such as vacant land and single-family homes. As properties become more complicated, however, the issues involved in developing a supportable estimate of value become highly complex. Leading the list of property types that are difficult to value for assessment purposes are hotels and motels. Assessors must understand that lodging facilities comprise more than the traditional property components of land, bricks, and mortar; they are retail-oriented, labor-intensive businesses necessitating a high level of managerial expertise. In addition, hotels require a significant investment in personal property (furniture, fixtures, and equipment) that has a relatively short useful life and is subject to rapid depreciation and obsolescence. All these unusual

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characteristics must be handled in a proper manner during the hotel assessment process in order to derive an accurate assessed value.

When a hotel is bought or sold, the owner generally transfers the entire property, which includes land, improvements, personal property, and the existing going business. The sale price therefore reflects the total value of each of these four components. When valuing property for real estate taxes, the assessor can include only the real property components, which are the land and improvements. Since personal property and the going business are not assessable for real estate taxes, they must be separated out or isolated from the valuation process. The chief factor contributing to the overassessment of a hotel is the erroneous inclusion of personal property or business value in the ultimate tax assessment.

Example. There are several theories used to develop an assessed value for a hotel. The one that has generally been adopted by most assessment jurisdictions is illustrated with the following simplified example.

Hotels and motels are almost always valued by an income capitalization approach that takes the property's stabilized net income and capitalizes it into an estimate of market value.

Stabilized net income is intended to reflect the anticipated operating results of a hotel over its remaining economic life, given all applicable stages of buildup, plateau, and decline in its life cycle. The stabilized net income excludes from consideration any abnormal relation of supply and demand and any transitory or nonrecurring conditions that may result in unusual revenues or expenses of the property. Table 1 represents the stabilized net income for the subject property. Omitted from the statement are management fees, property taxes, and reserve for replacement. These expense categories will be estimated separately.

The capitalization rate is the weighted cost of invested capital that takes the form of mortgage debt and equity. Since the valuation is being made for property tax purposes, the capitalization rate will also include the local tax rate expressed as a percentage of market value. This allows the capitalization of the net income before real estate taxes by assuming that the ultimate tax burden will equate to the municipally mandated relationship to market value. The following table sets forth the data for developing a capitalization rate as of the appropriate date of value:

Mortgage interest	11%
Mortgage amortization	30 years
Mortgage constant	0.11428
Loan-to-value ratio	75%
Equity dividend	12%
Assessment ratio	60%
Real estate tax rate	$45.00 per $1,000 or $.045 per $1

The before-tax overall rate is developed by the band of investment, which is a weighted average cost of capital plus an adjustment for the real estate tax rate.

Mortgage	0.75 × 0.11428	=	0.08571
Equity	0.25 × 0.12	=	0.03
After-tax overall rate			0.11571
Tax adjustment	0.60 × 0.045	=	0.027
Before-tax overall rate			0.14271

At this point, the normal procedure for valuing this hotel would be to take the stabilized net income of $2.425 million and capitalize it by the overall rate of 0.14271, which results in a value of approximately $17

TABLE 1. STABILIZED STATEMENT OF INCOME AND EXPENSE

Total rooms:	200	
Occupied rooms:	52560.0	
Occupancy:	72.0%	
Average rate:	$85.00	
	Total $	**% Gross**
Revenues		
Rooms	$4,468	53.40%
Food	2,510	30.00
Beverages	1,100	13.10
Telephone	120	1.40
Other income	175	2.10
Total revenue	$8,373	100.00%
Departmental Expenses		
Rooms	1,117	25.00%
Food and beverage	2,888	80.00
Telephone	120	100.00
Other income	70	40.00
Total expenses	$4,195	50.10%
Departmental Income	$4,178	49.90%
Undistributed Operating Expenses		
Administrative and general	$ 670	8.00%
Marketing	375	4.50
Property operations and maintenance	335	4.00
Energy	293	3.50
Total undistributed operating expenses	$1,673	20.00%
Income Before Fixed Charges	$2,505	29.90%
Fixed Charges		
Insurance	$ 80	1.00%
Total fixed charges	80	1.00%
Net Income	$2,425	28.90%

million. Since this value includes both the personal property and the business components, it would not be appropriate for real estate tax assessment purposes.

Removing Personal Property and Going-Business Components From Property Value. The problem lies in the fact that the stabilized net income contains income attributed to furniture and equipment and the going business. To remove these components from the final estimate of value, their income contributions must be removed from the income statement. This can be accomplished in two stages.

Stage 1: Personal Property Adjustment. Two calculations are necessary to remove the personal property value from the income flow: a return of personal property and a return on personal property. The return of personal property is based on the fact that furniture and equipment have a relatively short useful life and must be replaced on an average of every six to ten years. To reflect this cash flow deduction, most hotel companies utilize a reserve for replacement that normally ranges from 3 percent to 5 percent of total revenue. By making this deduction from the stabilized net income, the cost of future personal property replacements have been accounted for.

Assuming a 3 percent reserve for replacement, the return of personal property would be

$$\$8,373,000 \times 0.03 = \$251,000$$

The return-on-personal-property calculation accounts for the value of the furniture and equipment currently in place within the hotel. Since real estate taxes exclude personal property, any income attributed to this component must be removed from the income stream.

The percentage rate of return on personal property should reflect the cost of capital commonly used to purchase the furniture and equipment. For the purpose of this example, the overall rate after property taxes of 0.11571 derived earlier by the band of investment will be utilized. One could argue that a higher rate may be more appropriate to reflect the uniquely high risk of personal property investments. An appraisal of the personal property estimates its values to be $8,000 per room, or $1.6 million. The return on personal property is calculated as follows:

$$\$1,600,000 \times 0.11571 = \$185,000$$

Stage 2: Business Value Adjustment. The business component of a hotel's income stream accounts for the fact that a lodging facility is a labor-intensive, retail-type activity that depends on customer acceptance and highly specialized management skills. Unlike an apartment or office building where tenants sign leases for one or more years, a hotel experiences a complete turnover of patronage every two to four days. In addition, if a hotel benefits from a nationally recognized hotel-company name, either through a franchise affiliation or a management contract, this benefit can create a significant amount of business value.

Several procedures have evolved to estimate the business value of a hotel. The most appropriate theory for today's environment is based on the premise that by employing a professional hotel management company to take over the day-to-day operation of the hotel, thereby allowing the owner to maintain only a passive interest, the income attributed to the management company has been taken in the form of a management fee. Deducting a management (and franchise) fee from the stabilized net income thereby removes the business component.

In this example, it will be assumed that the hotel is operated by a nationally recognized hotel management company that provides both operational expertise and a name affiliation. Its management fee is calculated based on 3 percent of total revenue plus 10 percent of income before fixed charges after deducting 3 percent of total revenue. The income attributed to the business component is calculated as follows:

$8,373,000 × 0.03 =	$251,000
$2,505,000 − $251,000 = $2,254,000 × 0.10 =	225,000
Income attributed to the business	$476,000

The value of the real property component can now be calculated by deducting the return of personal property, the return on personal property, and the income attributed to the business from the stabilized net income and capitalizing the result into value utilizing the before-tax overall rate.

Stabilized net income		$2,425,000
Less:		
Return of personal property	251,000	
Return on personal property	185,000	
Income attributed to business	476,000	
Income attributed to real property		$1,513,000

Capitalization:

$$\$1,513,000/0.14271 = \$10,600,000$$

The value of the real property can be proven by deducting the real estate taxes from the stabilized net income before real estate taxes and using the overall rate without the tax adjustment to verify the value of the real property component.

Market value of real property	$10,600,000
Assessment ratio	0.60
Assessed value	$ 6,360,000
Tax rate	0.045
Real estate tax	$ 286,000
Net income attributable to real property	$ 1,513,000
Less: Real estate tax	286,000
Net income after real estate tax	$ 1,227,000

Capitalization:

$$\$1,227,000/0.11571 = \$10,600,000$$

Compared to the previously calculated total property value of $17 million, the magnitude of the personal property and real property components within a hotel investment is readily apparent. Depending on the age and quality of the personal property and the strength of the management company and chain affiliation, the personal property and business components can account for between 25 percent and 40 percent of the total property value. This relationship shows the potential margin of error for property tax assessments when these components are not accounted for properly during the assessment process.

Hotel owners can monitor their property tax assessments by comparing the assessed value with the total property value less the personal property and business components times the assessment ratio. If the personal property and business components account for between 25 percent and 40 percent of the total property value, then the real property comprises 60 percent to 75 percent of the entire property value. For the subject property, the real property component is approximately 62 percent of the total. The above assessment estimate calculation would be as follows:

$17,000,000 × 0.62 =	$10,600,000 (real property component)
	0.60 (assessment ratio)
Estimated assessed value	$ 6,360,000

If the actual assessed value is greater than the $6.3 million, then there could be justification for a property tax appeal. ■