

The Rushmore Approach vs. the Business Enterprise Approach The Judge Renders his Decision

Last month a property tax judge in New Jersey ruled on a precedent setting case which supported and vindicated the “Rushmore Approach” for allocating a hotel’s total value among the real, business and personal property components. The opposing methodology, known as the “Business Enterprise Approach” (BEA), has recently come into favor with hotel property tax reps and several appraisers because it moves 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. A bigger concern that goes far beyond this New Jersey tax case is the potential that widespread adoption of the BEA could radically reduce the values derived for hotel mortgage loan appraisals.

The Rushmore Approach separates the business component by deducting a management and franchise fee from the hotel’s stabilized net income. The BEA also makes these deductions but further subtracts business start-up costs. The Rushmore Approach handles the tangible personal property component by deducting a reserve for replacement along with the actual value of the personal property in place. The BEA follows this procedure but also deducts a return on the personal property in place which effectively double counts the value of the existing personal property. The end result of all these erroneous calculations was illustrated in a New Jersey tax case whereby the Business Enterprise Approach estimated the value of the real property component to be only 36% of the hotel’s total value while the Rushmore Approach said it was a more plausible 60% of total value. The judge in this case concurred with the testimony of Stephen Rushmore and confirmed the Rushmore Approach produces the most credible hotel valuations.

This was the first and only trial in which Stephen Rushmore, the creator of the Rushmore Approach, and David Lennhoff, who developed the BEA, have faced each other in court. While Rushmore did not actually prepare an appraisal of the subject property (the Marriott Saddle Brook Hotel) he was called in by the court to address three issues: (1) the calculation of the flag value; (2) the necessity for a separate deduction from capitalized income of the value of FF&E in addition to the expense allowances for return of and return on FF&E; and (3) the appropriateness of the amortization of start-up costs. By the time Rushmore testified, both sides in the case had stipulated to the hotel’s stabilized net income and capitalization rate. Therefore, the court was able to focus on the above three critical issues which are precisely the differences between the Rushmore Approach and the BEA. Furthermore, since the judges in the New Jersey Tax Court only hear property tax cases, they have far greater expertise in this specialized area than judges in other jurisdictions who hear all different types of disputes. The Marriott Saddle Brook Hotel case therefore became the perfect showdown between these two opposing approaches.

The following are pertinent excerpts from Judge Pizzuto's decision in this New Jersey tax case entitled Chesapeake Hotel LP vs. Saddle Brook Township.

The judge's decision starts by pointing out that the Rushmore Approach was adopted by the New Jersey Tax Court back in 1989. Pizzuto describes,

“In Glenpointe (a previous 1989 New Jersey tax court case), the court accepted the conclusions of an expert appraisal witness, Stephen Rushmore, concerning the particular adjustments that are necessary to extract non-realty income from total income so as to compute the income to be capitalized into real estate value. Rushmore is the author of Hotels, Motels and Restaurants: Valuations and Market Studies (1983). He has established a national reputation in hotel valuation and the procedure he employed is often described as the Rushmore method.”

The judge then summarizes the valuation procedures used in Rushmore Approach and its widespread acceptance by New Jersey Tax Courts and other jurisdictions.

”Rushmore considered that all payments to the entity that manages and operates the hotel constitute business income generated by the exercise of management and entrepreneurship. Accordingly, he excluded these payments in the computation of realty income subject to capitalization. In addition, Rushmore considered that a portion of the overall income was realized by the employment of furniture, fixtures and equipment (often referred to as “FF&E”). Since these items are (generally speaking) personal property rather than real estate, the income attributable to them, under Rushmore's method, is also excluded from realty income. 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). This method has been employed by experts in other hotel valuation cases...in New Jersey and other jurisdictions.”

Judge Pizzuto then focuses in on the Marriott Saddle Brook Hotel case and compares how Lennhoff adjusts the Rushmore Approach in presenting his Business Enterprise Approach.

“In the present case, the adjustments proposed by Lennhoff to the Rushmore method have both theoretical and empirical aspects. In other words, they are made for stated reasons, and they rest on particular data. In order for any adjustment to

have persuasive force in a factual finding of value, it should rest on cogent reasoning and be founded on reliable data. Lennhoff's proposed adjustments, on the whole, are not persuasive either from theoretical or empirical reasons."

One of the deductions made by Lennhoff was a concept known as residual intangibles which is the same as the competent management concept in the Rushmore Approach. Lennhoff argued that the stabilized net income for the Marriott Saddle Brook should be reduced because the subject's REVPAR was higher than its competitive set. While this competent management concept is sometimes appropriate in property tax valuations, the application by Lennhoff was incorrect. He compared the REVPAR of the Marriott with its competitors, some of which were not comparable- i.e. a functionally obsolete Howard Johnson and Holiday Inn. When Rushmore utilized a more comparable set of hotels including other Marriotts, Hiltons, Hyatts, Sheratons, and Westins, he found the Marriott Saddle Brook's REVPAR was exactly the same as these comps.

Judge Pizzuto again concurred with Rushmore's approach.

"Rushmore's observation that the competitive set of hotels in the vicinity is not comparable is sensible. The remaining data used by Lennhoff is not reflective of market conditions in this locality. In these circumstances, the deductions from income for flag value and residual intangibles are not accepted."

One of the key premises that forms the basis of the BEA is the concept of making a deduction for business start-up costs. While typical hotel buyers never look to recover the sunk costs incurred prior to opening by their predecessor, the BEA attempts to quantify a hotel's pre-opening sales and marketing expense, the cost of assembling a work force and the investment in working capital. During the trial, Rushmore argued that a hotel is in a constant state of "start-up." Because of the short-term nature of a hotel's tenancy it must constantly expend monies for sales and marketing. In addition, a hotel is constantly assembling a work force because employee turnover in the hospitality industry often approaches 100% per year. Lastly, appraisal literature has documented that hotels typically do not have a positive working capital so this deduction is also not appropriate.

Judge Pizzuto did not accept the concept of deducting business start-up costs. He went on to note that a business start-up cost deduction for a 30+ year old hotel makes absolutely no sense.

"In the present case, however, empirical considerations do not support the adjustment (for business start-up costs). Lennhoff proposes a 25-year amortization of start-up costs for a business already more than 30 years old on the valuation date, and the

cost estimate is derived from data having no relation to the subject. This adjustment also is not accepted.”

The last area where Rushmore and Lennhoff differed was the appropriate methodology for removing the value of the tangible personal property- FF&E. During court testimony, Rushmore clearly illustrated that it was permissible to deduct a reserve for replacement and either a return on FF&E or the actual value of the FF&E in place- but not both. Lennhoff’s approach effectively double counts the value of the FF&E in place, which error, Judge Pizzuto wisely catches.

“There may be differences of opinion over the rate of return appropriate on capital invested in FF&E or over the extent of depreciation, but to allow a deduction for a return on FF&E from income as well as a deduction of the invested capital from value is, as Rushmore concludes, to double count.”

Judge Pizzuto’s decision on this important hotel property tax issue totally supports all aspects of the Rushmore Approach while condemning the BEA approach as not being “persuasive either from theoretical or empirical reasons.” Hopefully, the various appraisal organizations that in recent years have suppressed the Rushmore Approach from their seminars and literature will now allow this time-tested methodology to again be part of every appraiser’s educational curriculum.

Lastly, and most importantly, hotel owners and lenders can breathe a little easier because it is now unlikely that the Appraisal Standards Board, who mandates proper appraisal methodology and standards, will impose the Business Enterprise Approach for all hotel appraisals, including mortgage loan appraisals. Just imagine what would happen to hotel economics if lenders could only lend on a hotel’s real property component representing just 36% of a hotel’s total value?

[Click here](#) to download a complete copy of Judge Pizzuto’s Marriott Saddle Brook decision. [Click here](#) for a copy of Rushmore’s article detailing the differences between the Rushmore Approach and the Business Enterprise Approach using actual data from the Marriott Saddle Brook trial (written prior to Judge Pizzuto rendering his decision).