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The Appeal of Tax Appeals

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“ If there is one saving grace to this downturn, it's that hotel owners can reap big savings by combating their property taxes.”

Interview with APTC Members, by Maria Wood - as published by [Hotels Interactive](#) - April 2010

The April 15 deadline for filing tax returns has passed. But for savvy hotel owners, an in-depth review—or possibly an appeal—of their property taxes could net a big refund.

As the lodging sector continues to bleed cash, more and more owners are pursuing property tax appeals to lessen what is typically one of a hotel's largest expense items. Yet while the reward in terms of a reduction can be great, the process is not easy, especially with many jurisdictions fighting to hang onto every last dollar of tax revenue during a lingering recession.

Hotel Interactive spoke to a trio of members of the American Property Tax Counsel (APTC), a national affiliation of attorneys that specialize in property tax appeals. All agree they are seeing more hotel owners fighting their property tax assessments.

“You are seeing significant drops in RevPAR, ADR and all the metrics that hoteliers look at,” relates Mark Hutcheson, a partner at Popp, Gray & Hutcheson L.L.P. in Austin, TX. “That, combined with assessing communities seeking to maintain their tax base, means you are necessarily going to come to a head.”

No income-producing property sector has escaped unscathed from the economic maelstrom. But hotels may have been hit hardest and therefore, owners are battling more aggressively now.

“What we are finding is that more hotel properties are actually litigating their values now than in the past,” Hutcheson says. “The reason why is because hotels—of all the different property types—have probably experienced the greatest decline in value, which is directly related to their drops in revenue.”

In fact, Fitch Ratings predicts that hotel property values may recede as much as 50% from their peak in 2007.

But just how do you value a hotel in a flat or declining market? The historical measurement of comparable property sales, which gives a snapshot of current cap rates, is of little value when few hotels are being sold these days. And to look back at sales completed at the height of the market distorts the present value of a lodging asset.

According to the APTC attorneys, there are myriad methods to value a hotel in a stagnant market, and they typically revolve around the all-important issue of what is an appropriate cap rate for a specific hotel in today's marketplace.

Stewart Mandell, a partner at Honigman Miller Schwartz and Cohn, L.L.P. in Detroit, says that he has used what is known as the income approach with great success in resolving valuation disputes between a taxpayer and a taxing authority.

According to Mandell, among the tools that use income and cash flows to determine a property's value are the direct capitalization and discounted cash flow methods.

In the direct capitalization method, a hotel's value is calculated by dividing the property's net operating income by an appropriate capitalization rate. In a discounted cash flow model, the net cash flow for each year during a given period is determined. Then, Mandell explains, the present value of each year's cash flow is added along with the current value of the property at the end of the period.

One point of contention between taxpayer and taxing jurisdiction is what revenue stream to use when valuing a property. According to Hutcheson, tax assessors may argue that 2009's poor showing was an aberration and that a property's stabilized income should be greater, more in the range of 2000-08 levels.

Conversely, taxpayers maintain that market conditions have changed dramatically for hotels and 2009 may end up being more of the norm than the peaks experienced in 2007 and 2008, Hutcheson says.

Due to the lack of meaningful sale transactions, Hutcheson's firm has recently applied the band of investment approach for determining cap rate. This formula usually yields hotel cap rates in the 10 to 12 percent range.

In that methodology, several factors are considered, such as the cost of debt and equity as well as what current loan-to-value ratios look like. However, Hutcheson points out that one of the disadvantages to the band of investment approach is the lack of market data for the equity dividend rate, or the return an investor would require on a down payment after debt services.

At the heart of that equation is whether a buyer thinks there is upside potential in a prospective acquisition.

“If, for example, the investor looks at a trailing 12-month income stream and thinks the property is going to do significantly better, then you'll end having a lower cap rate,” Hutcheson says. “The same is true if the assessor for 2009 were looking at a trailing 12-month income stream over the last 12 months of 2008. There would probably be downside potential in that cap rate, because going forward there was an expected decline.

“What most taxpayers are having struggles with now is how to develop a cap rate when there aren't any transactions, when the surveys [of cap rates] have very large spreads between buyers and sellers and where it's very difficult to relate that cap rate to whether there is upside or downside potential in the income stream,” Hutcheson continues.

As if that weren't enough to make valuing a hotel in today's environment more of a hair-pulling exercise, there is also the question of how to separate the worth of the tangible and intangible personal property from the actual value of the bricks and mortar.

Tangible and intangible personal property includes everything from a liquor license and the furnishings in a hotel to the estimated value of a management contract and brand affiliation.

“In some states, such as Michigan, personal property is taxed, so there is a calculation that the assessor comes up with in terms of valuing the personal property,” Mandell says. “That one, at least in Michigan, can be pretty easily agreed upon by the parties. But sometimes in those valuation issues, the analysis needs to be pretty sophisticated to give you some confidence that it's given you a number in the ballpark.”

In a down market, the issue of how to assess the business value of those tangible and intangible assets becomes particularly thorny, Hutchenson says. “The taxing jurisdictions will seek to allocate as much of the overall value as possible to the taxable value,” he says. “Of course, the taxpayers or the hoteliers will seek to allocate [out] as much as possible to mitigate their tax liability.”

In many instances, assessors use a cost approach to valuation by calculating the cost to build new and deducting physical depreciation, according to Mandell. A proper cost approach, however, requires also deducting any functional obsolescence (room types that are no longer desirable) and external obsolescence caused by the current economic downturn.

“Especially in a recessionary period, it's the economic obsolescence that causes so much of the loss in value,” Mandell explains. “If you look across the board at all sorts of properties, it's the economy that has driven the property values lower. Here in Michigan, we have such properties under appeal, virtually brand new hotels. They are built exactly to be what the market wants today, yet they're performing poorly because of the economy. So if an assessor values that property based on what it costs, less a little bit of physical depreciation, that property is going to be egregiously overvalued.”

So what can an owner do if he feels his property, as Mandell states, is egregiously overvalued? What can he expect to recoup if he decides to pursue an appeal? And how much of a pushback will he encounter from a taxing authority?

Much depends on the particular jurisdiction. Some will battle tooth and nail for every last dollar of tax revenue; others may be more open to negotiation.

"You are finding more taxing authorities challenging the appraisals to their assessments," Hutcheson says. "But by and large, most jurisdictions recognize that hotels have been hit hard. The issue is not that there is a decline, the issue is what the magnitude of that decline is. Most assessors and taxing units are obviously trying to hedge as much as possible to maintain their tax base. The issue boils down to negotiation."

For example, Hutcheson can present a cap rate of 11.5 percent using the band of investment approach based on a trailing 12-month income stream for a particular property. Meanwhile, the assessor might counter with a 9.5 percent cap rate, but based on a forecast.

Ultimately, settling on an agreeable value is more important than whatever method is used, Hutcheson finds.

Likewise, Kiernan Jennings, a partner with Siegel Siegel Johnson & Jennings Co. L.P.A. in Cleveland, says that a less adversarial stance may work best and get the taxpayer a resolution sooner. It's not uncommon for tax appeals to drag on for several years.

"When the taxing authorities are looking to hold onto their money longer because of their own circumstances, you need to find win/win solutions to the real estate tax problem," he says. "We've found that by working with the taxing jurisdiction we can come to a settlement that helps both the district and the taxpayer. You need to be creative and understand where [the taxing agencies] are coming from and vice versa. That speeds up the process."

In some instances, the taxing district may be willing to accept a lower assessment for tax purposes in future years in exchange for no break in payments due to a tax dispute. "By reducing the assessment for future years and possibly taking a credit on the reduction for the past year, you can help the tax district even out their budgetary constraints due to overall falling assessments," Jennings says. "If there is a wave of tax reductions coming, and you are able to get to a resolution sooner, you are actually helping the tax district."

Jennings estimates that a successful tax appeal can cut an owner's tax liability by at third of what it was several years earlier.

"If values have fallen by 30 percent and you were properly assessed previously, then you could expect you could reduce your taxes by about 30 percent," he maintains.

Mandell agrees owners can reap a hefty savings on their tax bills, but the exact percentage is hard to pin down.

"The vast majority of hotels that we are seeing need to be appealed because they are excessively taxed," he says. "But whether [the reduction] is 10, 20, 30 or even 50 percent, which we sometimes do see, it varies depending upon the profile of the property and in particular, the income."

Many hotel owners routinely review their property assessments. But all can benefit from hiring an appraiser or property tax attorney, even if the upfront cost is great. "In many jurisdictions, once you establish a value that value carries forward for future years," Hutcheson says. "So it could be the investment that keeps on giving if properly made now. And this is probably the best time to have a thorough, detailed analysis done simply because values are likely to be as low now as they have ever been, or at least over the past five or six years."

Since property tax laws vary from state to state, Mandell advises hiring an attorney that practices in the state where the hotel is located. Moreover, that attorney should be a skilled and experienced trial lawyer.

Equally as important as a skilled lawyer, an owner should find an appraiser who truly understands lodging real estate, Hutcheson adds.

But whatever assessment method is used or whomever the hotel owner hires as his attorney, undertaking, or at least considering, a tax appeal is simply good business.

"Especially these days, when everybody is very focused on the bottom line, it's imperative that people look at their property taxes," Mandell says. "To not appeal excessive property taxation is to throw money away. There is no difference. If you have a property that is excessively valued and excessively taxed, if a property owner doesn't appeal that, it's the same as throwing money away."



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