

# Perspectives

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Perspectives offers ideas, concepts and methodologies for property tax reductions

## Hotel Profits Down, Property Taxes Up

### How Savvy Owners Are Cutting Their Property Taxes

The hotel market experienced record high sales prices during the last several years, resulting in new highs for property tax assessments. Now, with the crisis in the credit markets prompting a market downturn, taxpayers must ensure that their assessments reflect current economic conditions, which indicate relatively flat or declining income projections and a limited number of sales.

Assessors tend to allow the high values to linger unless taxpayers take some action to bring their valuations in line with the market. Although taxpayers recognize the decline in the real estate markets, the typical assessor wants the taxpayer to show evidence of the drop. However, since the number of hotel sales has been reduced dramatically,

the taxpayer is left with little evidence to present to explain the market dynamics.

The two primary issues in valuing hotels for property taxes are determination of an appropriate cap rate and the meaning of hotel sales price. Clearly, the cap rates and sales prices seen in a fast rising market are not appropriate in a decreasing market. When the market turns quickly from hurtling upward to spiraling downward, assessments set just before the market begins to fall do not represent a fair picture of a property's market value in the crumbling market.

Particularly in the current market situation, it becomes incumbent upon taxpayers to educate the assessor in two critical areas, cap rates and sales prices.

#### Getting Proper Cap Rates

Since cap rate determination plays such a crucial role in the income approach, taxpayers need to understand and explain to the assessor the lag between cap rates from a hot market to a down market. This may seem obvious but is critical because of the lack of actual evidence of cap rates in the down market.

The lag is caused by valuation methods that focus on trailing income and expense as well as the use of cap rates from prior-year sales surveys. With a market in transition, assessors commonly err by using cap rates implied from prior sales in the rising market to capitalize current income streams, which show no upside potential for the property.

For example, assume a hotel, which was on the market in early 2007, had a prior-year net income of \$1 million and sold for \$15 million, resulting in a low cap rate of 6.6%. At the time of the sale, however, the buyer estimated that the net income would increase by 30% over the following year to \$1.3 million. Thus, the cap rate of 6.6% would be adjusted up to the "real" cap rate of 8.6% once the buyer's

anticipated upside is taken into consideration.

Now assume the same property is being assessed for tax year 2008. The assessor knows of the prior sale and has calculated the 6.6% cap rate, which he intends to use to value the property. Over the course of 2007, the buyer's expectations were exceeded and the property's net income grew to \$1.4 million. The assessor plugs the income information into his valuation model and calculates a whopping \$21.2 million for the hotel

As a result of the changing market conditions, however, the income projections are flat. If the lack of upside potential reflected in the market is considered, the assessor should have used the stabilized 8.6% cap rate. That would have resulted in a value of \$16.3 million, approximately a \$5 million difference in assessed value.

In addition, when interest rates increase due to the lack of commercial credit and with tighter underwriting standards, cap rates must go up to reflect these market conditions. Evidence of this increase, however, may be difficult to establish.

When the volume of sales transactions falls, the market extraction method, the one most used by assessors, becomes less reliable as there are fewer transactions from which to develop an appropriate market cap rate. One possible solution to the problem is building up the cap rate through a band-of-investment analysis, wherein a return of and on the debt and equity components can be independently established.

### Proper Use of Sales Prices

Assessors view the sales comparison approach as a reliable method for valuing hotel property. They argue that since few sales take place in a down market, they must demonstrate market value by using the only sales they have, the hot market sales. A taxpayer should not let this misguided logic prevail, since hotel sales rarely reflect the market value of a hotel for property tax purposes in a good market or bad one.

The education of the assessor concerning sales prices begins with the fact that most hotel transactions represent the sale of the total assets of the business, meaning they include not just the real property but the tangible and intangible personal property, too. Although some assessors will attempt to adjust the sales price of an operating hotel to

reflect the value of only the real estate, it is a near impossible task without access to actual income data.

The difficulty arises when assessors try to value franchise affiliation, restaurants, spas and reputation (the operating business), and separate it from the real estate value. Such adjustments are too speculative to be credible. In fact, appraisal texts suggest that the sales comparison method has little, if any application to a hotel property tax valuation other than as a check on the conclusions reached by more appropriate methodology.

By giving assessors an understanding of the market realities of cap rates and sales prices, taxpayers vastly improve their chances to obtain property tax reductions.

American Property Tax Counsel (APTC) is the only national affiliation of property tax law firms in the U.S. and Canada. Our member firms have represented more than 200 of the Fortune 500 and over 25 of the 50 largest REITs in property tax appeals at the administrative level and in the courts. The organization focuses on developing cutting edge strategies to reduce property taxes and works at state and local government levels to push these new concepts to acceptance.

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## APTC Firm Contacts

Our members would be more than happy to answer any questions you may have or to discuss any issues brought to mind by this Newsletter. Please call or email your local APTC member firm listed below:

### Alabama

DonovanFingar, LLC  
W. Howard Donovan, Esq.  
Phone: 205-414-1200  
E-mail: whd@donovanfingar.com

### California

John D. Cahill, Esq.  
Cahill, Davis & O'Neill, LLP  
Phone: 213-622-0600  
Email: jdc@cahilldavis.com

### Connecticut

Elliott B. Pollack, Esq.  
Pullman & Comley, LLC  
Phone: 860-424-4340  
E-mail: ebpollack@pullcom.com

### District of Columbia

Stanley J. Fineman, Esq.  
Wilkes Artis, Chartered  
Phone: 202-457-7829  
E-mail: sfineman@wilkesartis.com

### Florida

Jeffrey L. Mandler, Esq.  
Berman Rennert Vogel & Mandler, P.A.  
Phone: 305-577-4177  
E-mail: jmandler@brvmlaw.com  
Jeffrey Mandler has concentrated his law practice in the ad valorem tax area for 28 years.

### Georgia

Lisa F. Stuckey, Esq.  
Ragsdale, Beals, Seigler, Patterson & Gray, LLP  
Phone: 404-588-0500  
Email: lstuckey@rbspg.com

### Idaho

Norman J. Bruns, Esq.  
Garvey Schubert Barer  
1191 Second Avenue, Suite 1800  
Seattle, WA 98101-2939  
Phone: 206-464-3939  
E-mail: nbruns@gsblaw.com

### Illinois

James P. Regan, Esq.  
Fisk Kart Katz and Regan, Ltd.  
Phone: 312-726-1833  
E-mail: jregan@proptax.com

### Indiana

Stephen H. Paul, Esq.  
Baker & Daniels LLP  
Phone: 317-237-0300  
Email: stephen.paul@bakerd.com

### Kansas

Linda Terrill, Esq.  
Neill, Terrill & Embree, L.C.  
Phone: 913-814-8900  
Email: lterrill@taxappealfirm.com

### Maine

David G. Saliba, Esq.  
Saliba & Saliba  
Phone: 617-227-8640  
Email: davidg@attysaliba.com

### Maryland

Eric S. Kassoff, Esq.  
Wilkes Artis, Chartered  
Phone: 202-457-7805  
Email: ekassoff@wilkesartis.com

### Massachusetts

David G. Saliba, Esq.  
Saliba & Saliba  
Phone: 617-227-8640  
Email: davidg@attysaliba.com

### Michigan

Michael B. Shapiro, Esq.  
Honigman Miller Schwartz and Cohn, LLP  
Phone: 313-465-7622  
Email: mshapiro@honigman.com

### Minnesota

John Gendler, Esq.  
Smith, Gendler, Shiell, Sheff, Ford & Maher, P.A.  
Phone: 612-332-1000  
E-mail: jgendler@proptaxlaw.com

### Mississippi

Christopher S. Pace, Esq.  
Watkins, Ludlam, Winter & Stennis, P.A.  
Phone: 601-949-4900  
E-mail: cpace@watkinsludlam.com

### Missouri

Jerome Wallach, Esq.  
The Wallach Law Firm  
Phone: 314-997-4050  
E-mail: jwallach@wallachlawfirm.com

### New Hampshire

David G. Saliba, Esq.  
Saliba & Saliba  
Phone: 617-227-8640  
E-mail: davidg@attysaliba.com

### New Jersey

John Garippa, Esq.  
Garippa, Lotz & Giannuario  
Phone: 973-744-1688  
E-mail: john@taxappeal.com

### New York State (Excluding NYC)

Michael Martone, Esq.  
Koeppl Martone & Leistman, L.L.P.  
Phone: 516-747-6300  
E-mail: mmartone@taxcert.com

### New York City

Joel R. Marcus, Esq.  
Marcus & Pollack, LLP  
Phone: 212-490-2900  
E-mail: jmarcus@marcupollack.com

### North Carolina

Charles B. Neely, Jr., Esq.  
Williams Mullen  
Phone: 919-981-4007  
E-mail: cneely@williamsmullen.com

### Ohio

Fred Siegel, Esq.  
Siegel Siegel Johnson & Jennings Co.,  
L.P.A.  
Phone: 216-763-1004  
E-mail: fsiegel@siegeltax.com

### Oklahoma

William K. Elias, Esq.  
Elias, Books, Brown & Nelson, P.C.  
Two Leadership Square  
211 North Robinson, Suite 1300  
Oklahoma City, OK 73102-7149  
Phone: 405-232-3722  
E-mail: wkeliass@eliasbooks.com

### Oregon

David L. Canary, Esq.  
Garvey Schubert Barer  
Phone: 503-228-3939  
E-mail: dcanary@gsblaw.com

### Pennsylvania (Eastern)

John Garippa, Esq.  
Garippa, Lotz & Giannuario  
Phone: 215-665-5657  
E-mail: john@taxappeal.com

### Pennsylvania (Western)

J. Kieran Jennings, Esq.  
Siegel Siegel Johnson & Jennings Co.,  
L.P.A.  
Phone: 412-486-2848  
E-mail: kjennings@siegeltax.com

### Rhode Island

David G. Saliba, Esq.  
Saliba & Saliba  
Phone: 617-227-8640  
E-mail: davidg@attysaliba.com

### Tennessee

Andrew H. Raines, Esq.  
Evans & Petree PC  
Phone: 901-525-6781  
E-mail: araines@evanspetree.com

### Texas

Raymond Gray, Esq.  
Popp, Gray & Hutcheson, LLP  
Phone: 512-473-2661  
E-mail: raymond.gray@property-tax.com

### Virginia

Ilene Baxt Boorman, Esq.  
Wilkes Artis, Chartered  
Phone: 202-457-7806  
E-mail: ibaxt@wilkesartis.com

### Washington

Norman J. Bruns, Esq.  
Garvey Schubert Barer  
Phone: 206-464-3939  
E-mail: nbruns@gsblaw.com

### Wisconsin

Alan Marcuvitz, Esq.  
Michael Best & Friedrich LLP  
Phone: 414-271-6560  
E-mail: ahmarcuvitz@michaelbest.com