today's hotelier

Do your homework

Value associated with a hotel's flag is nontaxable. So, how do you calculate it?

by ANDREW CHOY *and* MICHAEL MILLER

AS MANY INDUSTRIES CONTINUE TO RECOVER FROM THE PANDEMIC, HOTELS ARE DEALING WITH SIGNIFICANTLY diminished revenue, searching for any good news they can find. Fortunately, the industry is seeing a continued evolution in the accepted methodologies for property tax valuation, which is changing the way hotels are being taxed and can drastically improve a hotel's bottom line.

A hotel's valuation for ad valorem taxation purposes is unique, complicated, and highly challenging to even the best tax attorneys or consultants. A significant portion of a hotel's value lies in its flag, and RevPAR is likely to drop significantly when its brand is removed. However, for ad valorem taxation, only real properties and tangible business properties are subject to tax. Real properties include land and improvements, and tangible business properties can include furniture, fixtures, and equipment. The value associated with a hotel's franchise, such as trade names, goodwill, franchise contracts, customer base, quality control, management skill, marketing, etc., are legally defined by law as intangible assets, which are exempt from ad valorem taxation in all 50 states.

SHORTCOMINGS

The problem many hotel owners encounter is most tax assessors, tax consultants, and hotel management companies don't know the difference between total market value and taxable market value. Practitioners generally agree that intangible value exists in hotels, but there's no general agreement regarding how to estimate the value of intangible assets. Perhaps the most controversy in property tax law today is the dispute between taxpayers and tax authorities over the existence, quantification, and application of business value vs. real and tangible personal property value of a going concern. For years, the hotel and property tax consulting industries have been searching for a logical solution to this debate.

The method used by most tax assessors, the Rushmore approach, measures the value enhanced by a hotel's flag by the amount of management and franchise fees paid to the franchisor. The flaw with this method, and one that many courts have commented on or ruled against the tax assessors, is that it fails to take into account an economic ROI because no rational economic investor would franchise their business or hire management to earn merely a return of their investment. There needs to be an adjustment to gross income for intangible value prior to making the expense deductions.

Another existing method, the business enterprise approach, used by many tax consultants, identifies significantly more intangible business enterprise value associated with an ongoing hotel's franchise. However, that approach has been frequently disputed by tax assessors for double dipping in revenue and expenses. Until the conflict is resolved, hotel owners will continue overpaying property taxes year after year.

FINDING VALUE

It's clear that an alternative solution is necessary. So, after years of research and development, the O'Connor Approach was created. This method uses historical data, if available, or uses comparable brands and classes where data is unavailable, to measure a brand's contribution to a hotel's performance. It's measured by quantifying the change in revenue that occurs when a brand is added, removed, or when it's compared to other brands or classes of hotels. After deducting all payments made to franchisors, the net gain clearly defines the intangible value of the brand. By separating the nontaxable portion from the total market value, property taxes can be drastically reduced.

The O'Connor Approach has been tested successfully at tax appeals

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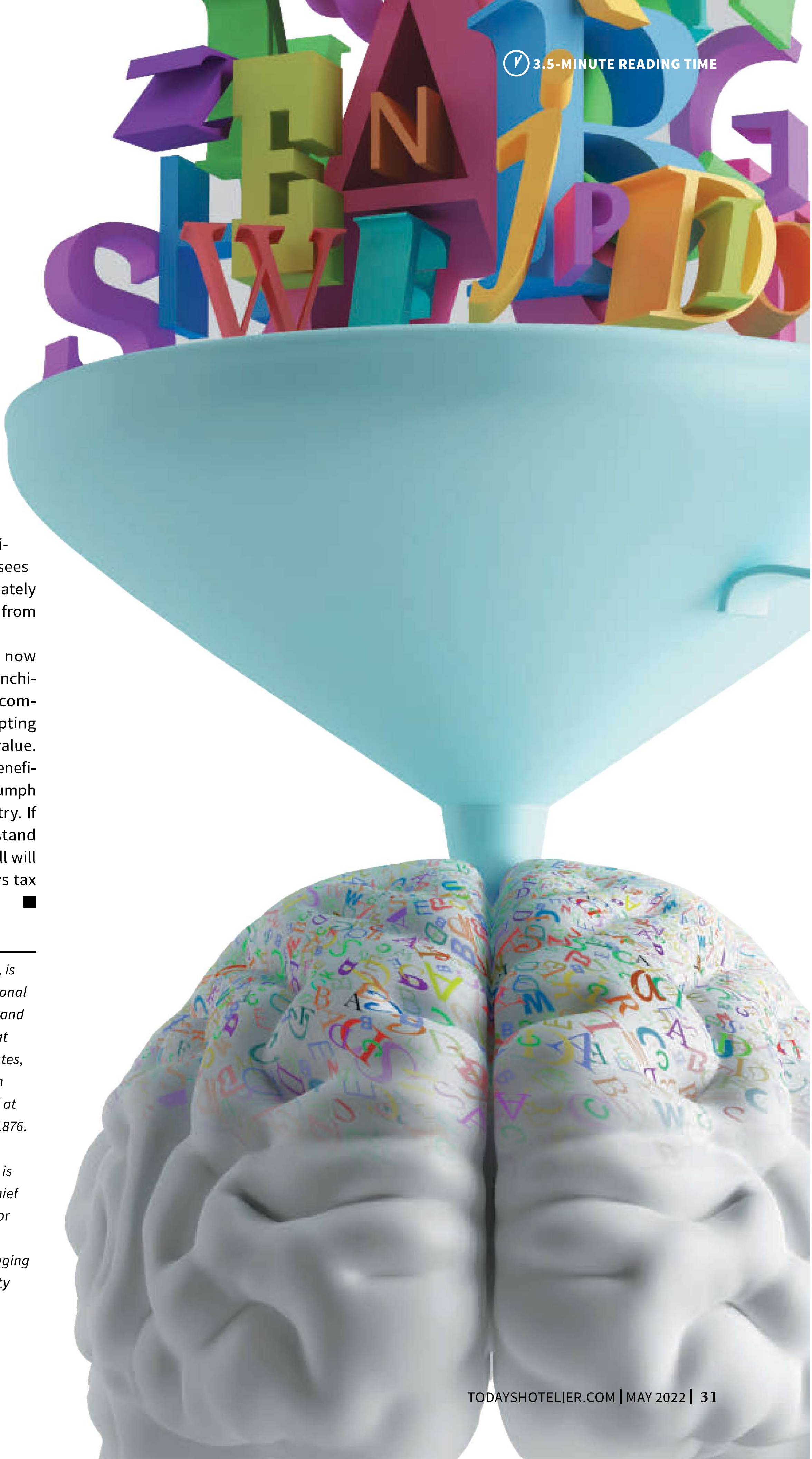

3.5-MINUTE READING TIME

in multiple states. A landmark court case may have opened the door to hoteliers in future property tax appeals. The Utah States Tax Commission issued its ruling on March 7, 2022, against the tax assessor in favor of an upper mid-scale hotel using the O'Connor Approach in his argument, resulting in a 32% tax reduction.

But, regardless of what approach hoteliers choose to utilize, it's imperative that franchisees do their homework and adequately assess the value they're getting from their brands.

Many hotel franchisors are now joining the ride to help their franchisees, but hotel management companies have been slow in adapting new methodologies to assess value. Sooner or later, though, what's beneficial for the hotel industry will triumph across all sectors of the industry. If the entire hotel industry can stand together in a united front, we all will see drastic changes in the ways tax assessors are taxing hotels. ■

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