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New Breakthrough Approach intended to settle the Dispute between the *Rushmore Approach* and the *Business Enterprise Approach* in Hotel Appraisals for Ad Valorem Taxation

by Patrick O'Connor, MAI, Mike Miller, MAI, and Andrew Choy -

Property tax authorities determine the market value of hotel and lodging properties, and many other income producing properties, by considering the rental income of businesses. Income Approach is widely accepted as the most appropriate methodology to value income producing properties because investors determine their market values based on past, current, or projected income generated by the rental of the property, and the cash flow derived from such rental income.

Practitioners generally agree that intangible value exists in hotels. However, there is no general agreement regarding how to estimate the intangible value. Perhaps the most significant controversy in property tax law today is the dispute between taxpayers and tax authorities over the existence, quantification, and allocation of business value versus tangible real and business personal property value of a going concern. This controversy arises because the business value of intangible property, such as a hotel's franchise, trade name, goodwill, etc. is exempt from ad valorem taxation.

Specifically, the major dispute lies on two different approaches: the *Rushmore Approach* widely used by tax authorities, and the *Business Enterprise Approach*, or commonly known as BEA, applied by taxpayers and their consultants or attorneys.

The *Rushmore Approach*

The *Rushmore Approach* is a model of hotel valuation developed by Stephen Rushmore. It is based on the theory that separating the business component by deducting management and franchise fees from the hotel's stabilized net income, it has given consideration for the intangible business value of the hotel. Put in another way, if the Subject is a Hilton hotel, Rushmore asserted that the intangible business value of a Hilton hotel is no more than the total franchise fees and management fees paid to Hilton. There is Net Zero Gain in purchasing the Hilton franchise? This is an obvious flaw in the Rushmore methodology which led to numerous court challenges across the country.

Walt Disney Parks and Resorts V. Orange County Tax Assessors – Florida Case No, 5D18-2927

In June 2016, Disney sued Orange County Property Appraiser claiming they overvalued 14 properties for tax year 2015 which included hotels, resorts, and theme parks. Below are excerpts from an opinion issued by the 5th District Court of Appeals, State of Florida on August 7, 2020:

> "Even if the *Rushmore method* was a professionally accepted appraisal practice, it could not be used in a manner that violated Florida law."

> “The *Rushmore method* failed to account for an economic **Return On Investment** because no rational economic actor would franchise their business or hire management to earn merely a **Return Of** their **Investmen**t; they would do so to earn a profit on their investment.”
>
> “The Florida Constitution specifically prohibits counties from levying ad valorem taxes on intangible personal property. Pursuant to article VII, section 4 of the Florida Constitution, no assessment shall exceed just value.”
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> “We agree with the trial court that Appraiser, in the manner in which he applied the Rushmore method, impermissibly included the value of Disney’s intangible business assets in its assessment. That application requires franchise and management fee expenses to be deducted from the total property income, which purportedly removes the business value from the assessment. However, it does not provide for adjustments to the gross business income for intangible business value prior to making those expense deductions. By taking a percentage out of a business’s net income for management and franchise fee expenses, without first removing intangible business value from that gross income stream, the *Rushmore method* does not remove all business value from an assessment.”
>
> The Court remanded the case to the trial court, with instructions that it remand to Appraiser for a reassessment of the Property consistent with its opinion. The case was later settled in April 2021 through mediation, resulting in tax refunds of approximately $1.3 million for each of the tax year 2015 through 2020 to Disney.

SHC Half Moon Bay v. County of San Mateo, California

In 2014, Ritz Carlton Half Moon Bay Hotel challenged the tax assessment value set by the County of San Mateo, California. It asserted the value of the hotel’s real property was erroneously inflated by the nontaxable intangible assets. The case was ultimately appealed to the Superior Court of the County of San Mateo. Below are excerpts from the Opinion issued by the Superior Court against the county assessor:

> “The California Constitution requires generally the assessment of property at “fair market value” … “Intangible assets and rights are exempt from taxation and shall not enhance or be reflected in the value of taxable property.”
>
> “In *Elk Hills*, the California Supreme Court clarified which intangible assets and rights have a quantifiable fair market value that must be deducted from an income stream analysis prior to taxation pursuant to California Revenue and Tax Code, sections 110 and 212.” As the court explained, “intangible assets like the goodwill of a business, customer base, and favorable franchise terms, or operating contracts all make a direct contribution to the going concern value of the business as reflected in an income stream

> analysis" and have "a quantifiable fair market value that must be deducted from an income stream analysis prior to taxation."
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> "Applying a de novo standard of review, we concluded the income approach used by the Assessor and approved by the Board of Equalization to assess the hotel violated California law because it failed to attribute a portion of the hotel's income stream to the enterprise activity that was directly attributable to the value of intangible assets and deduct that value prior to assessment."
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> "The issue is not whether the assessor misunderstood or distorted the available data, but whether he or she chose an appraisal method which by its nature was incapable of correctly estimating market value."
>
> "The Assessor's expert conceded that the *Rushmore Approach* deducting management and franchise fee expenses did not account for the intangible value of the property."

The court concluded that the assessment, conducted using the *Rushmore Method,* failed to exclude certain intangible assets, which violated California law. The California State Board of Equalization's Assessors' Handbook stated, "The value of intangible assets and rights cannot be removed by merely deducting the related expenses from the income stream to be capitalized. Allowing a deduction for the associated expenses does not allow a return on the capital expenditure." The Assessor did not follow the guidelines set forth in his own Handbook.

The *Business Enterprise Approach*

The *Business Enterprise Approach* ("BEA") method was developed by David Lennhoff. BEA points out there is significantly more intangible business enterprise value associated with an ongoing hotel's franchise than the franchise and management fees identified by the *Rushmore Approach*. Under its theory, the nontaxable intangible business value is estimated by the percentage of income increase derived from the hotel's franchise, trade name, goodwill, management, etc. Such estimated business value is removed from the direct income capitalization analysis to reach at the taxable real property value. Taxpayers and many tax consultants highly endorsed this Approach because it reduces the taxable real property value significantly.

Many tax assessors, and many Board of Equalizations across the nation, disputed the BEA method. They claimed BEA moves a disproportional share of a hotel's value out of the real property component, thereby significantly reducing a hotel property tax assessment. Opponents of BEA also claimed that by removing substantial revenue generated by intangible assets, and then further deducting franchise and management fees from the operating expenses, BEA essentially "double dipping" on the nontaxable business enterprise value.

In Defense of the "Rushmore Approach" by Stephen Rushmore

Stephen Rushmore issued a 17-page article to defend his *Rushmore Approach*. Here are excerpts from page 1 of this article:

> "I have been asked by many of my appraiser colleagues who specialize in valuation of hotels and motels and view the *business enterprise approach* as a real threat to the future of asset-based hotel mortgage financing to write this defense of the *Rushmore Approach*.
>
> The real issue is not the huge reduction in the value of the real property component used for tax assessment purposes, but the possible reduction in, mortgage asset security that lenders reply upon when making hotel loans. If the BEA is universally mandated for all hotel appraisals, it could severely restrict hotel owners from leveraging their acquisitions,
> which could lead to a significant decline in hotel values. During my 30-year career as a hotel appraiser and investor, I have worked with thousands of hotel owners, operators, and lenders. I do not know of any industry participant who utilizes the procedures set forth in the BEA for evaluating a hotel acquisition or determining market value for purchase or financing."

The *O'Connor Approach* © intended to settle the differences

O'Connor, Miller, and Choy analyzed the above findings. The dispute between the *Rushmore Approach* and the *Business Enterprise Approach* appears to be limited to ad valorem taxation purpose only. No one disputed the total market value for hotel acquisition or hotel financing, which appears to be Mr. Rushmore's main concern. In applying any valuation method, intangible assets must be excluded because they are generally not subject to direct property valuation. The key issue is not whether the assessors used a valid methodology, but whether the assessor subtracted an adequate value for intangible assets from the income stream of a hotel.

The intangible assets and rights have a quantifiable fair market value that must be deducted from an income stream analysis prior to taxation. While the *Rushmore Approach* may have failed to account for all the nontaxable business value associated with a hotel's flag, the *Business Enterprise Approach* may have placed too much on such value.

The *O'Connor Approach* ©, also known as the *Choy Methodology* (©2020 TX8-914-633), was originally created by Andrew Choy, Director of National Hotel Property Tax, and a senior property tax consultant with O'Connor & Associates ("O'Connor"). Choy asserted that the intangible business value of a hotel property can be quantified and measured if adequate historical data is available. Even if such data is unavailable, properties can be assigned a value based upon the most comparable brands and classes where data is available. *The O'Connor Approach* © measures a brand's contribution to a hotel's performance by quantifying the change in revenue that occurs when a brand is added, removed, or comparing to other brands or classes of hotels. O'Connor collects Average Daily Rates ("ADR"), average occupancy rate, and total franchise fees of various classes of hotels in local markets from various reliable sources.

Table 1 shows an example of an upscale hotel in a major market based on data collected from that market. Analysis of this hotel indicated ADR increased from $118 to $129, occupancy increased from 62% to 69%, RevPAR increased from $73.16 to $89.01 or 21.66% incremental increase in revenue generated by this hotel flag.

Table 2 shows total franchise fees for this hotel at 11.3% of income. Total franchise fees, which include royalty fees, marketing fees, management fees, loyalty fee, sales fees, initial fees, and other miscellaneous fees, represent the net increase in expenses associated with the flag.

Table 3 shows Intangible business value calculation: 21.66% incremental increase in revenue, less 11.3% incremental increase in expenses, equals to 10.36% Net Gain associated with the intangible assets. Such intangible business value is nontaxable and must first be removed from the revenue stream before taxation.

Table 1

Upscale Hotels
Average with / without Flag

	Without Flag	With Flag	% of Revenue
ADR	$118	$129	
Occupancy %	62	69	
RevPAR	$73.16	$89.01	
Average Revenue Increase		$15.85	21.66%

ADR = Base Year Average Daily Rate
Occupancy = Stabilized occupancy %
RevPAR = ADR x Occupancy %
Total Revenue = RevPAR x # of rooms x 365 days

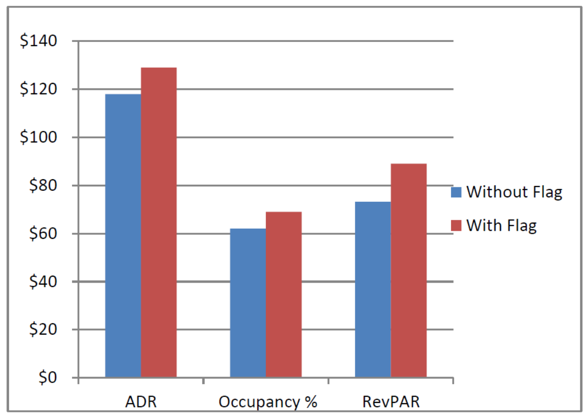
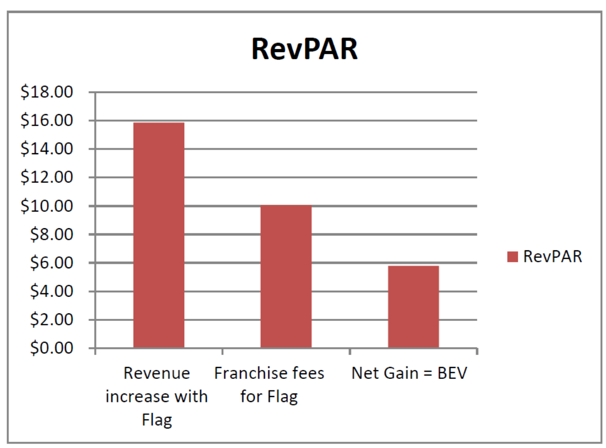


Table 2

	RevPAR	% of total revenue
Revenue increase with Flag	$15.85	21.66%
Franchise fees for Flag	$10.06	11.30%
Net Gain = BEV	$5.79	10.36%

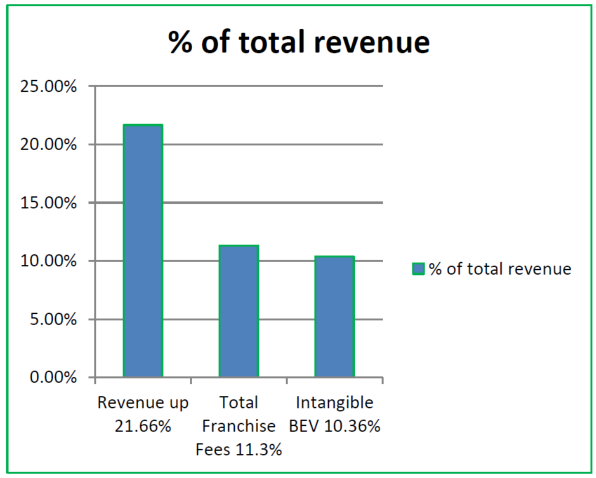


Total franchise fees include royalty fees, marketing fees, frequent traveler program, sales/reservation fees, initial fee & misc fees

Table 3

BEV = Nontaxable Intangible Business Value

Data Sources:
STR
HVS
CBRE Hotel
Enriched Data
Hotel Associations
Owner Surveys
Franchisors
Others



As illustrated in Table 1, 2 and 3, the percentage change in revenue per available room ("RevPAR") is determined by multiplying ADR by the average occupancy rate. The incremental change in operating expenses associated with the hotel flag is measured by the total franchise and management fee payable to the franchisor in percentage of income. The *O'Connor Approach* © calculates the intangible business value of a hotel's flag by the Net Gain (incremental increase in Revenue less Incremental increase in Expenses). It accounts for the additional Return On Investment missing from the *Rushmore Approach*. On the other hand, since franchise and management fees are excluded from the Net Gain formula, there is no more "double dipping", as the *Business Enterprise Approach* was alleged.

Arkansas Saline County Court Judge ruled against tax assessor

Saline Hospitality, LLC. engaged O'Connor to appeal the 2021 assessment value of $2,106,250 of a Days Inn motel in Benton, Arkansas. At the administrative level hearing, the Board of Equalization sided with the assessor's value. On appeal to the County Court, Property Owner's consultant, and his legal counsel presented the argument using the O'Connor Approach against Assessor's Rushmore Approach. Saline County Judge Jeff Arey ruled against the Assessor. His decision issued to the Property Owner stated: "Pursuant to the provisions of Ark. Code Ann. Sec. 26-27-317 and Sec. 26-27-318, a hearing on your appeal from the decision of the Saline Equalization Board's assessment of the property owned by Saline Hospitality, LLC was held on November 2, 2021in County Court. After hearing the facts and testimony, it is my decision to find the true and correct value of the property for ad valorem purposes at $1,078,900." The assessed value was reduced by 49% when applying the O'Connor Approach on income valuation.

Arkansas Faulkner County Judge ruled in favor of hotel owner

Nisha, LLC, owner of Country Inn Hotel in Conway, Arkansas, engaged O'Connor to appeal 2019 assessment $2,691,500 market value. At the administrative hearing, Faulkner County Equalization Board raised the value even higher to $2,999,307. On appeal to the County Court, Property Owner's consultant and his legal counsel presented the argument using the O'Connor

Approach against Assessor's Rushmore Approach. An appraisal report, separating the business enterprise and FF&E values from real property value was submitted into evidence. Mike Miller, MAI appraiser with Property Analytics, LLC was the expert witness testified for the Property Owner. He pointed out as much as $520,000 of the value was intangible business value under the O'Connor Approach theory. After hearing the facts and testimony, Judge Jim B. Baker ruled against the tax assessor and set the market value at $2,500,000, which was in line with the evidence presented by Owner's representatives.

In conclusion, the *O'Connor Approach* © may have resolved the flaws in both Rushmore and Business Enterprise Approaches. Under the O'Connor Approach, the intangible business value is appropriately calculated in a most logical and understandable manner. It lies between the values derived from both Rushmore and Business Enterprise approaches. Since the adaptation of the breakthrough *O'Connor Approach* © at property tax appeal hearings, it has widely gained acceptance by many tax assessors and Board of Equalizations across the nation.