

Loading The Cap Rate For Hotel Tax Appeals: Useful Tool Or Dangerous Weapon? - By David C. Lennhoff, MAI, SREA, CRE  
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Many tax assessors value hotels employing an income approach developed by using direct capitalization. This method converts an estimate of one year's net operating income for the real property into an indication of market value by dividing the income by an overall capitalization rate.

The capitalization or 'cap' rate must reflect the appropriate level of risk as well as the anticipated growth in income and value over the investment holding period. Because the purpose of the analysis is to establish the correct basis for the tax assessment, the actual taxes can't be used in the income and expense reconstruction. Instead, the appraiser calculates the net operating income by subtracting all other expenses from the effective gross income, and then adds the tax rate to the overall capitalization rate. By dividing this rate into the otherwise 'net' income, the value will reflect exactly the appropriate level of real estate tax expense as a function of the properly estimated market value. Seems easy enough and it is accurate as long as the methodology is followed to a tee. As will be demonstrated, however, when the method is misapplied the assessor often ends up taxing the intangible and tangible personal property.

Loading the cap rate can actually accommodate any expense item that can be expressed as a percent of the total property value. For example, suppose management fees were \$23,750 or 5% of effective gross income (collected income) and the appropriate capitalization rate was 10%. Assuming net operating income was \$285,000 with a deduction for management fees, the value would be \$2,850,000 (\$285,000 divided by 10%). Now, suppose instead of deducting the \$23,750 management expense we added the percent of value it represents (\$23,750 divided by \$2,850,000 equals .008333) to the cap rate, and then divided that rate into the net income before deducting the \$23,750. The answer, \$308,750 (285,000 plus \$23,750) divided by .108333 (10% plus .008333) equals the same \$2,850,000! Multiplying the .008333 times the value so developed indicates management fees of \$23,750 (\$2,850,000 times .008333 equals \$23,750).

Real estate taxes are a particularly good match for this analysis because they are expressed as a % of total value. By loading the cap rate, you calculate the taxes that would be appropriate for the correct value estimate, rather than the actual taxes, which are the subject of the analysis and may or may not be based on the correct value. The actual taxes will exactly equal the taxes indicated by a loaded cap rate if they have been based on a percent of the correct market value.

So, how can an assessor go wrong when using the loaded cap rate method to value a hotel property? The easiest way to illustrate how is to look at a typical assessment application. Suppose the assessor has identified the value of the furniture, fixtures and equipment for a 300 unit hotel to be \$25,000 per key. Total value would be \$7,500,000 (300 keys times \$25,000). Often the assessor will calculate the net operating income before real estate taxes, then divide it by a loaded capitalization rate then subtract the \$7,500,000 tangible personal property to get his indication of the market value of the real property. The problem is, by approaching the valuation in this way he has calculated taxes based on the value of the real property and the personal property. In other words, he has taxed the personal property. Let's demonstrate the error with a simple example.

**ASSUME:**

Net Operating Income, before either real estate taxes or FF&E: \$5,250,000

Assessor's estimate of value of tangible personal property (FF&E) \$7,500,000

Overall Capitalization Rate 10%

Real Estate Tax Rate (\$6.00 per \$1,000) .006

Assessor's Real Estate Tax calculation:

Net Operating Income divided by Overall Cap Rate

$\$5,250,000 \div .1006 = \$52,186,878$

Minus FF&E - \$ 7,500,000

Value of RE = \$44,686,000

The problem with this valuation is that it has been based on real estate taxes of \$313,121, which includes taxing the FF&E. A more appropriate model would look as follows:

Net Operating Income, before a deduction for real estate taxes or FF&E: \$5,250,000

Less return on and off FF&E (12% yield, 8 years) \$1,509,771

Net Operating Income before real estate taxes \$3,740,228

Market Value of the Real Estate ( $43,740,228 \div .1006$ ) \$37,179,211

Taxes at \$6.00 per \$1,000 would be \$223,075.

Any other elements of the total assets of the business that have not been properly accounted for will exaggerate the error. If, for example, the assessor has not accounted for business value, then by using a loaded cap rate he will be inappropriately including taxes on business value in the assessment.

There is a good chance for error any time the assessor is using this method of accounting for the real estate taxes. More often than not loading the cap rate is not done correctly, and the real estate taxes so developed are wrong. Be vigilant. When you see this methodology, be prepared to explain the issues and have the assessment corrected.

*1 This annual deduction accounts for the return of the \$7,500,000 FF&E value and a 12% return on it over the anticipated 8 year life.*

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