

Reduce Property Taxes By Using the Cost Approach - By Mark Hutcheson

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The valuation of hotels for property taxes has always been a difficult process. The increasing sales prices of hotel properties and increasing hotel REVPARs over the past several years have made the process even more difficult. The tax assessor response to these increases has resulted in ever increasing value for property taxes purposes and, thus, ever increasing tax bills.

Hotel owners traditionally addressed property tax valuations through the use of the income approach. This calls for capitalizing the net income produced by the operating property and then allocating the value among the real estate, personal property and business enterprise components. The use of the income approach in the face of increasing sales prices generated considerable push-back from tax assessors because of their discomfort with the resulting allocation of ever increasing amounts to the business enterprise portion of the going concern.

Thus, many owners now find it useful to step back and approach the issue from a different valuation perspective. They often employ the cost approach, which has proven to be a useful tool in discussions with tax assessors. Over the last 10 to 15 years, the cost approach fell into disuse for valuing hotels for property taxes. Two factors influenced the decision not to use the cost approach: 1) Investors do not give much consideration to the cost approach in determining the purchase prices of hotel properties and 2) It is difficult to measure economic obsolescence attributable to the real estate. While both of these factors are correct, they do not negate the potential use of the cost approach.

A quick review of basic hotel cost information from Marshall & Swift (a recognized source of cost information for appraisers and tax authorities) may indicate whether the cost approach will be useful. This information shows that construction cost ranges from \$84 to \$139 per square foot for Class A limited service hotels to \$99 to \$195 per square foot for Class A full service hotels.

If the preliminary review of Marshall & Swift data reveals a potential for the use of the cost approach, a more detailed cost analysis may be in order. The cost approach is one of the three generally accepted approaches to value. A traditional cost approach involves the following steps:

1. Estimate hard and soft costs of the improvements,
2. Estimate entrepreneurial incentive,
3. Estimate accrued depreciation involving physical deterioration, functional obsolescence and external obsolescence,
4. Estimate contributory value of land and site improvements.

These steps result in an estimate of the market value of the real estate portion of the hotel business's total assets. Generally, the cost approach is considered to represent the upper-end of value when appraising real property.

The following example demonstrates the usefulness of the cost approach as provided by a property tax appraisal of a full service convention type hotel. The appraisal valued the total assets of the business at \$200 million and the cost prior to depreciation at \$150 million. The appraiser ascertained that due to the size and location of the hotel, there were a limited number of potential operators. Consequently, his appraisal determined economic obsolescence at over \$50 million. This resulted in significant tax savings for the owner.

Thus, owners should give careful consideration to the use of the cost approach for valuing hotels for property tax purposes. With profits at record levels and sales at historically low cap rates, the income and sales comparison approaches create difficulties for assessors. Since tax authorities are comfortable with the cost approach, which they use regularly on other properties, this approach is very useful, especially because a hotel's profitability is not a consideration under the cost approach and the approach necessarily excludes intangible business value.

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