Flawed Florida Court Decision Could Affect Hotel Valuations

The monograph "The Valuation of Hotels and Motels" by Stephen Rushmore, published by the American Institute of Real Estate Appraisers in 1978, posited the first accepted methodology for separating out income attributable to business ("intangible asset") and income attributable to personal property from the entire income stream of a lodging facility. The procedure, which to this day continues to reflect the thinking and actions of hotel sector market participants, has been termed the "Rushmore Approach" within the property tax arena.

On June 19th, 2020, The Florida Fifth District Court of Appeal issued a flawed decision that could result in far reaching implications relative to the market valuation of hotel properties throughout the U.S. The Case (No. 5D18-2927), *Rick Singh, As Property Appraiser* ("Appraiser") *vs. Walt Disney Parks and Resorts US, Inc., et al* . ("Disney"), involved a tax appeal of the 2015 assessment of the Disney Yacht & Beach Club Resort in Orlando, FL. The appellate court reversed the trial court's assessment of property value based upon lack of evidence; however it did uphold the lower court's decision to reject the valuation methodology (Rushmore Approach) utilized by Rick Singh, As Property Appraiser (Orange County Property Appraiser) in connection with its assessment of the Disney Yacht & Beach Club Resort. The appellate court ultimately agreed with Disney and the lower court by categorically rejecting the challenged assessment methodology utilized by Rick Singh, As Property Appraiser in its valuation of hotel properties. Although utilized by other Florida County Property Appraisers, the appellate court opinion declared that *"the Rushmore Approach violates Florida law because it does not remove the nontaxable, intangible business value from an assessment*."

The appellate court instructed that a revision of the assessment of the Disney Yacht & Beach Club Resort utilize an income approach analysis that considers hypothetical rental rates for ancillary revenue sources such as restaurants, bars, meeting/convention space, retail stores, parking facilities, and spas at the subject property. Essentially, the decision implied that including this type of ancillary income (aside from rooms) in the projection of total hotel revenue includes a business enterprise component which would overstate the value of the real property. For example, the court is suggesting that when attempting to establish the market value of a lodging facility, the actual revenue generated from hotel restaurant(s) and lounge(s) selling food and beverages is not the appropriate income to consider. Rather, the revenue should be speculatively established by what the real property (land, buildings, fixtures, and all other improvements to land) would supposedly rent for, established by competing restaurants, bars, meeting/convention space, retail stores, parking facilities, and spa properties in the market. In addition to representing a fabricated rental analysis which more than likely is not the highest and best use of the subject hotel property, under almost all circumstances, this rental rate consideration results in a manufactured relative lower revenue and net operating income, and a resultant market value conclusion that is artificially low.

On July 2nd, 2020, Rick Singh, As Property Appraiser, formally requested another hearing with The Florida Fifth District Court of Appeal to reconsider the June 19th conclusion that *"…the Rushmore method violates Florida law…."* Singh indicated that if the appellate court would not reconsider, the matter would be brought to The Supreme Court of Florida.

On August 7th, 2020, The Florida Fifth District Court of Appeal issued a revised opinion of Case (No. 5D18-2927), *Rick Singh, As Property Appraiser vs. Walt Disney Parks and Resorts US, Inc.*, *et al.* which concluded that similar to the trial court, Singh had incorrectly applied the Rushmore Approach. However, the revised opinion did not declare that the Rushmore Approach itself violates Florida law.

The June 19th, 2020 decision was perceived by many advocates as a tremendous victory for owners of Florida hotels, and ultimately titleholders of lodging properties across America. Although this was not the first time that a court of law had ruled against the Rushmore Approach, in the context of real property tax, for decades the Rushmore Approach has been embraced by tribunals throughout the nation. *Chesapeake Hotel LP vs. Saddle Brook Township* (Tax Court of New Jersey Docket No. 001690-99) was a seminal case decided on October 26, 2005. Judge Peter D. Pizzuto's written decision stated *"Rushmore considered that all payments to the entity that manages and operates the hotel constitute business income generated by the exercise of management and entrepreneurship. Accordingly, he excluded these payments in the computation of realty income subject to capitalization. In addition, Rushmore considered that a portion of the overall income was realized by the employment of furniture, fixtures and equipment (often referred to as "FF&E"). Since these items are (generally speaking) personal property rather than real estate, the income attributable to them, under Rushmore's method, is also excluded from realty income. Separate adjustments are made to provide for the periodic replacement of the personal property (the return of FF&E) and also for a yield on the investment in personal property (the return on FF&E). This method has been employed by experts in other hotel valuation cases and followed in reported decisions in New Jersey and other jurisdictions."*

During the past forty years, much has been written relative to what is commonly referred to today as "Total Assets of the Business" or "Business Enterprise Approach", and how the concept relates to lodging facilities. Unfortunately, most of what has been esoterically posited has been baseless and unsubstantiated by "the market" and has been put forth, for the most part, by generalist professionals who have no hotel educational background; little, if any, hands-on hotel operational experience; and little, if any, hotel investment expertise.

Essentially, these theories and methodologies are merely hypothetical academic constructs without any market foundation which have been developed by advocates for advocates for the sole purpose of reducing hotel property tax burdens. Analysis of the actions of hotel investors, however, indicates that the purchase of a hotel property reflects the acquisition of real and personal property only. Hotel investors account for income attributable to the business through the expense deduction of management and franchise fees. An investor purchasing a hotel “unencumbered” by a management agreement will not pay for a seller assembled work force, business name, patents, copyrights, working capital and cash, operating procedures, and manuals. A passive investment in a first-class hotel “encumbered” by a long-term hotel management agreement is riskier, but no different than a passive investment in a class A office building occupied by a long-term credit worthy tenant. Either passive investment yields a risk adjusted return on property and not a business.

There can be only one market value and the method employed to determine such must be the same under any circumstance including property tax appeals. In other words, the assets and the rights being valued do not change just because the use of an appraisal varies. Knowledgeable hotel investment market participants including buyers, sellers, lenders, and intermediaries do not acknowledge existence of, nor ascribe a separate value to intangible asset(s). Other than a deduction for management and franchise-related fees, this element is not reflected in their underwriting and investment decisions. It is only property tax advocates that utilize “Total Assets of the Business” or “Business Enterprise Approach”, and for the sole purpose of attempting to achieve reduced hotel property assessment valuations. If “Total Assets of the Business” or “Business Enterprise Approach” were utilized for mortgage debt purposes, hotel real property market values could be highly deflated due to an inordinate amount allocated to unfinanceable intangible assets, and result in greatly diminished debt proceeds and existing loans deemed underwater.

The issue of the appropriate treatment of hotel intangibles has engendered much confusion and discussion among appraisers, assessors, attorneys, judges, lenders, and regulators. The matter has been over-complicated for nothing, and way too much time has been spent debating this issue. The fact is that the “Rushmore Approach” has endured because it reflects the thinking and actions of hotel investment market participants. Until the market alters its underwriting/pricing of hotel assets, there is no justification to accept unfounded “violation” and/or “illegal” judicial property tax valuation rulings promulgated by courts of law that know little, if anything, about real estate and/or hotels.

By **Daniel H Lesser** | August 19, 2020 at 07:09 AM