A Workable Plan for Business Valuation

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The process of valuing the different components of a business is always being redefined. Here is one way to estimate valuation for property tax purposes.

Property tax authorities do not determine the market value of the property of a doctor or lawyer by considering the income of their businesses, but they do so for many other types of taxpayers. Significant tax savings may be achieved by the proper deduction of business value.

Perhaps the most significant controversy in property tax law in Texas today is the dispute between taxpayers and appraisal district 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 intangible property (business value) is exempt from property taxation under Tex. Tax Code Ann. § 11.02 (Vernon 1992). All tangible real and business personal property is taxable under Tex. Tax Code Ann. § 11.01 (Vernon 1992). This is simply illustrated by a fast food restaurant. The value for property taxes is based on the income generated by the rental of the property and not on the income generated by the fast food franchise.

Business enterprise value is a value enhancement to a going concern (the latter of which consists of real property, personal property, and business enterprise value) that results from intangible personal property such as marketing and management skill, an assembled work force, working capital, trade names, franchises, patents, trademarks, non-realty related contracts and some operating agreements. The Appraisal Institute, *The Appraisal of Real Estate* 578 (11th ed. 1996). In contrast, only value directly attributable to the physical characteristics of the real or personal property is tangible and therefore taxable. This is often represented by the capitalization of the income attributable only to the tangible property or by the replacement cost of the property.

The business enterprise value issue has arisen in property tax disputes involving various types of real and personal property such as shopping malls, hotels, health care facilities, telecommunication systems, golf courses and land-fills. The issue has been the subject of some litigation in other states, but these cases provide a general framework without much direction. In addition, numerous journal articles have been written concerning business value, again with very little consensus.

Similarly, the lawyer in Texas is left with little guidance. The Court in *Dallas Central Appraisal Dist. v. Tech Data Corp.*, 930 S.W. 2d 119 (Tex. App. - Dallas 1996, n.w.h.) stated that computer software was an intangible and not subject to property taxation. In *Gregg County Appraisal Dist. v. Laidlaw Waste Systems, Inc.*, 907 S.W. 2d 12 (Tex. App. - Tyler 1995, writ denied), the Court of Appeals upheld the exclusion of an expert witness based upon a conclusion that the witness' appraisal contained business value elements which could confuse the jury under Tex. R. Civ. Evid. 403. These two cases indicate that intangible value is not taxable (without defining it) and that business value elements should not be considered (again without giving instruction as to proper consideration).

Thus, the process of identifying and valuing the different components of a going concern in order to separate the taxable and non-taxable items is continually being refined by lawyers, appraisers and the courts. The following discussion presents a basic framework for the valuation for property tax purposes of one type of property containing business value: a hotel.

Three traditional valuation techniques are typically used to determine the market value of real property. These three approaches to value consist of the cost, sales comparison and income approaches. This article will to focus upon the income approach since it is generally accepted that the value of a hotel is generated through its income stream. Items that contribute to the income stream of a going concern consist of business value, real property and furniture, fixtures and equipment (FF&E). For the purposes of determining the market value of real property (land and improvements) and tangible personal property (FF&E), the contribution of business value (intangible personal property) must be extracted from the going concern.

Business value is an enhancement as a result of marketing and management skills, assembled of work force, working capital, trade names, franchise, non-realty related contracts, etc. Several methods have been developed to measure the contribution of business value of a hotel. One of these techniques consists of simply capitalizing the management fee. A second method not only includes the capitalized management fee but also considers the franchise fee plus pre-opening expenses and cost.

The following methodology is an extraction from a compilation of cases and articles on the subject. It recognizes Texas law with regard to intangibles and Texas law with regard to valuation of property based on fee simple rather than leased fee. However, it should be recognized that this is a framework for valuation and that there is no specific case law in Texas supporting this methodology.

The first step in the process of valuing the three components of the overall value (real property, tangible personal property and business value) is to reconstruct the hotel operating statement into a usable format. This operating statement should include income from various sources, which typically include, but are not limited to, room revenue, telephone revenue, gift shops, food and beverage service, vending machines and other miscellaneous items. Typical operating expenses should consist of room expense, food and beverage expense, telephone cost, marketing, insurance, property taxes, utilities, management fee, franchise fee, reserves for replacement, and other miscellaneous items. The gross income to the hotel can be determined through a comparison of actual income of the subject to operating income from comparable properties and industry standards. This market comparison is intended to neutralize the influence of a particular franchise on the real estate. When applying this technique care must be taken to insure that the expenses are handled in the same way. For instance, if the expenses associated with a franchisee with superior management skills are combined with a neutralized income stream, the overall expenses may be less than a typical operator's. The opposite could hold true if hotel management experiences expenses greater than the market average. If the overstated expenses are combined with the neutralized income from the property, the income stream may result in a bottom line that understates the value.

After reconstructing the operating statement, expenses are deducted from income which results in the net operating income (NOI) for the going concern. The first value component to be deducted from the overall NOI is income associated with the tangible personnel property (FF&E). This deduction is accomplished through a two-step process where calculations for the return of and return on funds directed toward FF&E is derived. Recovery of the invested capital is known as "return of" investment and the "return on" investment refers to extra capital obtained as payment for its use. The return of the FF&E is accomplished by estimating the replacement cost of the tangible personal property through utilization of cost publications or use of consultants who specialize in the field of furniture fixture and equipment. A return on the FF&E is calculated so that funds are set aside to replace it at the end of its life. Items considered in establishing the rate of return consist of an interest rate, a risk factor and the applicable tax rate. The appropriate interest rate can be based upon personal surveys or data extracted from various publications. Estimating risk factors is challenging and requires strong professional judgement after considering the characteristics of each property. Some of the items that may be considered in concluding a risk factor consist of age of FF&E, ability of the hotel to penetrate the market, changes in customer taste, cost of operating these items and potential of additional competition. The return of personal property is derived by multiplying the return on investment factor by the depreciated cost of the FF&E. The combination of reserves for replacement and return on personal property result in the income attributed to FF&E.

After deducting income to the personal property from the subject's NOI calculated in the recreated cash flow, the net income attributed to the real property and business remains. At this point the income attributed to the business can be deducted. Items to be considered in the income to the business consist of annual management fee, annual franchise fee and start-up cost. In this instance, management fee is associated with professional management other than the owner of the hotel. It is assumed that what the management is offering an expertise greater that what the owner can provide. This difference is value created outside of ownership. If the management fee is ignored the final value will include the value of the real estate and the value of the management company. Franchise fees include expenses commensurate with using trade names, logos, reservation systems and central purchasing. Management and franchise fees are typically straightforward and can be extracted from operating statements provided by the client and market research. Estimating startup costs are complicated by the fact that an applicable return and recapture rate of these expenses must be estimated. Expenses that should be considered in these startup costs include initial franchise fee, personnel training, pre-opening operating expenses and operating capital. A combination of these items provides the total startup cost associated with the business. By multiplying this total into a combined return and recapture rate, an amortized startup cost is determined. Total management and franchise fees can now be added to the amortized startup cost to derive total income to the business. This total income attributable to the business is deducted from the NOI leaving only income attributable to the real estate.

After deducting the income associated with the personal property and business, the remainder is the net income resulting from or attributable to the tangible property. Then the net income attributed to real property is capitalized by the appropriate rate to indicate the value of the real property.

An understanding of the methodology used to segregate business value from real estate value is necessary to determine whether the appraised value placed on a property by an appraisal district is acceptable. This determination should also consider that the purchase price of a hotel reflects the value of the going concern and rarely reflects market value for property tax purposes. In addition, the quality of management and franchise results in different levels of business value attributable to the property. This evaluation will then lead to a conclusion as to whether an appeal of the appraised value is appropriate.