Challenging the Assessments of Chain Restaurants in Texas

by Paul Pennington

The author discusses a special type of valuation discrimination in Texas relating to the assessments of chain restaurants as a class of property, based on the principal appraisal method being used-the cost approach.

In the Dallas/Fort Worth area, fast food chain locations sell for a fraction of their original construction cost because they no longer operate as chain restaurants or because they are sold to second generation non-restaurant-chain operators. Texas appraisal districts, however, tend to take the opposite approach, which is a dollar spent equates to a dollar of taxable market value. So how do you prove that the districts are wrong? Can one prove that the cost approach is not the best approach to use when valuing chain locations? Doesn’t the cost approach really determine the fee simple taxable market value of a chain restaurant? Is it true that the income and the sales comparison approaches may not be appropriate in valuing a new chain property? How do appraisal districts measure the going concern value of a chain restaurant? These are some of the questions that are discussed in this article.

VALUING CHAIN~THE COST APPROACH

Is it safe to assume that the cost approach is the best approach to use when valuing a chain restaurant? The answer in this author’s estimation is no. The cost approach should be challenged as the exclusive method of determining the taxable realty value of chain locations. Further, the other two approaches to value, income and sales comparisons, should be modified to truly appraise the taxable restaurant market. In the third quarter, 1990 issue of the Enterprise Valuation Reporter, John D. Emory, value points out that:

> *“Business valuation has to do with the value of the rights inherent in ownership of a commercial, industrial or service organization pursuing an economic activity. Real estate appraisal involves the valuation of land, improvements and associated rights. Real estate appraisal does not deal adequately with the whole area of intangible*

business assets such as patents, trademarks, copyrights, goodwill, customer lists, employment contracts, covenants not to compete, exploration rights, intangible drilling costs, franchises and licenses. The more a company depends on its intangible assets to generate earnings, the more important such assets are in any business enterprise value".

Robert Reilly notes in the January 1993 issue of Valuation, published by the American Society of Appraisers, that:

"Traditionally, real estate appraisals of location-dependent commercial encompass a portion of (if not all of) the intangible business enterprise value of the property. . . . The naive application of real estate appraisal procedures to location-dependent businesses will ignore the fact that the real property's highest and best use (and total concluded value) are dependent upon the existence and assemblage of such location-specific intangible assets as business licenses, certificates, permits, and franchises and such non-location-specific intangible assets as a trained and assembled workforce, goodwill, and going concern value. Therefore, by including an economic contribution from these intangible assets, the real estate appraisal may overstate the true market value associated exclusively with the subject "bricks and sticks" for these location-dependent businesses".

It has been this author's experience that Texas appraisal districts believe the primary approach to valuing chains is the cost approach; that is, the acquisition cost of the land plus the cost of personal property, plus the hard and soft costs of the improvements, less accrued depreciation, represent the taxable market value of a chain restaurant. The theory apparently relies heavily on the principle of "substitution," which The Appraisal of Real Estate, published by the American Institute of Real Estate Appraisers, defines as:

"The principal of substitution is basic to the cost approach. This principal affirms that no prudent investor would pay more for a property than the cost to acquire the site and construction improvements of equal desirability and utility without undue delay. . . . Because cost and market value are closely related when properties are new, the cost approach is important in estimating the market value of new or relatively new construction. The approach is especially persuasive when land value is well supported and the improvements are new or suffer only minor accrued depreciation and, therefore, represent a use that approximates the highest and best use of the land as though vacant'.

INTANGIBLE VALUE

However, a problem arises, for example, when the crane operator erects the golden arches, accompanied by the McDonald's logo and all of the associated paraphernalia, because at that point, an intangible personal property value is created. At the very least, a functional obsolescence becomes apparent, which is not dealt with by the appraisal district's cost approach. By not addressing this issue, appraisal districts may be assessing an intangible value that is exempted by law. The Texas Property Tax Code (Code), is very clear on this point. The Code divides taxable property into two categories real and tangible personal property. The test to qualify taxable property is noted in Section 11.01 of the Code:

> (a) All real and tangible personal property that this state has jurisdiction to tax is taxable unless exempt by law.
> (b) This state has jurisdiction to tax real property if located in this state.
> (c) This state has jurisdiction to tax tangible personal property if the property is:

(1) located in this state for longer than a temporary period;
(2) temporarily located outside this state and the owner resides in this state; or
(3) used continually, whether regularly or irregularly, in this state.

> (d) Tangible personal property that is operated or located exclusively outside this state during the year preceding the tax year and on January 1 of the tax year is not taxable in this state.

The Code states in Section 11.02 that:

> Intangible personal property, except as provided by Subsection (1)) of this Section, is not taxable.

The Code identifies intangible personal property in Section 1.04, (6) as:

> A claim, interest (other than an interest in tangible property), right, or other thing that has value but cannot be seen, felt, weighed, measured, or otherwise perceived by the senses, although its existence may be evidenced by a document. It includes a stock, bond, note or account receivable, franchise, license or permit demand or time deposit, certificate of deposit, share account, share

certificate account, share deposit account, insurance policy, annuity, pension, cause of action, contract, and goodwill.

To prove the existence of intangible personal property, just think about the last time you were driving down the road with a car full of kids after a ball game and you asked them where they would like to stop and eat. More than likely you heard an adamant response in favor of Burger King, McDonald's, or another national fast-food restaurant. It seems likely that the kids wanted to go to a fast food chain because of franchise name recognition. Corporate-owned and franchise stores guarantee the customer the same quality of goods and services, be it a McDonald's in Dallas or one in Denver.

Appraisal districts adhere to several other misconceptions. For example, chains always work and if they don't, it's due to a location problem. Therefore, a successful chain location must be worth at least the cost to assemble the land, the building, and the personal property. Such speculation, however, is questionable, since it is sometimes difficult to define what constitutes a successful chain operation. For example, consider Addison, a suburb of Dallas. Addison, admittedly, is a very unusual community, in that less than 10,000 citizens live there but it has well over 120 restaurants. Addison is a community with an extremely high density of office, retail, and industrial space. Since 1978, one particular tract of land in Addison has had four chains built on it-three of which failed. Some might argue that the location of the tract of land caused the three to fail. However, it might simply be that these restaurants worked for a period of time, some longer than others. Further, the public's taste changes and over the past 16 years, this site supported a steak house, a Mexican, a Cajun, and now a seafood restaurant. This site averages approximately one new restaurant every four years. What is the typical life span of a chain location in a very competitive market?

The cost approach typically assumes that the economic life and physical life would be longer than four years. However, in highly competitive markets, appraisal districts typically do not recognize "real world" conditions when they use 20-, 30-, and sometimes 40-year lives on chains. Ask yourself, when was the last time you saw a 20-, 30-, or 40-year-old chain location? If you saw a 30-year-old McDonald's for example, you'd more than likely be looking at some sort of historical landmark.

Generally speaking, as restaurants get older they must be remodeled to keep up with the public's taste, or they are sold or leased to second-generation owners or tenants. Therefore, four restaurants on one site in 16 years might not be realistic for mass appraisal purposes; however using 20-, 30-, and 40-year lives is not realistic either in today's highly competitive market place. That is not to say that the structure itself may not have a 40-year life, but the highest and best use may change during its life. For example, at the time of this writing, several McDonald's sites were about to sell or go under contract to a back and neck injury company by the name of K Clinic. Thus, the highest and best use of these locations had changed over the last two decades. Moreover, the purchase prices were a fraction of the values carried on the 1994 Dallas Central Appraisal District tax roll.

FEE SIMPLE MARKET VALUE

Does the cost approach really determine the fee simple market value of a restaurant? It does not appear so. For example, a national chain restaurant opened in Dallas in 1993 and was closed by early 1994. According to the current broker, the owners had removed some of their personal property. However, they did not expect to recoup their original investment; in fact, they will probably realize a sizable loss. The Dallas Central Appraisal District, however, is still carrying the property on its tax rolls based on the cost approach. How can the asking price not be a better indicator of market value than cost? Cases such as this indicate that, unlike appraisal districts, the market place does not recognize, nor will it pay for, unique designs, paraphernalia, etc. Therefore, some components of a closed chain restaurant may create a certain amount of functional obsolescence, which the seller can not recoup.

According to one national chain operator, if one of their locations closed or was sold to a second generation operator, they would hope to recoup $30,000 to $40,000 for their personal property packages, which run between $200,000 and $300,000 new. In the case of the real estate, they would be happy to recoup their original land cost, plus $100,000 for the improvements.

Texas courts have long established that property should be valued "fee simple" for property tax purposes. That is, "... absolute ownership unencumbered by any other interest or estate, ... subject only to the limitations imposed by government powers of taxation, eminent domain, police power, and escheat." (See The Appraisal of Real Estate, published by the American Institute of Real Estate Appraisers.) Appraisal districts would argue that the cost approach recognizes the fee simple value of a newly built Wendy's or McDonald's. However, it could be argued that the franchise/going concern value of a newly constructed Wendy's or McDonald's would be encumbered, much like a leased fee estate encumbers income-producing properties. For example, a franchise is defined as, "A privilege or right that is conferred by grant on an individual or a group of individuals; usually an exclusive right to furnish public services or to sell a particular product in a certain community." (See The Dictionary of Real Estate Appraisal, published by the American Institute of Real Estate Appraisers.)

A franchise agreement contains terms and conditions that dictate the manner in which the property is maintained and presented to the public. If the owner or lessee of a newly constructed fast food restaurant did not adhere to the terms and conditions, the franchise agreement could be revoked. Thus, the agreement encumbers the ownership of a property. Typically, the loss of a franchise agreement would have an adverse effect on the property's value. However, with the loss of the agreement the property would be unencumbered by the restraints of a franchise, and so could be appraised as fee simple.

USING THE SALE COMPARISON AND INCOME APPROACH

Why not use the sale comparison and/or the income approach on a new property? In Texas, most appraisal districts that use restaurant sales, sale/leasebacks, and the income approach view going concern chain or discount second-generation sales as not being comparable. This approach results in the assessment of not only the taxable value of a restaurant but includes exempt intangible personal property. It is difficult, but not impossible, to use the sales comparison and income approaches to value, if you define what you are looking for.

For example, in the Dallas metro area, a chain location selling as a going concern, 99 percent of the time sells for a great deal more than those that were vacant at the date of sale or those that have become second-generation restaurants. The going concern value of the restaurant seems to make a significant difference in the overall value of a restaurant. Therefore, when trying to establish the fee simple value of only the tangible real property, one must find comparable market sales (not necessarily chain restaurant sales) and, using paired data analysis, identify specific differences.

It is preferable if sales comparables are vacant or are locations selling to second-generation non-chain-restaurant operators. This would simplify the value attributable to intangible personal property. After the sales comparables are collected, a sequence of market-driven adjustments should be made to quantify the comparison between the comparable properties and the subject. The elements of comparison include:

1. Real property rights conveyed
2. Financing terms
3. Condition of sale
4. Date of sale
5. Location
6. Physical characteristic
7. Segregated market value of the real, personal, and intangible property.

After the sales comparables have been adjusted on a market data grid, a reconciliation of the data should give an estimate of value, which will give the taxable value of a chain restaurant excluding any personal and intangible personal property.

In arriving at a value based on the income approach, it is difficult, but not impossible, to arrive at a taxable market value. One must identify comparable chain restaurants or comparable non-chain-restaurants, and analyze their income, expenses, and capitalization rates. A reconciliation of income and operating expenses of comparable properties should be performed to develop a market income pro forma, resulting in an estimate of value. A major problem with this approach is that overage rent (the percent paid over and above the guaranteed minimum rent) leads to yet another problem.

An appraiser must be able to quantify that the base rent with its overage does not exceed market rent for the real property being appraised. Further, overage rents tend to enter the gray area of going concern. If one is confronted with a Wendy’s, which is located in a submarket of 15 other chain locations, all of which rent between $22.00 and $28.00 per square foot including overages, this does not constitute the market rental range. Rather, it quantifies rental rates for going concern chain locations within a particular market. If the purpose of the appraisal is to use all three approaches to value in determining the fee simple market value of a property, the market area being examined should be broadened. If the Wendy’s is paying $25.00 per square foot, but comparable non-chain locations lease for

$15.00 per square foot, some of the difference could be attributable to the Wendy's intangible personal property. Therefore, for property tax purposes, one wants to identify that income which is attributable to the real estate and not to the restaurant's business cash flow.

How do appraisal districts measure the going concern value of a chain restaurant? The answer is very simple: they don't. So how should a taxpayer account for going concern? In The Appraisal of Real Estate, 10th edition (published by the American Institute of Real Estate Appraisers) going concern is defined as follows:

Going concern value is the value of a proven property operation. It includes the incremental value associated with the business concern, which is distinct from the value of the real estate only. Going concern value includes an intangible enhancement of the value of an operating business enterprise that is produced by the assemblage of the land, building, labor, equipment, and marketing operation. This process creates an economically viable business that is expected to continue. Going concern value refers to the total value of the property, including both real and intangible personal property attributed to business value. Going concern appraisals are commonly conducted for hotels and motels, restaurants, bowling alleys, industrial enterprises, retail stores, shopping centers, and similar properties. For these types of property, the physical real estate assets are integral parts of an ongoing business. It may be difficult to separate the market value of the land and building from the total value of the business, but such a division of realty and non-realty components of value is not impossible and is, in fact, often required by federal regulations.

Robert Martin, a Dallas metro area appraiser and consultant of real estate and closely held businesses and professional practices; states that:

It is possible to segregate these real and intangible values by using a residual approach. Here are the steps that an appraiser would follow in segregating the goodwill value of a business from the value of the real property:

Step 1. Determine the value of the business as a going concern.
Step 2. Determine the value of the real property using generally accepted appraisal methods.
Step 3. Subtract the value of the real property from the value of the business.

The residual value represents the amount of goodwill in the "going concern” enterprise. Mathematically, the procedure would look like this:

		Real Estate		Goodwill
		and		or
Business	-	Personal Property	=	Going
concern				
Value		Value		Value

> In applying this procedure to a question of ad valorem taxation, only the value of the real and personal property would be taxable. Any value assigned to goodwill would not be taxable.

Thus, using the above procedure for property tax purposes, one should limit the appraisal to the taxable value of the real estate and personal property only. One should only be concerned with the fee simple taxable market values of the components, discounting any identifiable functional obsolescence, intangible personal property, and going concern value. All three approaches to value may be used, but certain adjustments must be taken into consideration. For example, in using the cost approach one must be able to quantify the real world life of a chain restaurant based on industry norms. Further, one must be able to establish the amount of functional obsolescence that is created by chains that use unique design and construction layouts. This can be determined in the market by researching the similar sales in the same general vicinity of chain locations and second-generation operators. The market will identify the value that a chain’s uniqueness has when the property sells, and the new owner determines which items in the original assemblage are useful to the operation of the location and which are not. Also, the new owner will determine the amount of remodeling and refitting of equipment that will be required by the new operator.

In using the sales comparison approach, one should focus on comparable nonchain locations and chain locations selling to second generation operators. The same principle applies to the income approach. Use market income and expenses of nonchain and chain locations being operated by second-generation owners. Once the chain’s name is removed from an improvement, the market will ultimately dictate the value of the land, fixed assets, and improvements.

PAUL PENNINGTON is the President of P. E. Pennington & Co., Inc,. A regional property tax consulting firm, established in 1988 with offices in Austin and Dallas, TX.