Valuation Education

How to spot—and challenge—unfair tax bills

By J. Kieran Jennings, Esq.

Even if there is life left in this market cycle, commercial property owners should maximize returns now in preparation for the next buyer's market, whenever it may begin. Property tax is one of the largest expenses for most owners, so protecting the property, investment and tenants requires a thorough understanding of the tax system. With that understanding, the taxpayer will be better equipped to spot an inflated assessment and contest unfair tax bills.

Keep it (fee) simple

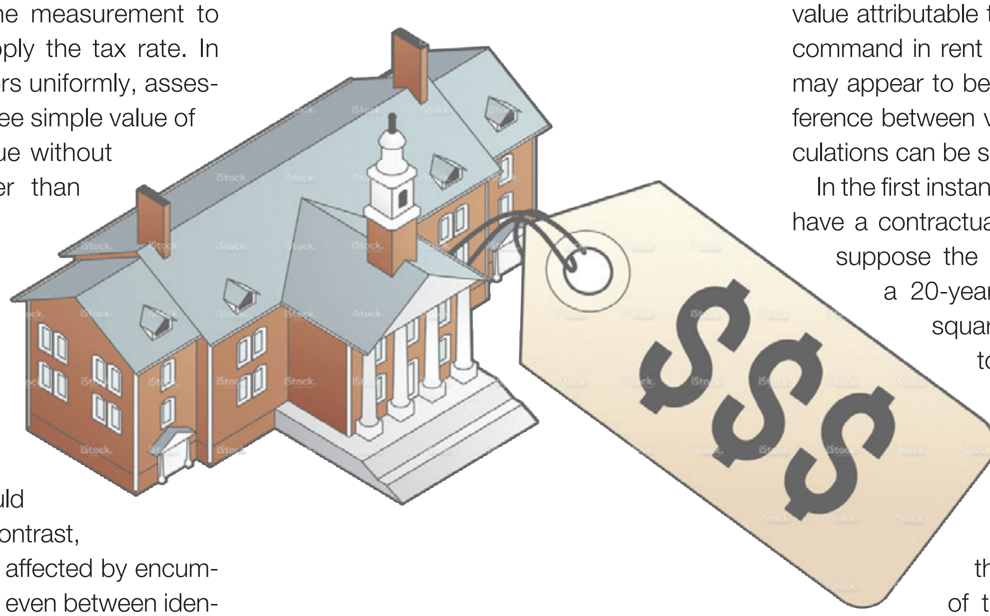
Merely knowing for how much a property would sell is insufficient to ensure proper taxation. Specifically, taxpayers need to know fair taxation starts with a fair measurement of value.

The assessment is the measurement to which taxing entities apply the tax rate. In order to treat all taxpayers uniformly, assessors must measure the fee simple value of the property, or the value without any encumbrance other than police power.

Why is that important? The principle is that a leased property and an identical owner-occupied property, valued on the same date and under the same market conditions, would be taxed the same. By contrast, leased fee value or value affected by encumbrances can vary greatly, even between identical properties. The concept is simple; the application, not so simple.

Assessors and courts alike struggle to determine an asset's fundamental real estate value because their primary source of data is leased-fee sales, or sales priced to reflect cash flow from existing leases. Several courts across the country have understood the necessity to assess properties uniformly and have mandated that assessors adjust sales data to reflect the unencumbered value of the real estate.

In Ohio, the state Supreme Court ruled that an appraiser who was valuing an unencumbered property had to adjust the sale prices of comparable properties to reflect the fact that the subject property was unencumbered (by leases, for example) and would therefore likely sell for less. The decision recognized that an encumbered sale is affected by factors besides the fundamental value of the real estate.



Courts across the country have been wrestling with the fee simple issue. For real estate professionals, the idea that tenancy, lease rates, credit worthiness and other contractual issues affect value is commonplace. In order to tax in a uniform manner, however, assessors must strip non-market and non-property factors from the asset to value the property's bare bricks, sticks and dirt.

Doing the math

Although part of the purchase price, contractual obligations and other valuable tenant-related attributes are not components of real estate. What is part of the real estate is the value attributable to what the property might command in rent as of a specific date. This may appear to be splitting hairs, but the difference between values based on these calculations can be significant.

In the first instance, the landlord and tenant have a contractual obligation. For example, suppose the rent a tenant pays under a 20-year-old lease were $30 per square foot. If the tenant were to vacate, however, that space might only rent for $10 per square foot today. The additional $20 per square foot premium is in the value of the contract, not the value of the real estate. Moreover, the contract only holds that value if the market believes the tenant is creditworthy and will continue to pay an above-market price.

When the tenant vacates, it's the real estate itself that determines the current market-rate lease of $10.

Good data, good results

Identifying an inflated assessment brings the taxpayer halfway to a solution. Step two is finding the best way to challenge the inappropriate assessment. Each state has its own tax laws and history of court decisions, but a few key principles will help taxpayers achieve a fee simple value.

First, sales and rents must have been exposed to the open market. A lease based on construction and acquisition costs reflects only the cost of financing the acquisition and construction of a building, not market prices.

Another principle assessors often fail to apply is that the data they use must be proximate to the date of the tax assessment. Therefore, a lease established years before the assessment is not proximate, even if the lease itself is still current.

What does make for good data is a lease that has been exposed to the open market, where the property was already built when the landlord and tenant agreed to terms free of compulsion. Equally reliable is the sale of a vacant and available property, or where the lease in place reflects market terms proximate to the assessment date.

Taxpayers who challenge assessments that are not based on fee simple values help themselves maintain market occupancy costs, which will in turn lead to better leasing opportunities and retention of tenants. CPE

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