REAL ESTATE TAXES: FIXED OR VARIABLE

Owner, financing and operating profiles can significantly affect the market value of a property and therefore the assessment of real estate taxes.

by Norman J. Quinn, III

Outside the debt service, taxes normally represent a property's largest single operating expense. As a result, any tax savings achieved fall immediately to the bottomline, benefiting both the owners and lessees of a property. Yet taxes are seldom challenged unless they increase suddenly and dramatically, and they usually are challenged only after the bill is received. However, by the time the bill arrives, it is often too late in the real estate tax assessment cycle to achieve any reductions.

The obligation to pay real estate taxes is determined by legislative mandate, and the actual amount is based on the market value of a property as of a specified date. This value of property fluctuates with the supply and demand cycle of the real estate industry. Exploiting cyclical swings in assessed market value maximizes the return on a real estate investment and creates a competitive leasing advantage.

Of all the elements in the real estate tax equation, market value is the most variable, and changes in assessed value have, by far, the greatest impact on tax liability. The market value of a property is traditionally determined by applying one or more of the three methods of valuation: the replacement cost, sales and income approaches. As the real estate industry changes, however, several non-traditional factors can dramatically affect the value of a property, no matter which approach is used. These include the significance of owner, financing and operating profiles on the determination of the true "market" for a given property.

Owner Profiles

A growing trend is the inclusion of owner profiles in evaluating and contesting assessed real estate tax valuations. Recognizing and understanding different owner profiles are critical in evaluating the comparability of assessed valuations and recorded sales transactions.

The characteristics of owner profiles change with the cycle of the financial and real estate markets, and they are impacted by federal tax rates, the length of the holding period, the cost of capital and the desired rate of return on the property. As real estate markets have reacted to the economic forces of the 1980s, two distinct groups of owners have emerged whose criteria for paying a given purchase price may include factors unrelated to, or no longer relevant to, traditional market value. Today, properties clearly are marketable to one group or another based on these owner profiles, and yet traditional tax assessment techniques may or may not take these into account.

Syndicators/Developers/Non-Institutional Owners

The first group of owners includes the real estate syndicators and developers who historically have been the originators of income-generating property. The determination

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of real estate market value for these owners has been affected greatly throughout the 1980s by federal tax laws.

The pre-1981 U.S. tax code was characterized by extended depreciation periods, the absence of accrued or deferred interest provisions on debt and a maximum individual tax rate of 50%. Supply and demand factors in the local real estate market determined the financial success of a project; so each of the three valuation methods, in general, yielded market values that were closely correlated.

The 1981 Economic Tax Recovery Act changed the accelerated depreciation computation, shortening the depreciable lives of properties from as much as 35 to as few as 15 years. This change increased the depreciation expense, which is a non-cash expense, and inflated net income after taxes. The increased income helped rationalize the utilization of accrued interest financing, which is also an accruable, tax-deductible expense. Capitalized income became the dominant method of determining market value as net incomes were inflated by the non-cash expenses generated by depreciation and accrued interest. A wave of inflation in property prices and new construction was triggered, resulting in market values that were far higher than the residual value of property as previously defined by the historical supply and demand variables of the local market.

The financial markets, perceiving the demand by investors for tax benefits, generated funding mechanisms that fueled the expansion in property prices. A higher purchase price generated greater tax benefits as the price acceleration cycle grew geometrically, creating an even greater discrepancy between residual economic value and sales value which, in turn, became federal tax value. Property assessments increased accordingly, based on comparable sales data and capitalized income.

The 1984 Tax Act eliminated the deduction of deferred or accrued interest but maintained a favorable, though modified, depreciation schedule. These changes only slightly slowed the price acceleration cycle. However, the 1986 Tax Act effectively doubled the depreciable life of assets back to the 30-year range, which decreased net income and capitalized values and cut the tax rate for investors from 50% to 28%. These tax law changes terminated tax-motivated investor demand for property and the resulting price acceleration cycle. The industry was caught with an abundance of supply and little demand for space. Market values in many areas plunged.

Today, evaluating property for tax appeal potential requires close analysis of the local market. In many taxing jurisdictions, prices have plunged as the post-1986 real estate investment market has searched for residual economic value, and as a result, tax bases have declined. A few markets, though, have continued to grow, fueled by local demand for new space.

Over the last few years, the local taxing jurisdictions that experienced the worst effects of this cycle, particularly those in the Southwest, have been giving more weight to other factors than comparable sales price. Other jurisdictions have continued to hold the sales price as the primary determinant of assessed valuation, even though the volume of arms-length transactions has radically declined. These jurisdictions have required an annual review of transactions and considered any properties acquired before 1986 as potential tax appeal candidates.

The unfortunate investors are the continuous owners from pre-1981 whose property's assessed value increased with the market. By not selling, they are now dependent on occasional arms-length sales in a depressed market to re-establish former values. For many of these owners, litigation may help restore valuations to former levels. Owners of property purchased in the post-1986 environment may be able to confirm the achieved equalization of local supply and demand forces or may have to bear witness to further price deflation.

The challenge for the tax manager is to understand the dynamics of the localized market and to identify opportunities for substantially reducing valuations and resulting taxes. The tax manager needs to recognize that currently syndicators, developers and non-institutional owners are evaluating the underlying economic value of property for acquisition and financing purposes, and he needs to communicate the valuation methodology and the resulting market values to the tax assessing body.

Pension Funds, Institutional Investors And Foreign Investors

The second major group of owners is the pension fund/institutional investor/foreign investor. These owners differ drastically from the first group in the size of individual groups of owners, the nature and amount of their financial resources, the low cost of capital they can obtain and their desire for stability and long-term capital gain. The emergence of these property owners has created the real estate industry classification of institutional grade property. The growing activity in the industrial grade property submarket exemplifies the importance of evaluating owner profiles when comparing location valuations. Among the most dramatic inequities created by local tax assessing authorities is through the application of institutionally paid prices to non-institutionally owned real estate.

Pension Funds/Institutional Investors. The 1970s marked the entrance of pension funds and other institutional fund sources into the real estate markets. While pension funds are unique in their federal tax exempt status, other types of institutional funds—such as insurance company funds—have tax structures that are favorable or equivalent to direct ownership. Nevertheless, the vast financial resources and long-term orientation of these owners, plus the low cost of capital they can command, not only give these owners competitive advantages in purchase negotiations but allow them to achieve higher prices while maintaining favorable yields.

Foreign Investors. A variety of national and international political and financial developments has motivated the entrance of foreign investors into the U.S. real estate

markets. (The most prominent member of this group has been the Japanese.) The principal inducement has been the worldwide perception of the stability and continued growth of U.S. investments.

What distinguishes this owners' profile from other investors is their source of funds which is characterized by a low cost of capital and often 100% financing and a commitment to a long holding term. Pension funds and foreign investors often compete for the same class of property; however, foreign investors appear to be more willing to hold properties longer and take greater risks in ownership. The purchase price paid by foreign owners thus may be more significant to these purchasers' unique financial position than to the properties' position in their markets.

This new buyer segment of the market again emphasizes the importance of investigating owner profiles when evaluating transactions in a local market. The tax manager who represents institutional and foreign owners of property must understand the local real estate market and the potential buyers and their driving economic differences. These considerations must be conveyed to the tax assessor to achieve equitable market valuations. Tax managers may utilize the income approach to valuation, to compare similar property valuation and overall market trends and to cite such judicial decisions as the U.S. Supreme Court case of *Allegheny Pittsburgh Coal Company v. County Commission of Webster County, West Virginia,* decided in January 1989.

Financing Profiles: Governmental And Creative

Governmental financing programs and the new generation of creative financing which incorporates ownership rights in lending instruments, require specialized knowledge and understanding by the tax manager in order to present and achieve equitable assessed tax valuations. The variety of encumbrances these new financing programs entail can make a significant impact on the salability and lease potential of a property. Tax assessing authorities generally fail to distinguish properties with these encumbrances from other properties, which can result in over-assessing the properties and reducing comparative yields to their owners.

Government Financing

A number of federal and local housing programs, i.e., Section 236, 238, Section 8 and municipal bond financing programs, place varying operating constraints on property owners which affect the market value of the property. These programs frequently span decades and are subject to legislative mandates which may alter the programs' original intent. Common are limitations on rents, tenant mix and caps on return to investors.

One valuation method the tax manager may use to address the operating constraints imposed by public housing programs is the computation of the equivalent return. This may be approached by working backward from an accepted capitalization rate and forward from adjustments to the income or expense categories affected by the encumbrances. Comparable encumbered complexes' values in the same or neighboring jurisdictions, as well as per unit or square footage values, should be researched. A tax manager must be aware that these encumbered properties require special analysis, presentation and possibly educational efforts in order for the taxing jurisdiction to determine equitable valuation.

For example, sales of municipally financed properties in many jurisdictions since the 1986 Tax Act have been less than or equal to the existing outstanding debt amount, which is usually more than the tax assessor's valuation. One method of overcoming the recorded title transfer price argument is to note the nonrecourse nature of the debt, when applicable, and the per unit value of comparable properties.

Creative Financing

New creative real estate financing mechanisms have equity participation features that are comparable to rights of ownership. Historically, ground leases and mortgages on occasion contained a kicker provision which allowed the holder to share in the increased income stream generated by the property. Mortgages have been indicators of value just as ground leases' present value computations often have been used to value land. The new hybrid of these traditional real estate ownership instruments, however, can effectively transfer the rights of ownership to a lender without creating the consequences of sales.

These encumbering instruments typically provide for extensive sharing in profits, management, options to market or purchase the property and extensive sharing in any sale's proceeds beyond the encumbrance's value. Such financing vehicles allow the property owners to cash out their equity and delay federal tax liabilities, while maintaining the incentive to maximize a property's potential. Essentially, the lender gets the operator's expertise and effective ownership control over the property, while the owner may receive the equivalent of sale proceeds with an additional financial incentive to operate the property effectively in the future through revenue sharing.

Taxing jurisdictions have not addressed these new financing methods primarily because mortgage activity generally escapes the assessor's information collection procedures. A ground lease component may be identified because of the recorded title change.

Tax managers dealing with property that utilizes creative financing should make sure that owners are informed of the disclosure process required in the jurisdiction before they pursue appeals based on these arrangements.

Operating Profiles

The different financial operating profiles of properties may have an impact on one or more methods used to value properties. Taxing jurisdictions that consider an income approach to value may provide for, or allow the inclusion of, stabilized financial figures and include both income and expenses in performing the computation

when revenue will be affected by a leaseup or vacancy or when repairs and maintenance expenses are expected to exceed actual expenses for a given year. The age, condition and comparative market position of the property determine the appropriateness of using this valuation adjustment.

The utilization of either economic rents or market rents will produce significant differences in a stabilized income statement for capitalization. In jurisdictions where rents are increasing, economic rents are advantageous; where they are decreasing, market rent arguments should be advanced.

Independent of the method of valuation, certain adjustments or allowances may be made in the determination of the final valuation. Adjustments may be made in income and expenses if income is to be capitalized, or they may be used as deductions from comparable or replacement cost values.

Older properties which may lag the market in terms of amenities, facilities or improvements may be allowed to deduct redevelopment or renovation costs that will keep or move them into a more comparable class of valuation. Normally, to be acceptable, these adjustments must be tangible, priced and intended to fall within a specific time period. An example of this type of adjustment for office buildings would involve changing from a large single tenant user to smaller multi-tenant offices. Generally, extensive improvements would be required to make the present, single tenant space rentable to the pool of prospective smaller tenants. The use of this type of expense to adjust value would be appropriate, particularly when a lease is nearing expiration.

Asbestos removal is another category of expense which may be treated as a deduction from valuation. Because many lenders will not finance redevelopment or renovation of properties with asbestos, tenants often will not rent space in buildings with asbestos and owners of these structures may be liable to injuries to third parties. Thus, asbestos reduces a property's value. One major concern in determining the usage of asbestos removal as an adjustment variable in the tax assessment process, is the impact from public disclosure of its existence. Owners and managers of property therefore, should be advised of the property tax consequences of an appeal on this basis. Another major concern is the different reactions to this argument among jurisdictions; some often want a specific time frame for completion of asbestos abatement.

Other types of future expenses that have affected market value include roofing repairs, parking lot additions, mandatory fire and life safety improvements and refurbishments in substandard residential complex amenities. A tax manager must understand the income statement components of a property and its market position in order to compute the most favorable method of valuation and communicate the logic of the calculations within the parameters of the assessing authorities.

It is important to know that appraisals used for real estate tax appeals may emphasize different factors than those prepared for the acquisition or financing of property. Often, an appraisal conducted for the purposes of real estate tax valuation will result in a lower value than appraisal prepared for other purposes because of the conservative nature of the assumptions underlying the determination of market value. A tax manager is well advised to seek advice from those individuals within the appraisal industry who specialize in real estate tax appraisals and have been accepted as experts by the local taxing jurisdiction.

Achieving Reductions

The responsibility for achieving an equitable valuation of a property may be assigned to an individual within an organization who has a solid education in financial and operating areas as well as good communication skills. Or the responsibility may be contracted out. The size and complexity of the organization's portfolio, the nature of the jurisdiction and the ability and time of internal staff may be deciding factors. Organizations with large portfolios often benefit from designating one management person who has access to property operations and investment strategy as the coordinator of all tax appeals. This approach centralizes responsibility and maximizes synergy.

Whether or not an organization maintains such expertise internally, real estate tax consultants also may be required. Historically, expert consultants have come from the ranks of attorneys, accountants, appraisers, former tax assessors and brokers. Unfortunately, the recent lure of lucrative fees and industry franchising has attracted other, less qualified individuals to this field; so property owners are advised to screen prospective consultants thoroughly before hiring them.

The principal job of the consultant is to gain access to and utilize locally acceptable assessment practices and valuation techniques to secure an equitable valuation of property for the owner. The consultant therefore must understand the property, including its financials and operations; research the property valuation and comparables; meet deadlines; follow appeals procedures; apply an appropriate valuation approach and complete any real or personal property renditions. Upon formalizing an opinion of value for the owner, the consultant should meet with the assessor to negotiate the assessment, ideally before any formal appeal or legal proceedings are required. This procedure will vary based on different jurisdictional requirements.

Local appeals' procedures may necessitate representation by an attorney; certainly, as the appeal formalizes into the litigation stage, an attorney's representation will be necessary. Attorneys should be selected based on their experience and reputation before the tax appeals boards. Corporate counsel or local industry groups may be able to recommend a specialized tax firm.

The balance of industry consultants may be referred to as negotiators. National, regional and local firms and independent practitioners are available. These negotiators differ in their experience with certain types of property,

their qualifications and ultimately the basis for their compensation. Property owners should check negotiators' references, since they are looking for frontline tax valuation experience and ability, and should be comfortable with their selection.

The fee structure varies within groups of consultants and from one consultant to another. Fixed fees based on the size of the account or property are common. Following general guidelines, charges for securing equitable valuations of completed apartments range from $3.00 to $4.00 per unit or from $1,000 to $3,000 per complex. Charges for obtaining fair valuations of office buildings and shopping centers average between $1,000 and $3,000 depending on size. Regional differences and the amount of work required will impact these estimates.

Contingency fee arrangements based on an annual percentage or total savings achieved range from 30% to 100% payable over one or more years. Contingency arrangements are considered to be most cost effective for owners of property that already are considered to be fairly valued and who entered into a fixed fee arrangement the previous year. Time and expense billing, with an optional incentive bonus, may be employed in jurisdictions that require attorney involvement. Matching the fee arrangement with the property's potential valuation reduction will control consultant costs while achieving an equitable valuation. The key to achieving an equitable valuation is knowing the property, the local market and the assessor's valuation process.

Trends

Multiple conflicting interests will impact future tax valuations. These include: slowed growth of tax bases; increased funding requirements of local government entities particularly for schools; decreased federal subsidies to state and local governments; increased interest by home owners in transfering the property tax burden to commercial or industrial owners; and increased interest in the passage of income or sales tax subsidies to offset property taxes. The environment is dynamic, and an active interest in the determination of tax valuations by property owners is essential to minimize ongoing tax liabilities.

EXHIBIT

The mathematics involved in the calculation of most tax bills is:

(market value)(ratio)(equalizer)(tax rate) = tax due

where:

market value = The value determined by the tax assessment process as of a specified date.

ratio = A legislatively mandated percentage which is generally fixed by property type classification.

A property owner should always verify that the property is properly classified, particularly during any development or transition in use. The timing of any changes in classification can have a dramatic impact on the amount of taxes that are payable for one or more years.

Some jurisdictions create multiple market values which may be transitional values or part of additional tax calculations.

equalizer = A legislatively mandated or locally determined factor used to compensate for under- or overvaluations of all the property within the jurisdiction. The equalizer is applied against all properties irrespective of their individual level of assessment, and it is based on overall averages. Application of the equalizer generally results in overvaluation of new construction and recent sales and undervaluation of older properties. In some jurisdictions, the equalizer itself may be contested.

tax rate = The adjusted product of the sum of all projected cash requirements of local tax levying jurisdictions for the fiscal year, divided by the total real property valuations within the tax jurisdictions. The tax rate may vary by property type classification.

The determination of the tax rate via the tax levy is solely the product of the political process. In most instances the real estate investor is limited by time, distance and lack of political power to change the course of the local process. Local lobbies and chapters of organizations, such as the National Apartment Association, the Building Owners and Management Association (BOMA) and International Council of Shopping Centers (ICSC), may affect the political process. An example of an entity that was instrumental in stopping a levy is the Los Angeles Downtown Property Owners Association, which helped stop the collection of special assessments for the construction of the subway mass transit line in Los Angeles. Increases of over 100% in taxes have been suspended pending hearings and court resolutions.

The importance of these organizations is increasing as local governments' sources of funds shift from federal to state and local revenue sources.