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Perspectives

Exert Control Where You Can – “Property Taxes”

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Volume 47, Number 23 - December 15, 2023 • Written by: Mr. Patrick Price, CRE

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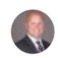
Mr. Patrick Price, CRE

As Vice President of Operations, Patrick leads an experienced group of property tax professionals througout the United States. He ensures DMA’s property tax services are best-in-class for DMA’s entire client base. In addition, Patrick works directly with DMA’s clients to negotiate assessment reductions via informal meetings with assessors and successfully defend positions before assessing jurisdictions and Boards of Appeal. Patrick’s base of industry-specific knowledge and education, together with extensive experience in valuation services, provides clients with the highest level of professional service and proven results.

Commercial real estate markets are in a transitory phase, the degree being contingent on which asset class is discussed. Nonetheless, virtually all segments of the market are facing some significant headwinds and/or corrections. While owners and managers cannot control macro-level forces influencing CRE value, there are indeed many things within your ability to mitigate value diminution and preserve market value. The “property tax” line-item expense is one such example.

A Brief Overview of the Property Tax Landscape

Ad valorem (Latin for "according to value") tax is one of the oldest and most reliable forms of revenue for state and local governments. At the local level – and we know real estate is "very local" – property tax collections can account for more than 70% [1] of municipal and county government funding in some localities. And those entities or services relying on this revenue are the most sensitive types…police, fire, schools, roads, etc. Over the course of a bull market that was unprecedented in length, most areas enjoyed increased revenue as real property assets appreciated, both commercial and residential. Spending was not limited to prior years or even needs, necessarily – but as more revenue was created by higher property values, budgets and spending grew larger. When the inevitable happens – markets correct and values decline – this has a real effect on those future-year budgets and spending habits. Rather than spending less than was collected in boom years, or "planning ahead" for the cyclical nature of property value trends…most governments have an overly optimistic (and sorely limited) vision for the future. Thus, when the value of the tax base reverses course and corrects, these entities and institutions have a very difficult time scaling back their spending.

Instead, while taxpayers are suffering through difficult economic times and dealing with falling property values, they are often simultaneously hit with "increased" property taxes. How can this be (higher taxes), if values are declining? Because the local governments will increase tax *rates* to ensure the same – or greater – amount of revenue is collected. We are already seeing this in many areas; it is almost a weekly occurrence that we read of some jurisdiction increasing their property tax rate, even ahead of the full impact of valuation corrections. Such a trend makes it even more critical that taxpayers – owners and managers – do everything within their power to control, manage and mitigate property taxes as an expense and reduction to net operating income. While you cannot control statutory matters like assessment ratios applied to different classes of property, or the tax rate itself – you can ensure that the "valuation" rendered by the assessment officials is representative of the market conditions on the tax lien date. This not only helps you weather the storms of real estate cycles, but every tax dollar saved is an increase to net operating income (and thus, may be capitalized exponentially for the value preservation of the asset, whether for disposition or refinancing).

Ongoing & Coming CRE Corrections

While this article length will not permit us to cover all the issues impacting the near-term future of valuation declines, it is the usual lineup of suspects. We know that the Work-From-Home and post-pandemic habits will have a lasting effect on Office values. Employees have adjusted to (and prefer) at least a hybrid model, if not entirely working remotely. Employers have realized through the forced-experiment that many roles and functions can, indeed, be performed well without being in-the-office. And they've realized this structure allows for the downsizing of physical space, and can result in considerable cost savings. We simply are not going back – at least not "all the way back".

Depending on which research you follow, it is predicted that there will be a permanent excess supply (some say 13%, others maybe 15%). Personally, as I review statistics in mid-2023 from various sources, I wonder if any of these prior estimates are accurate. According to Kastle Building Systems [2], which monitors access via security and card-swipe systems, many major markets are still barely seeing returns to the office that exceed 50% of the 2019 levels. In another report from McKinsey Global Institute [3], the observation is that office attendance has stabilized at 30%-below the pre-pandemic era. Whatever the case, we know the situation could be dire for many markets. Diligent consumers of CRE news have already seen various reports of owners handing the keys back to the lenders in some of the most distressed asset classes, and warnings of the CMBS terms still to come due. The situation for Office is just one of the more glaring examples; but we see potential warning signs across various categories – Retail, Multi-Family, Hotels and so on.

Rising above the nuanced factors impacting each CRE category uniquely, we have the broader financial markets that will impair value in virtually *every* category. Bolstered by artificially cheap money for many years, the rising interest rates today and their negative effect on value is quite real. Naturally, as debt becomes more expensive (and risk increases), both capitalization rates and discount rates will increase (reducing property value). Many owners are being confronted (and far more will be confronted) with balloons on their loans – loans for which they paid interest only payments. As they need to refinance, the collateral value of the property has declined (meaning the lender will not loan as much today, as exists on their remaining balance). If unable to bring significant equity to the table, many of these owners will have difficulty obtaining financing. Even if they are able, the new loan terms will include much higher interest rates than at the time of acquisition (perhaps 2x or 3x). This means the new debt service could eat up most, or all, of their net operating income. Some owners will be unable

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to secure financing and/or will default. Others may make the decision to walk away, simply because there is no longer any equity to preserve or protect. Concurrent with these difficult propositions, lenders are tightening their purse strings and will be far more selective in extending money to borrowers.

The Moral of the Story

There is ample literature and punditry on the state of the market – this article is not intended to be yet another opinion on that subject matter. Rather, it is focused on one thing that you can do during this correction and difficult economic cycle for commercial real estate. Owners will attempt to position their properties as favorably as possible in a competitive market. They will attempt to retain tenants, offer concessions, and control operating expenses. Within this realm, we invite more intense focus and scrutiny of your “Property Tax” expense.

Property Taxes are often one of the largest line-items of the financial statement for commercial real estate. Yet, far too many owners and managers do not employ proactive strategies to mitigate this cost of ownership. An owner, investor or manager needs to understand the nuances of the local and state property tax laws and statutes. Understand the appeal process, and the “timing” of when you can mitigate this large expense through informal review with the assessing office or formal administrative remedies. Too many owners express concern upon receipt of the tax bill – by which time the remedies or recourse may have expired.

Most jurisdictions mail out assessment notices well before sending the tax bills. At this time, you often have an opportunity meet informally with the assessment staff. After this period, there is typically an opportunity to appear before an administrative body (often named something akin to a Board of Equalization). In these environments, the atmosphere is typically informal and not intimidating. But you must be equipped with market data and persuasive evidence of why the proposed assessment value is in error. Assessing officials are charged with “mass appraisal” of thousands of properties – and they generally do so with “historical data” analysis. But transactions that occurred in May of 2022 are simply not reflective of the value of your property on January 1st, 2023. We are in a different economic environment, and there exists a completely different financial market or lending environment. A hypothetical purchaser on 1/1/23 is keenly aware of these facts. Their opinion of value will be forward-looking, based on what is known on that date. The assessor’s historical transaction data, however, will probably not reflect these current conditions.

Thus, it is the owner’s responsibility to articulate these realities – to educate the assessor or board on the various impacts to your specific property’s market value. Doing so will help you manage through difficult cycles, increase net operating income, preserve value…and ultimately weather the storm until macro-economic and financial markets improve.

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