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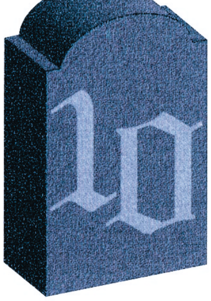
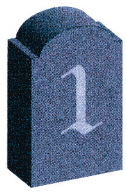
The  Commandments of Property Tax Evaluation

by Carl G. Vincent

Coopers & Lybrand recently published an amazing study. According to a broad-based survey prepared by their property tax services department, property taxes virtually equal income taxes on a state level. While state corporate income taxes comprise 38% of the state tax burden, real and personal property taxes make up a surprising 37%. Real estate taxes make up 22% of the state property tax burden and personal property taxes make up the other 15%. In light of these statistics, property managers must assume the responsibility for ensuring fair taxation for property owners. These Ten Commandments can prove to be a useful overview to maintaining fair property tax values.



The First Commandment: "Thou Shalt Not Neglect One of Thy Property's Greatest Fixed Expenses"

Real property taxes are usually one of the three largest fixed property line-item expenses. Many cost-conscious organizations focus on reducing another of the big three: utilities.

I was recently in a fellow property manager's office. He gave me a tour of the facility. The property manager walked me through and told me about the utility cost-control team that had come through the building. He pointed out the automatic shut-off light switches, the expensive HVAC computer that carefully regulated heat and humidity. Then he introduced me to his janitorial staff that was trained to be energy conscious. He pointed out their new weather-stripping, insulated windows and doors and air-seal entrances. "Kill-A-Watt" slogan stickers were everywhere. There were only two fluorescent tubes in four-tube fixtures. All of this effort at the recommendation of a cost cutting team. He also told me about the bonus he received last year for cutting utility expenses.

When we were finished with the tour and back in his overly warm office, I asked him how much time he had spent checking the property taxes. With a blank look on his face, he told me property taxes were a fixed expense and he could not do anything about them.

If he had directed the same effort toward controlling property taxes as he did to utility cost reductions, similar savings could be achieved. He would save the company more money and receive a bigger bonus if he had a property tax cost-cutting team.

Unfortunately, many property owners tend to think of taxes like insurance: trying to change them is not likely to do any good. This is not necessarily true. The remainder of the commandments explain why.

The Second Commandment: Thou shalt not confuse fair market value with book value, tax history or perceived value.

"Fair Market Value" is the price a piece of property will bring on the open market between a willing buyer and willing seller, neither being under any compulsion to buy or sell. This is the standard that most taxing entities are required by law to use when they set the value of the property.

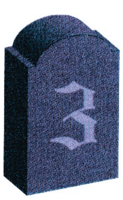
In organizations that have an accounting mentality, book value is accepted as the market value. Many organizations and individuals believe that if the assessor's value comes in below the book value, everything is OK.

Over the past ten years, much of the real estate in this country has experienced some decrease in value. The S & L crisis was created in part by the fact that the book value of many real estate portfolios was much less than the actual market value. Organizations that merely compare the assessor's fair market value with their book value may be overlooking the fact that the decline in real estate values should be reflected on their tax bill, even if it has not been written down on the books.

Others believe that if the taxes haven't changed in the last few years, everything is all right. Since the tax value is not going up, there is no reason to check the assessed value against the fair market value.

I once spoke with the president of a Midwestern credit union about the value of his headquarters building. He was just initiating the process of trying to sell the building and move to a better location. His building was valued by the assessor at $40 per foot. Two extremely similar buildings along the same thoroughfare within 100 yards of the credit union building recently sold in arms-length transactions for $30 per foot - $10 per foot less.

I asked this gentleman why he didn't file an appeal to equalize his value. He responded by saying, "Our building is worth at least $40 per foot and if we appeal for a lower value, any prospective purchaser will only want to pay the assessor's value." His perceived value of the building was $40 per foot. Based on the recent sales in the vicinity, the market value of the building was $30 per foot. For a 100,000 square foot building, his vanity was costing him over $10,000 per year in additional property taxes. And by the way, he never did find a buyer willing to pay $40 per foot.



The Third Commandment: Thou shalt study thy tax assessor's system so that ye may use the assessor's system to thine own advantage

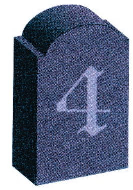
A businessman called me after purchasing a piece of property in another state. He had recently received the tax bill based on an assessed value of $76,000. He paid $200,000 for the property. Coincidentally, he lived in a state with a 33% assessment ratio. He wanted to know why the assessor was so generous in giving him such a low value, almost $125,000 less than he actually paid for the property.

The assessor was not being generous. Although the assessed value was only $76,000, the fair market value set by the assessor was $230,300. This is because the assessor multiplied the fair market value by the assessment ratio used in that state, which happened to be 33%. Almost every state has a different assessment ratio, and in many states, each county or taxing jurisdiction has a different assessment ratio. In this case, a simple appeal including a copy of his sales contract reduced his taxes by $1,000 per year. The new assessed value was $66,000.

Some states even use different assessment ratios for different types of property based on a land use classification system. In one of the states where we own property, some of our biggest savings are achieved by identifying parcels that are assessed at a commercial rate of 25% when they should be assessed at a vacant land rate of 16%. Another source of significant savings is applying statutory valuation methods that often result in values lower than actual fair market value. The problem is that most taxpayers are not aware of these statutory valuation requirements and miss out on the potential savings.

Industrial developers have a habit of buying agricultural land for development into an industrial park. Soon after purchase, they have the property rezoned for industrial use. Thanks to our agrarian background, many states grant favorable valuations or assessment ratios to agricultural property. Industrial developments, though, get to make full contribution to the tax base.

We advise our clients in the industrial development business to hold off on rezoning until they are actually ready to begin development. Sometimes, we have been successful in getting undeveloped industrial land reclassified as agricultural land, greatly reducing the developer's holding costs for the development.



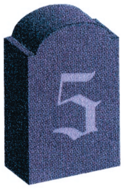
The Fourth Commandment: Thou shalt exert every effort to obtain all the information that the assessor has concerning thy property and verify its integrity.

Almost every taxing jurisdiction in the country, whether it is a county, appraisal district, village, township or city, maintains an appraisal record about each piece of property in the jurisdiction. The appraisal record contains pertinent information about the property such as size of land and building, age of construction, type of construction and how the appraiser determined the value.

Most taxing jurisdictions and appraisers are careful to document the information they place on the appraisal card, because it is the basis of valuation. However, there are still errors that occur from time to time that can cause your property to be overvalued.

One of my associates has "cookie cutter" type restaurants across the country. Almost without exception, they all fall into a specific size range. Not too long ago, they had a major remodel on one restaurant in a large city. Following the remodel, we received an assessor's notice of change in value that reflected a half-million dollar increase in value — double the value of the property. Although the remodel had slightly improved the value of the property, doubling its value was a little excessive.

I requested a copy of the assessor's property record card for my friend's restaurant. When the property was reappraised for the remodel, a new appraiser had remeasured the restaurant. Two of his dimensions were faulty. The appraiser's calculations reflected almost twice as much floor space as our restaurant actually had. Needless to say, double the square footage yielded about double the value. Because we caught the error so quickly, no appeal was needed, just a few phone calls to the appraiser. My associate received a new notice of value in the mail - much more in line with our expectations.



The Fifth Commandment: Thou shalt obtain expert knowledge concerning the valuation of real estate for the purpose of reviewing property taxes; for thou hast a fiduciary obligation to thine organization.

Many of the property owners who hire property managers are experts in their industry. Their success depends on it. They cannot afford to spread their focus from being the best restaurant or retailer they can be. Reviewing property tax values is secondary to conducting their business. They don't have the knowledge to track every notice of change in assessed value. Not only that, they do not want to be real estate appraisers.

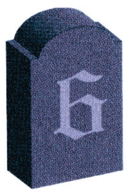
Real estate appraisal and property tax analysis consists of using "the three approaches to value." Each method consists of specific elements of data gathering, analysis and calculation. Fair market value, as defined in the first section of this article, is determined by applying at least one, and often all three of the approaches to value.

The Cost Approach uses data about the property's construction and condition in order to determine a value which reflects the cost to replace the property in its current condition. The Income Method examines the cash-flow from a property on a direct capitalization or income capitalization basis. The Comparable Sales method examines other property sales similar to the subject property to arrive at the market value.

For organizations with locations scattered across a large geographic area, it is extremely expensive to dedicate staff to stay on top of the real estate marketing in each of those areas just to review tax values. Gathering the local market information necessary to produce accurate income and comparable sales valuation information is difficult without having someone actively involved in those markets.

However, with a growing share of expenses coming from property taxes, the value of carefully managing those taxes is growing. National tax consulting organizations offer their clients the ability to handle property taxes in a proactive manner instead of reacting to unexpected changes in value and tax rates. Just as outside legal counsel and accountants free their clients from practicing law and accounting, property tax consulting firms relieve their clients of dealing with the complex issues surrounding real and personal property taxes.

If you are a property manager with only limited experience in dealing with tax issues, retaining a property tax consultant will probably pay you dividends in time and cost savings.



The Sixth Commandment: Thou shalt carefully review the assessments of thy brethren: for as they are assessed, so shalt ye be assessed.

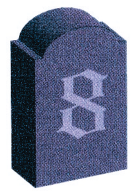
Many states where we have property will review real estate values based on "equalization." In other words, if market information is unavailable or unreliable, the assessor will examine comparable assessments to determine the taxable value. This is especially useful in geographic regions where the market is stagnant.

Tax values can be examined for properties similar to yours. Then if the value per foot or unit for the comparable assessments is lower than yours, there may be a basis for filing an appeal. However, many jurisdictions will only recognize market data and not assessment data.

Some of my friends in the convenience store business have locations in rural communities where there are several convenience stores, but not many comparable convenience store sales. This means that gathering market information is extremely difficult. In these communities, it is necessary to gather the assessor's valuation information for each convenience store in the area and compare it to our location. The property is reviewed in much more detail if there are significant differences between the convenience stores' values per foot.

Even in regions where market information is readily available, it is wise to review comparable assessments. If you have recently purchased a property for $30 per foot and comparable properties are still assessed for $15 per foot, either the assessor is under-assessing the comparables or over- assessing yours.

The Seventh Commandment: Thou shalt not be afraid of the assessor, nor give any weight to his naysayings, for his obligation is to maintain the tax base.



The Eighth Commandment: If in thine opinion, the findings of an initial tax appeal hearing are unacceptable, thou shalt not hesitate to advance to the next hearing level in the interest of thy organization.

At the time of this writing, our company has a number of assessor's decisions under appeal to district court in several states. One of the most notable cases is a large single-tenant office building in a mid-west city. Our review of the tax value revealed a valuation of about $10,000,000 or $72 per foot. When we examined the market and income values of the building, we discovered that it was actually worth about $6,000,000.

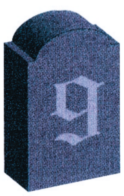
Of course, we immediately filed an informal appeal to the assessor. The assessor denied the informal appeal on the basis that it cost about $10,000,000 to build the facility seven years ago. How could we, property management professionals, claim that a $10,000,000 building was worth only half that amount? Why did we even deserve the privilege of filing such a ridiculous appeal? Well, seven years and several hundred failed S & L's later, we have learned that construction costs are no longer a good indication of value.

At the formal appeal, which we filed soon thereafter, we presented market information showing that three similar buildings, about the same size, age and construction had recently sold for $35 per foot. The Board of Appeals denied our formal appeal based on the assessor's contention that the property cost $10,000,000 to build.

Once again, the assessor dressed us down for bringing such a ridiculous appeal.

The next step was an action in district court. Our client, as an owner-occupant, was concerned with being “a good corporate citizen” and paying their fair share of the taxes. However, they were also concerned about not paying half the county government’s salaries by overpaying their taxes. Of course the assessor played on this fear, claiming that our requested value was unfair and that the press would get involved making the owner-occupant look like a Scrooge.

However, our evidence convinced the client to go ahead. The court action finally got the assessor’s attention. The final value we negotiated prior to trial was $6,000,000. If we had paid attention to the assessor’s claims our client would have spent and extra $80,000 in taxes over two years.



The Ninth Commandment: Thou shalt take care to examine thy personal property taxes in conjunction with thy real property taxes; and thou shalt not double pay taxes on any piece of property.

Double taxation is a major consideration in reviewing property tax values. This concern encompasses a type of property known as “leasehold improvements.” Leasehold improvements are generally defined as additional improvements made to a piece of real estate by a tenant. The assessor has a legitimate concern that once a property is constructed the tenant will occupy the property and improve it. The landlord may only want to pay real estate taxes on the portion that he provided and not the improvements of the tenant, so the assessor will add those leasehold improvements to the personal property of the tenant.

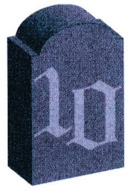
In theory, this is the best way to handle the matter. In reality, it is very difficult to tell where the real estate value stops and the personal property value starts for leasehold improvements. In a build-to-suit arrangement, the property-owner may completely build-out a facility for a tenant right down to paint, carpet and wallpaper. The value of this construction becomes taxed as real estate. Then, after a few years, the tenant may pull out the original carpet and put in new carpet. This new carpet is recorded on the fixed asset ledger of the tenant for depreciation which is provided to the assessor as the basis for personal property taxes. The assessor then picks up the carpet as “leasehold improvements.”

The problem arises because the assessor does not reduce the value of the real estate for the carpet that has been removed and replaced. So the landlord pays taxes on the original carpet, which has been ripped out and the tenant pays taxes on the new carpet.

Now, for one roll of carpet, this does not seem significant. But for long-term leases where the carpet will be changed a number of times, walls are moved, new bathroom fixtures are installed and overhead doors are replaced, the double taxation can add up rapidly.

One of my associates is a retail locations manager for a large national clothing retailer. They often lease previously occupied space in as-is condition. The value of the existing walls, bathrooms, ceilings and carpet, etc, is included as part of the real estate assessment. When the client leases the space, they completely renovate it and place the costs of renovation on their fixed asset listing, which they previously included in their personal property rendition. Prior to a careful audit of their property taxes, they paid real estate taxes on the old carpet, walls, paint and bathrooms as part of their real estate taxes and also on their renovations as personal property taxes.

Removing the renovations from the fixed asset listing has saved them an average of $100 per year per location. That’s $25,000 annually for this one small change.



The Tenth Commandment: Thou shalt be aware of what to expect from a competent tax consulting firm in both fees and performance.

Expect a thorough evaluation of the items we have discussed. A good tax firm will visit the property, pull the county records, get comparable sales and comparable assessments and charge a competitive fee for the region. Always obtain more than one quote and check references.

In most parts of the country, the contingency fees do not exceed 35% of the savings. You will also want to consider that some taxing jurisdictions consider anyone receiving a contingency fee as an unreliable witness because of their stake in obtaining a reduced value.
Always look for a firm with local experience. Some of the national firms have a great reputation in the larger metropolitan areas, but are very weak in the suburban and rural areas. Ask for a client list that shows the capacity to be effective in the specific areas that you have property.

Conclusion

Scrutinizing property taxes is a critical part of the professional property managers job. Although the commandments contained in this article are humorous, the advice and experience contained in the commentary can prove to be quite helpful.

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