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A Précis On The American Property Tax System

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The hundreds of billions of dollars of commercial real estate owned by foreign companies and individuals in the United States requires active management and oversight. This is so whether the property is triple net leased to a Fortune 500 company or is a multi-tenanted facility such as an office building or shopping center. While obviously the net leased asset requires much less attention by the owner and more oversight by a tenant responsible for all operating expenses, all real estate demands hands on. One vital aspect of this oversight is the management of *ad valorem* real property taxes.

Unlike many foreign jurisdiction, American real estate tends to be heavily taxed, relatively speaking. While few states impose *ad valorem* tax directly, localities and counties levy and rely heavily on property taxes to support their activities.

Unique among the charges attributable to real estate investments, the *ad valorem* concept mandates that taxes be paid based on the value of the asset regardless of how many and to what extent governmental services are consumed. Thus, while a shopping center generates no school children to justify education – related taxation, with some exceptions – see below - property taxes will be payable at the same rate and terms as a private dwelling which sends three children to the locality's public schools.

Most *ad valorem* property tax systems are predicated on market value, the definition which classically establishes value based on what a willing buyer will pay to a willing seller for a parcel of property, both of whom are equally informed and under no duress to either sell or buy. Depending on the jurisdiction, the annual property tax burden can approach 10% of market value or be lower than 1% of market value. Within the same state, tax burdens can vary wildly. For example, in the author's home state of Connecticut, property taxes in Greenwich, one of the wealthiest communities in the country, amount to approximately .75% of market value annually. Thus, a property situated in that town worth about $10 million will pay property taxes of $75,000 per year. Magically relocating the same property to the city of New Haven, home of Yale University, the property tax load would increase to approximately $300,000, all other things being equal.

1. <u>The assessment process</u>: While classically the city town and/or county in which the property is located will be the source of *ad valorem* taxation, in many parts in the United States, property taxes can also be imposed and levied by a county, borough, special taxing district, fire protection district, business development district or private association with taxing powers. In some states, local boards of education hold *ad valorem* taxing power alongside general municipal governmental authorities.

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The official charged with determining property values frequently holds the title of *assessor*. Assessments, which are the dollar amounts determined to be the property tax base for a particular property, derive from the law of the particular jurisdiction and the prescribed methodology used can range from 100% of market value to a small fraction. To add complexity to the system, some states permit different classes of property to be assessed at different percentages thereby allocating the city/county property tax burden disproportionally across different property types. In New York City, for example, certain residential properties are assessed at a much lower percentage than are office buildings in order to encourage private home ownership. As a result, those readers interested in purchasing a lovely townhouse in Brooklyn Heights, Riverdale, Manhattan's Upper East Side Tribeca or the Chelsea area will find property taxes delightfully low!

The manner in which American assessing jurisdictions deal with the issue of *reassessment* is blindingly erratic and may appear to the uninitiated to be bizarre. I say this because some jurisdictions determine values (and as a result assessments) annually. Others observe five year intervals. Some jurisdictions base their assessments on values determined when Jimmy Carter was President. The variation among jurisdictions as to this issue alone demands great attentiveness to the assessment process. Why? Failure to exercise appeal rights when new assessments are announced can operate to waive the ability to challenge new values and will produce an excessive tax burden.

One minor but potentially critical issue is that the assessor's office will periodically notify owners of new reassessment values or of assessment changes resulting from publically registered renovations or improvements. To effectively challenge such actions, the assessor must have the property owner's or its agent's correct address. Otherwise, protest rights may be forfeited. Notices may not find their way to the correct address or may be forwarded from one owner or managing agent to another. In the author's legal practice, it is not unusual for owners to receive notice after the relevant appeal period has expired because the assessor had a bad address.

2. <u>Assessment appeals</u>: If the foreign real estate investor has been scratching her head about American assessment practices, her consternation will increase as we discuss procedural and substantive rights available to property owners to challenge their assessments. Keep in mind again that when dealing with multiple properties in different assessing jurisdictions, each one may take a different approach towards determining a property's *ad valorem* assessment. By the same token, each jurisdiction may have a different appellate regime. Different states provide different appeal remedies.

For example, without attempting to be exhaustive, a locality may require an appeal to the local assessor and then, if satisfaction is not obtained, to a municipal board or commission. Another jurisdiction may require the first appeal to be taken to an administrative tribunal. A third jurisdiction may emphasize judicial as opposed to administrative or informal remedies. Filing dates and applicable procedures differ wildly from state to state and frequently among assessing jurisdictions with a state.

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Given the thousands of assessing jurisdictions, it is not possible to even begin to outline a “typical” procedure which must be followed. Consequently, there is no substitute for retaining an expert, frequently an attorney, who is familiar with local rules, practice, and procedure. To add to the complexity of this inquiry, some jurisdictions maintain “pay to play” rules – that is to say, if taxes are not paid in full, an appeal may not be prosecuted. Other jurisdictions permit owners to defer a small percentage of taxes levied on an the assessment which they are challenging. Note, too, that if an owner or corporate officer cannot sign certain documents and attend meetings and hearings, care must be taken in selecting a representative. In some states, an unlicensed property tax representative can act for an owner through a certain level of proceedings while in other states an attorney or appropriately licensed individual must be involved earlier in the process.

3. The assessor’s records: It is not sensible to challenge an assessment before fully mastering the facts on which the assessor based his conclusion. Building and land sizes, amenities, ceiling heights (especially in a case of warehouse facilities), number of parking spaces and the like are all key data to confirm before encountering any assessing authority. The methodology used by the assessor to determine the value should also be ascertained if possible[1]. If an income- based valuation approach was employed, were the rentals, expenses, discount rates, capitalization rates, vacancy factors and other inputs reasonable? If an income-based approach was used, was it the best methodology to capture market value? If not, why not? In other words, look before you leap.

4. Mastering the intricacy of *ad valorem* assessment challenges: This issue is important inasmuch as certain appeal levels demand a degree of participation and detail not required in other places. An assessment appellate board in one state, for example, may require the testimony of real estate appraisal and other experts in order for a property owner to win an appeal in a proceeding that may go on for a day or more. Another state may demand only a 30-minute presentation before an intermediate appellate tribunal, a fact which would hardly warrant an owner’s representative flying in from Düsseldorf for the occasion.

Even more importantly, care must be taken in assembling the materials which one thinks *might* be relevant at board administrative hearing. Given the limitations of any particular process, too much evidence and material maybe as bad as too little. The author can recall several circumstances in which an owner or designated representative appeared before a local board with copious data which the board concluded justified a *higher* value than had been determined by the assessor!

5. Be certain your data support your claim: Challenging an assessment in a jurisdiction where the local board has the right to increase the assessor’s value as well as to decrease it may not always be wise. Think about the case in which an owner’s representative did not carefully examine the assessor’s records before showing up for a brief appeal hearing. The assessor’s notes characterized that the property consisted of 150,000 square feet. The representative’s data contended that the building held 225,000 square feet. The representative earned an assessment *increase* for his client as a result.

6. Equalization: Most assessing jurisdictions are required by their states' laws to "equalize" property assessments. This means that the values of similar properties must bear a reasonable relationship to each other and that assessors cannot simply cherry pick individual property values or throw darts to establish assessments. For example, if there are 100 office buildings in the municipality, what metrics did the assessor use to value that property type? Did he employ an income-based approach, a cost-derived technique, or simply develop a valuation methodology based on size, that is to say, so many dollars per square foot of gross space?

Whichever methodology was employed, was it applied correctly to your property? An example of misapplication of a gross square footage – derived analysis might be where a building consisting of 500,000 *gross* square feet truly contained only 325,000 square feet of *rentable* space due to an interior atrium, excessively wide hallways, an atypical amount of space devoted to stairways, mechanical systems and the like. It is fairly easy to see that if that most buildings in the jurisdiction enjoy a ratio of approximately 90% of rentable to gross square footage, a hypothetical building which suffers with a 65% ratio should not be valued using the same approach. (Income and market methods might also be helpful to signal valuation differences).

7. Tenants' rights to challenge assessments: Especially in a net-leased environment, tenants who have assumed all property tax obligations under what is typically a long term lease may be more interested in challenging what is perceived to be an excessive assessment than would be the owner – that is, unless the lease is winding down and the owner is concerned about having an excessive tax burden on the property facing new prospective tenants.

Most American jurisdictions accord tenants appeal rights independent of the owner, based on the lease agreement or state law. Failure to coordinate appeal issues with tenants can lead to confusion if not loss of rights due to unsuccessful or conflicting challenges. Since most leases recognize the primacy of landlord's interest in prosecuting *ad valorem* appeals and permit the deduction of appeal costs from tax refunds before turning them over to the tenant, in most circumstances landlords should run the *ad valorem* appeal show. (The assessment appeal complexities associated with multi-tenanted properties must be deferred for a future discussion!)

8. A word about "market" rent: While most assessing authorities employ *market rent* as the benchmark for developing an income-based valuation, others draw heavily on current rents being paid under leases in place - especially when these rents are higher than current market levels! Conversely, state law may permit an assessor to disregard low existing rents and to apply *market rents* to determine assessments. This lattertechniquecan create serious stress for property owners whose full tax burden has not been extended to tenants. Understanding how a particular jurisdiction addresses this problem can be critical in the valuation process.

Conclusion

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When Theseus entered the Minotaur's maze, it might be argued that he faced a more manageable task than might be asked of the owner of multiple commercial properties in different states (and in different jurisdictions within a single state) throughout the United States. The federal system observed in America plays out exquisitely and painfully in *ad valorem* tax matters.

Tax rates are determined by local legislative bodies. While the management of property tax assessments . is daunting, property owners have no choice but to dig in and to grapple with them. Consider for a moment, a large office building suffering under a $1,250,000 annual tax burden which truly should be $650,000 if the assessment was properly set. Applying a capitalization rate of 6.5%, for the sake of argument, to the $600,000 of additional net operating income which might be generated by an assessment (and subsequent tax) reduction would increase the value of this asset by over $9.2 million. Hopefully, this observation by itself will be sufficient to generate increased interest in the oversight of the assessment of real estate assets.

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[1] In addition to income based valuation, cost and market analyses (based on sales of comparable assets) are frequently employed.

Professionals

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Practice Areas

Property Tax and Valuation
