TAX NOTES

Improper Use of Cap Rates Proves Costly

When assessors fail to apply the correct methodology, property taxes can balloon. **By Mark Hutcheson, Esq.**

Developing a capitalization rate for tax assessment purposes seems like a relatively simple task. Using the market extraction approach, the one most commonly employed by assessors and appraisers, a property's net operating income (NOI) is divided by the sale price to extract a cap rate. Sounds simple, right? While the math offers no challenge, the proper application of this method for tax assessment purposes presents a quite complex problem.

Property tax assessors and appraisers usually take a few recent comparable sales and do the quick math to establish an applicable cap rate for a property. However, just because the comparable sales look and function similarly to the appraised property does not necessarily mean they are financially similar. This is where the extraction method's complexity comes into play.

What's so complicated?

When using the extraction method, assessors seldom, if ever, consider three critical issues. First and foremost, there must be reliable and sufficient data on the comparable sales. The data should reveal the property's anticipated net income, operating expense ratio, financing terms, lease structure, the relevant market conditions and whether the property was part of a larger transaction.

Second, the NOI must be calculated or estimated using the same factors the assessor plans to apply to the assessed property. For instance, if the assessed property reports net income based on trailing 12-month financial statements, the comparables must report on the same basis.

Third, and possibly the most overlooked issue of all, is the need to determine the level of risk associated with each comparable sale. For each comparable property, risk must be analyzed by investigating tenant credit ratings, market conditions, the stability of the income stream and the property's upside or downside potential. This process requires investigation, due diligence and professional expertise to get it right.

Effects of improper methods

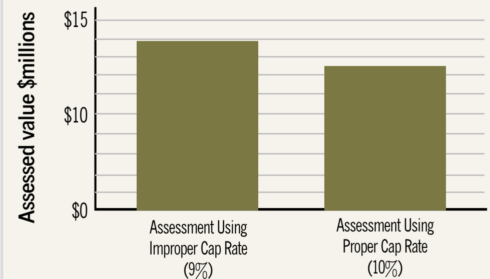
The following example shows how an assessor's failure to properly utilize the extraction method can cause taxpayers to pay unwarranted property taxes. Let's assume your local property tax assessor develops a cap rate to value your property using the market extraction method. In your jurisdiction, the property tax law dictates that an assessor must value the property at market value, based on prevailing market conditions as of a specific date, usually Jan. 1.

The assessor pulls comparable sales data in your competitive market area and corresponding NOI for each sale. Next, he simply divides the NOI by the sales price and determines that 9% represents a market cap rate for your property. This cap rate is then divided into your property's $1.25 million NOI, resulting in an assessed value of $13.9 million. This seems like a simple exercise, but the devil is in the details.

In your detailed review of the assessor's comparable sales, it becomes apparent that the sales transactions he used to generate a cap rate contained below-market rental rates and short-term leases. As a result, the 9% cap rate developed by the assessor to set your $13.9 million value actually represents a cap rate for properties with significant upside potential.

Your property, on the other hand, has above-market rental rates and long-term leases with national tenants who have outstanding credit. As you investigate the 9% cap rate, you discover that one of the assessor's comparables sold for $5 million and produced $450,000 NOI. The assessor divided that income by the sales price and derived a cap rate of 9%.

WRONG CAP RATE, EXCESSIVE TAX ASSESSMENT
Using improper comparables produced an assessment of $13.9 million. When proper comparables were used, the assessment fell by $1.4 million to $12.5 million.



Source: American Property Tax Counsel

Additional research, however, reveals that the property had below-market leases that were about to expire. Further, when you adjust the property leases to market rates, the comparable creates at least a $500,000 NOI. This $500,000 is divided by the $5 million sales price, yielding a 10% cap rate, rather than the 9% rate developed by the assessor.

By applying the 10% cap rate to your property's income of $1.25 million, the assessed value would be $12.5 million. As the accompanying chart shows, you'd cut your property tax assessment by just over $1.4 million.

In developing property tax assessments, assessors too often rely on the extraction method and its simple math to generate what they see as a correct cap rate. In fact, the proper extraction and application of a cap rate is a complex calculation that takes into account many factors to provide taxpayers with fair and equitable valuations of their properties.

By understanding all the factors used in developing your cap rate, you can avoid excessive property taxes.

Mark Hutcheson is a partner in the Austin law firm of Popp, Gray & Hutcheson, the Texas member of American Property Tax Counsel. He can be reached at mark@property-tax.com.