TAX NOTES

Avoid Pitfalls of the Cost Approach

How owners of industrial plants can methodically challenge high assessments. **By Jim Popp, Esq.**

COST REVIEW NETS $23M VALUE REDUCTION*

	Assessor's Valuation	Taxpayer's Data
Initial Cost of Industrial Plant	$70 million	$70 million
Physical Deterioration	-$7 million	-$11 million
Functional Obsolescence	$0	-$8 million
External Obsolescence	$0	-$10 million
Final Value	$63 million	$40 million

* Case study in which taxpayer prevailed

Source: APTC

The valuation of manufacturing plants for property tax purposes presents a challenge for both owners and property tax officials. First of all, industrial properties possess unique characteristics compared to such properties as offices and apartments, which tax authorities regularly value. Thus, tax officials are uncomfortable with the valuation of industrial properties.

Several issues differentiate industrial properties from apartments and offices. For example, industrial properties are often owner-occupied rather than leased to a user. If leased to a user, they typically carry long-term leases made with a single user rather than multiple users. Industrial plants sell infrequently compared with apartment and office buildings, and when they do sell, it's usually part of the sale of an entire business.

These characteristics limit the availability of industrial rental and sales data. Consequently, that makes the income and sales approaches more difficult to use for valuation purposes. As a result, tax authorities rely more heavily on the cost approach to value industrial properties than for other property types. The result is often a valuation that is too high.

Art of negotiations

The first step calls for a systematic review of the components used by assessors in the cost approach. The goal is not to convince them that their approach is wrong, but to make adjustments that benefit the taxpayer. Since the cost approach measures the property's physical characteristics, the owner possesses intimate knowledge that can help assessors understand why adjustments are needed for some or all of the property's physical characteristics.

The cost approach estimates the hard and soft costs necessary to construct a new building before adding land value to arrive at an overall opinion of value. This approach requires some deductions from the cost of the building, as if it were new, to equate it to the older building. The deductions are for physical deterioration, functional as well as economic obsolescence. Each of these deductions relies on someone's opinion and consequently becomes a subject for negotiation by the taxpayer.

Tax officials typically use commercial valuation services to develop data for their cost approach. Although these services provide the starting-point cost estimates, they don't provide information on the required deductions. Deductions are based on the assessor's opinion. Owners should determine whether the starting-point costs developed by the services represent their building's cost. Then, based on what owners know about their property and industry, they should determine if the deductions applied reflect reality.

Deterioration is a deduction for physical wear necessary to equate the new building starting point cost to the older building. Tax officials tend to believe that all industrial buildings have a life of about 40 years, for example, and measure deductions for wear based on this criterion.

In reality the life of an industrial building may be much shorter and should result in a reduction of the assessor's value. In addition, costs for maintenance, which simply keep a building productive, should not be used by the assessor to reduce the age of the plant, thereby, increasing the assessed value.

Functional obsolescence measures deductions necessary for changes in market design preferences. For example, if a taxpayer's manufacturing plant were built today, a different ceiling height might be required. This necessitates a deduction from cost. Full reviews of current design preferences can provide reductions.

Economic obsolescence requires deductions from a building's value for cost items that do not benefit the income-producing capability of the building. A common deduction is for pollution control or environmental requirement costs. Reviewing factors affecting economic obsolescence becomes essential.

Real-world applications

Several years ago a high-tech business owner built a manufacturing facility 20 miles outside a metropolitan area for $70 million. Recently, this owner challenged the property's tax value based on a cost review. The assessor had used the cost approach. The owner presented data supporting age deductions because the useful life of a tech building is shorter than other industrial buildings.

Deductions were also claimed for outdated design features and for location. Through cost review, the owner obtained about $23 million in deductions (*see table above*). The bottom line is that owners can use their superior knowledge of their property, the industry and the processes housed by the property to seek meaningful property tax reductions.

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