Distribution Center Dilemma

What Tax Assessors Don't Know Can Hurt You

By John Murphy

In construction terms, industrial buildings may be the simplest of commercial real estate holdings. But assessing industrial properties—and in particular distribution centers—for property-tax liability requires a good grasp of the way the assets function, as well as an understanding of which assessment methods do—and do not—apply to this property type. Owners who understand some essential concepts about valuing distribution centers can better determine whether an assessed value is fair or if a tax appeal is in order.

Important distribution center attributes to consider include building age, building size, land size, land-to-building ratio, interior clear ceiling heights, column spacing, cubic feet and freeway access. Both the sales comparison and income approaches are reliable valuation methods for this product type, but researching lease and sales information can be tricky. For one thing, the value of distribution centers on a per-square-foot basis can change depending on overall size and other factors affecting the building's functionality.

The following general rules will help to match comparables research to the property's size:

- For buildings 500,000 square feet and smaller, market research starts with the local market, county and surrounding areas.
- For buildings 500,000 to 1 million square feet, market research extends to state and regional levels.
- For distribution centers measuring 1 million square feet or more, research should span the national market.

With new facilities, assessors typically cite actual construction costs. It is important to note that the cost approach will result in an excessive assessed value without deductions for physical, external and functional depreciation.

Compared to other commercial property types, distribution centers often sustain accelerated physical depreciation soon after construction. Assessors rarely have the manpower to understand the complexities of a particular property, however, and typically apply a very modest depreciation amount annually. Thus, it is the responsibility of the owner's valuation expert to recognize and quantify these issues in an opinion of value.

The same principle applies to physical building attributes that benefit a specific user without improving the building's marketability. For example, new distribution centers typically have clear ceiling heights in the 32- to 36-foot range, while a few have ceilings as high as 110 feet. Obviously, the latter properties are built for particular users, and the additional clear height will not translate to additional value in the marketplace. On the contrary, that excess would result in a functional obsolescence deduction.

The cost approach is a valid valuation method with newer facilities, provided that all forms of depreciation are applied. Market extraction depreciation, or analyzing actual sales of comparable properties, is an appropriate way to capture all forms of obsolescence.

Another way to look at the excessive ceiling height issue is to consider cubic volume. Consider the example of a 500,000-square-foot facility constructed in 2008 with a 70-foot clear height. The height is a functional obsolescence issue, as the market will not pay for the additional clearance above the standard 32 to 36 feet. How can the property owner's valuation professional measure that obsolescence?

One useful technique to level the comparable playing field is to determine the subject's cubic feet of space. In this example, arguably, the cubic feet of the building would be comparable to properties with twice the square footage. So the comparables selected for the income and sales-comparison approaches would be 1 million square feet in size, with clear heights of about 35 feet.

The Abatement Trap

Many companies are constructing distribution centers using abatements, which provide real estate tax relief for a time. While these incentives are enticing, it is a good practice for the property owner to obtain an opinion of value from an experienced appraiser even during the years that the abatement is in effect.

Assessed values, however, tend to be overstated during the abatement period. If an owner sits idly by and ignores assessments during the abatement period, it will be extremely difficult to challenge an assessed value once the abatement expires. Annually reviewing the property's value should ensure a correct assessment both during and after the abatement.

Property owners need to be conscientious about the complexities involved in valuing distribution centers. This is especially true when a facility has physical characteristics that are outside the norm. Physical, functional and external forms of obsolescence should be recognized by the assessing jurisdiction, and owners must take responsibility for ensuring that assessors fully understand and account for all forms of obsolescence. CPE

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