Property Tax Reform Goes Awry

Caps on property value cause unfair taxation.

By **Darlene Sullivan, Esq.,** as published by **National Real Estate Investor**, October 2009

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At first blush, it appears that a cap on property tax values, often called appraisal or assessment caps, provides a panacea for limiting increasing property taxes. However, a closer look reveals that artificial caps precipitate other larger, more far-reaching problems, rather than producing a solution for rising property taxes.

The popular answer to the call for property tax relief continues to be a “cap” or limitation on increases on taxable value. Consider the effect of a property tax cap on two identical office buildings.

With no cap on taxable value, a building valued at $1 million sustains valuation growth at the rate the market increases, in this example, 10% annually. A cap on taxable value of 3% limits the rise of taxable value. Thus, the non-capped building’s valuation skyrockets from a $1 million to over $1.6 million in five years, while the capped property’s valuation grows to only about $1.16 million over the same period.

Illustrating the point

The enclosed chart demonstrates the difference in taxes paid by identical buildings, one with a tax cap, the other without.

To appease voters, some states place a cap on residential property only. This results in commercial property paying higher taxes over time and paying a greater percentage of all property taxes than before the cap was established.

Let’s suppose that before the cap was instituted, the commercial property sector paid 60% of all property taxes, while the residential sector paid 40%. The residential cap causes a reduction in the total amount of revenue collected from property taxes. To offset the revenue loss, the tax authority raises tax rates.

Since residential properties valuations are capped, commercial property now has a higher tax rate on its ever-increasing valuation. Thus, the commercial and residential sectors trade places, with commercial now paying 65% of all property taxes compared with residential’s 35%.

The residential cap, in effect, lets residential property owners pay taxes on less than the full market value of their property, while commercial owners pay based on full market value.

Still more pitfalls

Appraisal caps also lead to other negative effects. Like all artificial limits, a cap creates artificial and unfair competitive advantages. Properties receiving no value caps, such as those newly built, purchased or remodeled, will have an economic disadvantage when compared to competing properties that benefit from the cap.

Suppose a newly purchased office building is assessed by market value when purchased. Also assume that other like-kind office buildings, not newly built, purchased or remodeled, have capped valuations. The owners of these like-kind properties, who enjoy assessment caps, have lower property taxes than the owners of newly purchased buildings and, as a result, can charge lower rents.

In addition, caps don’t typically apply to personal property in manufacturing plants, refineries, chemical plants and utilities. The real property cap shifts the tax burden to personal property because local governments will raise tax rates to balance the budget shortfall caused by the real property cap.

That means increased taxes for personal property owners, since their tax assessment is based on full market value and they will be charged a higher tax rate on that value.

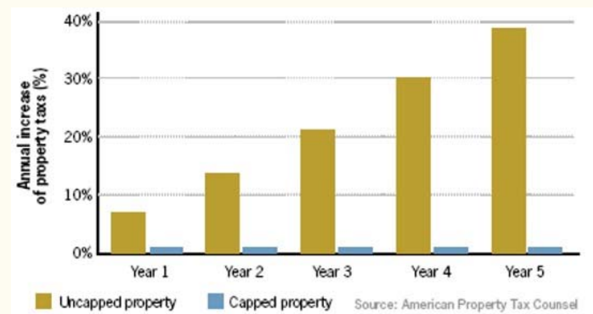
A cap also impairs local governments’ ability to provide critical services. In economic downturns, like today, the amount of state and federal money available to local areas declines, while state and federal mandates increase the need for more funding.

Thus, local fees and charges for municipal services increase but can’t compensate for the lost tax collections resulting from caps, inhibiting infrastructure development.

Artificial limits on property valuations produce a myriad of unintended negative consequences. Beware the so-called gift of property tax caps.

DRAMATIC EFFECT OF ASSESSMENT CAPS

Because non–capped property values increase at a faster rate than capped values, the non-capped property’s taxes grow exponentially over time. This chart highlights the difference over time on two buildings initially valued at $1 million.



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