TAX NOTES

The High Cost of Bad Tax Forecasting

Budget missteps cause millions of dollars in unforeseen taxes. **By Mark S. Hutcheson, Esq.**

Corporate accounting and tax departments often have difficulty in producing reliable property-tax expense forecasts for budgeting purposes. Inaccurate forecasts can reduce corporate net incomes by millions of dollars. These departments also suffer for any inaccuracies in budget forecasts because many are graded and awarded bonuses based on how well they anticipate future taxes.

Use common sense

Broadly speaking, the best way to develop reliable property tax forecasts is to stay informed. The more information you have about your property, its market, the assessor's office and local politics, the better your chance of making accurate forecasts and setting reliable accruals.

First and foremost, know your property. Most jurisdictions value investment-grade property based on the property's ability to generate income.

In developing budgets, consideration must be given to how changes in the property's actual performance affect future assessments. If the property's net income is up 20% over the prior year, budgeting only a 3% to 5% increase in property taxes will likely result in a shortfall.

Don't lose sight of deferred maintenance items, or extraordinary expenditures, and closely track any recent physical changes that may have altered the size, quality, condition, or use of the property.

Once you become fluent in the specific characteristics of the property, evaluate the property's competitive market. Perennial issues include changes in market rents, capitalization rates, comparable sales and changes in construction costs.

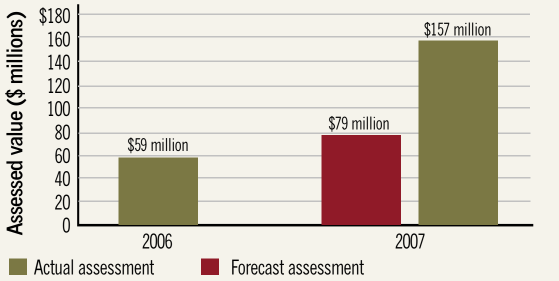
Methodology matters

Mastering the property and its market leads to the next important question: What methodology will the assessor use to appraise the property? Most assessors use a mass appraisal system to provide for uniform and efficient assessments.

Investigating and understanding the assessor's methodology enables a tax planner to model the property's performance and market conditions to arrive at a forecasted value. A strict reliance on the expected methodology, however, holds the greatest risk for being caught off guard by unforeseen changes in value.

UNEXPECTED SPIKE IN HOTEL PROPERTY TAX ASSESSMENT

Using the 2006 mass appraisal methodology, an appropriate assessment forecast for 2007 would have been $79 million, a $20 million increase. However, the assessor changed his methodology, producing an assessment almost double the forecast.



Source: American Property Tax Counsel

A recent and troubling example occurred in the 2007 assessments of full-service hotels in Dallas. In 2006, the assessing authority used a mass-appraisal method consisting solely of multiplying the gross room revenue by an arbitrary factor of 2.25.

Using that approach, the assessor obtained the annual room revenue for each hotel — as reported to the state — and arrived at a value for the taxable property by applying the multiplier. Exceptions were made during the appeal process, but overall the method was applied to all full-service hotels.

When Dallas hotel operators began budgeting for 2007, most forecasted property tax expenses were based on the assessor's 2006 model. In the interim, the assessor reviewed hotel market data and attempted to reconcile sales transactions with their mass appraisal methodology.

As a result, the assessor changed the model in 2007, concluding that a 4.0 multiplier would better capture the market value for full-service hotels. The resulting increases in value were staggering. Large full-service hotels that for years had been assessed at relatively stable levels saw two- to three-fold increases over the prior year's value. One large convention hotel's assessment rose from $59 million in 2006 to $157 million in 2007 (*see chart*).

Had the assessor maintained its 2006 model, this hotel would have been valued at $79 million, since the property's room revenue increased by 20% over the prior year. Instead, due to its shift to a 4.0 multiplier, the assessor's new value could result in approximately $2 million in additional unbudgeted property taxes.

Understand the politics

Finally, understanding local political dynamics can help predict property tax expenses. Tax rates change and increases in assessed values may be mitigated by reductions in the tax rate. Keeping a watchful eye on legislative initiatives provides good insight into what might be coming that affects property tax budgets.

Moreover, any interface with local governments for permits or tax increment financing agreements should be analyzed for the impediments they may create to effectively seeking value reductions.

In short, accurately forecasting property tax expenses is complicated and requires solid information about the property, the market, the assessor and local politics.

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