TAX NOTES

The Pitfalls of Sales Comparisons

By overlooking seller financing, assessors inflate taxable values. **By Michael Shalley**

It's no secret that commercial real estate sales volume is down. Sales transactions of U.S. commercial real estate valued at $5 million or more totaled 3,336 for all of 2009, down 60% from the previous year, according to Real Capital Analytics (RCA).

Despite more stringent underwriting and a growing reluctance by lenders to make commercial real estate loans, buyers and sellers closed a few select deals. Today, tax assessors are using those sales as a basis to value property for 2010.

Improper conclusions by tax assessors based on these imperfect sales could result in excessive values on which property tax assessments will be based.

Only 15% of U.S. property transactions last year represented a distressed situation, but the year's deals typically reflected a decline in value from highs of the preceding five years.

Due to the scarcity of credit available for real estate purchases, assumable mortgages and seller financing emerged as the dominant means of closing transactions in 2009, according to RCA.

That means that many of the past year's deals closed without the use of market-rate loans that would have pushed down closing prices.

True market value?

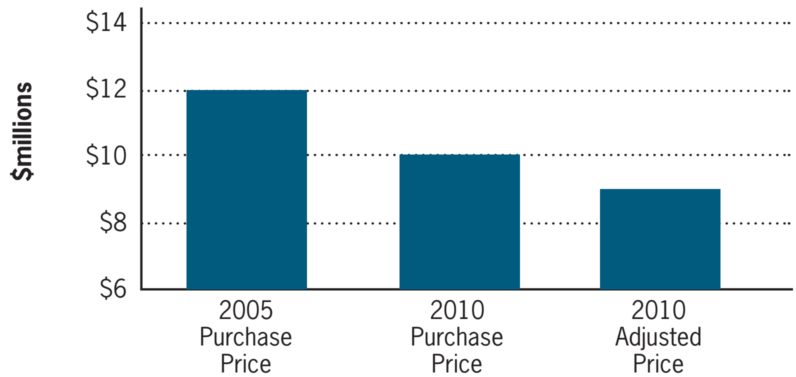
The prevalence of those significant price reductions, mortgage assumptions and seller financing in 2009 sales data poses a challenge for appraisers and tax assessors, and a threat to taxpayers.

If not properly adjusted for in a sales comparison approach to valuing property, these same three factors that sellers used to bolster sales may understate how far actual market values have declined.

Special financing or sales concessions often characterize transactions in depressed markets. Understanding the details behind each transaction is important for establishing a credible sales comparison approach to value at any time, but it becomes absolutely critical during volatile periods with few sales.

APPEARANCES CAN BE DECEIVING

A 17% decline in an office building's sale price represents a 25% drop in market value when seller financing is adjusted to reflect market rates.



Source: American Property Tax Counsel

Suppose an assessor valuing office buildings for his tax district believes that most property values have declined, but he has a limited number of transactions to determine market value. In a review of recent sales, he sees that a 100,000 sq. ft. office building has sold for a reported $10 million, or $100 per sq. ft.

The same property sold five years ago for $12 million, or $120 per sq. ft. With no further investigation of the transaction details, the assessor concludes that office building values in the neighborhood have declined 17% in five years and are now trading at $100 per sq. ft.

The devil is in the details

On its face, the assessor's conclusion appears reasonable, but with depressed markets we must dig deeper into the details of every transaction. In this example, the use of seller financing reveals a market value that is significantly lower than the $10 million transaction price would lead us to believe.

Assume the seller provides a higher loan-to-value ratio and lower interest rate than what the market offers. This props up the sale price by $1 million.

Adjusting the sale price for below-market financing, you arrive at a market value of $9 million, or $90 per sq. ft. That represents a 25% decline, as opposed to the assessor's 17% calculation.

As RCA reported, seller financing has become one of the primary alternatives to new loans, and it usually provides below-market financing terms for the buyer. Additionally, it provides the seller with a continued investment in real estate and avoids the need for a redeployment of capital into alternative investments.

Assessors are bound by the Uniform Standards of Appraisal Practice, which require an appraiser to address whether financing terms are at, below, or above market interest rates. The assessor also must determine whether a sale reflects unusual conditions, terms, or incentives.

Most sales closed today have a story behind the deal. By uncovering the details of each transaction, you might find that an adjustment is necessary to arrive at a true market value, and those details will give you a stronger case to present to the assessor in seeking a re-assessment.

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