TAX NOTES

Don’t Let Assessor s Box You In

Owners of single-tenant retail boxes could end up paying excess property taxes, if they’re not savvy. **By Jim Popp, Esq.**

Stand-alone retail boxes, which can range from 10,000 sq. ft. to more than 100,000 sq. ft., are among the least complex types of real estate. However, these boxes are often misunderstood and, as a result, overvalued by property tax authorities. They do not exhibit many of the real estate characteristics of offices or apartments with which tax authorities, are most familiar and upon which they tend to base their fundamental valuation assumptions.

The frequent, excessively high valuation of boxes results largely from assessors’ misunderstanding of the development and financing of many of these properties. Boxes are frequently the subject of sale-leaseback transactions or tenant leases on properties to be constructed. These leases differ substantially from the typical lease of an apartment or office. It is inappropriate for the assessor to use data from these transactions because the data may overstate the property tax value of the property.

The following example involving a freestanding, high-end 14,500 sq. ft. single-tenant store is useful for understanding boxes of all sizes. Typically, a developer will enter into an agreement with a drug store chain to construct a specially designed store on a predetermined site. The total construction costs, including hard and soft costs, may be $230 per sq. ft. for a total of $3.3 million, plus $1 million for land.

The developer and the drug store chain then negotiate a rent based on a return on construction costs or return on investment, taking into consideration the term of the lease and the creditworthiness of the tenant. A return on construction at 9% results in an annual rent of $390,150, or $26.90 per sq. ft. The developer may then sell the property to a third-party investor who is motivated by a stable, long-term return on his investment, or ultimately for purposes of a 1031 tax-deferred exchange

What follows are some of the issues regarding boxes that a taxpayer should bring to the attention of the tax authorities.

1 The parties to sale-leaseback transactions often have economic motivations that are different from parties in typical real estate leasing situations. Sale-leaseback transactions are popular because companies using boxes often focus on corporate liquidity, and they would rather have cash on their balance sheet than real estate holdings. Tenants can usually generate a higher return from cash in their business than in their owned real estate. In addition, these types of properties have become frequent investment targets because they are easy to use for 1031 exchanges. These factors are not under consideration in a typical lease negotiation.

2 Box owners should explore whether the actual rent calculated from financing construction costs is higher than the market rent on other boxes in the area. If the rent is higher, the tax authorities are placing excess value on the sale-leaseback property. The tax authorities then compound the problem by also using a rent figure based on construction financing as the benchmark to value other properties that are generating lower market rent.

3 The cap rates for these types of properties are below what is typical for the market place due to factors such as a lease negotiation based heavily on tenant creditworthiness, a longer than usual real estate lease period and the impact of 1031 exchanges. The tendency for tax authorities to use these below-market cap rates drives up the tax value of box properties.

4 The single-tenant nature and lengthy lease terms create situations different from the more commonly known apartment and office building patterns. Leasing and marketing expenses may not appear on current expense statements because they are sporadic rather than annual. The determination of market occupancy becomes difficult because these properties are either 100% or 0% occupied, and they may require a longer leasing period than multi-tenant properties. When these factors aren’t taken into consideration, tax assessments are too high.

5 Tax authorities often use the cost approach in valuing a property. Two issues should be explained to the assessor. The construction costs may include some costs attributable only to the specific needs of the build-to-suit tenant. They also may include entrepreneurial profit that is above normal for the contractor as a guarantee against cost overruns and time delays.

Owners of retail boxes should carefully examine their assessments in light of the five points detailed above. It is possible that all five points need to be addressed with the tax authorities, or only a few are germane to a specific property. Nonetheless, owners can avoid paying excess property tax on boxes by educating the tax authorities about these issues.

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