Control Property Taxes By Checking Lease Assumptions

Mistreatment of management fees can inflate property tax bills.

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Tax assessors make frequent, and sometimes inaccurate, assumptions about market lease structures. Incorrect assumptions can significantly inflate values, thus increasing property tax bills. One key item to check is the assessor's treatment of management fees.

Assessors generally consider all approaches to arrive at a property's taxable value: income, sales comparison and cost. Market lease assumptions can affect all three approaches, however, the impact on the income analysis is particularly significant.

What happens when an assessor deviates from the traditional understanding of which expenses are reimbursable under a triple-net lease? The result can be an inflated property tax assessment due to mistreatment of expense reimbursements.

Management fees for retail properties are typically understood to be nonrecoverable owner's expenses in market pro forma income analyses. That is, management fees are not passed through as expenses to the tenants but are kept as residual expenses to the owners, often quantified as 3 percent to 5 percent of the effective gross income.

However, management fees do not necessarily have to be treated as nonrecoverable expenses.

The real question for the taxpayer is whether a particular market's standards for a property type identify management fees as recoverable or nonrecoverable. To answer this question, closely examine the available lease data in the market, paying attention to how county assessors treat the expenses. If an assessor assumes that management fees are recoverable when they are not, the net operating income (NOI) on their pro forma income analysis will be overstated, artificially inflating the taxable value.

EFFECTS OF INCORRECT ASSUMPTIONS

Let's consider a hypothetical shopping center in a jurisdiction with a 100 percent assessment ratio, meaning real estate is assessed at 100 percent of its indicated appraised value, with a tax rate of $2.50 per $100 in assessed value. Our 100,000-square-foot retail center collects market rental rates that average $30 per square foot, and market lease data supports treating management fees as a nonreimbursable expense.

In the income models to follow, all input assumptions are held equal except for the treatment of management fees. In scenario one, management fees are treated as a nonrecoverable expense; in scenario two, management fees are treated as a recoverable expense. In both scenarios, management fees are calculated as 4 percent of the effective gross income.

In scenario one, the resulting NOI is $2.279 million. When treating management fees as a reimbursable expense, the NOI in scenario two is $2.414 million. Effectively, if management fees are incorrectly assumed to be recoverable, the resulting NOI is overstated by more than $135,000.

The result is a $2 million difference in assessed value between the two scenarios. That is, if the assessor improperly assumes management fees are reimbursable when market evidence supports treating them as nonreimbursable expenses, the property may be over-assessed, and the taxpayer may be liable for excessive property taxes.

The issue is further magnified if the assumptions driving the capitalization rate do not match the assumptions made in the assessor's pro forma income approach. Assessors most commonly derive capitalization rates from surveys and sales data. If such data is based on an underlying market assumption that management fees are nonrecoverable expenses, as is common, the resulting value indications could be even more distorted.

CONTROLLING THE TAX BURDEN

Real property valuation is often described as more art than science. Appraisers, assessors, owners and fiduciaries are all required to carefully observe the market and draw sometimes subjective conclusions from these market observations.

Property tax is often one of the largest expenses in a commercial property's profit and loss statement. If you are responsible for managing the property tax burden, pay attention to the details of how that property is valued by assessors, or hire someone who has the expertise and experience to do so. If an assessor is making assumptions about expense reimbursements that deviate from how leases in the market treat those expenses, request the information supporting their assumptions. Small changes in assumptions can dramatically impact property tax liability and, ultimately, the bottom line. **SCB**

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