OFFICE TRENDS RAISE PROPERTY TAX CONCERNS

During the pandemic, landlords and tenants need to track and document all issues affecting net operating income to help with the property tax valuation process.

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With property taxes comprising a significant portion of the real estate operating budget at most companies, both tenants and landlords need to understand how trends sparked by COVID-19 can impact their property tax valuations.

The pandemic has spurred governments to impose unprecedented restrictions on office capacity and fueled widespread uncertainty among companies that own or lease office space. Organizations are asking if, when and how they will use their offices in the months ahead and are scrutinizing expenses to reduce costs.

Many businesses are reevaluating their space requirements after adopting work-from-home initiatives, while greater familiarity with Zoom and other applications that support remote training and online collaboration has firms reconsidering their ongoing need for conference or meeting space. It is essential for real estate decision makers to monitor the effects of such trends on taxable property values.

Office Demand Evolves

In the early 1990s, it was common for companies to occupy 350 square feet of office space per person. This requirement changed as some businesses sought to maximize density and encourage collaboration.

In a COVID-19 world where social distancing precludes density, many companies are limiting the number of employees returning to the workplace. Some companies have adopted permanent work-from-home policies. If this trend continues, office tenants may renegotiate leases to occupy smaller spaces, or decline to renew.

Taxpayers working with assessors need to understand renewal probability, which measures the likelihood of a tenant renewing its lease during the holding period. Before the pandemic, renewal probability in a given market may have been 80 to 90 percent, while a post-COVID renewal probability could well be 50 percent or less.

Because assessors typically value property annually, they seldom consider renewal probabilities. Given the uncertainty of a pandemic, however, property owners need to discuss renewal plans with any tenants that have leases expiring within the next twelve months, and then share that information with assessors.

If there are a significant number of tenants at risk of vacating — and this is a trend that is being observed in the market — the assessor may need to adjust the capitalization rate used in the income approach to value the property.

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Adjust Assumptions

Owners of office buildings operating at stabilized occupancy levels for their markets must work with assessors to evaluate and analyze their vacancy risks. Buildings that lack stable occupancy rates as of valuation dates will face additional challenges as the pandemic continues.

When working with assessors, owners must properly forecast an appropriate absorption period for their vacant office spaces, in addition to projecting appropriate costs to build out spaces for occupancy. With the volume of office space offered for sublease increasing at a record pace across the nation, and often at below-market rental rates, taxpayers and assessors must consider an additional layer of competition that could create downward pressure on rental rates for direct office space. An office building that may have reached stable occupancy in 12 months in a healthy real estate market could now require 24 to 36 months to stabilize.

COVID-19 has also ushered in new health and safety measures that office owners and operators may be required to address when building out office space. Touchless entry systems, improved HVAC and filtration, and antimicrobial construction materials are just a few build-out responses companies are evaluating to bring workers back into the office safely.

If these additional costs become standard, they must be considered in a lease-up analysis. Furthermore, these calculations must include any additional time needed to complete build outs at a time when construction crews across the nation are operating under their own COVID policies.

Office protocols will likely continue to evolve into 2021. That makes it important for users of office space to save all documentation that may have a bearing on the property's net operating income. This includes rent relief agreements, renewal information, relocation requests, lease terminations, build out costs and other records to help ensure the assessor can properly consider all factors affecting the valuation for the upcoming tax year.

For the next few years, office space will remain at risk for declining values at least until a vaccine can be developed and properly administered across the nation. In this challenging period, it will be critical to ensure that assessors appropriately weigh all relevant documentation when selecting metrics in property tax valuation models.

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