Tricky Issues Impact Shopping Center Property Taxes

It's critical for landlords to understand how variations in performance affect property tax liabilities.

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Property tax assessments of shopping centers and other retail real estate may not capture the full extent of value losses those properties sustained in 2020. To avoid paying more than their fair share of taxes, it is important for retail owners to examine how market conditions affect each aspect of the tax assessor's approach to valuing their real estate.

In most jurisdictions, assessors value real estate for property taxes as of January 1 of each calendar year. Most appraisal districts assess retail properties at market value derived from the income approach, as would an investor looking to acquire one of these properties. Market value in this case is the probable price at which a property would sell in a competitive and open market, where the buyer and seller are motivated, well informed and acting in their own best interest, and with reasonable exposure time and typical financing.

In a stable environment, most appraisal districts' assessors capitalize the prior year's net operating income to reach a market value. Since the 2020 retail property market was less than stable, a modified approach could be to start with a stabilized value, then calculate the rent loss and leasing costs required to stabilize the asset.

The pandemic and stay-at-home orders affected retail property subtypes in varying ways, and performance often varied from property to property within a subtype through most of 2020 and into 2021. Multitenant strip centers saw large occupancy declines as a 20% drop in customer traffic nationwide left many tenants unable to pay rent.

MALL MAYHEM

Malls were among the hardest hit properties. Foot traffic in some malls dropped nearly to zero and mall anchors including JC Penney, Macy's, and Dillard's began liquidating many locations. Prior to the pandemic, enclosed shopping malls and brick-and-mortar stores were already struggling to maintain customer traffic related to massive increases in e-commerce. The effects of changing consumer behavior, in addition to mandated stay-at-home orders, accelerated this shift to e-commerce, and many mall-based tenants closed their doors completely.

Big box retailers arguably fared better than other store categories, as those designated as essential businesses remained open throughout 2020. Because of this, *Property tax is a significant expense to the property owner, with numerous issues and nuances to consider. Managing this cost may appear daunting but can be accomplished effectively with the correct understanding of the market conditions affecting the property.*

in many cases sales volume at big box retailers (especially those with grocery components) outpaced sales at other retail property types. Store sales do not equal market value for the purposes of property tax assessments, which underscores the need in 2021 for property owners to be more aware than ever of tax assessors' valuation standards.

While appraisal districts may emphasize increased sales volume in big box retail, property owners need to remember that business performance does not equal real estate value. Store sales may be up, but an increasing percentage of these sales come from online orders. Property owners must prove that, despite increased sales volume overall, big box property values are generally flat or decreasing. Ecommerce has weighed on real estate values for the past few years and has forced big box retailers to re-evaluate their approach to storefronts.

RENT ADJUSTMENTS

The pandemic forced property owners to make significant rent concessions to keep tenants in place throughout 2020, when those occupiers were able to do so. These rent concessions should reduce effective rents in the retail market, with variation by location and submarket. Additionally, with a large portion of tenants unable to pay rent, the retail market saw massive collection losses and climbing vacancy rates.

If a property is operating below average market occupancy, the assessor or appraiser must include a discount for lost rent or an adjustment for the cost of lease-up. Together with rent concessions, increased vacancies reduce the effective gross income these properties can produce.

Since most multitenant retail leases are structured on a triple net basis that requires tenants to pay for taxes, utilities, common area maintenance, administrative expenses and insurance, property owners are on the hook for 2020 expenses that they would normally pass through to tenants who are no longer in place. This could expose property owners to increased levels of risk.

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The pandemic also compelled property owners to reallocate capital expenditures to make buildings more resilient to virus transmission risks. As a result, other necessary capital expenditures may have been deferred, which could impact the bottom line and increase the difficulty of finding potential buyers for these properties.

QUESTIONABLE CAP RATES

After calculating net operating income, appraisal districts will then capitalize that income with a chosen capitalization rate to determine market value. The pandemic's effect on cap rates is difficult to ascertain, however, and lenders have grown more cautious. The increased risk associated with retail properties today requires an upward adjustment in cap rates, with a correlating decrease in property market values.

Property tax is a significant expense to the property owner, with numerous issues and nuances to consider. Managing this cost may appear daunting but can be accomplished effectively with the correct understanding of the market conditions affecting the property. It is important to understand the subtleties of how assessors value the property, or to partner with an experienced advisor with that knowledge. **SCB**

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