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## How Assessors Can Veer Off Course

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In a faltering economy, tax authorities want to cling to contract rents — the amount agreed upon by the landlord and tenants — as the basis for valuing property. Instead, assessors should rely on market rent, the rental income a property would command in the open market. Relying on contract rents to determine a property's value results in increased revenues from property taxes, but causes owners to pay excessive taxes.

Most taxing jurisdictions in the United States are supposed to value property based on market evidence, which is essentially what a willing buyer would pay a willing seller for property with neither party being under duress to act. In a growing economy, most property owners grasp this concept.

However, when the economy weakens and real estate values become depressed, this same concept is not as easy to comprehend. More importantly, even some taxing authorities have difficulty understanding exactly how this concept should work in a recessionary climate.

### Why rent isn' rent

Contract rent represents the actual rental income specified in a lease and can be greater or less than market rent, often referred to as economic rent. Market rent has become the basis for valuing property because it allows assessors to uniformly value all property based on the same standard of value.

In a contracting economy, with real estate values falling, the differential between contract rent and market rent can become quite significant. The differences between the two types of rent give rise to the need for diligence by property owners and managers.

This hypothetical example illustrates the point: Assume a 100,000 sq. ft. office building has been well managed for a significant period of time. As a result of superior management, the building is 100% occupied with an average rent of \$30 per sq. ft. The leases were negotiated more than two years ago.

Since that time, the office market has deteriorated. Current market rents at similar properties reach no higher than \$25 per sq. ft. net with a 10% capitalization rate.

Using contract rents, the value of the property comes to \$30 million, but employing market rents, the value is only \$20 million (rent multiplied by square footage divided by capitalization rate). Based on a 3% effective tax rate, the assessment at the contract rate comes to \$900,000, while the market rate assessment is \$600,000, a tax savings of \$300,000 (see chart).

An owner or property manager examining the rental income from the office property above can rest easy because it's clear that no problem exists. Here's a well-managed property fully leased in a weak economy. However, taxpayers must not be lulled into ignoring the need for a review of any tax assessment received in an economy under duress.

### BIG TAX SAVINGS IN A DOWN MARKET

This example of a 100,000 sq. ft. office building shows that property valuations based on market rents in a down market, should also reduce the property owners assessment.



If the taxing authorities are assessing on a market level, they should ignore contract rents and focus on appropriate market rent standards. The example shows that when valued properly the property — which by contract standards is correctly worth \$30 million — should be assessed for tax purposes at no greater than \$25 million, a significant differential.

Clearly, if the property's assessment comes in above \$25 million, it has been over assessed and requires a tax appeal in order to establish its value at the current market level of other properties.

### Make your case

The persuasiveness of a taxpayer's presentation to the assessor depends on differentiating the property's rental history from the marketplace realities. First, every available office rental comparable needs to be analyzed during the relevant time period.

Some of the physical elements of comparison should include security, HVAC, electrical systems, tenant finish, parking and location.

Second, the property owner should develop a scenario that explains why demand has eroded in the market. The owner should focus on factors such as changes in the workforce, the requisite space per worker, and analysis of vacancy rate changes over several years.

This study should cover the time period beginning with the building's lease-up. A study that demonstrates deteriorating market vacancy over a period of several years buttresses the argument that demand will naturally be weaker.

**In a declining market, taxpayers must challenge property tax assessment based on contract rents. Unless your assessment is based on market rents, a tax appeal should be the next step.**



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