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Proper Remedy for Excessive Assessments

Don't value medical office buildings higher than general office space. By Stephen Paul, Esq.

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Construction of medical office buildings is burgeoning throughout the country due to the aging population and its healthcare needs. Because these facilities generally operate as for-profit medical services, they usually become subject to property tax. Medical office owners often find their buildings assessed for real property tax purposes at excessive values when compared to general office properties.

Assessors normally use the cost approach to determine the value of newly constructed property. For the most part, medical office buildings house multiple tenants, including medical practitioners and associated healthcare facilities such as pharmacies, diagnostic imaging, labs or medical administrative services.

These facilities require certain specialized construction components and finishes to accommodate industry needs. Generally, the construction finishes are higher quality than available in the average office. So, logically, if construction costs more, the return on investment needs to be higher to offset these increased costs.

Two obvious construction cost differences stand out between general office and medical office space. First, medical offices require more partitioning due to the need for numerous small exam rooms, medical staff offices and nursing stations and for extensive file storage. Secondly, medical office space calls for more plumbing fixtures because every exam room must have facilities to maintain sanitary conditions as doctors move from patient to patient. Major costs also are incurred when an office building must accommodate X-ray machines, magnetic resonance imaging equipment, or CAT-scan equipment/ rooms that require special shielding, such as cinder blocks and double or triple thicknesses of drywall or lead. Moreover, some medical office buildings include outpatient surgical centers, which demand nonporous finishes, high intensity lighting and greater electrical service. Thus, the cost per square foot of medical office space rises well above that of conventional office space.

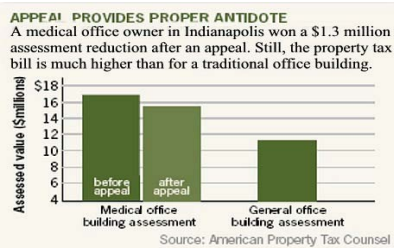
Data from Marshall & Swift Valuation Service, the industry bible, supports these facts. The data shows that the base cost to construct medical office space is 26% higher than the cost of building general office space.

Highly persuasive argument

Let's examine a property tax appeal involving a medical office property in Indianapolis in 2007. The assessor valued a newly constructed building at \$16.9 million. At the same time, the valuation on an Indianapolis general office building with the same square footage amounted to \$11.3 million.

The cost to build the medical building was \$15 million; the general office property cost \$12.4 million to construct. The assessor valued the medical office building \$5.6 million higher than the general office property, or nearly 50% more.

In preparation for the tax appeal, the taxpayer documented each construction component and compared it to general office buildings of similar size. This comparison showed that the real estate should be valued based on the basic components of a general office building.



Because each building has the exact same basic components, no justification exists for a larger tax assessment on the medical office building. In the appeal, the taxpayer also argued that an alternate or second user of the medical office building would likely purchase the property simply for office space.

As a result of this painstaking development and presentation of the relevant facts, the Appeal Board ruled in favor of the taxpayer and reduced the property's valuation by \$1.3 million to \$15.6 million. While this reduction was warranted, the medical office building remains valued higher than the general office building, proving that medical office buildings pay higher property taxes.

Lesson for assessors

Although the cost may be greater to construct medical office space, the added cost doesn't automatically justify higher property tax assessments. Because it is expensive to retrofit medical office space to fit general office needs, those costs should be deducted from construction costs to arrive at what would be market value for a general office building. Clearly, using the cost approach to value properties produces higher property valuations for medical office space than for general office space.

In a property tax appeal, the taxpayer must demonstrate that medical office property requires specialized construction and finishes, and lay out these facts to obtain an appropriate reduction in the property's assessment.



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