



PDF of this article

Mail the article

## Surprise: Falling Real Estate Market Brings Rising Taxes

By **John Garippa, Esq.**

as published in **Real Estate New Jersey**

April 2008

The office market in New Jersey has softened considerably according to statistics cited in a recent Wall Street Journal article. While sales of large commercial buildings have declined nationally, the drop in Northern and Central New Jersey has been significant. The area's office vacancy factor remains at 17.8% for the 4<sup>th</sup> Q4 of 2007. Then, too, according to Real Capital Analytics, Inc., a New York real estate research firm, the area is tied with Kansas City, Missouri and Sacramento California for the largest percentage decline in sales volume in the 50 major U.S. markets.

These facts bring into focus a key question: What will this slump do to property tax assessments? The answer depends on the level of due diligence performed by the tax managers and owners responsible for these properties.

Historical precedent tells us that even with a long term upward trending real estate market, there will always be periods of repose, and in some instances contractions. We are currently in such a contracting period. This means owners will put considerable effort into reducing operating expenses as portfolios are devalued. And, the single biggest expense, after debt repayment, for all types of properties is property taxes.

Many owners and managers fail to realize that property taxes must be examined annually to ensure equitable treatment across time for their properties. A property may be fairly valued and assessed for years and then, suddenly, become over-assessed.

This is precisely what the current confluence of events has precipitated this year in New Jersey. First, office market vacancy rates continue to remain at high levels with no indication of reduction. Second, the meltdown in the subprime mortgage market has seriously eroded the capital markets. Banks and financial institutions are requiring significantly more capital infusion from prospective buyers. This, coupled with lender fears, has forced capitalization rates to rise. Third, the employment climate in the state continues to weaken as fears of an economic recession rise.

While sophisticated owners and managers understand these facts, they often ignore the effect when they see a fully leased building. This remains the classic mistake made by owners when dealing with property taxes.

For property tax assessment purposes, property must be valued each year as if a snapshot of the market is taken on October 1<sup>st</sup> of the prior year. For 2008 property tax assessments, owners must ask themselves: What would the current economic market rent, vacancy, and capitalization rate be for each property as of October 1, 2007? Because of the events previously described, any reasonable level of analysis would conclude that most commercial property must be valued below the prior year. Therefore, even if the assessment remains static year to year, the property becomes over assessed because of macroeconomic forces.

Assume the following example: A 100,000 square foot office building leases for an average rental of \$25 per square foot based on leases that are several years old. The average vacancy in the building is 5%. If current economic rates indicate that as of October 1, 2007 the appropriate market rent for that building, were it exposed to the market, would be \$20 per sf with a 15% vacancy rate, using this example, the building's gross income would drop by more than 29%. This alone results in a significant change in value for this property.

However, the building's market value falls even more when a change in the capitalization rate is appropriate. Based on the macro economic changes described above, an increase in the capitalization rate would be appropriate. In this example, if the capitalization rate changed from 9% to 10%, the value of the property would decrease more than 35% from its original valuation. While a buyer examining the rent roll and net income, as indicated in the example, sees no change based on contract rent, enormous changes have taken place based on economic rent and current market conditions.

Marking a commercial property for long term capital appreciation represents a sound investment policy. Operating under such a policy puts enormous pressure on owners not to ignore cyclical downturns. Even in the short term, those down drafts can dramatically affect a property's valuation for property tax purposes, costing owners untold thousands of dollars in tax expense.



**John Garippa** is senior partner of the law firm of **Garippa, Lotz & Giannuario** with offices in **Montclair and Philadelphia**. Mr. Garippa is also the president of the **American Property Tax Counsel**, the national affiliation of property tax attorneys, and can be reached at [john@taxappeal.com](mailto:john@taxappeal.com).