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Reassessing Market Value

-Assessors' use of historical sales data in a recession inflates property values. -

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During periods of economic weakness, U.S. commercial and industrial real estate owners become vulnerable to unrealistic and excessive property tax assessments. Assessors' reliance on mass appraisal methodology and their use of data compiled during strong economic periods are the two main reasons for this problem.

Due to the large number of property tax parcels in a jurisdiction and limited resources to assess them, assessors typically employ mass appraisal methodology. In a mass appraisal, assessors gather and study certain economic data for a one- to three-year period preceding the assessment's effective date, including sales transactions, market rents, vacancy levels and/or levels of operating expenses.

Assessors then use that information to develop a valuation methodology, which they apply to individual parcels. For example, an assessor might study sales from the prior two years, which includes a dozen industrial properties located in his jurisdiction. He may determine from his study that the sold properties should have been valued 5% higher than the value at which they were carried on the assessment roll. The assessor would then increase the value of the entire class of industrial property by 5%.

As a result, assessors typically value individual parcels not so much by looking at the specific characteristics of a particular parcel, but rather by the application of a mass appraisal system that relies heavily on historical data. Recognizing and understanding the traditional methodology many assessors utilize is critical to enabling taxpayers to evaluate their risk of receiving excessive assessments.

Methodology under microscope

Odds are that assessors' usual valuation models for the 2009 tax year may be significantly flawed because a huge disconnect exists between economic conditions two to three years ago and today. This disconnect shows up in many ways.

The office vacancy rate in many markets has been low, from 5% to 10%, in the past few years. The current recession, however, is marked by financial sector turmoil and rising unemployment, resulting in increased office vacancies.

Shopping centers, too, are experiencing higher vacancies due to the recession's adverse impact on retail sales, which has been exacerbated by the reduction in new residential subdivision development and high residential foreclosure rates.

Perhaps the biggest data disconnect lies in capitalization rates, which act as a proxy for buyers' recognition of risk. Before the September 2008 economic crisis, buyers expected rental income and property values to continue rising. Now the reality of declining occupancy and rents, plus higher risk, has raised cap rates and lowered property values.

Upside of a downturn

A change in economic climate affects a property's valuation when the assessor uses historical data instead of current data. In 2007, a warehouse in Austin, Texas could command a net rent of \$5 per sq. ft. Back then, vacancy held steady at about 9%. An appropriate cap rate would have been about 7.5%.

In late 2008, the recession caused warehouse vacancy rates in Austin to rise to 14%. The market softness pushed up vacancies, and market rent fell to about \$4.50 per sq. ft. This trend raised the cap rate by at least 1%.

Based on the use of historical data, a 500,000 sq. ft. warehouse is valued at \$26.4 million (see *chart*). However, the value based on current data comes to \$19.8 million, a 25% reduction. Property taxes would amount to about \$595,000 annually with an assessment based on historical data. Using current data, the assessment would result in taxes of about \$445,000 annually, a \$150,000 difference.

Assessors often use historical data to assist in making property tax assessments. That methodology may suffice in periods of economic stability. Unfortunately, in these volatile and challenging times, assessments based on dated information will be inaccurate and overstated.

If assessors keep using the rear view mirror to determine assessments, taxpayers should file appeals to avoid head-on collisions with excessive property taxation. Critical to a successful appeal is the use of current data to indicate an appropriate property tax assessment.



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