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# Question of the Month: Property taxes: Does construction cost equal value? - by David Wilkes

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Let the Tax Assessor Know: Cost Doesn’t Always Equal Value

A frequent source of owner angst occurs when significant capital is spent on construction to erect, modify or expand a property and the local tax assessor immediately responds by increasing the assessed value by nearly the same amount that was spent. The question is whether the costs invested by an owner are always equivalent to added property value. Stated another way, and as many assessors like to ask owners, if something costs X to build, isn’t it worth X?

Often, to the chagrin of the tax assessor, the appraisal comes in lower than the cost. Getting the value correct can make a significant difference in the owner’s annual property tax bill. This issue is often the source of contention and sometimes litigation, and unfortunately in some instances courts will buy into the simplistic argument that cost must equal value.

Putting aside development projects driven by ego, which may ignore market forces, or a user’s need to build a structure for their operations based on business considerations that are unrelated to the real estate market, the cost of construction sometimes misses the market due to imperfect timing or other variables.

Specifically, in the tax assessor’s zeal to add assessment value to their rolls when a building permit lands on their desk, economic obsolescence is often ignored. As a reminder, economic obsolescence is the form of depreciation in a property that is caused by external factors like changes in supply and demand for the type of use the structure offers. For instance, by the time that well-intentioned construction of an office building is completed, other owners with the same idea may also have added supply or demand in the area may have declined, and therefore the capital expended on construction no longer equates to the anticipated value the developer had in mind.

It is much easier for the tax assessor to simply add the cost as a proxy of value and then wait and see whether the owner will dispute it than to take a hard look at whether and how much economic obsolescence may exist. Unfortunately, many owners view an assessment increase that aligns with their capital outlay as fair, and give the government its pound of flesh without an argument.

In reality, determining the extent of economic obsolescence – which tells you how much value may have been added due to capital improvements – is straightforward but does require a little research. The most common approach with commercial properties is to estimate the difference between what the market rent actually is and what it would need to be to provide a reasonable rate of return. The difference is the amount of economic obsolescence present, and that would be deducted from the cost new to determine how much cost has added value. The smaller the difference, the closer cost is to real value (assuming no other forms of obsolescence such as functional).

For a simple example, let's say you decide to build a 10,000 s/f suburban retail structure at a cost of $3 million. At the time you pencil out this project, the going rent for this type of space is $40 per s/f, triple net, and your net operating income after vacancy, credit loss, management and reserves would be $25 per s/f, or $250,000. Applying a market cap rate of 8%, a value of $3.125 million is indicated. By the time the project is completed, the best rent you can achieve is $35 per s/f, not fully net, and a bit more vacancy than you projected, leaving a net operating income of only $20 per s/f. Demand has also softened slightly for this type of space with added supply, so cap rates have increased to 8.5%. This results in a value of about $2.35 million, some $650,000 short of your capital investment, or approximately 22% less value than indicated by the cost of the project. This is the amount of economic obsolescence, and by law, the tax assessor must account for this gap.

For a variety of reasons, some of which may be individual to the developer, the project may still be viable and worthwhile, but as of the date of completion of construction the cost does not equal the market value of the property.

It is also important to keep in mind that New York's courts have repeatedly stated that cost is a ceiling on value, not an equivalent. This means that the tax assessor must be sure not to go beyond the costs of construction in determining value and, as shown above, remain mindful that in many cases the market value may be significantly less than the costs.

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