



Increased market risk can work to lower property taxes - by Brad and Sean Cronin

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We've now seen an extended period of time when risk and corresponding cap rates at which properties are trading have risen significantly. The reasons behind risk elevation are well known to commercial investors, starting with interest rates and inflation, but also including increases in labor costs as well as prices for goods and services and even availability of materials. These are just some of the factors that have heightened risk and led investors to shy away from consummating deals. Even though caps rates are rising, there are circumstances surrounding many sales that have suppressed cap rates and support the position that the true cap rate environment is even higher than the raw data indicates. These higher cap rates have a direct impact on an owner's property tax case and when analyzed properly, can reduce the tax burden.

After closer examination, even the few sales where buyer and seller have been able to agree, frequently turn out not to be truly market transactions. Many buyers who have moved forward with purchases in the current environment are users. Users are buying buildings with the intent to occupy and run their businesses at the property. This is a far different set of criteria for purchase as compared to an investor buying a property and looking for a positive return. Users are known to overpay for properties that fit their specific business needs, such as layout and configuration, as well as proximity of vendors and customers. Existing businesses must also purchase at a proximity that will allow their employees to continue to have similar commutes or risk losing some of their workforce. A user's biggest motivation may simply be to stop paying exorbitant rent costs and start building equity in a property. Regardless of the reasons, users have different motivations than

investors. Thus, user transactions distort cap rates downwards where a true market transaction would produce a lower price and higher cap rate.

Another sales trend that has come to almost a complete stop are speculative purchases. The practice of buying a location, and then waiting for tenants to occupy space has always been chock-full of risk, but given the factors cited earlier, the consequences are now much worse. The fall out from rising interest rates has made the carrying cost of a mortgage at a property with any sort of vacancy unbearable. The exodus of retail tenants provides the primary example of the dangers of buying vacant properties. Vacant banks and drugstores can no longer be purchased with the expectation that a similar tenant will sign a lease. Rather, the only transactions that are occurring for these types of properties are ones where the purchaser has bought the property for a change in use. In those instances, that purchaser is not paying a price for the real estate that presently exists at the property, but rather for that real estate plus the right to change that property to a more a profitable use. This is another example of a higher price providing cap rate data that is artificially low because of the circumstances surrounding the transaction.

These factors can, and should, support owner's pursuits of lower property taxes. The reason being that New York state courts have identified that commercial properties should not be valued based on sales, but rather the income stream to each individual property. For this reason, comparable sales are rarely considered when reviewing commercial property tax cases. Therefore, all the factors contributing to higher risks must be considered in an income analysis when analyzing a property for tax purposes.

New York law requires that all properties be taxed equitably. This compels assessors to strip away factors such as user purchases and change of use and focus on the true value of the underlying real estate. New York state judges also recognized that long-term leases may not indicate the current values as market conditions change. This has been extremely evident with leases signed post-COVID, particularly in the retail and office sectors. The courts require the assessor's income analysis to go to the market and support their rent with current transactions to show an old lease agreement is not artificially high. By the same token, property owners must provide data if they are to prove that the old lease agreement is no longer indicative of the current market rent.

No property sector is immune to inflation and increased costs. By highlighting the elevated risk in commercial real estate, property owners can strengthen their case to reduce their property tax burden. By translating the variables of an income approach to current market conditions, and ultimately applying an accurate capitalization rate, commercial property owners can avail themselves of income analysis that will yield a proper taxable value and reduced property taxes.

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