

What Happens to Property Taxes in a Down Market? - By Raymond Gray, Esq.

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The ongoing financial crisis has had a tremendous impact on the commercial real estate market and the downturn is abundantly evident in the hotel market. During the past three years, purchase prices for hotels have been at an all time high. These high purchase prices led tax assessors to use extremely low capitalization rates in their valuation models. This enabled the assessors to match the capitalization rates implied from high purchase prices.

Now that the crisis in the credit markets has virtually stopped the sale of hotel properties, taxpayers' must ensure that their assessments reflect today's economic conditions. In a down market, with relatively static income projections at best, the essential element of an accurate property tax assessment can be found by deriving the proper cap rate. A proper cap rate is one that reflects the limited upside potential in revenue.

The fallout from the current credit crisis continues, making it crystal clear that interest rates will increase due to the lack of commercial credit and tougher underwriting standards. Cap rates used to value real estate must go up as well to reflect this downturn in market conditions. However, some difficulty is encountered in establishing an increase in cap rates when sales activity has dwindled to relatively few properties.

The typical assessor uses the 'market extraction' method to determine the cap rate for property tax valuation. This is done by dividing the net income of an income producing property (such as a hotel) by the sales prices of comparable marketplace transactions. Because relatively few hotel transactions have taken place, the market extraction method becomes a less reliable method for deriving the proper cap rate.

Given the lack of transactions, conscientious owners and knowledgeable property tax professionals will use an alternative method of establishing a proper cap rate. That method employs a band of investment analysis to 'build up' the proper cap rate.

The 'Band of Investment' analysis (sometimes called 'cash flow method') determines a cap rate by blending the return or cash flow required by an equity investor with the return or interest rate required by the debt lender. An even more sophisticated methodology exists that uses the advanced 'mortgage equity technique' or 'Ellwood method', which adds equity buildup and the real estate investment holding period to the 'band of investment' model,

Unfortunately, practice shows that the more complex the valuation methodology, the more reluctant the assessor is to adopting it. Although the band of investment analysis is time consuming, and requires superior knowledge of valuation and appraisal principles, the extra effort entailed often provides the only path to convincing the assessor that your opinion of value holds the most credibility.

As we move from a robust market to a down market, taxpayers should exercise extreme care in analyzing their tax assessments. The assessor's underlying valuation methodology and the cap rate he uses will likely not reflect current market conditions regarding the availability or cost of capital, nor the lack of opportunity for income growth. Diligence in challenging the tax assessors' methodology and assumptions offers taxpayers a meaningful chance to lower their property taxes and produce a stronger bottom line.

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