

Keeping an eye on commercial property tax assessments

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Throughout the United States, assessors constantly search for new ways to squeeze value from commercial property. Assessing the business value of the property rather than just its real estate value has become one of the most common stratagems assessors employ. They do this by purporting to value the property on a traditional income approach, but then use the income generated from a business conducted on the property to derive the property's value. This violates the fundamental rule of *ad valorem* taxation, which states that only value generated by the real estate itself can be taxed.

This generally causes no problem for leased property. To take a simple example, a commercial office building clearly can be assessed based on the rental income it generates to the owner. Unquestionably, such income represents pure real estate income, generated by the real estate itself. No assessor would seriously seek to assess an office building by including income generated by the law firms, accounting firms and other commercial tenants who rent the office space.

The problem arises for owner-occupied property, where no rental income stream exists that the owner can identify as income generated by the real estate itself. In such cases, it becomes easier for the assessor to take the income generated by the business the owner operates at that location and try to portray that business income as income generated by the property.

In some cases, it should be obvious that the assessor cannot do so. For example, a successful retailer may generate several hundred dollars of retail income per square foot by selling high-end consumer electronics at its owner-occupied location. It would be difficult in that case for the assessor to claim that the income was attributable to the real estate and not the retailer's business skills. On the other hand, as we will see, where a business operated by the owner is less clearly separable from the real estate, the assessor will have an easier time trying to ascribe the income to the real estate.

Court weighs in on business value

Three Wisconsin appellate court decisions on this issue prove instructive and provide a fairly universal guide to steps property owners in any jurisdiction can take to ensure that assessors capture only the value of their real estate, and not the value of a business conducted on that real estate.

Wisconsin courts require that the real estate itself must have the "inherent capacity" to produce income before that income can be considered in assessing the property. In the first Wisconsin case on this issue, the Court of Appeals rejected a regional mall owner's argument that the mall should be assessed at less than its purchase price on the theory that the purchase price included a business value independent of the real estate. The court held that since regional malls exist for the purpose of leasing space to tenants, all the income generated by leasing this space is "inextricably intertwined" with the real estate and, thus, assessable.

In a second case, the Wisconsin Supreme Court found that income generated by a state-licensed, owner-operated landfill could be included in the property's assessment. The court stated that since the license was "specific to the site" and could not be transferred to any other property, the land itself had "an inherent capacity to accept waste that would not be present" in sites without licenses. The court noted, however, that neither side had been able to find evidence of leases in the local market, that is, instances where landfill operators paid the property owner market rent to lease a landfill site. The court indicated that had such market information been available, it likely would not have permitted the landfill income to be used in formulating the assessment.

Actions Owners Should Take

Property owners in any jurisdiction can glean several lessons from these decisions. First and foremost, whenever the assessor seeks income information, the property owner should ensure that only income attributable to the real estate is provided. For example, this will be relatively easy in the case of a retail sales location, since retail sales income is not properly attributable to real estate.

In more difficult cases, some income may be attributable to the real estate and some may not. In such instances, owners need to carefully structure their operating statements so that income sources not directly pertaining to the real estate are reported and categorized separately, and not intermingled with the real estate income. The more the owner blurs the real estate and other income together in a single operating statement, the easier it will be for the assessor to cite that statement as proof that the income in question is "inextricably intertwined" with the real estate income.

Finally, as the Wisconsin landfill decision makes clear, the best defense against an assessor seeking to include business income in a property assessment is actual evidence of local market rental rates for similar properties. Property owners need to exhaust all possibilities for finding like businesses that lease their space, since such market evidence makes it next to impossible for the assessor to claim that business income which exceeds those market rental rates is attributable to the real estate.

In sum, property owners who carefully review and understand the basis for their property tax assessments, and who regularly focus their attention on how their business income is reported to the assessor, stand the best chance of avoiding unlawful property taxation of their business income.