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PROPERTY TAX CONSULTANTS

What to Consider About Property Taxes During Underwriting

According to Real Capital Analytics, the volume of trades in multi-family is currently the highest since 2007. In the same vein, assets are trading at cap rates that are at the lowest level since 2007. Class A assets are regularly trading in the 5% range and even lower in the CBD's of major metropolitan areas. As cap rates reach a stabilized level, owners will have to singularly rely on property performance to increase the asset value. For acquirers, the emphasis on accurate underwriting becomes even more critical.

Of all the major asset classes, multi-family properties are the ones most consistently seeing increases in value validated by the trade volume and cap rates. For this reason, they have become a target for the local budget-starved taxing entities. In many parts of the country, apartment owners are starting to feel the pinch. Those that did not budget properly are experiencing negative variances and taxes that offset any increases in revenue.

What needs to be considered about property taxes during underwriting? Although most owners/managers do an adequate job of controlling property taxes during the hold period, there is usually a lack of understanding of expectations during the underwriting process. This is understandable as each jurisdiction operates differently and has different taxing laws. We recently had a client call us one week before closing and ask us to verify what they had in the underwriting for property taxes. They had neglected to reset the assessed value upon acquisition, and thus underestimated their obligation by roughly $200,000. This equates to $4,000,000 in value. Unfortunately, I had to be the bearer of bad news, and the deal never closed.

There are numerous sources of confusion during the underwriting process, and below are a few common questions:

1. How often are values reassessed? Is there an automatic reassessment triggered by a transaction?

2. What is the exact millage rate? How are they set? How often do they change?

3. Are there limitations to the increases in assessed values during the hold period (a la Prop 13 in California)?

4. What is the timing of the assessments and when exactly are bills due?

5. What is the appeal process and how long does it typically last?

As with many government organizations, it is difficult to get clear answers to the questions above by reading websites or speaking with their staff. As such, I recommend that underwriters engage professionals who can educate and guide them through the process. It is difficult enough figuring out what the taxes will be at the outset, but even tougher to think about how to pro forma numbers through the entire hold period. By

engaging professionals, investors will increase their confidence in the numbers and reduce the margin of error.

What must be done after acquisition to achieve the best property tax outcomes? After acquisition, it is important to actively manage your property tax assessments. Owners at times believe that property tax agents are able to reduce values based on their relationships with local jurisdictions. The vast majority of the time, this is not true (although relationships can be important at times).

In choosing a firm, two very important factors should be considered. First, make sure that agents clearly understand the appeal process. This can be done by simply requesting a step-by-step detailed outline of the procedures of the process. If they can't provide that in detail, then they probably do not have a firm grasp of it. Second, hire a firm that has a strong understanding of your property type. This is paramount because your selected experts must have the analytical rigor to understand the financial statements you will be providing.

For example, we have a multi-family client with an asset whose vacancy was increasing as was their gross potential rents. The two seem incongruous on the surface. Given our expertise in both understanding financial and operational aspects, we correctly assumed (and confirmed with the client) that this was based on the new pricing software they had installed. As units were becoming vacant, the system was reverting them back to market rents rather than street rents since there was no loss-to-lease line item expense in the P&L. Accordingly, we were able to justify a lower GPR and achieve a reduction. Other firms without that expertise would not have been able to identify that discrepancy and would not have achieved any reduction.