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Shifting Taxes to Tenants

High Demand Market Eases Owners' Tax Burden

By Wayne E. Etter and Charles E. Gilliland

The desire for property tax relief is a common refrain among taxpayers, Texas taxing jurisdictions and elsewhere. Usually, the discussion focuses on how property tax changes will affect single-family homeowners, but the effect on income property values is discussed less often. Real estate investors must understand the difference between the effect of property tax changes on the value of owner-occupied single-family homes and income properties.

Property taxes, levied on owner-occupied single-family homes, are a part of the owner's total housing cost. A buyer comparing homes in a high property tax community with those in a lower property tax community can afford to buy a more expensive home in the low-tax community. If this tax difference exists for several years, housing prices in the high-tax community should decline until total homeownership costs equalize between the two communities.

This is particularly true if the public services funded by the property tax in the two communities are perceived as being nearly equal. However, if the public perceives that the quality of municipal services (police and fire protection) in the higher-tax community are superior, then that community's homes could command a premium price. When property taxes are levied on income properties, however, the effect on value is more complicated.

Income Property Valuation

Income capitalization is a common means of valuing industrial, office, retail and residential income properties. After estimating a property's net operating income (NOI), an appropriate capitalization rate is used to convert the anticipated income stream into an estimate of the income property's value (Exhibit 1-A). Because a property's value is a function of its expected income, increases in value result from increased NOI.

Property tax payments are an operating expense and, along with other operating expenses, are subtracted from rental income to determine a property's NOI. Thus, the price paid for the property allows the buyer to pay a given property tax bill from the income stream. Consequently, a permanent decrease in the property tax should increase an income property's value (Exhibit 1-B).

This immediate increase in value, however, could be offset long term, if the quality of municipal services is diminished by a lack of tax revenue. (For example, slower response time by police, fire, EMS.) Whether or not the property owner

Exhibit 1

	A	B	
	Initial Tax	Tax Decrease	Tax Increase
Potential gross income	$100,000	$100,000	$100,000
Less: Vacancy allowance	-5,000	-5,000	-5,000
Effective gross income	$ 95,000	95,000	95,000
Less:			
All operating expenses except property tax	-23,000	-23,000	-23,000
Property tax	-12,000	- 9,000	-15,000
Total operating expenses	35,000	32,000	38,000
Net operating income	$ 60,000	$ 63,000	$ 57,000
Net operating income	$60,000	$63,000	$ 57,000
Capitalization rate	.10	.10	.10
= Value	= $600,000	= $630,000	= $570,000

Exhibit 2

A	Market condition: Little or no vacant space with continuing demand for space	Market condition: 20 Percent Vacancy
Potential gross income	$100,000	$100,000
Less: Vacancy allowance	-5,000	-20,000
Effective gross income	$ 95,000	$ 80,000
Less: Operating expenses	-35,000	-35,000
Net operating income	$ 60,000	$ 45,000
Value (NOI capitalized at 10%)	$600,000	$450,000

B	Market condition: Little or no vacant space with continuing demand for space	Market condition: 20 Percent Vacancy
Change in property tax levy	+$3,000	+ $3,000
Change in potential gross income	+ 3,000	-0-
Change in net operating income	- 150	- 3,000
Change in value	- 1,500	- 30,000

C	Market condition: Little or no vacant space with continuing demand for space	Market condition: 20 Percent Vacancy
Change in property tax levy	- $3,000	- $3,000
Change in potential gross income	-0-	- 3,000
Change in net operating income	+ 3,000	+ 600
Change in value	+30,000	+3,000

benefits from the increased value of the property depends upon the terms in the property lease agreement.

The actual change in the property's value depends on whether the property owner can retain the benefits of a tax reduction or shift a property tax increase to tenants.

Tax Shifting in the Short-Run

The more rental income a property generates relative to operating expenses, the more NOI it will generate. And, as Exhibit 2-A illustrates, market conditions have an important effect on a property's ability to generate rental income and net operating income. Market conditions and the terms of existing leases determine when rental rates can be increased to cover a property tax increase. They also determine whether the tenants or the owner captures the benefits of a tax reduction. These increases are possible when the property owner faces a *price inelastic demand for space*. The most important condition for price inelastic demand in the retail or office space market is the lack of close substitutes, coupled with continuing demand. If a commercial property owner secures a strategic location or other competitive advantage that makes the property unique, tenants are more likely to be willing to accept increased rental rates. A property's uniqueness makes the tenant demand for the property price inelastic, even if a significant overall vacancy in the market exists. In this situation, the property owner may be able to pass the tax increase to the tenant in the form of higher rents.

For example, when there is a continuing demand for space in a multi-family housing market that has little or no vacant space, apartment owners can increase rental rates to cover an increase in the property tax (Exhibit 2-B). But if the landlord is unable to increase rent to offset the higher taxes, there would be a decrease in value. Conversely, in an apartment market with considerable vacant space, apartment owners would most likely have to absorb the property tax increase. The resulting decrease in NOI would result in a $30,000 decrease in value (Exhibit 1-B).

The market conditions permitting an income property owner to benefit from a property tax reduction are the same as those that permit passing on an increase to tenants. When there is little or no vacant space in the multi-family market, an apartment owner can maintain rental rates and, thereby, increase value if there is sufficient demand for space, despite the property tax decrease (Exhibit 2-C). When a significant vacancy in the market exists, an apartment owner who receives a property tax decrease might be tempted to reduce rents to maintain occupancy, offsetting the benefits of the tax reduction.

When triple-net commercial property leases are used, operating expenses are paid by the tenants. Consequently, if there is a property tax increase, the tenant pays the increased property tax, and the property owner's NOI is unaffected. Conversely, if there is a property tax decrease, the tenant would reap the benefits. Again, the property owner's NOI is unaffected. In the short run, changes in property taxation do not affect the owner's NOI and market value is unchanged. Of course, this is the purpose of a triple-net lease—to eliminate variability in NOI caused by fluctuating operating expenses. It shifts the risks of tax increases to the tenant. However, the property must have a competitive advantage to cause tenants to accept lease terms that require them to pay increases in property taxes and other operating expenses.

Tax-Shifting in the Long-Run

Market conditions where property owners can pass tax increases on to tenants or benefit from tax reductions can be transitory because supply tends to adjust to meet demand. As competing developers respond to the profit potential implied by an inelastic demand, more substitute properties enter the market and erase short-term advantages.

Owners of existing properties see demand for their space become more elastic as tenants have more options from which to choose. Ultimately, rents fall for most property owners, with the exception of those who have a uniquely desirable building and have maintained its competitiveness through maintenance and good property management.

Otherwise, the long-run market dynamics tend to approximate the situation described in Exhibit 1-B, with property owners bearing the tax increase. In fact, because labor and capital are mobile resources, some economists argue that property tax increases will ultimately reduce land values for all properties. Of course, the long run may be years in materializing.

Conclusion

In the short run, the effect of changing property taxes on property values is determined by supply and demand conditions in the market. If there is excess space in the market, owners cannot raise rents when property taxes are increased and vice-versa. However, owners of unique properties that are well managed and well maintained may escape the tax burden even in the long term by passing on the increased taxes to their tenants.

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