Taking the Bite

Out of Property Taxes

Understanding how to properly value the real estate component of a senior housing property and familiarity with the assessment process translate into major tax savings

BY DEBORAH DAVIS

Your senior housing community may be missing out on sizable savings in property tax assessments. Tax assessors who lack an understanding of the senior housing industry or knowledge about how to separate the business from the taxable real estate often overstate the tax amount.

Senior housing is a unique business in that it combines a real estate asset with a health-care and service enterprise. In assessing senior housing, property tax assessors are allowed to consider only the value of the real property assets and, in certain states, also the tangible personal property assets. The value of the business, however, must be excluded from the tax base. To get a reasonable tax assessment, it's important to understand that "value" has multiple definitions.

Most owners/operators of senior housing are familiar with appraisals prior to obtaining financing, which often assume a definition of value as "the value of a proven property operation." This definition may include an intangible enhancement to the real estate value. Because most owners hope to maximize the property's net income and value in the hopes of obtaining the best financing possible, this definition may be appropriate.

In contrast, the definitions for market value for state tax purposes are much more narrow and specific than definitions of value for other purposes. For senior housing, the definition of "market value" for real estate tax purposes generally relates only to the market value of the real property and doesn't include any intangible or business value. The property tax expense is minimized by following the state definition of value and providing the assessor with the evidence (through appraisal or other analysis) that meets this narrower definition.

Many other definitions of value exist, including insurance value and investment value. Many owner/operators mistak-

AT A GLANCE

- Only tangible real estate is subject to real estate taxes
- Your senior housing community is both a real estate asset and a health-care business. Many assessors do not properly separate the two pieces and often overstate the taxes.
- Better appraisal methodology may assist you in reducing your taxes.
- Talk to the local economic development department before your next project.

enly compare the appraised value for financing or other purposes with the taxable market value, and then draw the conclusion that the property is reasonably assessed.

DETERMINING THE PROPERTY'S VALUE

Appraisers use three primary approaches to estimate the value of a property. Those approaches, each of which presents unique challenges with senior housing, are reconciled to determine a market value conclusion in an appraisal.

The **Cost Approach** fundamentally looks at the cost to build the property (either replace or reproduce); makes deductions for physical, functional, or economic obsolescence; and adds to it the estimated land value (usually obtained through market sales of similar land). Assessors typically receive copies of all building permits (as well as all real estate transfer declarations) and rely on that cost data as the basis of the building value unless they are given other information. Consider the following in regard to the Cost Approach:

- Local building codes (such as fire/life/safety) can be much more onerous for senior housing than for traditional apartment buildings, thereby increasing construction cost.
- Certain construction costs, such as emergency call systems, arguably can be considered part of the business enterprise.
- Deductions must be made for functional obsolescence. Some of the items that might be considered in this category include excess common area space, unit configuration, and wider corridors and doorways.
- Deductions must be made for external obsolescence. Examples include overbuilding or lack of demand, cost of funds, and poor site access or visibility.

Because quantifying the functional and external obsolescence adjustments tends to be highly subjective, the Cost Approach for assisted and independent living can be challenging and somewhat unreliable.

The **Sales Comparison Approach** looks at sales transactions of similar properties, using appropriate units of comparison (square feet, units, beds, etc.) and makes adjustments for superior or inferior features of the comparable sales.

Senior housing tends to sell as a business and may include an assembled workforce, business and lease contracts, and other intangibles. Both federal and state laws require allocations between assets. However, allocations are done inconsistently, and often the amount recorded on real estate transfer declarations (which goes to the assessor's office) or other closing documents, reflects the entire acquisition. As a result, sales of similar senior housing properties are rarely a good measuring stick of the property's real estate value. Exceptions may exist when a facility is sold as vacant without any intangibles or other personal property.

A better methodology to isolate the real estate component involves studying apartment sales data in the immediate market, such as price per square foot, operating expenses and margins, net income, and capitalization rates. Apartments tend to be a much purer form of real estate value and have far less intangible and tangible personal property that accompany a sales transaction. In many markets, the physical components of apartments and senior housing (assisted and independent living) are highly similar. Yet a review of current assessment data can show big disparities. For example, an actual independent living facility with mostly one-bedroom units in central Illinois has an assessment of $87,000 a unit (or $84 per square foot). A review of comparable apartment sales in the area indicates a value of around $40,000 a unit (or $39 per square foot). An appeal is underway.

Obviously, adjustments are required to make the comparable sale similar to the subject property. The key adjustment is the accounting for the excess common area space. While typical apartments have 5 to 10 percent of common area space, typical independent and assisted living may have 35 to 50 percent of common areas, which may include dining and commercial kitchens, recreational areas, libraries, sitting areas, beauty salons, etc. There are at least two ways to measure and include a value for this common area space. One is to gross up the net square footage of the individual units in the subject property to account for the excess common area space. Then, apply the grossed-up square footage number to the value per square foot obtained from the apartment market.

Another method is to first determine the value of the individual (net) units, derived from the apartment market. Next, obtain the value of the common areas from the commercial real estate market. For example, sales data and lease rates are readily available for commercial kitchen and dining space. The challenge is in determining the value of the libraries, sitting areas, and other common areas (where there is little commercial market data). For this reason, the first method is mathematically simpler and is accepted by most assessors.

Finally, the **Income Capitalization Approach** converts an anticipated and/or current income from the property to obtain a property value. Consider only the real estate income for the shelter. Because the typical rent for senior housing includes not only a portion for the real estate but a large portion for the multitude of services, the difficulty lies in separating the revenue streams.

Again, the apartment market can provide excellent indications of rental rates, operating margins, and capitalization rates. You can then apply these factors to your property to calculate a stabilized real estate value using the income approach. Some of the factors to consider in this approach include vacancy issues, lease-up time and typical turnovers, and deductions for personal property.

CALIFORNIANS, TAKE NOTE

Under California's Proposition 13, real property assessments are based on the acquisition value (as opposed to market value). That base value is locked in with increases limited to 2 percent annually until there is a change in ownership. It is critical to make purchase price allocations before acquisitions (especially for senior housing) and record those allocations between real, personal, and intangible property assets on all deeds and transfer declarations.

The process for challenging your assessment ranges from informal discussions with the assessor to formal district court filings.

Remember to consider property tax assessments during new construction or additions to a property. Most states require partial assessments based on the percentage completed on the date of valuation. You also can appeal and negotiate this partial value.

COMPUTING YOUR REAL ESTATE TAXES

Real estate taxes are based on the assessed value of a property—the value of a property according to the tax rolls. The assessed value may be higher or lower than market value, depending on assessment ratios for the area. For example, Illinois (other than Cook County) has an assessment ratio of 33.33 percent. If a property has an assessed value of $500,000, the indicated market value is $1.5 million.

The tax payment is then calculated by applying the tax rate to the assessed value. If the tax rate is 6 percent, the resulting taxes would be $30,000. When reviewing the value of your facility, you must consider the assessment ratio to properly calculate the market value. While you can do little to contest tax rates (other than voting), there's much you can do to establish the assessed value of a property.

The timing of tax payments varies greatly by state. Typically, by the time the tax bill is issued, the time to appeal the assessment has long since passed. Most assessors' offices are helpful to taxpayers and can advise you of key dates and timing. Developing a good relationship with your assessor is essential. The assessor may also advise you of exemptions or abatements a property may be eligible for.

But it's prudent to be discreet in the information provided to the assessor. Assessors often request income and cost data, yet typical operating statements reflect the value of a business enterprise and not the taxable real estate asset. Even actual cost data will contain many elements that support the business enterprise rather than the taxable real property.

DEFINING TAXABLE REAL ESTATE

State definitions of taxable real property vary greatly. Definitions of non-taxable and/or intangible property are even more disparate. The concept of identifying and separating business assets from real estate assets continues to be an issue that impacts not only senior housing, but other property types, including hotels, retail, recreational facilities, etc. These assets must be separated for state and federal tax planning, business planning, financing, and many other purposes.

The Appraisal Institute (www.appraisalinstitute.org) has begun to recognize inconsistencies in valuation terminology related to this issue and is developing better definitions and nomenclature. One newer phrase is Total Assets of a Business (TAB), defined as "the tangible personal property (real property and personal property, including inventory, furniture, fixtures and equipment), and intangible property (cash, workforce, contracts, name, patents, copyrights, and other residual intangible assets, to include capitalized economic profit) of a business."

Basically, TAB includes real property, tangible personal property, and intangible property. The Appraisal Institute has created further definitions for intangible property. Why is this important? Because it further solidifies the fact that certain property types have significant amounts of non-real-estate assets that must be identified and removed to properly value the real estate component.

Significant amounts of intangible assets must be excluded from senior housing communities—especially assisted and independent living—to properly value the real estate, especially for real estate tax purposes. These intangibles include dietary and meal services, recreational activities, housekeeping, transportation, medical assistance, an assembled workforce, management of the business, assisted living licenses, physician and specialist relationships, and more.

GETTING YOUR FAIR ASSESSMENT

The process for challenging your assessment ranges from informal discussions with the assessor to formal district court filings. Timing, steps, and processes are unique for each area. Assessed values change periodically, from every year in some states to every four years or more in others. It is critical to note that the time period to appeal the value of your property is usually very limited. If you miss the deadline to appeal, there is little you can do to change the value for that tax year.

Bear in mind that abatements and incentives are available in some areas. Talk with the local economic development department and assessor to determine if any incentives or property tax abatements might apply to your property. And be sure to have this discussion prior to issuing any press releases, filing building permits, or confirming final projects. While most state incentives go to manufacturers and are tied to job creation and capital expenditures, certain opportunities exist for residential properties. Iowa has recently been more generous in providing property tax abatements to new senior housing developments.

The property tax expense for senior housing is much more manageable and controllable than most taxpayers realize. Regular and aggressive monitoring of this cost, understanding how to properly value the real estate component of a senior housing property, and familiarity with the assessment process has the potential to dramatically reduce property taxes.

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