

## TAX NOTES

## Fair Taxation Often Eludes Build-to-Suits

Identifying illegal assessments helps make a case for property tax reduction. **By J. Kieran Jennings, Esq.**

In a build-to-suit transaction, the value of the property to the user who had it built is greater than the value that property holds for the next user. For instance, a store built as a McDonald's would not have the same value to a Taco Bell. Although both users are fast-food chains, the layout, design and exterior appearance all work to identify, market or assist the first occupant's business.

The decrease in value from the original user to the subsequent user represents built-in obsolescence. Failure to recognize this obsolescence often subjects first-generation owners to excessive property tax assessments.

A triple-net-lease property that was a build-to-suit may be sold to a new owner, even if the original user remains the tenant. In this case, the sale price reflects the value of the tenant's lease. The assets involved in the purchase include both the lease and the real estate.

Because the revenue created by the lease primarily drives the price of the deal, an assessment based on sale price can result in an illegal assessment when it is based on the value of the property to the user.

### Fighting back

The first step in reducing improper taxes requires that owners prove to the assessor or the courts that the rent and/or sale represent value to the user, not the market value of the property. The next task is to prove actual market value for the real estate.

A sale involving a first-generation lease is more a financing operation than a transaction in real estate. In the past, many single-tenant real estate users — often retailers not wanting to tie up capital — financed their real estate through sale-leaseback transactions where they recouped the capital costs by inflating both rent and the corresponding sale price. This practice is still prevalent today.

The user currently has a relationship with a local developer who will acquire the site and build the property on behalf of the user to suit the user's needs. As with a sale-leaseback transaction, the user will enter into a long-term lease based on the costs of building the property to meet the user's specific needs.

The developer then either retains the property or sells it with the lease in place. Thus, the tenant has outsourced to the developer the financing, site selection, construction and other exterior and interior finishes. The third-party purchaser sees the transaction as essentially buying a bond secured by real estate.

Until the first-generation user vacates the property and the real estate is exposed to the open market, the real estate value has not been tested. Furthermore, because the lease drives the sales price of a net-lease property, only a second-generation lease reveals true market value and produces a correct assessment.

### Case study makes the point

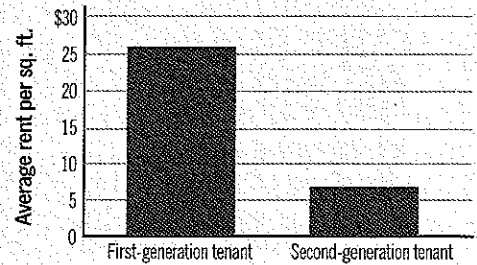
Data from a recent drug store case illustrates the difference in first- and second-generation leases for comparable properties built as national retail drug stores. The average drop of \$19 per sq. ft. in rent from the first-generation user to the second generation illustrates the difference between value in use and market value.

The difference is due to obsolescence, a fact first-generation tenants must demonstrate to assessors. Data like that shown in the accompanying chart prove the existence and value of the obsolescence.

Not only are the rents affected by the first-generation tenant, the capitalization rate is significantly lower than market rates. The net-lease market into which these properties are sold is among the most active and developed in the real estate market, allowing for substantial

### COMPARING 1ST AND 2ND GENERATION LEASES

Original tenants in a chain of comparable drug stores paid an average of \$26 per sq. ft. The second generation of tenants paid \$7. The \$19 difference is due to obsolescence, which should be removed from tax assessments.



Source: American Property Tax Counsel

liquidity, efficient pricing, and tax deferral through 1031 exchanges.

As a result, the capitalization rates have been reduced to exceedingly narrow margins. Therefore, cap rates derived from sales of first-generation property should not be used in determining assessments.

### Proving market value

Assessment laws generally provide that property must be valued using market terms and conditions. Therefore, market rents, those paid by tenants in comparable properties, not contract rents, those paid by the net-lease tenant, determine the income attributable to the real estate.

The difference between market rents and contract rents demonstrates the amount of obsolescence. Furthermore, the differences in sales prices of property from first-generation users to the next generation can also be used to prove obsolescence.

The road to a fair and honest assessment is not easy, but as illustrated in the accompanying chart, the difference between use value and market value can be substantial.

