34th ANNIVERSARY ISS INSIDE SELF-STORAGE®

A Modern Approach to Self-Storage Tax Assessments: Why the Cost Method May Be the Most Reliable Indicator of Value

Outdated property-valuation methods have burdened many self-storage owners with inflated assessments, diminishing their return on investment. According to the author, now's the time to take a modern approach that delivers fair, accurate estimations that better reflect today's market realities. This article explains the three traditional assessment techniques and identifies the one that produces the most reliable results—and why.

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June 25, 2025

5 Min Read

As a market segment, self-storage was once overlooked by assessors and other taxing authorities. Now, it's front and center, and county values and respective taxes prove it. But are these real property assessments correct?

Across the country, tax assessors rely on outdated practices and law when assigning property value. They frequently base assessments on sales comparisons referencing bottom-line transfer prices, for example, ignoring allocations for intangible business value. Yet the growing standard in real estate investment trust (REIT) transfers is to allocate 30% to 40% of total consideration to intangibles. In addition, data suggests that REIT deals represent the majority of class-A self-storage transfers.

Bottom-line transfer-price reliance has assessors comingling tangible non-real-estate values, which are exempt from property tax, with the real estate they assess for taxation, thereby inflating their conclusions and the taxpayer's liability. The burden falls on taxpayers, expert appraisers and tax professionals to help correct this injustice and rein in unfair assessments.

Outdated Valuation Approaches

It's no secret that the self-storage market has undergone significant, if not transformative, change over the past decade. Single-story, mom-and-pop facilities that formerly adorned highway offramps have been replaced with technologically advanced fortresses owned by national and international corporations.

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The self-storage sector also grew monumentally during the COVID-19 pandemic, enjoying double-digit, year-over-year rental-rate increases from 2020 to 2022. Those have since cooled, however, this boom drew attention—not just from investors, but from taxing entities and assessors, who have been eager to capture the industry's newfound growth for the tax base. Unfortunately, their methods of valuing these increasingly sophisticated properties remain mired in outdated practices and case law.

Like apartments and hotels, self-storage is a real estate business that leases space. Case law historically demonstrated that valuing these spaces required rolling any intangible value into the value of the real estate, as it could not be severed. Square footage was the commodity, and the expectation was a floor, a ceiling, three walls and a door. It stands to reason that the standby for valuing these assets would be the income approach, an appraisal method that determines value from a property's net income.

Things are different now. Self-storage customers look for name recognition and reputation. They demand around-the-clock access, advanced security and climate control. They seek convenient and efficient layouts including vehicle access to individual units. They often expect to insure their possessions through the storage operator and go so far as to pursue in-unit camera monitoring that's accessible through mobile apps.

Self-storage owners often hire third-party management firms, face exponential increases in their own insurance premiums, and must account for higher replacement reserves for tangible but non-real-estate items like modern trucks and equipment. *All* of these attributes add expense. *Many* are necessities of successful income generation. *Few* are directly tied to the real estate.

So, we know the sales-comparison approach can lead assessors to ignore allocations for non-taxable intangibles. Another downside is the tendency to lump together sales of traditional, single-story self-storage properties with those of multi-story, climate-controlled facilities. Doing so rarely if ever provides an apples-to-apples evaluation. Even when an appraiser attempts a proper analysis by identifying and extracting all non-real-estate items in a transaction, there remains the problem of valuing those line items without knowledge or access to actual price allocations from the buyer or seller.

Also, it's challenging to adjust sales appropriately without information about the property's income generation and deductions made for replacement reserves and off-site expenses like accounting, legal, human resources, marketing and information technology.

The income approach is more reliable than sales comparisons but still has its problems. It requires careful analysis to calculate an appropriate capitalization rate and determine market rent and occupancy. An appraiser needs a firm grasp on the expenses to determine the self-storage property's net operating income.

Likewise, sales comparisons suffer issues related to expense ratios, which are typically higher for multi-story, climate-controlled buildings than published benchmarks derived from traditional, single-story structures. Income and expense characteristics are markedly different between the two.

The Cost Approach

The remaining property-valuation method—the cost approach—is increasingly recognized as the most reliable indicator of fee-simple value for self-storage property. Pennsylvania courts are among the first to embrace its utility, having issued decisions in recent years relying on advanced appraisals assigning heavy weight to the cost approach, which focuses solely on real estate items.

Developers and investors alike recognize cost-based appraisal as a reliable value indicator founded on the principle of substitution, or building new vs. buying an existing asset with the property's highest and best use. It cuts through all the challenges that impede both the sales-comparison and the income approach and effectively removes the often subjective nature of adjustments to the others.

Cost-based appraisal must be implemented carefully, however. Most tax and valuation professionals use the Marshall & Swift Valuation Service cost manual, which helps to determine physical depreciation based on the age of property improvements. While widely relied upon, the manual fails to consider either functional or economic obsolescence.

> Functional obsolescence occurs when a property, its structures, features or layout fall out of sync with current expectations for its use, making it less valuable.

> Economic obsolescence, sometimes called external obsolescence, refers to properties that become less valuable due to trends or conditions in the wider market. A substantial shift from apartment renting to homeownership, for example, could create economic obsolescence for self-storage properties by reducing consumer demand for offsite storage.

It's the appraiser's responsibility to correct this shortcoming of valuation service-cost manuals by accounting for both types obsolescence.

Of the three accepted valuation strategies, the cost approach will yield a result closest to the fee-simple value or market value for self-storage facilities—provided the method is correctly applied. The challenge for owners is to not only use it effectively but to convince those that assign property values of its strength and utility. Taxpayers, working with expert appraisers and advisors, are in the best position to convey that message.

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Source: https://www.insideselfstorage.com/facility-value/a-modern-approach-to-self-storage-tax-assessments-why-the-cost-method-may-be-the-most-reliable-indicator-of-value