Lack of Strategic Property Tax Planning Leaves Assets at Risk of Underperformance

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By Terry Bishop, Executive Vice President, Eastern Canada - Tax Group at Altus Group

With the recent upward cycle in the commercial real estate (CRE) market, both property values and property tax disbursements are reaching record highs. As the CRE industry continues to attract capital at record levels, the competition for available assets and expectations for existing asset performance have never been higher. Property tax is the single largest operating expense affecting commercial properties, yet, it is an area often overlooked as an opportunity to drive strategic investment decision-making. Unlike most operating costs, taxes cannot be negotiated or lowered through contracts, but there are established processes to manage them. A proactive approach to property tax management presents a significant opportunity for firms looking to derive greater asset value and returns from their portfolios.

Many CRE firms believe they have adequate property tax planning strategies, however, an Altus Group survey revealed that few manage their property tax as they would other operational expenses. Three quarters (75%) of over 200 C-level and senior CRE property tax and finance executives surveyed describe their property tax management as reactive and purely or largely operational and cost reduction oriented. With $515 billion USD of asset investment sales last year in Canada and the United States, this results in $165 billion USD of CRE assets, including $9 billion in Canadian CRE assets, that are at risk of underperformance due to the lack of strategic property tax planning.

When compared to the CRE industry's level of analysis typically applied to the review and control of property management costs, the limited attention paid to the tax line item becomes more pronounced. With only 25% of executives surveyed

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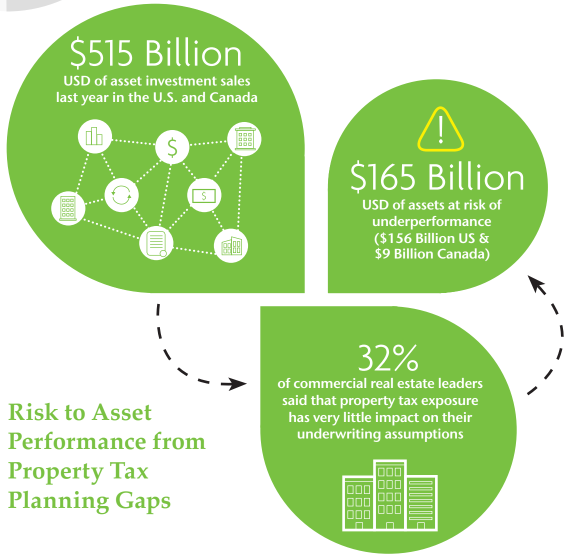

Risk to Asset Performance from Property Tax Planning Gaps

Key Gaps:

41% only periodically review assessments to identify appeal opportunities

56% do not incorporate property tax refunds into their ongoing valuations

52% lack the tools to analyze property tax information

44% lack the expertise and resources to identify property tax data sources

incorporating property tax management directly into their investment strategy and decision-making, the result is an increased risk of portfolio and asset-level underperformance.

Property tax is often viewed as a fixed expense driven by market and government assumptions. The lack of analysis of historical or benchmarked tax data has led to an industry standard of applying a static growth factor, typically of 3%, to the property tax liability when budgeting and underwriting. But, an overall assessment of past industry underwriting and transactions show that most property tax growth assumptions are inaccurate, as taxes do not typically grow at consistent rates. This carries with it a significant risk of inaccurate property tax forecasting, which in turn erodes value.

While the frequency and comprehensiveness of assessment reviews to identify appeal opportunities varies among firms, efforts to understand a portfolio's tax liability versus a competitive or comparable set of properties within the market are less common. It is important for owners to know where their property stands in comparison to competing properties for leasing and disposition purposes, and also to remain competitive by providing a 'lower real estate tax cost' to potential tenants or buyers.

Additionally, a proactive approach to tax analysis and management can provide firms with a highly strategic benefit to their investment decision-making and directly contribute to what, where, when and how assets are bought, sold and managed. Benchmarked tax information can provide these critical insights on current and future investment performance, and add tangible value to assets. Even though benchmarked tax information can provide these critical insights, 21% of firms surveyed said they use enhanced real estate tax analysis that includes benchmarking to identify exposure of their portfolio compared to the market and 32% said that property tax exposure has very little impact on their underwriting assumptions. With multiple ways to add tangible value to assets and increase the bottom line, why are only 25% of executives incorporating property tax management directly into their investment strategy and decision-making?

While a lack of rigorous tax processes seems to be one of the major issues inhibiting a more strategic approach, having access to and utilizing data is another critical factor. Of all respondents, 83% think their firms have enough property tax information and/or the right tax metrics necessary to optimize their underwriting decisions and investment strategy, but Altus Group uncovered that a lack of tools and resources is a key factor impacting underwriting and investment strategy. The survey revealed three main barriers which typically hinder firms from utilizing their data, one of which is that tax data comes from a variety of sources including taxing authorities, research reports, market data subscriptions as well as consultants and industry peers, leading to inconsistencies in formats and reporting, and 39% of firms identified the lack of normalized formats as a barrier to utilizing property tax data. Another barrier is that data must be properly aggregated, vetted and analyzed so firms can extract meaningful insights, and 52% of firms surveyed said they lack the tools to assist with both data capture and analysis. Finally, firms must equip themselves with skilled and innovative tax professionals who understand the complexities of property tax data and are able to extract meaningful insights, and 44% of respondents identified that a lack of internal expertise or resources to identify property tax data sources is an inhibiting factor to their property tax management.

There is a growing recognition of the critical role property tax must play in asset management and portfolio strategy. In fact, 73% of respondents firmly acknowledged that improvements to their tax planning analysis would help with better decision-making. With the right investments in process and technology to provide better visibility into tax growth, risk and savings, the opportunity for property tax to play a more strategic role in investment decision-making is significant.

Implementing proactive forecasting is essential to maximizing asset performance and, as property values and tax assessments continue to rise, so too does the amount of money firms are missing out on by not proactively managing their property tax. Maintaining an annual review of all new property assessments or mid-cycle assessments, adopting standardized reporting across asset types, and benchmarking a property against itself and similar assets in the portfolio are some steps firms can take to ensure property tax plays a more strategic role in investment decision-making. Undoubtedly, these steps can have a huge impact on the bottom line.