DeCotiis, FitzPatrick, Cole & Wisler, LLP

Lighting the Candle:

The Tax Benefits of a Soft Real Estate Market

The old saying is that it's much better to light a single candle than to curse the darkness. Well, the New Jersey commercial real estate market has been very dark lately. There has been very little good news for quite some time. However, if you know where to look for it, you can find a bright spot in the darkness – substantial decreases in real-estate taxes. Here at DeCotiis, we have been able to realize very large tax discounts for certain clients, and some kind of decrease for almost all of them. But, just as a candle won't light itself, taking advantage of the tax breaks you may be owed takes a little doing. Here's how it works:

Property tax in New Jersey is calculated using a simple formula: Assessed Value x Tax Rate = Amount of Tax. There is nothing you can do about the tax rate, or the amount of tax finally owed. However, there is a great deal you can do about your property's assessed value.

Assessed value is determined based on the property's income-generation potential. For a lot of interrelated reasons, a slowdown in the general economy (and thus in the real estate market) significantly lowers that potential. Just as a starting point, many of the commercial property tax assessments in New Jersey were set during the recent boom in real estate values. Now, add to that what the downturn has done to income-generating potential. A few specifics:

- Higher vacancy rates and lower achievable rents.
- Additional concessions to tenants – free rents, more generous work allowances – increasing operating costs of commercial properties.

- More expensive real estate financing, increasing capital costs and decreasing profits.

Add these all up, and you have a perfect economic storm for New Jersey real estate. To lower your taxes, you have to challenge your assessment. This, by the way, is not simply a matter of mailing in a form. It's real litigation, in tax court.

To begin, property tax appeals have to be filed by April 1 of the year in question (2009) with either the applicable county Board of Taxation or the Tax Court of New Jersey. Determining whether an appeal makes sense requires understanding the somewhat Byzantine method the state uses to calculate a property's assessed value, and hence your tax bill. Here's how it works:

The starting point for this will be the property's annual Notice of Assessment (a computer-printed postcard) mailed in January or February to property owners. This notice will contain two key figures – the property's assessed value, and the equalization ratio. Dividing the former by the latter will produce what the Board of Taxation believes to be the property's true value. If the true value is significantly greater than what the currently depressed market actually justifies, you may have a potential appeal.

To go into this in a little more depth, The New Jersey Department of Taxation undertakes annual sales ratio studies by which it produces an "equalization ratio". This ratio purportedly reflects the ratio of the common level of assessments in a municipality to true value. The math looks like this:

$$\frac{\text{Assessed Value of Property}}{\text{Equalization Ratio}} = \text{Equalized Value (the property's true value)}$$

The point of all this is that Assessed Value and Equalized Value are two completely different numbers. Here's a concrete example. Let's say your property's assessed value is $1,000,000. Since you recently purchased the property for $1.5 million, you may believe that a tax appeal might be a bad idea, and could conceivably increase your tax bill. However, you have not factored in the equalization ratio.

For the purposes of this exercise, let's assume the equalization ratio is 25%. Plug those numbers into the equation above:

$$\frac{\$1{,}000{,}000}{25\%} = \$4 \text{ million}$$

The result:

- The property's market value (the equalized value) is calculated to be $4 million. Since you recently purchased it for $1.5 million, this is a drastic overvaluation.

- Given that, basing your tax on an assessed value of $1 million is also a drastic overvaluation.
- An appeal is a good idea.

How good an idea?

Well, applying the numbers above, if the appeal results in the equalized value of the property being reset at $1.5 million, the actual market value, then the revised equation looks like this:

$375,000 = $1.5 million
25%

Since the tax rate is fixed, and you have just reduced your property's assessed value by 62.5%, you have also just cut your tax bill by 62.5%.

Two caveats. First, as they say on television, your results may vary. Second, as noted above, a tax appeal is real Tax Court litigation. It's a complex, specialized proceeding, complete with discovery, testimony in court, evidentiary rules, and so on. Over the course of a decade, we have litigated hundreds of such tax appeals, and have learned the subject matter as well as or better than anyone involved in the field.

That being said, because a tax appeal is basically a mathematical exercise, and because as a property owner you know exactly how much income your properties generate, we can tell you with a fair degree of precision whether an appeal would make sense in your case. And a tax decrease, of course, goes straight to your bottom line. Given what's happened in the real estate market, you may be pleasantly surprised. Many property values were set during the boom years, and consequently, are far higher than they are in the real world. Contact us – we'd be happy to discuss your situation, and help you determine whether an appeal makes sense for your properties.

For more information, contact Michael J. Caccavelli author of this newsletter, at mcaccavelli@decotiislaw.com (201-347-2106)

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