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# Keeping an Eye on Real Estate Taxes

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In Minnesota, real estate taxes generally constitute the most significant cost of operating real estate. Owners, managers, tenants, lenders, and others having an interest in real estate are, or should be, carefully considering whether their real estate taxes are too high.

In a general sense, real estate taxes are based on the rate of taxation, which is a legislative issue outside the scope of this article, and the value of the real estate. While rates vary somewhat among taxing districts, taxes on apartment buildings have historically been around 1%-1.25% of the property's estimated market value and taxes on non-residential property, i.e. retail, office, industrial, hotel and other commercial properties, have historically been around 3% - 3.3% of the property's estimated market value. These percentages are likely to increase as real estate values decline.

For a number of years, the value of all types of real estate had generally been trending upward. That has changed and it is now commonly understood that values began to decline sometime in 2007. This decline is due, in part, to significant changes in the financing available to buyers and, in part, by an increased sense of risk on the part of buyers. The boom in real estate values was driven, to a great extent, by the ease with which a purchase could be financed. However, since the fall of 2007, loans have become increasingly more difficult to obtain and those lenders still willing to make loans have toughened underwriting standards, required larger equity contributions, increased interest rates and shortened amortization periods. As a result of these changes, buyers seek lower prices in order to maintain the expected return on their invested cash. Additionally, as economic problems have become more and more evident, buyers have perceived more risk and have insisted on purchase prices that reflect higher capitalization rates to compensate for the increased risk.

Capitalization rates are to real estate values what interest rates are to bonds. The higher the capitalization rate, the lower the value of the real estate. Different types of real estate have experienced different declines in value since 2007 but many market participants believe that most types of investment property have experienced significant increases in capitalization rates. Even a 1% increase will result in a significant decline in the value of property. For instance, if a retail property with a net operating income of $100,000 sold in early 2007 at a capitalization rate of 7.5%, the purchase price would have been $1,333,000. However, if the capitalization rate has increased just 1% to 8.5%, the resulting purchase price will be $1,176,000, a decline of approximately 12%. Of course, a larger increase in the capitalization rate will result in an even greater decline in value.

Assessors are required to value property in January of each year, with such values being the basis of calculating taxes payable in the immediately following calendar year. However, as the economy and the real estate market have slowed, assessors face a difficult task. When the real estate market was active, assessors had many sales transactions from which to extract comparable sales information, capitalization rates, and other data needed for the real estate valuation process. More recently, as the real estate market has slowed, there are fewer and fewer transactions from which to extract the required data. Additionally, many of the recent transactions that have occurred have been influenced by unique circumstances that cause the transaction to be of limited help in valuing property not affected by the same circumstances. The reduction in data on which to base an estimated market value creates a greater potential for inaccurate estimated market values. As a result, careful consideration should be given to whether property is being overvalued and, therefore, excessively taxed.

In addition to being valued for tax purposes at an estimated market value not in excess of actual value, real estate should be valued on a basis substantially equal to that of other real estate in the taxing district. If property is valued at a greater percentage of its actual value than is the case with other properties, it will be unequally taxed in relation to the other properties. The only practical approach to this "equality" issue is through use of the assessment/sales ratio studies prepared annually by the Minnesota Department of Revenue. These studies compare the sales prices of various types of property that sell during the study period with the assessors' estimated market values of such properties. Various statistical ratios prepared on the basis of such comparisons are used for various governmental purposes, including equalization. Under applicable Minnesota law, in the event that the applicable ratio for a given type of property in a given taxing district is less than 90%, each property of the given type in the given taxing district is entitled to be taxed at a discount from its actual value, the amount of the discount being equal to the difference between the ratio and 95%. For instance, if the applicable ratio is 90%, then no discount from actual value is available but, if the applicable ratio is 89%, then a 6% discount from actual value is available. Unfortunately, the applicable assessment sales ratio studies have, historically, not been available until after April 30th, the filing deadline for real estate tax challenges each year. Accordingly, in order to preserve the right to secure a reduction on the basis of a low ratio, it is necessary to be timely in filing a petition challenging real estate taxes.

The process of contesting real estate tax values is relatively simple. While there are several approaches available, the most common is to commence a court proceedings by filing and serving a petition. The deadline for filing and serving a petition is April 30th of the year in which the taxes to be challenged are payable. For example, in order to challenge taxes payable in 2010, a petition must be filed no later than April 30, 2010. A petition may be filed by anyone having any estate, right, title, or interest in or lien upon the real estate in question. Accordingly, owners, tenants, lenders, and the holders of various other interests are empowered to initiate such proceedings. Tenants contemplating a contest should, however, review their lease to make sure they are not contractually prohibited from filing a contest and should, particularly in the case of a multi-tenant property, consider whether it would be better to proceed through the landlord. The petition is a simple document to prepare and is relatively inexpensive to file. If the property is "income producing," which is generally defined as property that is not owner-occupied, certain financial information must be provided to the assessor not later than 60 days after the filing deadline for the petition. Such information includes 1) year-end financial statements for the year prior to the assessment date, (2) year-end financial statements for the year of the assessment date, (3) rent rolls on the assessment date including tenant name, lease start and end dates, option terms, base rent, square footage leased and vacant space, (4) verified net rentable areas in the form of net rentable square footage of the building or buildings, and (5) anticipated income and expenses in the form of proposed budgets for the year subsequent to the year of the assessment date. If such information is not provided in a timely fashion, the petition may be subject to dismissal.

Many real estate tax contests are resolved by negotiation between the assessor and the taxpayer's representative. But if negotiations are unsuccessful, the matter will eventually be tried before the Minnesota Tax Court.

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