TREND report

Proactive Property Tax Considerations and COVID-19 "New Norm"

Jodi Bain • published in the January 2021 issue

After over 15 years of practicing law in the U.S., in the years since Proposition 117 implementation in 2014 changing the Arizona property tax regime, explaining property tax is akin to describing some kind of hybridized Dr. Who and Star Trek mini-series plotline.

Nothing is quite as it appears. More than ever, a strategic, multi-year plan coupled with an understanding of available legal and policy avenues is necessary. It is not a simple matter of arguing "comps" and costs and submitting competing appraisal positions.

This year, navigating the valuation landscape was further complicated by the economic disruption of the COVID-19 pandemic. National and Arizona economic indicators are in flux. Almost daily I am asked how property values and property taxes should be estimated in this "new norm." How should one adjust for tenant deferred rents or closures in commercial marketplaces, higher unemployment rates, inflationary concerns and increased U.S. debt. Answer—each case should be evaluated on its own merits.

Bottom line—Be Proactive and Strategic

Attorneys, business owners, clients, developers, investors, insurance executives and lenders ask me how The Bain Law Firm PLLC obtains a desired outcome—reduction of valuations, limitation on tax exposure or impact results that increase NOI—when other representatives have not. For property tax clients, our focus is on the strategic reduction of tax exposure and the resulting increase of a project or property's NOI. This occurs during the project planning stage, through construction phases and continues for years after an asset is in service.

In the COVID-19 "new norm," plan for short term interruptions, strategize for the long game, know your exit strategy options (yes, plural), and factor in your (and your pro forma's) resilience and tolerance for risk.

Property tax and related matters, while fluctuating, are costs that can often be managed. Sometimes it may take 2–3 years to achieve significant desired valuation outcomes without litigation. However, be prepared to consider litigation options. Understanding property valuation, tax and related legal considerations and pitfalls is key.

Meanwhile, with the staff turnover in virtually every county assessing office over the last five years, sophisticated firsthand knowledge of the actual statutory options is more important than ever. Below are two commercial scenarios I handled in the last year. The underlying situations have since reoccurred and I share them with you as a cautionary tale.

Hypothetical #1: One Property=Two Contemporaneous Considerations

A. **National Client—Notice of Value:** Client receives an Arizona 2021 tax year valuation notice of $112,000,000 full cash value (FCV) at 75% construction completion for a mixed-use property. National client contacts our office asking if there are paths to successfully obtain valuation reduction based on available legal statutory and local practices.

B. **Same National Client—Parcel Split and Recombination:** Client representatives simultaneously ask how to "sell off" separate project uses. This means the creation of a horizontal parcel regime via parcel split and recombination that almost always triggers a Rule B.[1]

Discussion & Considerations

Estimated real property taxes for a $112,000,000 noticed FCV with a "Rule B" application is approximately $1.414M for the 2021 tax year. Client reports this new property is expected to have phased use "openings" under temporary Certificates of Occupancy beginning August 2020, with projected stabilization in 2022 or 2023.

A. **Options to reduce property tax valuation**

- *Be Proactive—Key considerations:* client project critical date path, cost of construction, phasing of putting the asset into service, income and expense (actual, proforma, stabilized), equity amongst similar properties similarly situated, statutory options and market sales approaches.
- *Be Strategic—Know the client project and state law:* Constitutional constraints and opportunities, statutory requirements and local policy options are factored in. Hands on, proven legal knowledge and experience of how to prepare, submit and argue an appeal on the record with reservation of rights is crucial. Substantive property tax appeal representation is grounded on the understanding and planning for a potential Tax Court filing.
- *Firm Results—Successful valuation reduction:* One year estimated tax savings of $870,980. Taxable value reduced to $30.3M. Hearing was completed in about an hour and included a focused 100 + page work up that incorporated significant, admissible, primary source materials. This included properly presented Contract Documents, (AIA) contract budget materials, client declarations and certified conformance correspondence.

B. **Parcel Split and Recombination**

- *Know the client purpose and desired outcome:* What is the client trying to accomplish? Is there a bank covenant breach, a lock rate expiring on a new loan product, litigation requirement or divestiture of a partner, etc.? Check in with the project director, property manager or in-house attorney to understand unintended consequences to the critical date path and project estimates.
- *Firm Advice—Advised client to "hold" and consider other tax implications.* When the client provided information was reviewed, I discovered that a parcel recombination to a horizontal regime would trigger other significant project tax implication over $1M. I brought this to the attention of the project C suite who contacted the TPT and Speculative Builder Tax construction folks. Had a property tax representative not understood the bigger picture, a parcel recombination would have been pushed through without consideration of other consequences that could not be unwound. Know when to "stand down" and wait.
- *Bottom line:* a general understanding of value approaches and traditional appraisal techniques is often not enough. Current, sophisticated life-cycle experience that fosters real understanding of the intended (and avoidance of unintended) consequences of a property tax appeal filing or advisory representation is key. This means think outside the box; again be proactive and strategic.

Hypothetical #2: Church/Religious Worship Properties—Owned vs. Leased

A 50,000-square foot commercial strip center. 2021 tax year FCV $6,600,000 with Limited Property Value (LPV) $2,780,000. Hypothetical real estate taxes approx. $72,875 or $1.46/sf.

What is the property tax impact difference if the church is the property owner user or is a tenant user and files religious use paperwork to an Arizona assessing office? Is filing religious use application good, bad, or neutral? For the Church? For the owner and the other tenants?

A. Church Owns the Property

- If a property is bought by a church (or is owned by a church), is 100% used for church purposes and qualifies for an Arizona statutory religious use exemption, the real property taxes are often 100% exempt. Meaning $0. This is an example of 100% real property tax exemption.
- If partially exempt, understand the impact to the non-exempt non-church tenants. A Rule B may be triggered that increases real property tax exposure to the non-exempt users. This may in turn NOT be a pass-though expense in a lease to a non-church tenant user.
- *Firm Advice:* before filing exemption paperwork, obtain a property tax estimate of potential impacts, including to the non-religious church tenant property portion.

B. Church as a Tenant in the Property

- A church asks to rent 4,500 sf. Of 50,000 sf property. Church informs landlord it is filing paperwork to obtain statutory real property religious use status for the space. Church asks landlord to sign the landlord assessor religious use filing form.
- *CAREFUL: Neutral or Good, No Rule B Trigger* In some Arizona counties filing religious use paperwork for church leased space does not trigger a Rule B. If a Rule B is not triggered, the LPV would increase to no more than 5%. Impact is potentially neutral or positive for the church and other tenants.
- *BE AWARE: Rule B Trigger* Same scenario as before, however, the County Assessor *does apply* a Rule B. If the church leased portion of the property is granted 'religious use' status for the tax year and receives Class 9 status with 1% assessment ratio, in this hypothetical the LPV would increase from approx. $2,780,000 to $5,768,400 based on FCV $6,600,000. LPV increases over 200% and estimated taxes to the non-exempt portion of the property more than double. Estimated real estate taxes for 2021 tax year increase to approx. $135,000 or $2.70/sf.
- The church tenant would receive Class 9 status for its 4,500 sf, while the overall property is exposed to a significant real property tax increase from $1.46/sf to $2.70/sf. Owners and property managers beware! Unintended consequences do exist and can often be avoided.
- *Firm Advice:* Seek a property tax estimate of potential impacts.

COVID-19—Be Proactive

The COVID-19 public health emergency is expected to continue to have a significant impact on business through 2024. Historically, Arizona property valuations do not quickly adjust in an economic downturn. The current COVID-19 "new norm" impacts private and public sectors alike. It must be a consideration of property valuation and tax appeals.

While COVID-19 as a complicating factor is considered, business decision makers will be well served to understand that Arizona has one of the most convoluted real property tax and valuation statutory regimes in the county. It also provides Arizona property owners robust and multi-tiered appeal options. Arizona's critical date path for appeals and tax court filings is sensitive; there is little room for error.

Be Savvy and Be Aware

Arizona 2022 tax year notices of value are mailed out to taxpayers by **March 1, 2021**. Taxpayers will have a short

60-day window to review and elect to appeal these valuations. Collaborative planning assists management in budgeting for reserves, managing investor expectations and reducing surprises.

Opportunities to work through the maze of exemptions, exceptions to exceptions, pitfalls between traps and significant statutory constraints to obtain valuation adjustments, tax savings and relief do exist.

Take-Aways

"Don't be afraid to give up the 'good' to go for the great."

—John D. Rockefeller

Today, developing and maintaining a robust Arizona property tax valuation appeal plan is critical. In many instances, successfully appealing a valuation for tax year 2022 tax year, may provide savings over a two year or longer period. Planning for capital expenditures, demolition, new construction and changes in use with experienced legal counsel is a sound business move.

Keep in mind, the Arizona property tax regime does not limit actual property taxes to a 5% increase. What may look like an immaterial, simple change in the property and its use, can have large economic implications. Contact a well-informed real estate property tax attorney to preserve your bottom-line before making a costly decision.

1 A "Rule B" application results in release of the statutory 5% increase cap on the taxable value generally set out in Arizona Revised Statute §42-13302(A): "A. In the following circumstances the limited property value shall be established at a level or percentage of full cash value that is comparable to that of other properties of the same or a similar use or classification:
1. Property that was erroneously totally or partially omitted from the property tax rolls in the preceding tax year, except as a result of this section.
2. Property for which a change in use has occurred since the preceding tax year.
3. Property that has been modified by construction, destruction or demolition since the preceding valuation year such that the total value of the modification is equal to or greater than fifteen percent of the full cash value.
4. Property that has been split, subdivided or consolidated from January 1 through September 30 of the valuation year, *except for cases that result from an action initiated by a governmental entity*." (Emphasis Added)

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