

The Taxation of Commercial Real Estate: A Burden on Business?

There are many perspectives from which real property taxation may be discussed, most of which will undoubtedly be considered often, and in considerable detail, during the deliberations of the City of Vancouver Property Tax Policy Review Commission. This brief paper presents a general discussion of one perspective: that of the ultimate burden of property taxes and how they are capitalized into real estate asset values.

The discussion is best started with a simple, conceptual example. Consider two adjacent vacant commercial properties, identical in all respects save one – the property line between them is also the boundary between two municipalities (lets call them municipality A and B). This means that, while otherwise identical, the two properties are subject to different property tax rates (commonly referred to as the mil rate). In this example, this difference is significant, as the commercial property tax rate in municipality A is 2.5 percent of the assessed value, five times the 0.5 percent which prevails just across the property line in municipality B. This results in annual property taxes of \$30,000 for the property in municipality A and only \$8,182 for the identical property next door.

A firm moving to the area, perhaps a bakery, an art gallery, or a language school, is considering occupying one of the two properties under a lease that specified that the occupant will pay the municipal property taxes, other occupancy expense recoveries and base rent (in real-estate terms a “triple net” lease). As the properties are identical and adjacent, a firm’s business, as measured in gross annual revenue, will be the same regardless of which of the two properties it occupies. The firm would not be able to sell more, or more expensive, bread or paintings, or more or better paying students by occupying one property over the other. Nor would the business be willing to forego profits in order to occupy one property over the other.

In every case, the firm would make occupancy decisions that would ensure that it could make normal profits, or the minimum amount of profits necessary to ensure that it could continue its business over the life of the lease. Therefore, in the context of perfect information and rational economic behaviour, the firm would ensure at the time of making an offer to lease, that negotiations would lead to the same occupancy cost at both locations. The firm has determined that, given its expected cash flow, their annual expenditures for space can not exceed \$100,000. The firm would certainly be happy to have lower occupancy costs at either property as this would permit them to earn above normal profits, but it would be neither willing nor able to pay more than this amount.

This means that any prospective tenant would negotiate lower rent for the property with the higher taxes and, conversely, negotiations would lead higher base rent for occupancy at the property with the lower taxes, both subject to the constraint of a maximum total occupancy cost of \$100,000 per year. In this simple example, with the tenant’s total occupancy costs of \$100,000 per year and other recoveries of \$10,000, lease negotiations would result in rent of \$60,000 per year in municipality A (the high tax rate property) and \$81,818 per year in municipality B (the low tax rate property). The tenant would be indifferent to occupancy of either property under these conditions, as the current (and anticipated) property tax levels would be capitalized into the maximum rents paid at each property.

This leads to a first conclusion: so long as the annual property taxes over the life of the lease do not exceed those anticipated during lease negotiations, no business would experience a differential burden as a

Example One	High Rate - A	Low Rate - B	Example Two Blended Rate
Total Occupancy Costs	\$100,000	\$100,000	\$100,000
Other Recoveries	\$10,000	\$10,000	\$10,000
Property Taxes	\$30,000	\$8,182	\$19,091
Rent Paid	\$60,000	\$81,818	Net Operating Income \$70,909
	5%	5%	Cap Rate 5%
	\$1,200,000	\$1,636,364	Property Value \$1,418,182
	2.5%	0.5%	Mil Rate 1.3462%

result of differences in property taxes. While the firm would pay much more in property taxes at one location, this would be accounted for in compensating base rent differentials as the firm's ability to pay does not change between the two locations.

This conclusion leads to the question of who then bears the burden of the differences in property taxes? To answer this we need to look to the revenue stream paid to the building owner. Given the operating income is ultimately the rent stream paid by the tenant (again net of taxes and operating expenses), the full amount of the annual difference in property taxes will be reflected in the net operating income paid to the owner. With the condition of all other things remaining equal, the rate of return (capitalization rate) required by an owner of the real estate asset will not be different between the two identical adjacent properties in municipalities A and B.

Using a capitalization rate of five percent, the high tax rate property would have a value of \$1.2 million, while the low tax rate property would have a value of \$1.6 million. These are the prices an investor would be willing to pay to own the right to receive the rental stream from the occupants based on the anticipated future net rental stream from each asset.

This example leads to a second set of conclusions and a number of salient points about the relationship between property values and property taxes. The first being that differences in property values are not directly the result of differences in property taxes, but rather are the result of differences in rent paid by occupants, which in turn are the result of property tax differentials. The second is that the property values are based on the anticipated rents to be received over the life of the property, not merely over the life of the lease of the current occupant, and hence investors will have a longer term interest in the level of taxes compared to property occupants under shorter term leases. The third is that while there will be differences in rent streams from identical properties as a result of differences in property taxation, there will not be differences in investment yields to owners of property, as they will account for the differences in revenue flows at the time of purchase. In the end, to the extent that the market value of property is reflected in assessed value, the assessments in high tax rate municipalities will be lower than those for comparable properties in low tax rate municipalities as a result of these factors.

A final point, which takes us into a second brief example, is that there will be differences in total occupancy costs for tenants and in yields for owners between the two properties if future changes in property taxes turn out to be different from those anticipated by property owners at the time of purchase and by tenants at the time of leasing. Exploration of this situation provides an example of the circumstances when differences in property tax rates would result in a differential burden on both owners and occupants. Following the terms of the first example, consider the consequences of the two municipalities potentially being amalgamated. This would mean that both identical commercial properties would be treated the same in terms of the property tax rate

that was charged on their assessed value. Presuming that this rate was set so that the same gross amount of tax revenue was raised from the properties as before the amalgamation, the new tax rate would be 1.346 percent.

The result of applying this rate would be a unforeseen gain of \$10,909 per year for the tenant in the previously high tax municipality A, as the annual taxes would fall from \$30,000 to \$19,091, and an unforeseen burden of \$10,909 for the occupant of the previously low tax municipality B as property taxes would increase from \$8,182 to the same \$19,091. As the amount of the annual rent is fixed by the lease, until the end of the lease this gift and burden would be realized (or shouldered) by the occupants, unshared by property owner.

However, once the term of each occupant's leases expired, big changes would occur. While the tenant who benefited from the windfall gain from the falling taxes will be more than happy to renew at the previous rent, the landlords (and also competing prospective tenants) will want their share, and negotiations will begin. Next door, the tenant who has had to operate at \$10,909 a year below normal profits will be looking for either a new location or a lower rent. As all prospective tenants will be considering the same properties, a different set of negotiations will occur. The result will be that the rent paid in the two identical and adjacent properties will be the same \$70,909 per year, as the property taxes will be the same \$19,091 per year for both properties.

As a final note, consider the owners of the two properties. They will also feel the impact of the changes in property taxes, as the value of the previously highly taxed property in municipality A would increase from \$1.2 million to \$1.42 million, as its net rent will increase to \$70,909 per year. Conversely, the value of the property in municipality B which previously enjoyed lower property taxes would fall from \$1.64 million to \$1.42 million. There is no way owners can avoid these shifts in value, as any subsequent purchaser of the property would capitalize the new property tax levels, as reflected by the rental streams for the properties, into purchase prices. Thus unanticipated changes in property tax rates create short term (until the end of lease) winners and losers in property occupants, and longer term winners and losers in terms of property owners (until the property changes owners on the open market).

The situation of the tenant in the property where the property taxes increased substantially provides one further example of the effect of the capitalization of property taxes into asset values. Consider the situation of, for example, an art gallery that was occupying the property in municipality B where the annual property taxes increased by an unanticipated \$10,909. At the end of the lease, the gallery owners would clearly seek to negotiate a rent reduction of this amount, to bring the rent down from \$81,818 under the old lease to \$70,909 under a new one, as the gallery would not be able to stay in business without such a reduction in operating costs.

The landlords, however, may not be willing to see their income fall by such an amount, in which case the art gallery would relocate. If the landlords are able to find a new tenant, perhaps a coffee chain, which can pay both the rent and the property taxes, then, while unfortunate for the art gallery, the new tenant will be putting the land to the highest and best use, at least in economic terms. If, however, the market rent for the space is in fact the \$70,909 that the art gallery was will to pay (and by the way what is being paid at the identical property next door), the landlord will have a vacant property and no income until they acknowledge reality of what the market is willing to pay and reduce the rent.

To the extent that leases are renegotiated from time to time, therefore, occupants will bear differential property tax burdens as a result of differential tax rates only if taxes increase more than anticipated at the time leases are contracted. Over the longer run the burden of differences in tax rates will fall on land owners, not occupiers. Competition for space means that as long as property can be leased, while some businesses may not be able to afford the taxes and other occupancy costs at a location, those that can make best economic use of the property will.

These conclusions logically lead to other perspectives on real property taxation that might be considered at another time. One being the economic relationship between the relative benefits that a property occupant or owner receives from the municipality and the property taxes they pay. It is commonplace to add up the total value of services received by different classes of property and compare this to the taxes received from these properties. This approach generally shows that commercial properties pay more taxes than they receive in municipal services, while residential properties get more services than they pay in taxes. While this accounting approach is of interest, it should not be confused with an economic analysis which would seek to determine what benefit commercial property receives from being in a municipality where there is residential property that houses customers and workers. There are also the non-economic perspectives that could be considered, such as the social benefits that arise from the art gallery remaining in the community or the environmental impact of the gallery moving to an outlying municipality where more people would have to commute to enjoy the exhibits. So many interesting topics for the Policy Review Commission to consider!

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