



## True Insights

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# Decreasing Property Tax Liability: Obsolescence Claims in a Down Economy

Recently, the landlord of a multi-tenant office building in Chicago's Loop reduced its taxes by over \$500,000 after successfully demonstrating the building suffered from economic obsolescence given recent vacancies and the building's subsequent underutilization. Similarly, a real estate developer constructed an office building in Los Angeles and secured a property tax reduction of \$300,000+ based on rent loss calculations. Also, an Indiana assessor reduced the tax liability of a large manufacturing company by \$1,600,000 by accepting obsolescence calculations from the taxpayer for their tangible personal property. Companies with significant real or personal property tax liabilities may reduce their tax bill by identifying, quantifying, and demonstrating the obsolescence of their equipment and facilities.

During periods of economic weakness, companies with considerable amounts of tangible assets such as machinery and equipment, computer equipment, land, and buildings, struggle with rising unemployment, decreased demand for goods and services, headcount reductions, increased vacancies, raised capitalization rates, and lowered real estate property values. Meanwhile, many of these assets or properties maintain the now-unrealistic and excessive property tax assessments of boom times. Every company responsible for real and personal property taxes should utilize the consequences of the current economic climate to reduce their property assessment and decrease their tax liability.

Almost every state requires real and personal property to be valued based on its market value for property tax purposes. However, when economic conditions depress the values, assessors are slow to recognize the change. When the

available and comparable sales data do not accurately reflect the current economic conditions, companies need to conduct a close analysis of multiple elements of depreciation to accurately reflect these conditions. Typically, a property assessment analysis segregates the total depreciation into three individual component parts:

1. Physical Depreciation
2. Functional Obsolescence
3. Economic Obsolescence

### Physical Depreciation

Tax assessors usually consider physical depreciation when valuing real and personal property. However, functional and economic obsolescence is typically ignored or disregarded because assessors do not have the resources or the time to quantify the obsolescence. Effectively identifying, quantifying, and demonstrating the existence of obsolescence is an essential method of securing substantial property tax savings.

### Obsolescence

Obsolescence is the process of becoming or the condition of being nearly unnecessary. Simply put, property, both real and personal, becomes obsolete because of its inadequate functionality or economic redundancy.

### Functional Obsolescence

Functional obsolescence results from internal factors of the subject property (i.e., the subject property's inability to perform the function for which it was originally designed or intended). Common examples include excess capacity, excess operating costs, and defects in design or process. Vintage office buildings with outdated HVAC systems or inadequate communications wiring, or manufacturing lines that cannot maintain its production capacity may be considered functionally obsolete. Properties with inherent design flaws or outdated amenities may be able to adequately demonstrate functional obsolescence to reduce current tax liabilities.

### Economic Obsolescence

Economic obsolescence is caused by factors external to the subject property, such as lack of demand, excess supply, shifting use patterns, and government

regulations. For example, a New York City office building would suffer from economic obsolescence if the Manhattan-wide office occupancy rate fell from 93% to 75%. Decreases in demand for vehicles have significantly affected the automobile industry creating tremendous reductions in value. Due to current economic weakness, economic obsolescence is significant to virtually every company and every industry who owns tangible property.

After identifying a property's functional and economic obsolescence claims, their quantification begins through careful analysis of associated costs and benefits. The primary techniques include estimation of cost to cure obsolescence, analysis of market data, and capitalization of income loss or excess operating cost. A company will need to demonstrate the obsolescence elements, justify their quantification to the local assessors, and respond to any objections effectively to secure a reduced assessment and/or refund.

Effective obsolescence identification, quantification, and the subsequent assessment negotiations can result in significant property tax savings. If you have any questions about reducing your company's property tax liability, please contact one of our property tax specialists.

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