

## Unintended Consequences: The Perils of Appraisal Caps

By Mark S. Hutcheson

During the 78<sup>th</sup> Regular Session, the legislature considered a proposal that would have placed a 5% cap on unsold and unimproved residential and commercial appraised values. Under the bill, once a property is sold or undergoes an improvement, the property would be appraised at market value and the 5% cap would not apply until the subsequent year.

The bill was originally intended to address the perceived increase in property taxes on residential homestead properties, but was expanded to include commercial real property during the committee process. Despite significant opposition from local governments and businesses with income producing properties, the bill came within one procedural step of adoption.

Because this proposal is expected to be considered again when the legislature addresses school finance, it is important for both the business community and our policy makers to understand the potential unintended consequences and perils of appraisal caps.

- Lower Values = Higher Tax Rates: Property taxes are currently determined by multiplying the market value of the property by the applicable tax rate. A 5% cap on the values of real property will not translate into “property tax relief” if taxing units are able to make up the shortfall by simply raising tax rates. In fact, because the cap does not apply for the tax year subsequent to purchase or improvement, owners who buy or improve real property will end up paying *more* in property taxes than they do now because they will be appraised at full market value *and* taxed at a higher rate.
- Disincentive for Economic Development: The 5% cap may affect an investor’s decision to purchase income producing properties like apartments, hotels, office buildings, and shopping centers. If the market includes competing properties that benefit from the 5% cap, an investor may decide not to develop (or develop somewhere else), rather than compete directly with those properties that can charge less rent for the same profit.
- Artificial Market Advantage: A cap on appraised values creates disincentive for the acquisition and improvement of income producing properties. Income producing properties generally build their expenses, of which property taxes is one of the largest, into their rental rates. Properties that receive a 5% cap on their taxable values will have an artificial competitive advantage over properties recently acquired or improved because, due to the lower tax expense, they will be able to charge less rent for the same amount of profit.
- Unequal taxation: The Texas Constitution requires property to be appraised in an equal and uniform manner. This requirement is based on the fundamental principle of equality and fairness in taxation. For the reasons stated above, equality among their competitors in taxation is one of the primary concerns of

property owners. The proposed cap on values destroys equality by requiring the taxation of recently acquired properties at full market value, while competing unsold properties would be taxed at a reduced, capped value. The *only* way to ensure equality in taxation is to have a uniform standard for valuation (“market value”). If property tax relief is the policy goal, it should be accomplished by reducing the tax rates (which apply equally to all owners), not applying valuation caps to a subset of real property.

- Unfair Burden on Personal Property and Minerals: The proposed cap would not apply to personal property or mineral valuations. Because, as noted above, a 5% cap on real property will result in higher tax rates, owners of personal property and minerals will likely end up paying more in property taxes than they pay now. Industrial and manufacturing facilities, which are usually highly capitalized in machinery and equipment, along with mineral and royalty owners, would thus carry a disproportionate share of the property tax burden.
- Lower Resale Values: This bill may result in artificially lowering the value of commercial properties. The market for income producing properties will ultimately adjust to a reduction in property taxes by lowering rental rates. When the property sells, however, the net operating income (“NOI”) used to determine the sales price will reflect the anticipated increase in property taxes at market value. This will result in an increase in expenses, while the income remains constant—ultimately lowering the expected net operating income of the property. When the net operating income goes down, the sales price and “market value” of the property go down. Thus, any savings realized in property tax reduction may be lost when the property ultimately sells at a reduced price. This will affect the overall tax levy for all taxing units, including schools, by reducing the total value of the commercial appraisal roll.
- Maintain Viable Property Tax: By now, everyone should be aware of the damage caused by California’s version of property tax relief – Proposition 13. California artificially capped appraised values and significantly reduced its reliance on the property tax. As a result, it has one of the highest state income taxes in the nation and its local and state-wide budgets have been in disarray for over a decade.

Experts who have studied systems of taxation agree that among the three primary types of taxes: (1) property taxes, (2) sales taxes, and (3) income taxes, property taxes are clearly the most stable and reliable source of revenue to fund state and local governments. Before we rush to dismantle the property tax system (as California did with Proposition 13), we must first conduct a thorough and careful analysis of the impact the proposed cap would have on our economy and our ability to fund local government. We should not downsize the scope of our property tax system before we adopt (and the citizens of this State ratify) an appropriate and reasonable alternative method for taxation.

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