

# LONG ISLAND ASK THE EXPERTS

## Cap rates are rising, property taxes should follow the market's reality



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For much of the past decade, commercial real estate owners benefited from a favorable environment of historically low interest rates, abundant capital, and strong investor demand. As a result, capitalization rates, commonly referred to as cap rates, compressed across nearly every asset class, helping drive property values to record levels.

Today, the market has changed. Interest rates have increased significantly, financing has become more expensive, and investors are demanding greater returns to compensate for increased risk and uncertainty. The result has been rising cap rates across many sectors of the commercial real estate market.

While investors, lenders, and brokers have quickly adapted to this new reality, property tax assessments often lag changing market conditions. As cap rates increase, property owners should see assessed values and property taxes decline to reflect the market's adjustment.

Property owners also recognize that cap rate expansion is only one factor

influencing value. Rising operating expenses, increasing reserves for replacement, tenant improvement costs, leasing commissions, and capital expenditure requirements all affect a property's economic performance and market value. In many cases, these factors work together to place downward pressure on values even before capitalization rates are considered.

If a potential investor can stomach all the increased costs and concessions in today's market, cap rates then become one of the most important components to their valuation analysis. After taking into account other variables, the final piece of valuation is determined by dividing its net operating income by an appropriate capitalization rate. Even small changes in cap rates can have a significant impact on value.

Consider a property generating \$1 million in annual net operating income. At a 7.5% cap rate, the property would be valued at approximately \$13.3 million. If the market cap rate increases to 8.5%, the value declines to approximately \$11.8 million. At a

9.5% cap rate, the value falls further to approximately \$10.5 million. Importantly, the property's income has not changed. The decline in value is driven entirely by investors requiring a higher return on their investment. A two-percentage-point increase in the capitalization rate results in a reduction in value of more than 20%, illustrating the significant impact cap rate expansion can have on commercial real estate valuations.

In property tax valuation, however, an additional step is required. Unlike many investment analyses, real estate taxes are removed as an operating expense and instead accounted for through the capitalization process. This is accomplished by adding an effective tax rate, referred to as a tax factor, to the base capitalization rate to create a "loaded" capitalization rate. For example, a property with a market-derived capitalization rate of 9.5% located in a jurisdiction with an effective tax factor of 3.0% would have a loaded capitalization rate of 12.5%. By removing taxes from the expense structure and incorporating them into the loaded capitalization rate, appraisers and courts can properly account for the tax burden associated with a particular location while avoiding the circularity that would otherwise occur if taxes were treated solely as an operat-

ing expense. As market capitalization rates rise, the impact is magnified because the loaded capitalization rate also increases, resulting in substantial downward pressure on value indications in tax certiorari analyses.

This dynamic is becoming increasingly relevant throughout Long Island. Office properties have experienced some of the most significant upward pressure on cap rates as investors continue to evaluate the long-term impact of remote and hybrid work arrangements. Industrial properties, which enjoyed years of exceptional demand and cap rate compression, have begun to experience increased vacancies in many markets. Retail properties continue to show varying levels of performance depending upon tenant quality, lease structure, and location. Even multifamily properties, traditionally viewed as one of the most stable asset classes, have seen investors become more selective as financing costs rise.

The challenge for many property owners is that assessments do not always move as quickly as market conditions. In some jurisdictions, assessed values may continue to reflect assumptions that were reasonable when borrowing costs were substantially lower and investor demand was stronger. As a result, assessments may

be based upon values supported by cap rates that no longer reflect current market realities.

This disconnect is particularly important because property taxes are often one of the largest operating expenses associated with commercial real estate ownership. When assessments fail to recognize changing market conditions, property owners may find themselves paying taxes based upon values that exceed what a willing buyer would pay in today's market.

The debate over cap rates will remain one of the more significant issues affecting commercial property valuation and property tax appeals. While every property and market is unique, the broader trend is that increased risk has investors demanding higher returns than they did several years ago. For property owners, understanding how cap rates influence value is no longer simply an academic exercise. In today's environment, it may be the difference between a fair assessment and a tax burden based upon yesterday's market rather than today's reality.

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Cronin & Cronin specializes in Tax Certiorari, protesting the real property tax assessments and condemnation for commercial properties throughout New York State.

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