K&LNG Alert

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Property Tax

Should Owners of Real Property File Assessment Appeals in Pennsylvania?

SUMMARY

Although local real property taxes represent the single largest source of tax revenue paid by businesses and individuals to state and local governments in the Commonwealth of Pennsylvania, these taxes also have the distinction of being levied based on subjective opinions regarding the value of property that in most counties are not regularly and routinely revised and updated. As a result, local tax burdens often differ dramatically among otherwise similarly situated taxpayers. Annually, however, all taxpayers have the opportunity to correct any equities and seek reduced property tax burdens by filing assessment appeals with the county Board of Assessment Appeals or the Board of Assessment and Revision of Taxes. In addition, taxpayers receiving reassessment notices generally have 40 days from the date of the notice to file assessment appeals or 30 days for changes in valuation associated with a county-wide reassessment.

While some counties establish other deadlines, most counties utilize a September 1st deadline for filing annual assessment appeals. The filing of assessment appeals is simple and inexpensive and taxpayers need not engage counsel or professional real property appraisers to do so. For valuable commercial and industrial properties, however, most successful appeals are filed pursuant to a strategy carefully developed by property owners in consultation with their professional advisors, including counsel experienced in dealing with assessment appeals and qualified real property appraisers.

In determining whether to file appeals in 2005 for taxes to be paid for county, municipal and school district fiscal years beginning in 2006, taxpayers should be aware of several important developments that may make 2006 an opportune time to file assessment appeals. While a property owners' opinion about whether property is overassessed is always the most important factor that should govern decisions to pursue assessment appeals, several additional factors also need to be taken into consideration, including:

- Do changes in the "common level ratio" for which the property is located make the filing of appeals more advantageous?
- Do current assessments properly exclude types of property and improvements determined to be not subject to tax pursuant to recent court decisions, including improvements used in any manufacturing, mining, industrial or agricultural operations?
- Have assessed values been properly adjusted to take into consideration any adverse impacts on property values caused by easements, encumbrances, governmental restrictions upon the use or conveyance of property, environmental contamination, depreciation and functional or economic obsolescence?
- Have any complex property conveyances recently occurred involving the sale of real property together with other business assets?

Each of these topics are briefly discussed below.

CHANGES IN COMMON LEVEL RATIOS

In several counties, substantial reductions in so-called "common level ratios" published by a state agency known as the State Tax Equalization Board have generated significant opportunities for taxpayers to reduce assessed values, even if assessments accurately reflect the market value of property. These opportunities arise in a number of counties, including Berks, Bradford, Carbon, Centre, Chester, Cumberland, Dauphin, Delaware, Fayette, Fulton, Greene, Lancaster, Lehigh, Montgomery, Perry, Schuylkill, Sullivan, Tioga and York Counties.

Each county in Pennsylvania is responsible for annually determining the assessed value of property within its boundaries. The assessed values determined by the County Tax Assessment Office are then utilized by the county, cities, boroughs, townships and school districts to levy real property taxes. Tax rates are stated in millage rates which are one-tenth of a percent of assessed value. For example, a 27 mill tax is equivalent to a tax of 2.7% of assessed value.

Assessments are based on a predetermined percentage of market value of property. This percentage (which is used to calculate assessed values based upon the market value of property) is known as the "predetermined ratio." Where counties have recently conducted county-wide reassessments, the amount of tax levied upon a parcel of real property is generally determined by multiplying the market value of property by the predetermined ratio to calculate the assessed value and by multiplying the assessed value by the decimal equivalent of the millage rate. For example, if a commercial or industrial property has a market value of $2.5 million, in a county with a 25% predetermined ratio, its assessed value should be $625,000. A 27 mill property tax results in an annual payment of $16,875, *i.e.*, $625,000 x 0.027.

When assessments are not periodically adjusted or rapid changes occur in the local real estate market, the predetermined ratio may fail to accurately reflect the actual difference between the market value of property and tax assessments. The State Tax Equalization Board is required by law annually to estimate the actual ratio of market value to assessed value of property based upon property conveyances reported to the County Recorder of Deeds. This amount is known as the "common level ratio." If a county utilized a predetermined ratio of 25%, and the common level ratio calculated by the State Tax Equalization Board for the county was 6.6%, this means that, on average, assessed values of property in the county reflect only 6.6% of market value rather than the standard 25% predetermined ratio used by the county. Where the common level ratio differs significantly (*i.e.,* by more than 15%) from the predetermined ratio, counties are required by law to use the common level ratio rather than the predetermined ratio in resolving any tax assessment appeals.

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The most recent common level ratios published by the State Tax Equalization Board saw seven counties fall below the 15% threshold that allows the use of the common level ratio in assessment appeals, *i.e.*, Berks, Bradford, Carbon, Dauphin, Greene, Schuylkill and Tioga Counties. As a result, even if the market value of an individual property did not change from 2004 to 2005 and the assessed value in 2004 accurately reflected its market value, substantial opportunities for reductions in assessed value may arise. For example, Schuylkill County has a 50% predetermined ratio, but saw its common level ratio fall from 43.2% to 41.4% of market value between 2004 and 2005. Because a 41.5% common level reflects more than a 15% difference from Schuylkill County's predetermined ratio (*i.e.,* a ratio less than 42.5%), for appeals filed during 2005 taxpayers may utilize the common level ratio rather than the predetermined ratio. As a result, tax reductions of 17.2% are possible if property values have not increased and higher savings can be achieved if properties are overvalued.

In several other counties that previously fell below the 15% threshold allowing use of the common level ratio in assessment appeals, significant reductions in common level ratios also generated opportunities for added tax savings. For example, common level ratios dropped 4.4% in Centre County, 4.26% in Chester County, 5% in Cumberland County, 7% in Delaware County, 6.5% in Fayette County, 5% in Fulton County, 5.8% in Lancaster County, 4.2% in Lehigh County, 4.8% in Perry County and 5.9% in York County. These drops in commonly level ratios particularly make it more attractive to challenge tax assessments to the extent that properties in these counties are otherwise overassessed.

EXCLUSION OF PROPERTY NOT SUBJECT TO LOCAL TAXATION

In an important 2002 decision, the implications of which are only being recently understood, the Pennsylvania Supreme Court in *Independent Oil & Gas Assn. v. Fayette County* ruled that the only types of real property and improvements subject to tax assessment are the types of property and improvements specifically listed in county assessment laws. These properties are limited to land, buildings, trailers or mobile homes, parking lots, industrial facilities, offices and coal reserves. While the Commonwealth Court has recently ruled that the term “land” includes other types of hard mineral reserves and attributes common ascribed to land itself, numerous opportunities exist to challenge the inclusion in assessed values of various types of improvements and other property not expressly subject to tax assessments.

A series of important decisions by the Commonwealth Court between 2001 and 2005 in the matter of *Allegheny Energy Supply v. Greene County* have also broadly construed the extent to which machinery, equipment and other improvements used in manufacturing, mining, agricultural operations and other industrial activities are excluded from real property taxation. The Court found that the machinery and equipment exclusion applies to all improvements to real estate, whether attached to the land or otherwise, which (1) are used directly in manufacturing, mining, agriculture or other industrial activities; (2) are necessary and integral parts of such activities; and (3) are used solely for effectuating such purposes.

SPECIAL FACTORS AFFECTING PROPERTY VALUES

Special characteristics of a property, limitations on the use of the property or limits upon the financing or rental income of the property may impact upon the value of the property. For example, where a property is subject to significant environmental contamination and the property owner is willing to put that fact into evidence, the property could be deemed unmarketable and only a nominal market value assigned to the property.

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With respect to rental property, where there are income restrictions as a result of federal or state regulations, such as with subsidized housing, and an owner is prevented from increasing the income earned on the property, the Pennsylvania Supreme Court in *In re Johnstown Associates* mandated that a court must take into consideration that encumbrance. In 2003, the General Assembly adopted legislation that codified the holding of *In re Johnstown Associates* and requires that “In arriving at the actual value of real property, the impact of applicable rent restrictions, affordability requirements or any other related restrictions prescribed by any Federal or State programs shall be considered.” In addition, the legislation prohibits the consideration as income any Federal or state income tax credits with respect to the property.

The ruling of *In re Johnstown Associates* has been extended to other property where the use of that property is encumbered by an unwaivable, certain obligation. In those circumstances, it is the value of the property in its encumbered form that controls. Such encumbrances may include easements or rights of way that detract from the marketability of the property. Such encumbrances may also arise as a result of a contractual limit on the amount of income that may be generated by the property. For example, a property owner enters into a long-term lease of the property. Typically the property would be valued pursuant to the cost approach using a reproduction or replacement value. However, as a result of the encumbrances, the income generated by that lease is significantly lower than value of the property using the cost approach. In that instance, the value of the property must be considered in light of the encumbrance, which not only will lower the value of the property, but will require the use of a different valuation methodology that will permit the appropriate consideration of the encumbrance.

OPPORTUNITIES AND PROBLEMS POSED BY BUSINESS ASSET SALES INCLUDING REAL PROPERTY

Even in the absence of other problems affecting the valuation of property, in order to reduce transfer taxes, taxpayers may wish to consider pursuing assessment appeals if they have recently completed or are contemplating sales of business assets that include real property. In such transactions, it is often difficult to ascribe the amount of consideration paid for the conveyance of real estate, and the Department of Revenue has recently begun challenging conveyances in which consideration used to calculate transfer taxes is less than the assessed value of property divided times the common level ratio for the year of the transaction (an amount referred to as the "computed value"). The Department has also in such transactions often refused to consider appraisal reports as evidence of the actual value of property.

To the extent a reasonable and up-to-date value is determined pursuant to an assessment appeal, the risk that computed values substantially varying from market value will be used for real estate transfer tax purposes is eliminated. In addition, to the extent taxes were paid using inflated computed values, by filing and successfully prosecuting assessment appeals, taxpayers may not only enjoy reductions in real property tax burdens but generally are also able to receive refunds for transfer taxes paid on computed values in excess of actual values determined upon the completion of assessment appeals.

THE ROLE OF LEGAL COUNSEL IN ASSESSMENT APPEALS

The assistance of counsel may be critical in the effective pursuit of tax assessment appeals. There are a number of unique aspects of Pennsylvania law that can affect property valuation for tax purposes, including application of the machinery and equipment exclusion, the effect of property contamination (such as environmental contamination, asbestos, etc.), zoning restrictions, the effect of easements, property leased at above or below market rates, and application and weighting of the various accepted appraisal approaches. Knowledgeable legal counsel can assist owners to develop a persuasive presentation, identify helpful and unhelpful evidence, prepare summary exhibits, enlist and work with outside appraisers where appropriate, and otherwise help property owners obtain optimal results. Thus, a small investment in legal counsel may lead to a large payoff in tax savings for many years to come.

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The law firm of Kirkpatrick & Lockhart Nicholson Graham LLP (K&LNG) has represented property owners in numerous counties across Pennsylvania, and at every level of the assessment and exemption appeals practice, from informal reviews and corrections, to Board level appeals, Courts of Common Pleas, Commonwealth Court of Pennsylvania and the Supreme Court of Pennsylvania. The firm has handled appeals involving office buildings, department stores, shopping centers, manufacturing facilities (e.g., primary and specialty metals, pharmaceuticals and electronics), entertainment facilities, a railroad, a brewery, group homes for mentally ill and retarded adults and children, electric power plants, gas distribution facilities and landfills.

Lawyers at K&LNG have also handled numerous appeals for hospitals, nursing homes, cemeteries, cultural facilities and extended care communities regarding denials of real estate tax exemptions, including the landmark matter of St. Margaret's Seneca Place before the Pennsylvania Supreme Court.

K&LNG is a national law firm with Pennsylvania offices located in Harrisburg and Pittsburgh. Lawyers in both the Harrisburg and Pittsburgh offices are currently handling assessment appeals in many counties throughout the Commonwealth.

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