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The Use of Capitalization Rates in the Income Approach to Value
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BY DAVID P. DORNER & MEGAN LISTON MAHALIK

This edition of *Tax Trends* features an article by Donald Rubin entitled "The Use of Capitalization Rates in the Income Approach to Value." Don's article provides a discussion of capitalization rates and their use in the income approach to value when valuing properties for real estate tax purposes.■

The Use of Capitalization Rates in the Income Approach to Value

BY DONALD T. RUBIN

Numerous variables have to be considered when establishing an appropriate capitalization rate to be applied to a net income stream for the purpose of deriving a market value for a property by way of the "Income Approach" to value. The long-used IRV formula[1] simply derives a rate by dividing the annual net operating income ("NOI") by value equals rate (NOI/Value = Rate). For instance, an NOI of $100,000 divided by a Value of $1,000,000 = 10% Rate. Application of this formula seems simple on its face, but it is not. Many professional assessment and appraisal organizations such as the International Association of Assessing Officers (IAAO) and the Appraisal Institute (Institute) have devoted countless hours to developing and teaching the various methodologies employed in deriving applicable capitalization rates.

A great explanation of the components of the capitalization rate, can be found in a 2022 tutorial published by the Indiana Department of Local Government Finance, which, as paraphrased below provides in part:

> The capitalization rate is made up of several principal components. The discount rate is the required return on the investment. It is comprised of both an interest rate (the required rate of return on borrowed funds), and the yield (the required rate of return on

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equity); the recapture rate (the rate of return on the depreciated portion of the investment = recovery of capital); and the effective tax rate (the property tax rate expressed as a percentage of market value).[2]

Direct capitalization is a method used to convert a single year's estimated net income into an indicator of value. Cap rates can also be derived from sales of income producing properties if an NOI is reported. They can also be determined using a discounted cash flow analysis, providing an estimate of value by way of projecting future income, and then discounting that income at a certain rate to ascertain a present market value. Another accepted method is the "band of investment technique," which derives a total rate of return by adding together the weighted average for both an estimated rate of return of the investment (debt service), and a desired return on the investment (return on equity).

Capitalization rates generally measure the level of risk that potential investors are willing to accept when considering an investment in real estate. Generally, lower rates result in higher valuations, as they are indicative of lower risk and a higher likelihood of return, whereas higher rates indicate a greater level of risk to the ability to meet both (a) the required *return of* the investment and (b) the prospects for a reasonable *return on* the investment. The reliability of the income stream is a key factor in determining an appropriate capitalization rate. Properties having long term leases with blue chip tenants provide less risk, while leases for large spaces that are coming to term, or short-term leases of smaller spaces for retail or office uses by independent renters, would involve a higher degree of risk. Location is also a factor in deriving a reliable cap rate. For example, two competing businesses, although located just across the street from each other, can have significantly different investment values because one has better access by way of offering additional curb cuts, thereby allowing easier ingress and egress, or perhaps a higher traffic count favoring one business over the other.

When building a capitalization rate, practitioners must also consider the source of financing. Oftentimes, east and west coast investors, generally accustomed to higher overall market values and rents, might accept a lower capitalization rate than would local investors. The same is true for non-domestic investors, as the value of the dollar versus their native currency can have a direct impact upon current and future investment decisions. For example, as of the approximate date of this article the current value of the Canadian dollar was $0.73 to the American dollar; 100 yen was equal to $0.67 to the dollar, while the Euro was worth $1.06 to the dollar. Clearly, the ebb and flow of the exchange rate could have a marked impact upon these investment decisions.

There are also investment options known as Real Estate Investment Trusts (REITS), which offer stock on the open markets to raise capital for the acquisition and development of real estate and can also take advantage of favorable tax treatment. REITS do not pay corporate income taxes, returns of distributions are tax deferred, and investors can take a 20 percent deduction of their paid dividends as a business income deduction. Additionally, REITS typically invest in a diverse portfolio, reducing the overall risk to their shareholders. A further advantage offered by a REIT is liquidity. There is often a ready market for shares of a successful REIT; whereas, a longer holding period for investments in a single asset, coupled with that lack of liquidity, can cause some investors to avoid direct investments in individual assets, as they must wait for the sale or refinancing of the asset before they can realize a return.

While the stock market establishes the share value of a REIT, the income performance of the assets track the real estate markets. Generally, REITs invest in superior quality and high value properties. As a result, REIT share prices tend to be less volatile than shares trading on platforms such as

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the S&P 500. Because there is generally less investment risk, capitalization rates of a REIT can be lower, and lower cap. rates generally translate into a higher market value.

Published capitalization rates compiled by highly regarded investment services can also provide a broad picture of the returns being sought by investors in similar classes of property during the course of the year. While some investment service publications concentrate on high end Class A institutional grade properties, several are now tracking rates for lesser classes of property as well, such as those located in both urban and suburban neighborhood locations. The addition of non-investment grade properties allows the market to consider investments in these types of properties as well, and generally reflect the higher rates attending the greater risk typically inherent in these properties.

In Illinois, the court case most frequently cited for determining the value of a property using the Income Approach, and one often cited by the Property Tax Appeal Board, is *Springfield Marine Bank v. Property Tax Appeal Board, 44 Ill.2d 428 (1970),which* stands for the proposition that while many factors may deprive an owner from realizing the full potential income from their property, it is the capacity to earn income and not the actual income realized that will be employed to determine the "*fair cash value,*" of the property for determining its market value for property tax purposes. In simple terms, it is the potential market rent and not the contract (actual) rent that will be used to establish a market value for a property.

Turning to the subject of impact of property taxes on capitalization rates, the Cook County Assessor's comments, as to his explanation of the use of tax loads, as contained in the Assessor's policy statement, *Assessor's Policy and Practice-Using an Unloaded Cap Rate*, is ambiguous as to its application. For instance, while the Assessor recognizes that both Gross and Modified Gross Leases allow for the use of tax load factors, the statement goes on to say "[t]he Assessor does not load the overall cap rate in any scenario." The policy further states that the "tax expense cost is inclusive of the real estate tax." However, in this author's opinion, the Assessor generally applies a predetermined percentage of overall expenses that rarely account for the full amount of taxes paid. Furthermore, the Assessor's calculation of the property tax expense uses the previous year assessed valuation, and not the current year proposed assessment, which is then applied to the last known equalization factor and tax rate. As a result, this formula does not take into consideration regular substantial increases in taxes due to significant increases in assessments during a triennial reassessment year.

Research completed by my former Golan Christie Taglia, LLP ("CGT") attorney, Marsha Kleffman, now retired, found the following:

> "Research completed on the use of the Income Approach found that employing the Income Approach to value property must be used as recommended by professional organizations such as the *IAAO*. The IAAO recognizes that property taxes are an operating expense of a business and must therefore be deducted as an expense in the operating statement, or, as recommended by the IAAO, *as a component of the capitalization rate* (emphasis added). This method allows for variations in tax rates and eliminates the problem of estimating real estate taxes prior to completion of an appraisal. *(See Mass Appraisal of Real Property Robert J. Gloudemans, IAAO and Property Assessment Valuation, Third Edition, IAAO.)* This component is often referred to as a "tax load."

In Cook County, tax rates in 2022 ranged from a little over 6 percent to as much as 45 percent (Rich Township) -emphasis added). Applying these rates and using the last known state multiplier of 2.9237, tax loads for a commercial property could range from a low of 4.4 percent to as much as 32.9 percent. Therefore, the use of tax loads is preferred by the IAAO because it allows for significant variations in tax rates.

In conclusion, although this article is not by any means intended to be an exhaustive study on the derivation of capitalization rates, it is hoped that it will serve to explain the use of these rates in deriving the market value of a property.■

The author would like to acknowledge the contributions of GCT attorney Jim Chipman, and Marsha Kleffman, as previously noted.)

1. "I" = Income; "R" = Rate and "V" = Value.
2. https://www.in.gov/dlgf/files/2022-level-ii-certifications/2022-Level-II-Income-Approach.pdf.