THE THREE FORMS OF OBSOLESCENCE AND PERSONAL PROPERTY TAX

When it comes to a business' personal property assessments, there are three obsolescence factors: economic, functional, and physical. Personal property tax is based on the value of an asset and there are multiple methods for reducing the overall personal property tax for assets where obsolescence may exist, but has not been properly accounted for in the value.

Personal property is generally valued on a fair market standard with states measuring it differently. This includes market value installed, market value in exchange, and market value in continued use. For property analysts, it is important to know the premise of value in the states where the property is being assessed.

Assessors typically value personal property using a measured mass appraisal cost approach technique, which means they depreciate the asset's historical cost per the company records to arrive at a taxable value. This approach typically does not encompass all forms of obsolescence and may result in a company being over assessed and paying more than their fair share of property tax.

Commonly, state guidelines established for assessors require that assessors consider all three forms of obsolescence:

Physical Obsolescence

Physical depreciation is the normal wear and tear that physical assets experience over time. Often there are extreme variations between states on how they assess depreciated property as well as the salvage value, or otherwise known as the floor value.

Assets depreciate over a typical life cycle and physical depreciation tables attempt to calculate this obsolescence over a period of its useful life. However, depreciation can occur more rapidly in some instances such as bedroom furniture in hotels, or shelving in a retail store.

Functional Obsolescence

Functional depreciation is a loss in value caused by conditions within the property, such as design, materials, or processes, resulting in inadequacy, overcapacity, or lack of utility for excess operating expenses.

For example, it may become too expensive to operate a particular production line, due to it being highly inefficient. Businesses may also seek to replace store signage and fixtures before they have reached the end of their intended useful lives in order to offer a fresher and more appealing look to drive business.

Economic Obsolescence

Economic obsolescence occurs as a result of outside factors that impact a company's ability to survive, compete, and thrive in the marketplace.

Economic forces and environmental changes that affect the supply and demand relationship between a company and the marketplace cause this type of obsolescence. As such, this form of obsolescence has captured the attention of larger companies around the globe.

Some of these rapid and dramatic outside factors include the economic downturn and its impact on companies' ability to finance capital investments. In addition, the rise of e-commerce has caused big-box retailers to realize less return on their brick and mortar assets and encounter reduced profit margins. Finally, political reforms relative to healthcare and financial institutions have impacted pricing and operating costs for many companies.

Calculating the valuation of these assets is highly complex. As a result, assessors overlook additional obsolescence – often due to a lack of resources, and not having full clarity on the full spectrum of issues that may affect an asset's value. Economic obsolescence may be very subtle and difficult to recognize without a full examination of many elements of the financial metrics of a company. For example, revenues may be increasing, yet profit margins and net income are declining due to factors such as higher competition, escalating costs of conducting business, and regulatory constraints.

In the next part of this series of articles, we will be showcasing examples of economic obsolescence and how third-party consultants can help evaluate these complex issues to reduce overall personal property tax obligations.

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