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Tax Grab: Are New York Assessors Inflating Values for the Wrong Reasons?

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The New York City real estate community has been through the wringer since 2007. It has endured a dearth of major property transactions, suffered through the meltdown of the financial services industry and watched available debt financing evaporate. Lenders and special servicers are more in control of the real estate market than ever before.

In the real world of property ownership and development, many taxpayers are experiencing a drop in occupancy for office, hotels and rental apartment buildings. Condo sales have slowed to a trickle and construction of new office, hotels and apartment buildings has come to a virtual standstill.

In this environment of dropping office rents, condominium fire sales and increasing costs of operations, real estate taxes — the largest component of a building's expenses — have skyrocketed. Why is this happening?

New York City satisfies its budget needs through a variety of taxes, and of all of them, the real estate tax is the most important and durable. The city now finds itself facing a cutback in state and federal aid and has big budget deficits. This is happening at a time when corporate and personal income taxes and sales taxes have declined, and other taxes such as transfer and mortgage-recording taxes have all but disappeared.

The city's revenue options are few. People and businesses can move to New Jersey or other areas to escape New York City's income taxes or sales taxes, and this puts a practical limit on what New York City can extract. Real estate, however, is stuck in New York City and can't escape the city's tax grip.

Excessive taxes erode equity

The real estate tax is based on the tax rate and a property's assessed value. In the face of all the troubles and distress seen in real estate over the last three years, the City of New York has made some outsized increases in its estimates of market values, which it uses to assess properties for taxation.

A snapshot provided by the City of New York Department of Finance highlights some of these amazing hikes in estimated market value. In Queens, for instance, assessors raised the market values for cooperatives 32.37% (on average12.05% citywide) from last year and Queens luxury hotels experienced a 27.97% increase as well. Manhattan luxury hotels underwent a 14.82% raise in values, while values climbed 9.65% for cooperatives and 15.91% for condominiums.

Many in the commercial real estate industry believe that the jump in assessed real estate market values is related to the city's budget woes, rather than to actual changes in the market place. The city vociferously denies this notion, but as Shakespeare's Hamlet said, "The lady doth protest too much, methinks."

How much tax is too much?

An analysis of the city's system for assessing properties shows that in office and other commercial properties the property tax bite consumes almost 34% of a property's pre-tax net income. Let's examine with this hypothetical example the formulas used by assessors.

An office building charges $45 rent per sq. ft. Its operating expenses are $12 per sq. ft., and its amortized leasing and tenant expenses are another $4.50 per sq. ft. Therefore the pre-tax net income is $28.50 per sq. ft.

The city divides that income by 13.64%, which is derived by adding a 9% capitalization rate to 4.64%, or 45% of the 10.312% tax rate. That yields a fair market value of $209 per sq. ft.

Assessed at 45% of fair market value, the result is a tax assessment of $94 per sq. ft. and a tax bill of $9.70 per sq. ft., based on the 10.312% tax rate. Therefore the city is a partner in 34% of the net operating income without any equity investment at all! This is before debt service, depreciation and capital improvements are accounted for — expenses that only the owner has to pay but for which the owner gets no credit from the city. Not bad if you can get away with it.

For apartment buildings, the pattern is even more egregious. If rents are $45 per sq. ft. and expenses are $12 per sq. ft. as in the office example, the assessor takes 45% of the 13.353% Class-2 tax rate (which is 6.009%) and adds a 7.5% cap rate to get a loaded cap rate of 13.509%. Divide the cap rate into the net operating income of $33, and the fair market value is $244.28 per sq. ft.

The assessment, therefore, is $110 per sq. ft., and this applies to the tax rate results in annual taxes of $14.69 per sq. ft. That's 44.5% of the property's pre-tax net income. Boy, what a deal the city has! If major capital repairs are needed for such expenses as the facade or elevator modernization, a roof or an apartment makeover, they are borne solely by the owner. None of these expenses are factored into the city's formula.

Property owners can always appeal their assessments, but many believe that it's the city's policy on taxes instead, that needs a reassessment.

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