

Real Estate Taxes and What They Mean to You as a Tenant

Written by Bert Rosenblatt & Andrew Stein - Vicus Partners, LLC

Did you know that the single largest expense to a landlord in running a commercial office building in Manhattan (outside of debt service) is real estate taxes? And did you know that 48.10% of New York City's total tax revenue or 26.7% of its total 65.9 billion dollar budget is derived from real estate related taxes? Yes, that's billion with a B. And in case we haven't gotten your attention yet, did you know that in the last decade, real estate taxes have increased by 108%?

So what does this mean if you're a tenant leasing office space? Does it affect you? Should you care? The clear answer is yes. You're going to get a tax bill along with your rent bill and you want your eyes open as to what to expect.

Real estate taxes are big business in New York City. Your landlord pays a whole lot of money to the city each year – and you can bet your bottom dollar that he will attempt to pass much of this cost off to you, the tenant. It also means that if taxes increase during your lease term (and if history is any indication, they will), so too will your tax payments under your lease.

Landlords in New York City can't predict how and when taxes will change, and, as owners of buildings, they have to protect their profit margin, hence the taxes being passed on to the tenants. Dumbed way down, here's how it works: office tenants typically pay a proportionate share of their building's real estate taxes above a current base year. So, let's say you move into a building with a tax bill of \$100k in year one which increases to \$110k in year two. Since you have 10% of the building, your tax bill is 10% of the increase or 10% of \$10k...or \$1k. Make sense?

But in all likelihood, the building's tax bill is not \$100k and your share is a lot more than \$1k. How much more...? Unfortunately, it depends. The minutia involved in fully understanding how taxes are tabulated is enough to choke a horse. That said, it is important to understand the basics of what to be aware of and have a broad sense of how you protect yourself from increases and surprises. Let's pull back the curtain and make some sense of this.

For example, let's take a look at the world-famous Empire State Building. This building was built in 1931. Over the past five years, there's been a great deal of renovation done to the building to bring it up to speed. Previously, the building, despite its fame, was quite run down, and hence, there weren't many large blue chip tenants that were willing to seriously consider the building as a potential home. The building may have always had an iconic status, but large sections of it were simply vacant. In the summer of 2006 all this changed. The building emerged from years of litigation with a clear and stable ownership structure that was ready to make big changes. This landlord methodically began to renovate all eighty-one floors in the building. They rehabilitated the lobby and all the bathrooms among other things and restored the building to its former glory. This restoration has been estimated to run the owners approximately 500 million dollars.

What does this have to do with taxes? Well, when a building is renovated, its value changes, and when the value changes, the taxes increase. In the case of the Empire State Building, the taxes on the building increased approximately 10 million dollars in a very short period of time.

While these increases are typically factored in over a 5-year time horizon, they nonetheless take a nasty bite. That said, if you're a tenant who signed a ten-year lease prior to these renovations, your taxes are going up and you're going to pay your proportionate share.

Even if you only occupy 1% of the building and thus only pay 1% of the increase in taxes, 1% of a cool \$10 million is a whole lot of money! All of a sudden, as a tenant, you have a huge tax payment that you weren't expecting.

What to do? Work with your broker to understand which buildings are likely to be repositioned, as the Empire State building was, so you can go in with your eyes open when budgeting for occupancy costs, moving or renewing your lease. Work with your broker and your attorney to ensure that you have a fair and equitable tax clause in your lease. Make sure you are allotted your proper building percentage above a logical base year. Further, you should be allowed to share in any tax reimbursement that the landlord receives from the city as a result of the landlord's challenge to the method used to determine the real estate taxes for the building.

Leases generally only roll over once every five or ten years so make this moment in time count by protecting your interests.