CONCRETE THOUGHTS

The Madness of City Property Taxes

Owners continue to pour money into government coffers based on a bewildering assessment process—the consequences to come

Robert Knakal

About a month ago, the city's Department of Finance published the tentative assessment roll for fiscal year 2012 (July 2011—June 2012). Projected market values in the upcoming year increased by 3.75 percent to about $823.5 billion for New York City's more than one million properties. This statistic confirms what property owners have known for a very long time: The city will increasingly look to the real estate industry for a growing percentage of its revenue, regardless of the fairness of its tax policy.

Last year, real estate taxes—and related real estate charges such as transfer taxes and mortgage recording taxes—represented approximately half of the total tax revenue collected by the city. As the city relies more heavily upon property owners to pay for constantly increasing government spending, the tax burdens on owners continue to escalate the time when market conditions blatantly indicate they should be doing the reverse.

In order to illustrate the unfairness of the present system, we need look no further than the fact that, on average, citywide property values on a per-square-foot basis have dropped about 38 percent from the market's height to present levels. At the same time, assessed values (which are what real estate taxes are based upon) had increased by 26.4 percent, according to a report from the Real Estate Board of New York. This inequity is being felt by property owners across the board and is beginning to dissuade some investors from continuing to purchase New York City properties.

If you are a regular reader of Concrete Thoughts, you know that one of the things I always mention that has exerted upward pressure on value is an acute supply-demand imbalance. Demand for Gotham's properties has been overwhelming, as both domestic and foreign purchasers have been scouring the city for opportunities. Unsurprising, the supply of available properties for sale is very low, as it historically is, leaving many of these potential buyers, extremely frustrated. It might, therefore, seem unimportant that some investors are getting turned off by ever-increasing real estate taxes, but what is important to realize is that a forest fire starts with a single spark.

It is difficult for owners to rationalize how their tax bills continue to increase, year after year, when property values have been dropping since 2007.

There is an old saying that goes, "If something happens once, it is an isolated incident. If it happens twice, it is a coincidence. If it happens three times, it's a trend." Based upon this maxim, the trend has been that investors who have purchased New York City properties for years are, increasingly, looking at opportunities outside of the Big Apple as real estate taxes continue to spiral out of control. This leaves them feeling like they are working hard to drive revenue just to pay real estate taxes, water and sewer charges and other fees levied by the city.

From a property owner's perspective, the only thing that really matters about real estate taxes is the amount of their real estate tax bill each year. It is difficult for owners to fathom how their tax bills continue to increase year after year when property values have been dropping since 2007. In order to understand the real estate tax issue more clearly, we must look at how real estate taxes are calculated.

In what is a gross oversimplification, real estate taxes are determined by multiplying a property's assessed value by the appropriate real estate tax rate. The assessed value is the property value ascribed to the property for tax purposes. The New York City Department of Finance determines a property's assessed value by multiplying its estimated full market value by the assessment ratio for the property's tax class.

In New York City, a property can have three different assessed values: an actual assessed value, a transitional assessed value and a billable assessed value. There are four different tax classes of properties in New York. Class 1 generally is for one- to three-family homes; Class 2 is for larger residential properties, including rental buildings, co-ops and condos; Class 3 is for public utilities; and Class 4 covers commercial properties. For the purposes of this discussion, we will not address Class 3 properties.

The assessment ratio for Class 1 properties is 6 percent of market value; Class 2 and Class 4 properties carry ratios of 45 percent of market value. Market value is determined by the Finance Department using different methods, which are usually manipulated toward whatever approach is beneficial to the city (more to come on this later). These methods include using comparable sales

PROSPECTIVE TENANTS *Micro Center*

Would-Be Apple Scoping Manhattan

Retailer has checked out 420 Fifth, may benefit from Borders bankruptcy

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BY LAURA KUSISTO

Steve Jobs can't sneeze on a storefront without creating a fan frenzy, but a similarly high-end tech store has been scoping Manhattan space without eliciting so much as a tweet. **Micro Center**, a big-box–size retailer with aspirations to an Apple-like desirability, is scoping Manhattan space, including along top-tier Fifth Avenue, sources tell *The Commercial Observer*.

The store's customers have the same education level as a Saks consumer, according to Ed Luken, a spokesman for Micro Center, although he conceded the young, hip IT consultants "are not making nearly as much money."

Sources say Micro Center has checked out 420 Fifth Avenue, which housed a CompUSA until the store closed a couple of years ago. Broker George Constantin, of Heritage Realty Services, said he's shown the space to electronics companies but declined to specify which ones. Efforts to contact other major electronics retailers went unrewarded: Indianapolis-based hhgregg said it wasn't looking at the space, and Radio Shack declined to comment.

Mr. Luken said Micro Center doesn't comment on specific locations, but noted that it's been looking in the area. Mr. Luken also sees potential in the bankruptcy filing of Borders as the retailer may vacate some of its Manhattan stores.

Micro Center has 23 locations in major centers such as Washington, D.C., and Chicago, as well as a Yonkers location that opened in the summer. They generally range from 35,000 to 62,000 square feet, but in Manhattan the company is looking for something on the smaller end. The company seeks to position its stores, which features a "knowledge theater," a "knowledge bar" and an unusually wide selection of computer books, in areas where they will reach an affluent, highly educated customer.

That sounds an awful lot like Fifth Avenue.

True, Mr. Luken said, but added: "You can find that in Harlem today. You can find that in parts of the Bronx. We're definitely highly interested in all of New York."

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ta for Class 1 properties and ei- er a gross-rent-multiple approach a capitalization-rate approach for ass 2 and Class 4 properties.

After assessed values are deter- ned, they are multiplied by the propriate tax rate (expressed in rcentage terms) for each class of operty. In the 2010–2011 tax year, e tax rate for Class 1 properties is 364 percent; for Class 2 it is 13.535 rcent; and for Class 4 it is 10.312 rcent.

The recent tentative assessment lls for fiscal year 2012 have left operty owners scratching their eads. For example, according to the ty, Class 1 properties saw value rise 0.86 percent based upon compara- e sales, and assessed values rose by 65 percent. Market values for Class properties rose by 13 percent and sulted in assessed values increas- g by 8 percent. In Class 4, market alues rose by 9.95 percent, pushing ssessed values up by 7.25 percent.

While these figures are difficult nough to comprehend under cur- ent market conditions, what is more erplexing is that during the recent ownturn, in which we saw average rices per square foot for Class 2 and properties drop from peak levels in 007 through 2010 by about 38 per- ent, assessed values continued to ncrease. According to a REBNY re- ort, from 2008 to 2012, the city's stimate of market value increased y 3.46 percent and assessed values ncreased by 26.4 percent.

While I could take up several pages of *The Commercial Observer* with examples of simply crazy assessment increases, I will use just one to illustrate what is happening.

The 49-unit apartment building at 315 West 115th Street changed hands about a year ago. Since the sale, no regulated units were deregulated, so the income has not changed much. The present owners are renovating a few of the vacant units, but no significant major capital improvements were completed. The assessed value here nearly tripled in the 2012 tentative assessment roll from $422,550 last year, up to $1,233,900. How can such an increase be explained when essentially nothing has changed at this property? This is just one example amid thousands that just don't make sense.

These unfathomable numbers have left a dynamic in which real estate taxes are constantly rising as a percentage of gross revenue.

When I mention that valuation methodology is manipulated by the city, remember that in the 1980s, Class 2 and 4 properties were reassessed upon sale at 45 percent of the sale price, and the difference between the resultant number and the old assessment was phased in equally over a five-year period.

This left some properties with multiple assessment "clocks" running at any particular time, making it very challenging to project where taxes were headed. The city loved this method during the mid-to-late 1980s, when values were increasing annually. However, as soon as values started to decline after the savings-and-loan crisis in the early 1990s, assessed values were dropping too rapidly and the city abandoned their previously beloved methodology. Assessed values were then going to be determined based upon income and expenses and value trends within neighborhoods. This shift was clearly implemented to keep real estate tax revenue from dropping too sharply.

In addition to these meandering assessed value calculations, we mentioned that tax rates were also subject to manipulation. When we hear elected officials proclaim that "real estate taxes will not go up," they are commonly referring to the tax rate itself. If a rate was 10.5 percent one year, and remained 10.5 percent the next year, politicians cheer that "taxes did not go up." However, a property owner's tax bill is sure to increase as the assessed value rises. As I stated before, the amount of the check written to pay real estate taxes is all that an owner is really concerned about.

Interestingly, if we look at historical tax rates, we generally see more rapid increases when times are tough than when times are good. While this is counterintuitive, it is not surprising as municipal tax revenues slide during recessionary periods and real estate taxes are a way to help bridge the gap. From 1981 through 1991, tax rates among all classes of properties remained consistently between 9 and 10 percent. In 1992, during the height of the S&L crisis, rates increased about 10 percent to about 11 percent.

Tax rates remained fairly steady throughout the balance of the 1990s and early 2000s. During the 9/11-and-dot-com-led recession in the early 2000s, tax rates jumped significantly. From fiscal years 2002 to 2004, Class 1 tax rates increased from 11.609 to 14.550, a 25.3 percent increase; Class 2 rates increased from 10.792 to 12.620, a 16.9 percent increase; and Class 4 rates climbed from 9.712 to 11.431, a 17.7 percent rise.

If we analyze tax rates during our most recent recession, we see that tax rates have jumped again. From 2008 to 2011, Class 1 rates are up 12.5 percent, moving from 15.434 to 17.364; Class 2 rates have climbed 13.5 percent, from 11.928 to 13.535; and Class 4 rates increased 2.5 percent, going from 10.059 to 10.312. To pound property owners at times when they are being slammed by broader economic conditions is a one-two punch that can be demoralizing.

If we compound the tax assessment increases we have seen with these tax rate increases, we see that today's real estate tax burdens are disproportionately eating up gross revenue at higher percentages than ever before. This dynamic is taking a toll on investors and operators. It will be interesting to see if the governor's tax-cap pledge will be implemented and, if so, whether it was meant to simply cap the tax rate, or the amount of the check property owners have to write to the city.

Owners have the ability to fight their tentative assessments. Owners of Class 1 properties who wish to file an appeal must do so by March 15. Owners of all other property types must file by March 1. The final assessment roll will be published on May 25. In June, the Finance Department will use this final roll to calculate property tax obligations for fiscal year 2012, beginning July 1.

Fiscally, there is much optimism today, as Governor Cuomo appears to be resolute in his quest to cut government spending as the way of addressing the state's budget woes. The mayor also seems to be on board with this approach, and the importance of a successful implementation of this route cannot be overstated. To the extent they are unsuccessful, there is no doubt that additional real estate tax increases will be right around the corner.

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