



**Reduced taxes are necessary for office properties to endure -
by Brad and Sean Cronin**

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The office market is a sector that continues to adapt to a post-pandemic environment. “Work from home” has become commonplace and landlords have been forced to adjust. However, the exact impact on the office market is much more complex than looking at a rent per s/f figure. A true analysis requires a more in depth look at all aspects of a lease and how the different clauses and concessions affect the landlord’s net operating income. It is only after factoring all these components, along with the increased risk of office investment, that a correct tax burden can be concluded.

The law requires properties to be valued on that jurisdiction’s valuation date for tax purposes each year. This allows for the tax burden to be adjusted based on the circumstances of the market annually. The courts have concluded that the best manner to determine value is an income approach. In order to perform an income analysis annually, the true rent for a property on valuation date must be established. This is the critical component that calls for a downward adjustment for office buildings since COVID.

How do we decipher true market rent for an office building post-COVID? Under New York law,

leases that were signed prior to COVID that are at amounts higher than the current market cannot be used to evaluate a property's taxable value. Since most office leases are for extended terms, the income may appear to be high, but the courts recognize this is not a true reflection of the property's value. The logic behind this analysis is the same as a real-world investor would see in that property. Any knowledgeable purchaser would not assume that the above-market rates will continue after old leases terminate, and this would be factored into their desire to invest in that property. Therefore, looking at pre-COVID leases provide little guidance as they are not indicative of the world we live in now. In fact, the only reason many tenants continue to pay their pre-COVID lease amounts is because they signed a guarantee or good guy clause that holds them liable for the remainder of the term.

For practical reasons, and also to follow the law, we must examine leases subsequent to March of 2020 for tax purposes. When we look at these leases, it is not just the rent per s/f that should be considered, but the concessions and construction allowance from the landlord. Many landlords, under pressure from the market, have been coercing tenants to sign agreements by offering months of free rent. Even if it's only two months of free rent, that's a 17% reduction in collections on an annual basis. This is an obvious adjustment that must be made to the rent per s/f figure.

Less evident is the impact a landlord's contribution to the tenant build out can have on the bottom line. If a landlord is contributing \$40 per s/f for a 10,000 s/f office space that's \$400,000 of present day money being spent by the landlord just to get the tenant in the space. This exorbitant expense must be recognized as an additional deduction in any analysis beyond the operational expenses.

Another variable in the analysis that is currently unclear in the current market is the true market vacancy rate. Drive by any office park and compare the parking lot to pre-COVID and it is evident that the number of cars is drastically reduced. With so many leases beginning prior to COVID, there is a great deal of "leased space" with no one actually inside the space. Unable to sublease the space, many tenants are counting the days until they are off the hook for their lease payments.

All these factors make the office market an incredibly risky investment that must be reflected in the cap rate. When class A buildings are struggling with these issues, the risk is even that much greater for class B and C properties. The financing environment mirrors this sentiment with many lenders hesitant to take part in office deals. In fact, office conversions are more attractive to lenders currently, but under the law, the property may not be taxed on any new use until the conversion actually occurs.

The troubles facing the office market became obvious ever since "Zoom" entered our lexicon, but understanding the full impact requires a dissection of these new agreements. Starting with finding the true rental amount and following through with a vacancy analysis, then applying higher cap rates will result in a dramatically reduced tax burden for office properties. As this sector continues to suffer the effects remote working and shrinking footprints, reducing the tax burden to a level that can be sustained by landlords is critical to keep the remaining offices operable.

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