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Question of the Month: Does a recent sale impact property taxes? It all depends. - by David Wilkes

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A recent, arm's length sale is often considered a strong indicator of a property's value. But a sale price can also mask considerations that went into a deal that would be unknown to an outsider, such as business motivations, financing terms, and retained interests. In the world of property tax, the use of sales as indicators of value for assessment is still more complex, requiring a thorough understanding of principles of valuation, definitions of "value", and the assessment practices of the local jurisdiction.

This is an area in which appraisal and law intersect, but not perfectly, and common sense is not often helpful. Most tax certiorari attorneys in New York state are familiar with the general rule about sales that has been restated by the Court of Appeals in several landmark cases: "the purchase price set in the course of an arm's length transaction of recent vintage, if not explained away as abnormal in any fashion, is evidence of the 'highest rank' to determine the true value of the property at that time."

Know the Local Playing Field

One might assume from this that a straightforward sale of the subject property would make simple work of determining its assessed value. As with most real estate issues, much turns on location. If your commercial building is located in New York City, generally the sale price is irrelevant for assessment purposes and may be disregarded, with a simple income approach to valuation being the primary method. In stark contrast, outside of the five boroughs is an entirely different playing field with different rules. In most of New York state outside the City, a recent sale can play a crucial role in determining the assessed value.

A large portion of the assessing jurisdictions throughout the state do not annually update or reassess properties on a municipal-wide basis, but some do. The relevance of a recent sale to the property tax load will be markedly different – sometimes the decisive factor in whether a deal proceeds or not, and whether taxes will increase or decrease – and it is therefore crucial to know the assessment system on a hyper-local basis.

For example, in a suburban town that does not regularly reassess its properties based on the market, a building that sells in an arm's length transaction for well above the assessed value may, by law, enjoy a disproportionately low property tax burden for many years. In that same town, another building that sells for a price significantly below the assessed value may be entitled to a large reduction in its annual taxes.

However, in a neighboring town that performs annual reassessments, a sale for a price that exceeds the current assessment is likely to trigger increased taxes, so much so in many instances that the proposed transaction no longer makes economic sense and the buyer may need to look at alternative options, including, under the right circumstances, the possibility of taking the property off the assessment roll altogether through an arrangement with the local Industrial Development Agency.

Sales and Valuation

The high court's heavy reliance on arm's length sales as evidence of the "highest rank" to determine property value, while often warranted, can also often overshadow important valuation nuances. Key here is the distinction between a leased fee and fee simple value. For property taxes, the standard is fee simple, which assumes that all rentable space, occupied or not, is at market rent, from which is deducted a market-based factor for vacancy and collection loss, as well as market-based expenses. Many sales implicitly prioritize in-place rents and actual occupancy which may skew the price more toward a leased fee value than fee simple. For example, an existing major tenant with an above-market rent may drive up a sale price and, in fairness, the tax assessor would be smart to adjust the value downward to account for the market. Likewise, a building with full but tenuous occupancy may sell at an optimistic value that does not account for the market's typical vacancy.

Not surprisingly, tax assessors notoriously tend to rely most heavily on sale prices when they help to support an assessment, disregarding important factors that may discount the true value. In some instances, a buyer may be uniquely motivated to purchase and is less interested in getting the "right" price than others in the market, such as where the purchaser may be under the duress of effecting a 1031-based exchange, or where the buyer needs to control the use of properties adjacent to its existing ownership; this might be the case where, for instance, a prominent retailer wants to ensure that a competitor does not acquire a neighboring property. The excess paid over market value is related to the value of the business, not the taxable real estate.

Another common circumstance occurs where a buyer over-pays just before a market downturn, e.g., the unanticipated onset of COVID spoiled many real estate projections, or where a major tenant suddenly goes out of business leaving a gaping hole in a pro forma that is difficult to refill without much unexpected time and cost.

In all of these scenarios, the notion of a recent sale price being prime evidence of value must be tempered by a realistic review of the current market, motivations of buyer and seller, adjustments based on recent net operating income and occupancy, and, most important, an in-depth understanding of the local jurisdiction's assessment system, which can be radically different depending on location within New York state.

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