REAL PROPERTY TAX CONSIDERATIONS FOR LANDLORDS AND TENANTS IN NEGOTIATING LEASES OF COMMERCIAL PROPERTY

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I.

Tenant Analysis of Property Tax Considerations Prior to Entering into Lease

The fundamental question for tenant’s counsel in reviewing a commercial lease is whether the lease places any obligation for payment of real property taxes and assessments on the tenant. In a gross lease transaction, the landlord will bear the expense of real property taxes. In a true “net lease,” the tenant will bear the cost directly. However, in the majority of instances involving commercial leases, liability for real property taxes falls somewhere between the two, with the landlord bearing the expense up to a certain base amount and the tenant bearing the expense for property taxes either relating to the improvements made upon the leased premises by or for the benefit of the tenant, or for all increases over a certain base amount. Such provisions are frequently referred to as tenant escalation clauses.

In the case of either a “net lease” or a lease involving an escalation clause, the lease should address several different concerns: the current base tax figure used in the escalation computation; the scope and type of improvements that would result in an escalation in taxes for which the tenant is liable; the history and computation of real property taxes for the subject parcel; and rights to administratively challenge (grieve) the assessed value of the leased property under Article 5 of the New York Real Property Tax Law (“RPTL”) and, if necessary, to challenge the assessment through litigation under Article 7 of the RPTL.

1. Basic Property Tax Terminology.

The term “real property taxes,” as the term is most often used in New York, refers to general municipal (County and Town, City, or Village) taxes and school district taxes imposed on a parcel of real property. The real property tax is an ad valorem tax, insofar as it is levied against all taxpayers within the municipality and school district (hereinafter referred to as the “taxing jurisdictions”) according to the proportionate share of the value of each parcel of property to the overall value of all properties within the taxing jurisdictions. However, the term real property taxes is often referred to in a more general sense, to also include special ad valorem taxes and special assessments (which are sometimes referred to as “charges”), all of which are generally reflected on the tax bill, but not characterized as real property taxes, per se.
A special ad valorem tax is “a charge imposed upon benefited real property in the same manner and at the same time as municipal taxes to defray the cost of a special district improvement or service . . . on a county or citywide basis and, like a tax, does not consider any direct benefit received by an individual parcel.” Warren’s Weed, New York Real Property § 133.03 (5th ed. 2009). Special ad valorem levies may include charges for water and sewer districts, highways, library districts, lighting districts, fire districts, and other municipal services for public works improvements.

Special assessments, on the other hand, “are impositions upon benefited real property in proportion to the benefit received by such property to defray the cost of a special district or service (that) relate to the benefit received by a particular property from an improvement.” Id.

In this article, the terms “taxes” and “real property taxes” will include special ad valorem taxes and special assessments unless otherwise noted.

2. Base Tax Year Considerations.

Whether a lease is a true “net lease” or the lease imposes liability on the tenant for property tax increases beyond a given base year, tenant’s counsel should carefully review and consider the base year that is being used to compute the tenant’s tax liability. In either event, the tenant will be liable for increases in real property taxes in some manner. In the net lease scenario, the tenant must understand that all assessment increases affecting the tax parcel in question, whether as the result of an increase in assessment based upon revaluation by the assessor, an increase in tax rates, overall market conditions, or improvements made to the leased premises will result in an increase in real property tax liability.

Landlords and tenants must also be cognizant of the consequences of assessments applying to tax years which are not calendar years. For instance, the assessment roll filed on or about July 1 in most towns in New York State sets assessments which are used to determine the school tax from July 1 until the following June 30 although the school tax bill is generated on or about September 1. The county, town tax bill based on the same July 1 assessment roll is issued on or about January 1st of the following year, and applies to the period from January 1 through December 31 of the year after the July 1 assessment roll. Accordingly, the assessment roll applies to certain taxes over an eighteen month period. But, more troublesome is the situation where, due to a revaluation or other circumstance, a property assessment changes on a successive July 1 tax roll. In such instance, during one calendar year the school tax is based on one assessment and the county, town tax is based on an entirely different assessment. The use of a calendar year base year, therefore, is fraught with peril. If the lease is executed prior to July 1 of the base year, it may be difficult or impossible to estimate what the base tax amount will be. Even if the tenant knows the property tax amounts that will constitute the base, the failure to understand the timing and impact of assessed value could have drastic negative consequences. For a tenant, such a misunderstanding especially in a lease escalation
clause, could result in a large escalation payment commencing in year two of the lease term.

3. **Scope and Type of Improvements Resulting in Tax Escalation Liability for Tenant.**

   If a lease includes a property tax escalation provision, the tenant should carefully define what improvements resulting in an increased assessment will result in property tax liability for the tenant. For instance, where the leased premises will benefit from substantial build-out prior to, or after, commencement, the tenant may be able to negotiate such that the base year for escalation purposes will be the year after the improvements are completed (which factors in the cost of such improvements). Alternatively, should the base year for escalation purposes be a year before the date such improvements are made, the tenant should anticipate an immediate and significant tax liability upon completion of the improvements (the build-out will increase the fair market value of the leased premises, which may result in an increased assessment). In some cases, the cost of build-out by the landlord will be included in the base year tax figure, with later improvements done by or at the request of the tenant giving rise to escalation.

4. **Tax Parcel History and Tax Computation Considerations.**

   In reviewing potential increases in real property tax liability by the tenant in a net lease or tax escalation scenario, the tenant should review the history of the property tax assessment for the subject parcel. For example, in a net lease, or in the case where the assessment as of the year of commencement is the base year, the tenant should investigate the assessment to determine whether it may be artificially low as a result of a prior settlement or judicial determination in a tax certiorari proceeding brought pursuant to Article 7 of the RPTL. A settlement or judicial determination reducing the assessment in a year prior to commencement of the lease may have prohibited an increase in assessment. Note that pursuant to RPTL § 727, a three-year freeze is placed on an assessment following a judicial determination, including a court order approving a settlement. However, such a stay on property tax increases will no longer be effective in the fourth year following settlement, in which case the assessment may be subject to an increase.\(^1\)

   The landlord and tenant should also understand the concept of equalization rates and their impact on escalation provisions. Equalization rates are percentages computed by the New York State Office of Real Property Services (“ORPS”) to ensure that the taxing jurisdictions within the state equitably allocate the overall state tax liability among

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\(^1\) RPTL § 727(1) provides that, “where an assessment is found to be unlawful, unequal, excessive or misclassified by final court order or judgment, the assessed valuation so determined shall not be changed . . . for the next three succeeding assessment rolls prepared on the basis of the three taxable status dates next occurring on or after the taxable status date of the most recent assessment under review.” Although the statute only pertains to final order, where the parties to the action incorporate the terms of Section 727 in the stipulated order pursuant to settlement, the same terms apply. *See Matter of Malta Town Centre I, Ltd v. Town of Malta*, 3 N.Y.3d 563, 789 N.Y.S.2d 80 (2004).
the many taxing jurisdictions. Equalization rates are the ratio of total assessed value in the taxing jurisdiction to the total market value of properties within the jurisdiction. Assessed values are determined by the taxing jurisdiction, and the total market value of properties is determined by the state. The equalization rate formula is:

\[
\frac{\text{Total Assessed Value (AV)}}{\text{Total Market Value (MV)}} = \text{Equalization Rate}
\]

In many taxing jurisdictions, assessments are considered to be at full value (i.e., the assessed value equals the fair market value of the property), with a corresponding equalization rate of 1.0. However, often the assessed values for properties within the taxing jurisdiction are a percentage of the actual fair market value.

Regardless of the equalization rate, in any year in which a revaluation does not occur, the actual equalization for a property will vary because assessments normally remain static while actual fair market value changes. Historically, values have tended to increase over time. However, in the recessionary times beginning in the Summer of 2008, values in many areas of New York State have fallen by thirty to forty percent. In situations where the rate lowers but fair market values of commercial properties do not increase, the lower rate will still tax the property as if the value did increase. For example, if the fair market value of all properties within a town was $100,000 in Year 1, the assessed value of those properties was $100,000 in Year 1, the Equalization Rate would be 1.0 (or 100%). If in Year 2 the assessed values remain the same but due to market increases the fair market values increased to $102,000, the resulting Equalization Rate would be 98%.

Where values of commercial properties have precipitously declined, the implications on equalization rates and upon actual value of the property assessed can create unintended consequences in a lease setting. As values decrease and assessments remain static, the equalization rate rises. The lower the equalization rate in the taxing jurisdiction in which the leased premises is located, the more volatile the value is, insofar as significant increases in value may occur with no increase in assessed value and, therefore, the commercial property owner may bear a disproportionate tax burden to properties assessed at their actual fair market value. In either event, an analysis whether assessments should be challenged and who has the right to commence the challenge come to the forefront.

Sophisticated tenants should determine the fair market value of the leased premises and, where applicable, the overall tax parcel in which the leased premises is located, and compare that value with the assessed value. In the event that the fair market value exceeds the current assessed value, the tenant should be concerned with a potential increase in the assessed value during the lease term.

A further consideration for the tenant in a “net lease” or escalation scenario is the allocation of tax liability between multiple tenants within the tax parcel of which the leased premises is a part. In a multiple tenant scenario, the tenant’s liability should only relate to the percentage of value pertaining to the tenant’s leased premises. Increases in
assessed value relating to the premises of other tenants should not be included within the subject tenant’s tax obligations. In addition, the tenant’s percentage of tax liability should be computed as a percentage of the tenant’s leaseable square footage of the overall tax parcel. If the tenant’s liability is a percentage of the actual leased square footage of the overall tax parcel, the tenant will ultimately bear a portion of the tax liability relating to vacant portions of the overall tax parcel.

5. **Tenant Rights to Contest Tax Assessments through Grievance and Litigation Processes.**

   (a) **Primer on Administrative Review and Tax Certiorari Proceedings.**

   Where a tenant will bear liability for all or a portion of real property taxes throughout the term of the lease, the lease agreement should include a provision giving the tenant the right to contest the real property tax assessment for the leased premises. All of these rights granted should be understood in the context of what challenging an assessment includes. While the following treatment is not meant to be an exhaustive analysis of the procedures, it provides an outline of some basic points that the parties should know.

   First, a party that is aggrieved by a real property tax assessment must seek administrative review and exhaust all such remedies before proceeding to the courts. Lee & LeForesteir, *Review and Reduction of Real Property Assessments in New York* § 2.01, p. 63 (3d ed. 2000) (citing Sterling Estates v. County of Nassau, 66 N.Y.2d 122, 495 N.Y.S.2d 328 (1985)). This administrative review procedure is set forth in RPTL § 512.

   With some exceptions, assessing units issue their tentative tax assessment rolls on May 1st of each year. RPTL § 510 requires assessors to notify any property owner whose property tax assessment has been increased, or if a change has been made regarding property tax exemptions applying to the property. Typically at this time, the assessor will provide notice to the property owner of the dates and times when the assessing unit’s Board of Assessment Review (“BAR”) will convene to hear any grievances. Any property owner may file a grievance with the BAR, in a form provided by the ORPS on or before the appointed grievance date. RPTL § 512. The grievance form must be signed by the property owner or an authorized representative and certified as accurate.\(^2\) RPTL § 523. Although little information regarding the complaint is required in the form, it is often in the property owner’s interest to provide additional supporting documentation supporting the claim that the assessment is excessive. Personal appearance before the BAR at the grievance proceeding is not required, unless the BAR notifies the property owner, although it is often recommended. The BAR may also require that the grievant provide other types of documentation relating to the value of

\(^2\) Grievances of assessed values for properties located in the City of New York must be made on the documentation required by the City and must be verified by a person having knowledge of the facts stated therein.
the property. This may include any recent appraisals, information on recent capital improvements, information relating to recent sales, leases, or marketing efforts for the property, or any number of other items. The key concept for the grievant to be aware of is that failure to appear when requested and a willful failure to provide requested documentation is not only grounds for dismissal of the grievance, but may be grounds for dismissal of a subsequent certiorari proceeding under RPTL Article 7.

The BAR may issue a response, to either lower, raise, or leave unchanged the assessed value, at the grievance proceeding, but the Board often reserves decision and notifies the grievant later. The assessor will modify the assessment according to the decision of the BAR and issue the final tax roll.

If a property owner has proceeded through the grievance proceeding set forth in RPTL Article 5, and the owner is still aggrieved by the assessed value, then the owner may petition the Supreme Court for a writ of certiorari to review the assessment pursuant to RPTL Article 7. Such a proceeding is commenced by filing a verified Petition and Notice of Petition, alleging the manner in which the assessment is excessive, unequal, unlawful, or misclassified, the extent to which the petitioner will be injured thereby, and the result of administrative review proceedings under RPTL Article 5. RPTL § 706(2). Filing of the Petition is subject to a strict statute of limitations, requiring the Petition and Notice of Petition to be served within thirty days of the later of the date of publication of completion and filing of the final tax roll, or such date fixed by law for completion of the final tax roll. RPTL § 702(2).

The assessed value in an Article 7 proceeding bears a presumption of validity which must be overcome by proof provided by the petitioner. RPTL § 1134. Generally speaking, an Article 7 proceeding will proceed much in the manner as other litigation proceedings. However, there are several unique attributes to an Article 7 proceeding:

- **Filing of Income and Expense Statements.** For proceedings outside of the City of New York, prior to filing a Note of Issue, the petitioner must serve a certified statement of the income and expenses of the property for each year under review in the proceeding, or a certified statement that the property is not income-producing. 22 N.Y.C.R.R. § 202.59. Within the City of New York, the same requirement applies; however, the income and expense statement must be completed on the form provided by the Tax Certiorari Division of the Office of Corporation Counsel. 22 N.Y.C.R.R. § 202.60.

- **Filing of the Note of Issue.** Once discovery is complete, a Note of Issue must be filed to place the matter on the trial calendar. However, in Article 7 proceedings, the Note of Issue must be served and filed within four years from the date of service of the Petition and Notice of Petition unless the parties stipulate to an extension or the court so orders on good cause shown. RPTL § 718(1). This rule is strictly applied, and failure to do so will

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3 See below for a discussion of whether or not a tenant qualifies as an aggrieved person.
generally constitute dismissal of the action. However, in a recent decision a Nassau County Court has attempted to soften this rule by establishing a creative analysis of what could constitute a stipulation to revive an action that had been dismissed. *Transtechnology Corp. v. The Board of Assessors and/or The Assessor of the County of Nassau, et. al*, Index No. 012256/96 (Nassau County May 15, 2008).

- **Exchange of Appraisal Reports.** A unique attribute to Article 7 proceedings is the exchange of appraisal reports by the petitioner and the respondent. 22 N.Y.C.R.R. § 202.59(g); 22 N.Y.C.R.R. § 202.60(g). The appraisal reports constitute the most critical evidence in most Article 7 proceedings, and their preparation is of utmost importance because the testimony of the appraiser as expert witness will generally be limited to the facts alleged in the report. Preparing an appraisal is also often a costly step in an Article 7 proceeding, and the parties will frequently pursue settlement vigorously prior to engaging appraisers. For proceedings outside of the City of New York, such discussions are frequently facilitated by a pre-trial conference, which may be demanded by any party or mandated by the court. 22 N.Y.C.R.R. § 202.59(e). Upon the exchange of appraisals, Article 7 proceedings will often proceed to trial swiftly if settlement is not reached.

- **Relief.** In the event that the petitioner is successful, the court will order refunds to be paid on taxes over and above the fair market value of the property as determined by the court. RPTL § 726. The petitioner will be entitled to the payment of interest at the statutory rate on such refunds from the date of payment of taxes through the date of the order. RPTL § 726(2). Costs may be awarded to a successful petitioner where the reduction is equal to or greater than half of the reduction sought by the petitioner in the prior grievance proceeding, or at the discretion of the court. RPTL § 722(1).

- **Restriction on Future Increases.** After a final judgment of the assessed value has been entered, the assessing municipality may not increase the assessment, and the petitioner may not challenge the assessment for the following three assessment rolls unless there is (i) a revaluation or update of all real property on the assessment roll or of similar class in a special assessing unit, (ii) there has been a physical improvement to the property, (iii) the zoning for the property has changed, (iv) the property has been destroyed or altered by a catastrophic event, (v) the government has taken action which has caused a discernable change in area values, (vi) the occupancy rate of the building has changed by twenty percent or more, (vii) the owner is no longer eligible for an exemption, or (viii) the use or classification of the property has changed. RPTL § 727.
Lease Provisions Relating to the Right to Contest Real Property Taxes.

In order for a tenant to have the right to commence either an administrative review proceeding with the Board of Assessment Review for the taxing jurisdiction pursuant to RPTL § 524 or a Tax Certiorari Petition pursuant to RPTL § 704, the lease must explicitly state that the tenant has the right to bring such a proceeding. Such provision should include an obligation of the landlord to provide the tenant with all notices relating to tentative and final assessments on the property. However, tenants should be aware of the timing for posting of the tentative tax roll, Board of Assessment Review hearing dates, and the outside date for bringing a certiorari action (within thirty days following posting of the final tax roll).

It should be noted that a tenant’s ability to bring an action to contest real property taxes has been reviewed extensively by the courts. Where a non-fractional tenant (i.e., one leasing the entire property interest comprising the tax parcel in question) is bound by the lease to directly pay the entire tax assessment on behalf of the landlord, the tenant will have standing to commence a tax certiorari proceeding. See Matter of Burke, 62 N.Y. 224 (1875). A ground lessee will not automatically have standing, unless the building owned by the ground lessee constitutes a separate tax parcel from the land. This is the case even if the lease does not contain a provision expressly granting the tenant the right to contest an assessment. See Matter of EFCO Products v. Cullin, 161 A.D.2d 44, 560 N.Y.S.2d 158 (2d Dep’t 1990) (also holding that payments in lieu of taxes required to be made by a tenant where the property is owned by an industrial development agency, and thus technically exempt from property taxation, are equivalent to property tax payments for purposes of determining the right to contest an assessment).

With respect to fractional tenants, the analysis is more involved to account for the potential conflicts in granting standing to multiple parties to contest a single assessment. In Matter of Waldbaum Inc. v. Finance Admin. City of New York, 74 N.Y.2d 128, 544 N.Y.S.2d 561(1989), the Court of Appeals set the standard under which a fractional commercial tenant may bring a tax certiorari proceeding. In that case, the tenant, Waldbaum, Inc., was a fractional tenant in premises for which the landlord paid all real property taxes. Under an escalation clause, Waldbaum was obligated to pay additional rent equal to its pro rata share of the taxes in excess of a base tax amount. However, Waldbaum’s tax payments to the landlord were to reduce any additional rent paid to the landlord under a percentage rent provision. Unless the tax payments exceeded percentage rent, the net tax liability to the tenant would be zero. The court held that, in order for a fractional tenant to have standing to bring a tax certiorari proceeding, a lease must either (i) give a fractional tenant the right to assert the landlord’s “undivided” property interest in a tax certiorari proceeding, or (ii) require the tenant to directly pay the entire, undivided, tax bill. Id. at 132. The court further held that, even if one of these standards is met, the tax assessment must have a direct adverse effect on the tenant’s “pecuniary interests.” Id. Because Waldbaum was not obligated to pay the entire tax bill affecting the leased premises and had no contractual right to bring an action to contest the entire tax assessment, the court held that it lacked standing.
The court in Waldbaum further held that the provision requiring a reduction of percentage rent by the amount of taxes paid by the tenant negated Waldbaum’s argument that its pecuniary interests were directly affected by the tax escalation provision. *Id.* at 135. The court found that such adverse effect was “legally remote and only consequential” because of the possibility that there would be no net tax liability on behalf of the tenant if percentage rent were to exceed the pro rata tax obligation of Waldbaum. *Id.*; see also *Matter of C&P Partners v. Dep’t of Assessment*, 192 Misc. 2d 139, 744 N.Y.S.2d 829 (Sup. Ct. Albany County 2002). As a result, in drafting a provision on behalf of a tenant authorizing the tenant to contest the assessment, one should take care that there is not another provision in the lease which may entitle the tenant to a setoff of its tax liability against rent.

Although the tenant in Waldbaum was denied standing, the rule has been followed to grant standing to tenants where the lease included the right to commence a tax certiorari proceeding. *See Ames Dep’t Stores, Inc. v. Assessor of the Town of Greece*, 261 A.D.2d 835, 689 N.Y.S.2d 791 (4th Dep’t 1999); see also *Matter of Caldor, Inc. v. Town of Ramapo*, 253 A.D.2d 876, 678 N.Y.S.2d 508 (2d Dep’t 1998).

The courts have held that a provision granting the right to contest property tax assessments in the landlord’s name is sufficient to satisfy the Waldbaum test, even if the lease provision does not expressly state that the tenant’s right extends to the landlord’s “undivided interest.” *Matter of K-Mart Corp. v. Board of Assessors*, 176 A.D.2d 1034, 575 N.Y.S.2d 185 (3d Dep’t 1991). There, the court found that the language “in lessor’s name” was sufficient to establish the right to assert the lessor’s undivided interest. *Id.*

*Practical Note:* A tenant needs to be wary of a right to bring an action in which it may not be able to meet discovery demands of the municipality or provide necessary information to its own appraiser. If the tenant has such right to contest the assessment, its duty will be to appraise the value of the entire tax account number, not just the rental parcel, and all information relevant to all uses and tenants of the property are both discoverable by the municipality and relevant. Therefore, a clause requiring the landlord to cooperate fully with discovery if a tenant is prosecuting an assessment is both appropriate and necessary.

The right to commence an administrative review proceeding pursuant to Section 524 has been held to require the same standards as the right to commence a tax certiorari proceeding. 7 Op. Couns. SBEA No. 123 (a shopping center tenant who was obligated pursuant to the lease to pay taxes had the right to bring an administrative review proceeding).

The provision relating to real property tax actions should clearly identify who will bear each portion of the litigation expense. This is especially important in multiple tenant, single tax parcel scenarios. In such cases, the tenant should be aware of the rights of other tenants in the premises to ensure that the tenant’s future tax liability will not be controlled by other tenants within the overall tax parcel.
Where the tenant is unable to negotiate the right to contest the assessment, the lease should include language stating that the tenant will be entitled to its share of any refunds if the landlord or another tenant elects to bring a contest. This right should survive termination or expiration of the lease in the event refunds on taxes paid during the lease term are not paid until after termination or expiration. In addition, it should be noted that the parties controlling an Article 7 proceeding may elect to settle the proceeding by prospective relief, in the form of reduced assessments for a period of time following settlement, rather than refunds. Such a settlement may be governed by the terms of RPTL § 727 as noted above. Therefore, where the lease does not provide the tenant the right to control an Article 7 action, but does require the tenant to bear a portion of the tax liability, the tenant should seek to have the lease obligate the landlord to not only pay the tenant the monetary equivalent of its proportional share of any refunds accepted prospectively if none are paid, but the party controlling the action accepts prospective relief for tax years beyond the lease term.

How the tenant’s share is defined is a function both of the tenant’s pro rata share of the overall tax liability, and a function of the extent to which tax increases relate to improvements to the tenant’s premises in the case of an escalation provision. The tenant should obtain a right of setoff for taxes paid on the landlord’s behalf because the landlord normally pays taxes directly. A tenant should seek to negotiate representations and warranties from the landlord that it will timely pay all taxes due. In the event the landlord fails to pay, that failure can threaten the tenant’s quiet enjoyment of the leased premises. The tenant may, therefore, seek the right to pay taxes directly if the landlord fails to do so and to have a corresponding right of setoff against rent. On the other hand, if there is an excessive assessment on the property, a landlord may as a practical matter choose not to pay the taxes while it seeks to have the taxes lowered, and risk a default with the landlord’s lender, if any.

It must be remembered that there is no right in New York State to pay less than the full amount of tax due during the period of time in which an assessment is being challenged. RPTL § 704(3). Therefore, the landlord must either pay the whole amount of taxes due or nothing at all, and if no payment is made, the property may be subject to tax foreclosure despite the pendency of an action contesting the real property taxes. See W.T. Grant Co. v. Srogi, 52 N.Y.2d 496, 438 N.Y.S.2d 761 (1981). In the instance of an actual tax foreclosure for nonpayment of taxes, a landlord may have a reason to allow the tax foreclosure to proceed where, for example, the outstanding property tax liability exceeds the value of the property. A tenant should consider this issue in light of the fact that most leases contain provisions limiting the landlord’s exposure for damages of the tenant to the landlord’s property interest. If that interest is so diminished by a tax foreclosure, the tenant will be without recourse against the landlord. This is yet another reason why a tenant should negotiate a right to make payment on the landlord’s behalf with a corresponding setoff against rent, and if the rents remaining under the lease are less than the amount of the tenant’s payment on the landlord’s behalf, a contractual right to seek damages from the landlord.
II.

Landlord’s Analysis of Real Property Tax Considerations Prior to Entering into Lease

1. Real Property Tax Escalation Clauses.

When viewing tax escalation clauses from the landlord’s perspective, one should be cognizant of the same general issues as when viewing on behalf of the tenant. Landlords will generally desire to have the base year for escalation purposes exclude the tenant’s improvements and build-out expenses. The lower the base year assessed value, the greater the tenant’s tax liability will be. In addition, the landlord may be better served by defining the base year in terms of property tax dollar amounts rather than assessed values. In so doing, the landlord is able to defer liability to the tenant where property tax amounts increase, even where assessed values do not or are not the sole factor resulting in such increase. For instance, where property tax amounts increase as a result of an increase in tax rates, the tenant would be liable for such increases. From the landlord’s perspective, the property tax escalation provision should relate to all charges based upon the assessment – not just real property taxes.

2. When Landlord Contests Property Tax Assessments.

Unless the landlord has contracted to give away the right to bring an assessment proceeding to a tenant, the landlord always retains a right to challenge tax assessments. In general, unless the tenant in a single-tenant property is solely responsible for payment of property taxes, the landlord will want to control litigation with respect to the affected tax parcel. If a landlord grants a tenant too much control, the tenant’s actions may adversely affect other tenants and the marketability of other space within the premises. In such cases, the lease should be clear that consulting, appraisal, and legal fees incurred by the landlord will be borne by the tenant to the extent of the tenant’s applicable share of the tax liability, and will be chargeable as additional rent.

A unique consideration for landlords in evaluating the right to contest assessments relates to the impact of reduced assessments on the profitability of subsequent leases of the subject premises. If an assessment is reduced too aggressively, the landlord may be faced with resistance by a future tenant because the base year is considered too low and, therefore, likely to create too large a tax burden. For that reason, the landlord should consider reserving control over real property tax litigation, especially in the later years of the lease term.

In addition, the landlord may seek to include a provision in the escalation clause such that any reductions below the base assessment will result in a corresponding reduction in the base assessment. A tenant has no incentive to have the assessment reduced to an amount lower than the amount which would produce the equivalent of the base tax since that amount is paid by the landlord. On the other hand, the landlord would have an incentive to have even the base assessment reduced. In such instances, the
landlord would want the tenant to pay based upon the reduced base. This is all a matter of negotiation and relative bargaining power.

3. Interaction between Rents and Real Estate Taxes.

Whatever the extent of the tenant’s property tax obligations under the lease, the landlord should take care to clearly identify any property tax and other payments, as well as costs of pursuing reductions in assessments through litigation, made to the landlord as “additional rent”. If not, the landlord will not be able to enforce payment by the tenant as a matter of contract under the lease. Such an outcome would obviously defeat the purpose of any clause relating to the tenant’s obligation to bear a portion of the real property tax expense.

In addition, when drafting an escalation clause on behalf of the landlord, one should take care that the lease does not otherwise contain a cap on additional rent. If the parties agree to an annual cap on additional rent pursuant to a rent escalation clause, the landlord’s counsel should be clear that such a cap is over and above the total rent paid for the prior year – in effect compounding the prior year’s tax escalation into the base rent. Courts have held that the failure to clearly state that such prior increases are cumulative compounded into base rent will result in a holding that the annual escalation cap is based upon the rent paid in the first year of the lease. See Benson Plaza v. Great Atlantic & Pacific Tea Co., Inc., 44 N.Y.2d 791, 406 N.Y.S.2d 33 (1978); see also CBS, Inc. v. P.A. Building Co., 200 A.D.2d 527, 606 N.Y.S.2d 674 (1st Dep’t 1994); see also Kennilworth Realty Trust v. Banker’s Trust Co., 112 Misc. 2d 523, 447 N.Y.S.2d 210 (Sup. Ct. N.Y. County 1982).

III. Property Tax Exemptions and Abatements and Their Impact on Lease Negotiations

RPTL Article 4 outlines a wide variety of property tax exemptions available to owners of real property. In the commercial leasing context, many exemptions may be available to landlords in their capacity as owners, developers, or investors of commercial real property. However, several exemptions may be available to tenants, or should be considered by tenants in commercial leasing transactions, because the benefits, in the form of property tax savings or even reduced rental payments, can accrue to tenants. This section will outline several of those exemptions.

1. Municipal Industrial Development Agency Exemption

Where property is owned by a municipal Industrial Development Agency (“IDA”) or is otherwise under its jurisdiction, control, or supervision, and is used in a qualified manner as defined in RPTL § 412-a and General Municipal Law § 874, the property may be eligible for a real property tax exemption in the amount of one hundred percent of all real property taxes due (excluding special ad valorem levies and special assessments). A
tenant in a commercial lease transaction should be aware of the existence of such an exemption where title or a leasehold interest to the leased premises is vested in an IDA, or where the vesting of title or a leasehold interest in an IDA would be possible, as in certain single-tenant build-to-suit leases or leases to qualified single tenants.

As a threshold matter, in order to obtain the exemption, there must be an applicable IDA with jurisdiction over the municipality in which the real property is located. There are many IDAs throughout New York State, and a current list can be obtained through the ORPS. Each IDA that offers an exemption program has an established uniform tax exemption policy which establishes guidelines under which the exemption may be granted. In establishing such policy, an IDA must take into account its benefit on job creation and retention and other impacts on both existing and future businesses in the municipality, among other factors. In addition, the policy must address the impact of the exemption program on the local tax base. For this reason, the granting of such an exemption is frequently conditioned upon the property owner entering into a payment in lieu of tax agreement (“PILOT”). PILOT agreements may be advantageous to landlords and tenants insofar as they frequently lessen the tax burden and provide a stable basis on which to estimate future tax liability. In each instance where a PILOT is required, the agreement must set forth the time, place, and manner of payment, the amount of each annual payment and the allocation among the affected taxing jurisdictions, and the date upon which the payment will be treated as delinquent if it is not paid. It should be noted that PILOT agreements are not considered tax payments and are, therefore, not designated on the tax rolls for the assessing unit. As a result, a party to a lease including provisions relating to the obligation of a landlord or tenant to pay real property taxes should consider whether the lease should specifically reference PILOT payments as well as real property tax payments.

Qualified property uses include those which promote, encourage, develop, or assist in acquiring, constructing, or improving industrial, manufacturing, warehousing, and commercial facilities.

2. Business Investment Property and Commercial Property Exemptions

(a) Business Investment Property Exemptions (Outside New York City)

Pursuant to RPTL § 485-b, commercial or industrial facilities located outside New York City that are constructed, or improved, at a cost exceeding $10,000.00 or such other minimum amount chosen by the applicable taxing jurisdiction, may be partially exempt from taxation and certain special ad valorem levies. This partial exemption is only effective after the construction or improvements have been completed. Eligible properties are those used primarily for buying, selling, storing, or developing goods or services, for the manufacture of goods, for raw materials, or for hotel or motel purposes. The exemption is available at a declining scale over a period of ten years. There are limitations on 485-b exemptions to the extent that other exemptions apply for the same property or improvements.
Taxing jurisdictions do have a certain amount of control over the application of the exemption. For instance, taxing jurisdictions may elect to restrict the exemption to properties located within a specific geographic area, usually for targeted economic development purposes. They may also restrict the types of businesses that are eligible for the exemption, and may elect to raise the minimum construction cost for eligibility, up to a maximum of $50,000.00. Furthermore, they may elect to offer either the Basic Exemption or Accelerated Strategic Exemption, as set forth below. Taxing jurisdictions (except for the city school districts of Buffalo, Rochester, Syracuse, and Yonkers) may also elect to administer the exemption program through the establishment of an Industrial Commerce Incentive Board (“ICIB”), which formulates a plan to address the various options mentioned above.

The exemption relates to increases in assessed value due to improvements, similar to the Empire Zone exemption outlined below. Two exemption options are available, both over a ten-year term: a “Basic Exemption” and an “Accelerated Strategic Exemption.” The Basic Exemption is a fifty percent reduction of any increase in assessed value relating to improvements in the first year of the exemption (or such reduced percentage as the taxing jurisdiction may elect), declining by five percent in each subsequent year through year ten. The Accelerated Strategic Exemption provides for a fifty percent reduction in the first three years, declining from forty percent to five percent through year ten. The Accelerated Strategic Exemption may only be enacted where an ICIB has been established and recommends restricting the exemption to certain types of business properties and to certain geographic areas, where necessary for targeted economic development.

The RPTL § 485-b exemption has broad application for commercial lease transactions in both build-to-suit scenarios and those with substantial build-out for renovations. Because the owner of the property is the only party eligible to apply for the § 485-b exemption, tenants should consider a lease provision requiring the landlord to apply for the exemption to minimize tax liability on the tenant.

(b) Commercial Properties in Designated Areas of Manhattan

Pursuant to RPTL § 499-b, certain real property constructed before January 1, 1975, that is located in designated areas of Manhattan and contains premises which are occupied or used for retail or office purposes pursuant to a lease dated after April 1, 1997, is eligible for a three-year tax abatement (not including special assessments). In order for a lease to qualify, however, it must be for a term of between three and five years. The tax abatement is for a period of three years.

Computation of the RPTL § 499-b abatement is based upon the tenant’s share of the eligible square footage multiplied by the abatement base (the per square foot tax liability, with a maximum of $2.50 per square foot in the first year of the abatement, two-thirds of that amount in the second year, and one-third for the third year).

In order to qualify, this abatement provides varying standards for when and to what extent expenditures on improvements must be made, depending on the tenant’s
status and the number of employees in the facility. For a new or expansion tenant, expenditures must be made within sixty days of the lease commencement date. For a renewal tenant, expenditures must be made within one year. The amount of improvement expenditures required varies with the number of persons employed: 125 or fewer employees and a lease term of five years or more require improvement expenditures of at least $10.00 per square foot; 125 of fewer employees with lease terms of less than five but at least three years require improvement expenditures of at least $5.00 per square foot; and buildings with more than 125 employees with a lease term of ten years or more requires improvements of at least $35.00 per square foot to be eligible.

(c) Commercial Properties in New York City outside Designated Areas of Manhattan

RPTL § 499-bb provides an exemption for real property located within the City of New York, but outside the designated areas of Manhattan, subject to the exemption contained in RPTL § 499-b described above. This exemption may be for a period of five years or three years for Abatement Zone B or three to ten years for Abatement Zone C, and does not include special assessments. Abatement Zone A applied to commencement only through March 31, 2001, and will not be discussed.

Abatement Zone B is defined as any districted zoned commercially or industrially in any area of New York City, except south of the center line of 96th Street in Manhattan. If property in Zone B was constructed prior to January 1, 1999, and is occupied or used for office, commercial, or manufacturing purposes (excluding retail, hotel, or residential use) pursuant to a lease agreement certified by the New York City Department of Finance and dated on or after July 1, 2000, with an aggregate floor area of 25,000 square feet, it may be eligible for a five-year tax abatement. In such instance, the abatement is computed as the tenant’s proportionate share of the overall eligible square footage of the building, multiplied by the “abatement base.” The abatement base is (i) $2.50 of the tax liability on a per square foot basis, or (ii) fifty percent of the tax liability per square foot for the first three years of the abatement and two-thirds of that amount in year four and one-third of that original amount in year five, whichever is lesser.

The three-year abatement in Zone B is the tenant’s share of the eligible square footage of the building multiplied by the abatement base. The abatement base for the three year exemption in Zone B is $2.50 per square foot for year one, two-thirds of that amount for year two, and one-third of the original amount for year three.

Abatement Zone C includes properties occupied or used for industrial or manufacturing activity in an area zoned commercially or industrially by a tenant pursuant to a three- to ten-year lease executed on or after July 1, 2005. The same restriction for properties located south of the center line of 96th Street in Manhattan applies, except for the Special Garment Center District as defined by resolution of the City of New York. In Zone C, the abatement is from three to ten years, depending on the term of the lease. It is computed as the tenant’s share of the eligible building square footage multiplied by the abatement base, which is the tax liability per square foot up to a maximum of $2.50 per square foot for each year of the lease.
All of the abatements under RPTL § 499-bb are administered by the New York City Department of Finance, and require a certificate of occupancy as proof of construction before the applicable timeframe.

All of the aforementioned tax exemptions and abatements under RPTL §§ 485-b, 499-b, and 499-bb should be considered by landlords and tenants entering into qualified leases or, in the case of RPTL § 485-b, constructing or improving the property within the qualified time period. It is important for the parties to a lease to include language requiring mutual cooperation with obtaining such abatements and to ensure that the benefits run to the parties in conformity with other real property tax provisions as negotiated in the lease.

3. Empire Zone Property Tax Benefits

The Empire Zone property tax exemption for improvements in a designated Empire Zone, set forth in RPTL § 485-e, provides for a ten-year declining scale tax exemption attributable to the value of new construction or improvements to commercial property after a certain base year. In order to be eligible for an Empire Zone exemption, the following factors must exist: (i) the affected county, city, town, village and school district must elect to offer an Empire Zone exemption; (ii) the property affected must be located in a designated Empire Zone; and (iii) the construction or improvements to the property affected must be made after the date that the Empire Zone is designated.

Each Empire Zone is designated by the New York State Empire Zones Designation Board. In order for the affected taxing jurisdictions to enact an Empire Zone exemption to apply to the Empire Zones designated by the Board, they must elect to do so by adoption of a local law or ordinance, or by resolution after a public hearing. In enacting the exemption program, the taxing jurisdictions have two options for defining available benefits: either (i) a fixed ten-year term for the exemption on a floating basis commencing with acceptance of an Empire Zone application for a particular property, whereby one hundred percent of the base tax amount will be exempt during the first seven years of the exemption, with seventy-five percent of the base amount being exempt in the eighth year, fifty percent in the ninth year, and twenty-five percent in the tenth year; or (ii) a benefit whereby the exemption percentages will be computed according to the life of the Empire Zone, ending in the tenth year.

Not to be confused with base tax amounts in the discussion of escalation clauses above, the base tax amount for Empire Zone exemption purposes is defined as the increase in assessed value due to construction or improvements during the first year of

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4 Although the present Empire Zone legislation is scheduled to expire in June of 2010, an understanding of this exemption will be of value to the practitioner with respect to any similar programs that may be enacted by the legislature in the future.

5 Put differently, where a fixed ten-year exemption is not elected, the Empire Zone is designated and the benefit accrual runs from the date of the designation, regardless of whether or not a benefit is received. In the event that an exemption begins in year three, for instance, the benefit will run from year three to year ten, according to the same declining scale as defined in the fixed ten-year option.
the exemption. Thus, it is the increase in assessment that will be the measure of the exemption. The base amount remains unchanged during the term of the exemption, unless there is either additional construction or improvement during the term of exemption or the assessing unit effects an overall change in assessments throughout the unit of fifteen percent or more. In either case, the base amount for exemption purposes must be adjusted.

The exemption applies to all general municipal and school taxes, as well as special *ad valorem* tax levies. However, it does not apply to special assessments. Unlike many exemptions, there is no specific requirement for property use in order to be eligible for Empire Zone designation and exemption, although the taxing jurisdictions and Empire Zones Designation Board may impose certain criteria related to economic development that must be adhered to in order to be eligible.

The application must be made by the owner of the real property to the assessor on or before the applicable taxable status date and in no event later than one year after the date of completion of construction of the improvements.

Naturally, this property tax exemption may be attractive to tenants and landlords in transactions involving either new construction or substantial build-out of the leased premises. Such an exemption can significantly reduce property tax expenses relating to improvements, which are either borne by the landlord in a gross lease transaction (resulting in higher rents to account for the tax liability) or passed on to the tenant in net lease transactions or leases involving escalation clauses relating to the cost of improvements. It should therefore be considered carefully by tenants prior to entering into a lease, because the property tax exemption may require the cooperation of, and indeed accrue to, the landlord.

Although the exemption may be granted within one year of completion of improvements, it is not advisable for a tenant to enter into a lease in reliance upon such a later designation because the taxing jurisdictions may enact legislation opting out of the Empire Zone exemption where one previously existed. In *Matter of Boynton Suites, LLC v. Board of Assessment Review of the City of Plattsburgh*, 274 A.D.2d 926, 711 N.Y.S.2d 266 (3d Dep’t 2000), a contract vendee entered into an agreement to purchase real property in reliance upon, among other things, the availability of an Empire Zone exemption. Prior to the time such exemption was granted, but after the purchase contract was entered into, the taxing jurisdictions enacted legislation repealing their prior Empire Zone exemption program. The contract vendee commenced an action against the taxing jurisdictions claiming that RPTL § 485-e did not allow for taxing jurisdictions to “opt out” of an Empire Zone exemption program once they had opted in. The Third Department held that it was within the powers of the municipality to do so, and denied the petition. However, once an exemption is granted, it will remain in effect throughout the duration of the exemption period regardless of repeal of the effective local laws or termination of the affected Empire Zone (provided that subsequent improvements will not be eligible for the exemption in either case).