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Prop 8 Tax Impacts: What You Need to Know

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While much of the spotlight during lease negotiations is focused on the rate our clients will pay for rent, that's really only scratching the surface of the service we aim to provide. Case in point: as the market continues to rebound and property values increase, we are staying busy protecting tenants from entering into leases that have artificial property tax reductions as the result of Proposition 8.

Like Prop 13, its more well-known sidekick which limits increases in the original assessed value of a property to an inflation factor of 2%, Prop 8 was also passed in 1978 to give property owners the ability to temporarily reduce their assessed value. This proposition grants that if the market value on January 1 of any current year falls below the assessed value of a property, the assessor must temporarily reduce the assessment to reflect market conditions. As you might imagine, with commercial properties these reductions are truly significant, with six-figure savings occurring quite frequently.

While this all sounds like a win-win situation for property owners and their tenants, there are traps tied to Prop 8 that can result in significant cost increases for the tenant. This is triggered when the temporary reductions that existed at the commencement of a lease begin to dissipate as the market recovers.

This occurrence can impact tenants under both a "triple net" lease and "full service" lease. Under a triple net lease, most tenants enter into the lease with an understanding of their share of operating expenses. In a full service (AKA modified gross) lease, the landlord provides a "base year" for operating expenses. The "base year" ensures that the tenant will only be responsible for their share of expenses above the initial year, or "base year". (Incidentally, operating expenses, along with the rental rate, are the two main factors used to compare the economics of lease alternatives).

To illustrate how a Prop 8 reduction can affect tenants, consider the following scenario:

- Assume you are contemplating renting 20% of a building with a regular assessed value of $50 million, which puts the taxes at $550,000 per year.
- Now assume that, as a result of low occupancy and poor market conditions, the owner is able to reduce this assessed value to $30 million, thus reducing the tax liability to $330,000 for a savings of $220,000 per year!
- As an incoming tenant, you are likely to evaluate your share of building expenses with the $330,000 basis for taxes. For a triple net lease, your 20% share will be $66,000 per year (20% x $330,000). For a tenant in a full service lease, the $330,000 will be included in your "base year" so you assume you only need to worry about the 2% increases permitted under Prop 13, which is very minimal.
- Now assume that, as a result of improving market conditions (not to

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As the market fluctuates, tenants should beware the hidden costs that can result from Prop 8.

mention the improved occupancy just achieved with your lease for 20% of the building!), the owner is unable to convince the tax assessor that the value is still below $550,000 and the tax liability returns to $550,000 per year (for simplicity, I won't factor in the 2% inflationary factor that will also be included).

- For the tenant under a triple net lease, your annual share of expenses just increased from the $66,000 previously illustrated to $110,000 ($550,000 x 20% share). That's an increase of $44,000 or 83%.
- For the tenant under a full service lease, your situation isn't any better. That "Base Year" amount you thought would take care of taxes is now history and the building expenses in year 2 (and probably for the remainder of your term) are now $220,000 higher because of Prop 8. Your share is $44,000 per year.

It's well known that the only constant in real estate is change. The markets change, values change, rates change. At Hughes Marino, it is not only our job to stay on top of these changes, it's also our passion. We are here to educate and protect you from potential costly pitfalls, including additional expenses due to lowered property values as permitted by Prop 8.

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