# WHY CALIFORNIA TENANTS NEED "PROP. 13 PROTECTION"

## BACKGROUND:

Proposition 13 is a statutory limit on increases of the assessed value of real estate for property tax purposes in California. In short, it limits the annual increases of assessed value to no more than two percent (2.0%) per year unless certain events / transactions occur which allow the property to be re-assessed. These events / transactions boil down to "transfers" (of anything equal to or more than 50% of the property), such as a sale of the building, or construction of "improvements", such as new tenant improvements or other physical structures. In addition, the state general levy (ad valorem tax rate) is limited to one percent (1.0%). There is no limitation on municipal tax rates and/or special assessments (voted indebtedness), although the voters in the subject area must approve such additional taxes with majorities of either 55% or 66.67% depending upon the proposed use of the funds. As such, the total tax rate can exceed 1% and ranges from just over 1% to a little over 2% in a number of California jurisdictions. That said, in California the biggest driver, historically, of a building's property tax fluctuations has been tied to reassessments under Proposition 13, and it is these reassessment events commercial tenants should pay particular attention to when negotiating new leases in California.

## EXAMPLE:

Assume you occupy 25,000 square feet of a newly constructed, 250,000 square foot building (i.e., 10%). Assume further you occupied your premises on the day the Building opened, and that your lease is structured as a "Base Year" lease, with the first year of the Building's operation being the Base Year.

The Landlord, who was also the developer, paid $150 per square foot (including all tenant improvements), to construct the building, or $37,500,000. Upon the Building's completion the county assessor assessed the building based upon its construction value, meaning the assessed value during the first year – your Base Year – would be $37,500,000. If the tax rate is 1.50% of the assessed value, the property taxes included in your Base Year would be $562,500 ($37,500,000 x 1.50%). If the taxing authority concludes next year's increase in assessed value is 2.0% (the maximum), assuming the tax rates stay the same, the building's subsequent year's taxes would be $573,500 [(37,500,000 x 1.02) x 1.5%]. Thus, in this scenario, you would effectively pay your pro rata share of the difference between the $573,500 and $562,500 in Base Year taxes. This difference amounts to $11,000.00. At a 10% pro rata share, you would pay $1,100.00 for taxes during the second year of the lease term, which is the first comparison year following the Base Year. Assuming the same two percent increase in assessed value for the third year of the lease term, you would pay $2,272.50 as your share of that year's increase in taxes over the Base Year.

Now, assume the building is sold in the third year of the lease term, and is therefore reassessed to its full value pursuant to Proposition 13. This is where the County gets to bring the building's assessed value back up to market, assuming appreciation rates were actually greater than the 2% per year maximum. If the building sold for $225 per square foot, or $56,250,000.00, the taxes in the third year would be based on this sales price. Assuming the tax rates have remained constant, the Building's taxes would now be $843,750.00 ($56,250,000 x 1.50%). Now you would be paying your prorata share of the difference between $843,750 and the $562,500 in Base Year taxes. At 10% pro rata share, **your payment for taxes in the third year as a direct result of the sale and Proposition 13 reassessment equates to $28,125.00, versus the $2,272.50 that would have been paid if you had "Prop. 13 protection" in your lease.** Clearly, this has an enormous impact on your financial obligations, and is solely brought about by the landlord's decision to sell the building.

## SOLUTION:

Needless to say, thousands of tenants in California have been adversely impacted by scenarios such as this, which is precisely why having "Prop. 13 protection" is so important to tenants. "Prop. 13 protection" is a commonly negotiated provision, and is more prevalent in leases negotiated in markets where tenants have more leverage. By way of example, the following language can be utilized as an exclusion to the definition of property taxes contained in the lease to achieve Prop 13 protection (though it should be conformed to the terms of the subject lease):

> *"Notwithstanding anything to the contrary, Real Estate Taxes shall not include any increase of Real Estate Taxes and assessments due to any change in ownership including, but not limited to, the sale or any other form of full or partial transfer of title of the Building/Project or any part thereof, or due to the transfer of title of any leases in the Building/Project, or due to any renovation or new construction in the Building/Project or related facilities."*

The sample provision above is taken from CyberLease's Building Operating Cost Addendum ("BOCA"). This BOCA document can be downloaded from our website and includes many other important and useful operating expense and property tax provisions for tenants of all sizes,. If you currently have a Base Year structured lease which lacks "Prop. 13 protection," you should be vigilant about ensuring your Base Year taxes reflect the same valuation methodology (i.e., based on income stream or sales comparables as opposed to simple construction costs) as used in later years and that the Base Year taxes reflect a full build-out of tenant improvements and common areas. Finally, every tenant, before entering any lease in any building in California, must find out when the building was last reassessed pursuant to Proposition 13; if it was more than 24 months ago, obtaining "Prop. 13 protection" is imperative. The longer the span between today and the Building's last reassessment, the greater the tenant's exposure to the possibility of extreme property tax liabilities arising from a Proposition 13 reassessment.

***Additional Questions? Contact us.***

CyberLease, LLC