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Be careful when attempting a reclassification, it isn't the no brainer it appears to be

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There are four primary tax classes of real property in New York City: Class 1 - small primarily residential, such as 1, 2 & 3 family houses; Class 2 - primarily residential with four or more units; Class 3 - utilities; and Class 4 - commercial. Usually, reclassification ensues when there is a change in the use of a property, such as office (class 4) to residential (class 2).

Rarely does a week go by without a client calling me about a potential reclassification of their property. Reclassification is the process of changing the tax class of a property. There are four primary tax classes of real property in New York City: Class 1 - small primarily residential, such as 1, 2 & 3 family houses; Class 2 - primarily residential with four or more units; Class 3 - utilities; and Class 4 - commercial. Usually, reclassification ensues when there is a change in the use of a property, such as office (class 4) to residential (class 2). That type of change is often precipitated by owners pursuing the highest and best use of the property, as opposed to merely seeking an improved bottom line via a lower real estate tax bill.

As real estate taxes have continued to soar, reclassification ideas increasingly involve only minor changes to the number of units in order to move into protected or capped tax classes. For instance, tax class 1 benefits from a state restriction on assessment increases (6% maximum one year/20% over a five year period). Similarly, 3 subcategories of tax class 2 (2A, 2B & 2C) are capped at 8% maximum year-over-year increases & 30% over a five year period.

Fact pattern A: You own an 11-unit apartment building, in regular tax class 2, currently paying $40,000 in real estate taxes. The adjacent building in tax class 2B, with exactly the same square footage and age but only 10 units is paying $20,000.

Straight-line thinking motivates some owners to combine two units - thereby reducing the total to 10 units - making the building eligible for a move out of regular uncapped tax class 2 and into capped tax class 2B. While moving from an uncapped class to a capped class has obvious long-term potential benefits, the near term real estate tax implications do not always correspond. Those owners wrongly assume that the taxes will be reduced to more or less equivalent levels of the adjacent property by this maneuver. Unfortunately, straight-line thinking is rarely true in the real estate tax arena.

This counterintuitive result is caused by the city's compulsory valuation procedures. The city assessor generates an assessment for residential property utilizing statistical models which are premised on income and expenses for similar properties. Assessments for tax class 2 properties are normally 45% of the estimated market value established by the assessor. The catch here is the state limitation on tax classes 2A, 2B and 2C insofar as the assessments on those properties are normally less than 45% of market value because of the cap. In other words, capped properties are frequently assessed at levels far below 45% of market value, leaving the city with an insufficient collection on affected properties. It can take many years for a capped property's assessment to reach 45% of the market value. This is what leads property owners into the precarious reclassification game; detrimental reliance on another property owner's under-assessment.

Fact pattern B: You purchase a four unit townhouse, paying $12,883 in yearly property taxes, for $1.75 million. Additionally, you planned to convert the building to a single-family home. The hard cost of the conversion can be assessed separately, but we will not analyze that element. A four-unit townhouse is in tax class 2A. Converting to a one family necessarily reclassifies the property to class 1.

This fact pattern is extremely common and exceptionally dangerous. Unsuspecting, straight-line thinking buyers anticipate a tax bill that is about to be cut in half due to surrounding one family taxes, while the surprising reality is a tax set to escalate. The reasons are twofold; tax class 1 is the only tax class in NYC wherein you are assessed based on arms-length transactional value; and the current class 1 tax rate is 19.554%. Contrast that rate with class 2 which is presently 12.883% or tax class 4 which is a mere 10.656%. To be clear, in fact pattern B, the owner is automatically facing a 52% increase to their applicable tax rate!

To analyze in more frightening detail, this purchaser paid 1.75 million. Tax class 1 is assessed at a maximum of 6% of market value; so, 1.75 million times 0.06 results in a new assessment of 105,000. Multiply 105,000 by the tax rate and the new tax bill is a distressing $20,532 or 59% more than what the prior owner was paying.

Bottom line, to make certain your investment doesn't go astray, consult your tax certiorari counsel prior to making a decision on any reclassification if your goal is a lower tax bill near term.

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