Seven Things You Need to Know Before You Buy Rental Property — Thing Five: Taxes

On behalf of Dornish Law Offices, PC | Feb 1, 2010 | All, Firm News, Real Estate Practice

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Spring is in the air, and tax season is in full swing. What better time to write about taxes? But the taxes I'm talking about in this article aren't income taxes, or even transfer taxes, but the property taxes you will pay every year on every property you own in Pennsylvania. Property tax increases shrink cash flow from a rental, and underestimating property taxes causes big problems for the inexperienced investor.First, you need to understand that no matter how unfair it may be, all similar rental properties, even in the same neighborhood, do not pay similar real estate taxes. All three real estate taxes, county, municipal and school, are based on an assessment of the property by the county tax assessor. Some counties use base years, and don't change assessments on sales, while others look for recorded deeds showing sales prices above the assessment, and raise the taxes of recently sold properties. Even if the assessor doesn't reassess, the county, municipality, or most often the school district can watch for sales and appeal your assessment based on the price you paid for the property.

What this all means is that in some places, like Allegheny County, you may buy a rental property with an assessment way below the purchase price, and think your cash flow will be good based upon the real estate taxes the present owner pays. But after your new deed is recorded, the solicitor for the school district in which the property is located sees the price on your deed, and appeals your tax assessment, doubling the assessment and doubling your county, municipal and school taxes.

The property next door has not changed hands for years, has a lower assessment, lower taxes, and much better cash flow, so you can't raise the rents in your building to cover the new taxes, because your tenants will go next door. So your strong positive cash flow becomes break even or worse. You are committed on your mortgage, utilities and taxes, so you struggle through and hope to be able to break even for a few years, until you can raise rents or refinance for a lower mortgage payment.

You can't prevent the above scenario from happening, but you can predict what will happen to your taxes before you buy, and factor your prediction into what you are willing to pay for the property. Check the assessment of the property you are buying. If the assessed market value is substantially lower than the price you are paying for the property, check the court dockets in your county for property tax appeals by the county, municipality and school district on properties which sold last year or the year before. Are their assessments changed from before the properties were sold?

Next, if you find the changes on those properties, look up the sale prices of those properties and compare those prices to their new assessments. Assume your assessment will change the same way theirs did. To figure out your likely new taxes, multiply your best guess at your new assessment by the current millages for county, school and municipal taxes in the municipality where the property is located. You may not like the answer you get, but at least you won't be surprised by the tax increase you see after you buy the property.

And before we leave the topic of taxes, there are two more things to consider. First, check out the tax history and current activity of the municipality and school district. If the municipality hasn't raised taxes in many years and has major road repairs or a new municipal building to finance, don't be surprised by an increase in municipal millage, even if your assessment doesn't change. And the new $100 million dollar high school being planned may improve the rentability of your units to tenants with children in school, but count on school tax millage increases when the school is built. Start to raise rents gradually now, so you have the cash flow to pay those increased taxes later.

The final words on taxes are for those of you feeling pretty smug about the counties and municipalities where you invest. In the Clifton case out of Allegheny County, the Pennsylvania Supreme Court held that a 2002 base year for real estate taxes in Allegheny County was unfair to some taxpayers, and remanded the case for the county to set up regular reassessments of properties upon which future taxes would be based. Justice Baer commented in a concurring opinion that any county where the dispersion coefficient for recent sales (a measure of the relationships between sale prices and assessed values) is more than 20%, the court would welcome similar lawsuits to Clifton, forcing reassessments in those counties.

To see where your county sits on the base year and dispersion coefficient scales, go online to www.steb.state.pa.us. Then, go to the county information tab and select all information for all counties. The longer it has been since the last reassessment and the higher the dispersion coefficient, the more likely your county faces a lawsuit to compel reassessment in the next few years.

For example, remember that the Supreme Court ordered Allegheny County, which has a dispersion coefficient around 26 and a base year of 2002 to reassess. What do you think the odds are that the court would order a similar reassessment in Beaver County, where the base year is 1982 and the dispersion is 41.1 percent? I don’t need a crystal ball to predict the reassessment of my properties in Beaver County over the next few years.

I’m preparing for that reassessment now, keeping good records of income and expenses, and doing what I can to keep cash flow up. I wouldn’t max out on loans against the properties increasing loan payments and decreasing cash flow until I see what my tax bills will be after the reassessment. And I wouldn’t buy a rental property right now on a very tight cash flow in Allegheny County or any county with a high dispersion coefficient. Before you buy, make sure you will have enough of a cash flow cushion to cover a tax increase.

(Created February 2010)