

Property Tax Exposure in the Commercial Real Estate Distress Cycle

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In this article, the authors discuss why property tax belongs on every lender's real estate owned checklist.

An increasingly common scenario is playing out in special servicing departments across the country: A lender forecloses on an office building. Net operating income has fallen by 30% or more. Vacancies are climbing. Potential buyers are few and far between. And yet the property's tax bill, calculated using data from superior market conditions, keeps rising as though none of this has happened. In some cases, it gets even worse: The act of foreclosure itself can trigger a reassessment that pushes the tax burden even higher.

This is not an edge case. It is the defining property tax dynamic of the current distressed commercial real estate (CRE) cycle, and many lenders are not managing it proactively. For financial institutions originating or servicing commercial mortgage debt, the next phase of value erosion is increasingly being driven not just by leasing risk, but by property tax exposure that attaches when title transfers through foreclosure, deed-in-lieu transactions, or consensual surrenders.

A TRILLION-DOLLAR WAVE AND THE TAX EXPOSURE IT CREATES

The commercial real estate distress cycle that began as a post-pandemic refinancing problem is becoming a foreclosure problem. According to a report by the Kaplan Group,¹ approximately \$957 billion in CRE loans matured in 2025 — nearly triple the long-term average. Only an estimated 50% to 55% of those loans were repaid at maturity. The rest were extended into future refinancing windows that may prove no easier to navigate. An additional \$539 billion in CRE debt is expected to mature in 2026, followed by roughly \$550 billion in 2027.

The arithmetic is unforgiving. Many of these loans were originated when interest rates sat between 3% and 4%. Borrowers now face a refinancing environment where debt costs are nearly double those levels. Delinquency and special servicing rates — particularly in the office sector — have responded accordingly. Trepp reports² commercial mortgage-backed

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securities (CMBS) office delinquency rates exceeding 12%, an all-time high that surpasses even peaks of the global financial crisis.

As refinancing risk converts to foreclosure activity, lenders increasingly find themselves stepping into ownership positions on assets they never intended to hold. With that title transfer comes a property tax exposure that is poorly understood, time-sensitive, and, if ignored, materially costly.

THE ASSESSMENT LAG: PAYING TAXES TODAY ON YESTERDAY'S ASSET VALUE

In most jurisdictions, property tax assessments are inherently backward-looking. They reflect stabilized income assumptions, historic rent levels, and capitalization rates from prior years. These are market conditions that may bear little resemblance to current leasing or financing realities. When a lender forecloses on an office, multifamily, or hospitality asset experiencing net operating income (NOI) impairment, the property tax assessment frequently continues to reflect years-old market conditions.

That lag has real costs. Property taxes are frequently the largest nondebt operating expense for real property assets. Depending on the jurisdiction's millage rates, each \$1 million of excess assessed value costs \$20,000 to \$40,000 per year in unnecessary but avoidable tax liability. Across a portfolio of foreclosed commercial assets, that excess becomes a portfolio-level internal rate of return issue rather than a line-item nuisance.

Prospective buyers recognize this. Increasingly, they underwrite anticipated tax liabilities

where assessments are too high or require escrow holdbacks where assessment challenges are unresolved. Unchallenged over-assessments do not merely inflate carrying costs during the REO hold period; they discount the eventual sale price.

THE REASSESSMENT PROBLEM: WHEN FORECLOSURE RAISES THE TAXES

Not all property tax exposure arises from over-assessment. In certain acquisition-value jurisdictions, the act of foreclosure itself may trigger reassessment that materially increases the asset's property tax liability.

California is the most prominent example. Under Proposition 13, real property is assessed at a base-year value that increases by no more than 2% annually, until a "change in ownership" occurs. Changes in ownership include foreclosures, whether judicial or nonjudicial, and deed-in-lieu transactions. Upon transfer, the property is reappraised at current fair market value and assigned a new base year value as of that transfer date.

In a declining market, that reassessment may reduce taxable value. However, where a borrower acquired a property years or decades earlier, the existing assessed value may be significantly lower than present market value. A lender foreclosing on such an asset may therefore trigger reassessment and inherit a sharply higher tax burden even though net operating income has declined and capitalization rates have increased.

The property taxes resulting from that reassessment effectively skyrocket for the duration of the REO holding period and for any subsequent purchaser underwriting stabilized

operations. Bottom line: in California, a lender can foreclose on a property with declining NOI and inherit a higher tax bill than the defaulting borrower ever paid.

PROPERTY TAXES AS A LEASING PROBLEM

Many lenders think about property taxes as an ownership expense. But they are also a variable in leasing, and that distinction matters when trying to stabilize a distressed asset.

In most commercial lease structures — particularly in office, retail, and industrial assets — property taxes pass through to tenants as operating expense recoveries. Where those taxes are excessive relative to comparable properties, the resulting occupancy cost impairs the owner's ability to receive the full benefit of market rents or to retain existing tenants and attract new ones, regardless of base rent. A building carrying a higher tax load than comparable properties is structurally uncompetitive, even at a below-market asking rent.

Reducing property tax liability lowers all-in occupancy costs, supporting both tenant retention and absorption during the holding period. For buyers underwriting the asset, improved leasing momentum and lower occupancy costs translate directly into stronger pricing, even where a substantial portion of the tax burden is contractually recoverable from tenants.

TAX APPEALS AS TRANSFERABLE ASSETS

Even for lenders expecting only a short hold period before disposition, initiating a property tax appeal at the first available opportunity may be prudent. In many jurisdictions, a

purchaser may take over a pending assessment appeal filed by the seller, and the appeal can be transferred to a purchaser as part of the sale. In jurisdictions that require the appeal to remain with the prior owner (in this case, the lender who initially filed the appeal), the lender can offer an agreement to cooperate with the purchaser and assign any proceeds resulting from a successful appeal.

In either case, a pending appeal can be a transferable asset that enhances marketability and preserves value at exit. Where appeal rights have lapsed or were never exercised, sophisticated buyers discount their offer or require escrows and indemnities. Where a timely appeal is on file, a buyer can step into the lender's position, pursue tax relief post-closing, and factor anticipated savings into their underwriting. Assessment appeals can therefore support a price the lender would not otherwise achieve.

As part of the foreclosure process, lenders should also evaluate whether the borrower had a property tax appeal in progress. Loan documents often grant the lender an interest in property taxes paid on the collateral, and some jurisdictions recognize that this interest extends to any refunds or assessment reductions resulting from pending appeals. Where a borrower challenged an assessment for tax periods leading up to foreclosure, the lender may be entitled to step into the borrower's position, continue the appeal, and recover any resulting proceeds to offset advances made or losses incurred.

THE REO PROPERTY TAX CHECKLIST

Property tax strategy on a distressed commercial asset cannot wait for the asset man-

agement team to settle in. The clock starts at title transfer. Here is what lenders should do as they prepare to take back the keys:

- Determine the jurisdiction's reassessment framework (annual reassessment versus acquisition value). The risk profile and strategy are fundamentally different.
- Identify appeal deadlines immediately. In many jurisdictions, the window runs from the assessment notice date, often measured in weeks, not months.
- Benchmark the inherited assessment against current market conditions. Engage a qualified property tax professional to evaluate whether assessed value reflects market level NOI, vacancy pressures, and current cap rates.
- In acquisition-value states, model the reassessed value at foreclosure and stress-test the tax impact before finalizing the REO holding period budget.
- Preserve existing challenges and evaluate whether the lender can assume the borrower's position in the proceeding.
- Consider filing a protective appeal if any ambiguity exists. The cost of filing is minimal. The cost of missing the deadline is not.
- When preparing for disposition, structure the sale to include assignment of any pending appeals. Buyers will pay for the optionality.

IN SUMMARY

- More than \$1 trillion in CRE debt matured or was extended since 2025, with another

\$1 trillion expected by 2027. Financial institutions are increasingly facing foreclosures and deed-in-lieu transactions, often inheriting property tax assessments that exceed current market conditions.

- In annually reassessed jurisdictions, lenders may inherit overstated assessments that inflate holding-period carrying costs. In acquisition-value states like California, foreclosure itself can trigger a reassessment that, counterintuitively, results in higher property taxes at precisely the moment net operating income is falling.
- Timely appeals may transfer to buyers, enhance marketability, lower tenant occupancy costs, and support stronger disposition pricing. Property tax strategy can be an active value-recovery tool.

THE BOTTOM LINE

Property taxes on a distressed commercial asset are an active value-recovery tool, and lenders who treat them as a closing formality leave money on the table. In a market where exit valuations remain compressed and every carrying cost is under scrutiny, a well-timed tax appeal can be among the highest-return items on a lender's REO checklist.

The wave of maturities, extensions, and foreclosures has created enormous property tax exposure sitting unaddressed in lender portfolios. Some reflects assessments that have not caught up to declining asset values. Some reflects triggering events, such as foreclosures or deed-in-lieu transactions, that reset tax obligations upward at the worst possible moment. In either case, the lenders who move first will recover the most.

NOTES:

¹ <https://www.kaplancollectionagency.com/business-advice/whats-the-state-of-u-s-business-debt-entering-2026/>.

² <https://www.trepp.com/trepptalk/office-cmbs-delinq>

[uency-hits-an-all-time-high-what-the-data-is-really-saying.](#)