CONCRETE THOUGHTS

The Real Estate Tax Capital of the U.S.

Understanding the relative burden New York City property owners face and some things that could help

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Last week, Massey Knakal hosted its annual Multi-Family Summit at the McGraw-Hill Conference Center in midtown. The crowd of over 700 attendees had an opportunity to hear perspectives from dozens of speakers, including many of the top participants in this market segment in New York City. Throughout the day, speakers discussed various topics such as the volume of apartment building sales, value trends, rent regulations, operating best practices and the status of debt markets. It is clear that the multifamily market in the city is gaining positive traction as the dollar volume of sales is increasing as well as the number of properties sold. Cap rates are compressing, financing is plentiful and voracious demand significantly outpaces the supply of available properties for sale.

Generally, the speakers were very optimistic about the short-term and medium-term prognoses for this market segment. The one theme that always entered the conversation when "concerns about the future" were discussed was the impact steadily increasing real estate taxes are having on operating performance. While real estate taxes are supposed to reflect a relationship to market value, it appears this relationship has deviated along the way as the city seeks to keep tax practices rigged such that revenue continues to pour in, regardless of market conditions.

The calculation of real estate taxes is sometimes perplexing to some property owners. A politician makes a campaign pledge that real estate taxes will not be increased and then says the campaign pledge was fulfilled and "real estate taxes will remain unchanged this year." Then, an owner gets their tax bill and the amount on the invoice is much higher than the prior year. What has happened here? Let's take a look at how real estate taxes are calculated.

There are two components that make up the real estate tax calculation. The first is the real estate tax assessment. This number is supposed to bear some relationship to the market value of the subject property and is typically a percentage of that value (there are other aspects of assessments like a "target assessment" and a "transitional assessment," but for the purposes of this discussion we will assume there is an assessment upon which taxes are based). The other component is the tax rate, and there are different rates for different classes of properties. The tax assessment is multiplied by the tax rate to come up with the amount of tax that is due each year.

When politicians say they are going to support a platform of "no real estate tax increases," they are typically speaking about the tax rate alone. Even when the rate stays flat, if the assessment rises, an owner's tax bill is going to increase. From the owner's perspective, they really don't care if the rate goes up or down, or if the assessment goes up or down. All they really care about is how much they have to pay each year.

When I used the word "rigged" in the second paragraph, I was referring to practices implemented in the city that keep tax revenues rising. For instance, let's use the early 1990s as an example. Throughout the 1980s, the city had a policy of reassessing properties at 45 percent of their selling prices. The difference between this new target assessment and the current assessment was phased in equally over a five-year period. To the extent that a property may have been sold multiple times within a five-year period, or other reassessments had been made, there may have been several of these assessment "clocks" in motion concurrently.

Throughout the '80s, when values were increasing every year, the city was very happy as real estate tax revenue continued to climb each year and this process of reassessment was thought to be wonderful. However, when the savings and loan crisis hit in the early 1990s, values began to fall sharply and properties were selling for a fraction of what they were selling for years before. Had the city kept the same assessment practices in place, real estate assessments would have fallen dramatically as would have real estate tax revenue. Seeing the writing on the wall, this system of reassessment was suddenly not so wonderful and was abandoned to ensure that real estate tax revenues would continue to flow.

Manipulations like this have continued to exert upward pressure on the amount of real estate tax each property pays and these burdens continue to escalate. During the recent recession, New York City saw its average property value drop by 38 percent from peak-to-trough over a three-year period (2007-2010) yet tax assessments continued to climb during this period and continue to climb today. If taxes are supposed to bear a relationship to market value, something is amiss. But maybe intentionally so.

Presently, New York City generates about 50 percent of its revenue from the real estate industry. Between real estate taxes, water and sewer charges, mortgage recording taxes, and transfer taxes the real estate industry is critical to the economic health of the city.

There are two primary objections that owners have when it comes to real estate tax burdens. The first is that taxes are disproportionately skewed toward commercial and multifamily properties to the benefit of single-family homes and cooperative apartments. The second is that the actual amount of taxes paid is simply too high, leading to an uncompetitive dynamic relative to other locations.

The tax burden faced by office-building owners have been steadily climbing. Today, in an office building, real estate taxes can be as high as $25 or $30 per square foot. When operating costs of $10 to $15 per square foot are added to this amount, some building would need to achieve rents of nearly $50 per square foot just to break even and this is before even a single dollar of debt service is taken into consideration. According to Mary Ann Tighe, CEO of the tristate region at CBRE, the average asking rent in midtown is currently $61.49 per square foot. This leaves little room for mortgage payments or profit.

On the residential side, rental apartment buildings also pay a very high amount of real estate taxes per square foot. Taxes per square foot are expected to be high in New York City as rents per square foot are the highest in the country. What is more of a concern, however, is that taxes as a percentage of revenue are ballooning. In multifamily buildings today, real estate taxes can be as much as 30 percent of revenue. This means that if a monthly rent for an apartment is $3,350, that tenant is paying over $1,000 in real estate taxes.

These percentages make New York City real estate less competitive with other markets as our 30 percent ratio is by far the highest in the nation. In fact, it is nearly double the burden faced in Boston which comes in a distant second.

In condominium buildings, similar to multifamily rental buildings, real estate taxes can be as high as $20 to $25 per square foot. What drives some owners crazy is that real estate taxes on cooperative apartments can be only a few dollars per square foot even though their market values may be similar to those of comparable condominium units. This makes absolutely no sense and politics have more to do with this dynamic than any reasonable empirical formula. Similarly, *'During the recent recession, New York City saw its average property value drop by 38 percent from peak-to-trough over a three-year period (2007-2010) yet tax assessments continued to climb during this period and continue to climb today. If taxes are supposed to bear a relationship to market value, something is amiss.'*

single-family home taxes per square foot are miniscule but getting taxes on some sort of parity with other properties is politically very difficult. Creating awareness among those who pay the disproportionately high taxes would make the political hurdles lower and increase the likelihood that tax parity could become a reality. However, no one is holding their breath at the moment.

In multifamily properties, real estate taxes have risen at rates much higher than rent-regulated increases that have been granted, and at a much higher percentage than market rate rents have increased, leading to an increasingly lower bottom line, as a percentage of revenue, for owners each year. This relationship is unsustainable and will eventually cause a disruption in the marketplace. For this reason, many believe that, decades from now, there will be perhaps only a few elevator rental buildings left in Manhattan, as the excessive cost to operate theses properties will force owners to pass these expenses along to residents. The only way to effectively do this will be to convert properties to cooperative or condominium ownership. This would cause further supply constraint in the market for those looking for rental housing.

Given the importance of real estate taxes and related charges to the local economy, it is not reasonable to expect the cumulative burden to be reduced. However, a more equitable sharing of the burden should be implemented. Additionally, the distinction between the city's perspective of real-estate-tax-revenue-per-tax-lot versus the industry's perspective of real-estate-taxes-per-square-foot provides a tremendous opportunity to forge simple, mutually beneficial policies. This would be in the long-term best interest of both.

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