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FURMAN CENTER POLICY BRIEF

Shifting the Burden:

Examining the Undertaxation of Some of the Most Valuable Properties in New York City

In this policy brief we highlight features of New York's property tax law that result in the severe and persistent undervaluation of some of the most valuable co-op and condo properties in the city. We report evidence about the magnitude of this undervaluation, identifying 50 individual co-op units that were sold in 2012 for more than the Department of Finance's estimated market value for the entire co-op building. We then explain the consequences of this undervaluation within the context of the property tax system as a whole.

1. The Problem of Finding Comparisons for Hard-to-Compare Buildings

Section 581 of New York's Real Property Tax Law provides that:

> [R]eal property owned or leased by a cooperative corporation or on a condominium basis shall be assessed for purposes of this chapter at a sum not exceeding the assessment which would be placed upon such parcel were the parcel not owned or leased by a cooperative corporation or on a condominium basis.[1]

New York City interprets this provision to mean that co-op buildings and condo buildings with at least four units should be valued by the Department of Finance (DOF) as if they were rental properties. Rental properties are valued based on the income they generate and so condo and co-op buildings must also be valued using this approach.[2] However, because condos and co-ops do not generally generate income for their owners, the income from "comparable" buildings must be used to impute income to them. DOF uses statistical modeling to select the rental buildings used for these comparisons.

Section 581 places DOF in the difficult position of having to find rental properties that are comparable, for example, to highly prized buildings on Central Park. Quite simply, many of these sorts of buildings are not comparable to any rental properties in the city. Few, if any, rental buildings attract tenants as wealthy as people who buy luxury pre-war co-ops. Further, the city often selects rent regulated buildings as comparables for pre-war co-ops, presumably because of their comparable ages.[3] Just over 29.5 percent of the units in the rental buildings selected as comparables for the top ten buildings listed on Table 1 are subject to rent stabilization, and thus the amount of income they can generate is artificially limited. Rent regulation also likely affects investment in building improvements and maintenance, making those buildings especially poor comparisons.

The example of rent stabilization highlights the fact that a rental building may be similar to a co-op building in its size, location, number of units, and age, yet differ in other ways that make it less valuable. Many of these differences cannot easily be taken into account in a rigorous way. For example, the average value of the three buildings DOF selected as comparables for a very valuable building on the Upper East Side was, according to DOF, approximately \$188 per square foot. Meanwhile, a single unit in this building recently sold for \$54 million—or approximately \$4500 per square foot. This extreme difference is driven in part by the fact that close to 30 percent of the units in the three rental buildings in question are rent regulated. However, even if the city were to value older luxury co-ops using the rental buildings that DOF has assessed as the most valuable in the city as comparables, the co-ops would still be significantly undervalued. Indeed, the most valuable rental buildings in Manhattan are valued by DOF at well under \$500 per square foot—still less than one ninth of the per-square-foot sales price of the unit described above.[4]

1 N.Y. Real Prop. Tax Law § 581(1)(a) (McKinney 2013). Smaller condos belong to tax class 1 and are valued using comparable sales. In this brief we will discuss only condos in tax class 2.

2 New York City Independent Budget Office (2006, December 5). *Twenty-Five Years After S7000A: How Property Tax Burdens Have Shifted in New York City* (p. 17) (hereafter IBO Property Tax Report). Retrieved from http://www.ibo.nyc.ny.us/iboreports/propertytax120506.pdf

3 To the extent that the city relies on building age when selecting comparables, any condo or co-op building built before 1974 is likely to be compared to buildings containing rent regulated units.

4 This suggests that DOF may also be undervaluing luxury rental buildings as well.

The use of comparables has resulted in many of the most valuable residential properties in the city being systematically undervalued for years. While the city exacerbates the problem by selecting partially rent regulated buildings as comparables to luxury co-ops, even the most valuable rental buildings simply do not compare to the most valuable condo and co-op buildings in the city. More to blame is Section 581, requiring the city to value condos and co-ops as if they were rental buildings, rather than by simply by comparing them to other recently sold condos and co-ops. The city does use a comparative sales methodology when valuing smaller (1-3 unit) residences, and arrives at much more realistic valuations. For example, DOF currently values Mayor Bloomberg's Upper East Side townhouse at $17.6 million—or approximately $2300 per square foot.

For a number of very valuable properties, the undervaluation this methodology creates is large. The Furman Center has identified 50 individual co-ops (in 46 buildings) that were sold in 2012 for more than DOF's estimate of the market value of the entire building for the coming fiscal year. Table 1 includes the sale prices, DOF's estimated building values, building values as percentages of the single unit sale price, number of residential units in the buildings, and neighborhoods of each of these properties. While these units were undervalued, that does not mean that the owners of the units did anything wrong. They are obligated to pay only the taxes charged. The problem instead lies in the assessment methodology and policy set by the state legislature and the city.

In one particularly striking case, a single apartment in a co-op building with 13 residential units was sold for $50 million, while the entire property was valued at $15.6 million. Even if the other 12 units in this building were totally worthless, and the entire property was valued to be worth only as much as the sales price of that single unit, the co-op building still would have owed approximately $1.6 million more in property taxes in the past year. The truth, of course, is that the tax discount received by the co-op's residents is far more than $1.6 million per year because the other 12 units are also worth a substantial amount. As the final column of Table 1 reveals, these severely undervalued properties are concentrated in Brooklyn and Manhattan, with more than 70 percent located in just a few neighborhoods: the Upper West Side and Upper East Side, and the Park Slope/ Carroll Gardens and Fort Greene/Brooklyn Heights Community Districts.

Although these 50 units are extreme examples, the undervaluation of condos and co-ops is pervasive. Indeed, a study published by the Independent Budget Office in 2006 found that co-ops and condos were being valued at 23.4 percent of the amount that they would have been assigned using an alternative, sales-based methodology.[5] Moreover, that study found that the discount that condo and co-op owners enjoy on their market valuation varies widely across the city, with condos and co-ops in Park Slope/ Carroll Gardens valued at 22.5 percent of their sales-based market values, and those in Jamaica valued at 44.8 percent.[6] This variation in the discount resulting from the DOF methodology arises from differences in how truly comparable rental buildings are to condos and co-ops across neighborhoods. In many cases, the rental buildings that are used as comparables for condos and co-ops are quite different from those co-ops and condos. The differences are particularly stark for pre-1974 co-ops, because they are compared to rental buildings that often are subject to rent regulation.

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5 IBO Property Tax Report at 33.

6 IBO Property Tax Report at 35.

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Table 1: Sales in 2012 Where the Unit Price Exceeded DOF's Estimated Value of the Entire Building

Unit Sales Price ($)	*FY2013/14 DOF Estimated Building Value ($)*	*Estimated Building Value as % of Single Unit Sales Price*	*Residential Units in Building*	*Community District*
54,000,000	41,099,000	76%	66	Upper East Side
50,000,000	15,735,000	31%	13	Upper East Side
42,000,000	34,104,000	81%	24	Upper East Side
40,064,000	15,766,000	39%	19	Upper East Side
31,500,000	18,881,000	60%	18	Upper East Side
27,222,500	22,818,000	84%	17	Upper East Side
26,000,000	15,765,000	61%	12	Upper East Side
24,500,000	11,610,000	47%	20	Upper East Side
23,900,000	13,821,000	58%	12	Upper East Side
22,000,000	11,558,000	53%	14	Upper East Side
20,000,000	15,617,000	78%	12	Upper East Side
19,500,000	13,132,000	67%	6	Upper East Side
14,000,000	9,994,000	71%	17	Upper East Side
12,800,000	12,221,000	95%	13	Upper East Side
10,133,333	4,065,000	40%	16	Greenwich Village/Soho
4,275,000	3,801,000	89%	13	Clinton/Chelsea
3,250,000	1,629,000	50%	19	Fort Greene/Brooklyn Heights
2,922,175	2,153,000	74%	9	Upper East Side
2,800,000	1,390,000	50%	10	Fort Greene/Brooklyn Heights
2,600,000	2,347,000	90%	6	Upper West Side
2,550,000	1,390,000	55%	10	Fort Greene/Brooklyn Heights
2,300,000	1,770,000	77%	4	Upper West Side
2,100,000	1,596,000	76%	5	Fort Greene/Brooklyn Heights
2,010,000	1,609,000	80%	21	Upper West Side
1,880,000	1,455,000	77%	3	Park Slope/Carroll Gardens
1,865,000	1,128,000	60%	4	Park Slope/Carroll Gardens
1,805,000	1,749,000	97%	4	Greenwich Village/Soho
1,762,500	984,000	56%	20	Fort Greene/Brooklyn Heights
1,650,000	896,000	54%	3	Park Slope/Carroll Gardens
1,403,500	437,000	31%	2	Fort Greene/Brooklyn Heights
1,375,000	660,000	48%	11	Greenwich Village/Soho
1,359,300	1,351,000	99%	4	Upper West Side
1,350,000	1,243,000	92%	4	Fort Greene/Brooklyn Heights
1,240,000	437,000	35%	2	Fort Greene/Brooklyn Heights
1,210,000	1,125,000	93%	4	Park Slope/Carroll Gardens
1,150,000	1,012,000	88%	4	Park Slope/Carroll Gardens
995,000	854,000	86%	7	Fort Greene/Brooklyn Heights
975,500	712,000	73%	3	Fort Greene/Brooklyn Heights
880,000	437,000	50%	5	Bedford Stuyvesant
780,000	741,000	95%	6	Greenpoint/Williamsburg
699,000	570,000	82%	4	Park Slope/Carroll Gardens
630,000	432,000	69%	11	Park Slope/Carroll Gardens
625,000	583,000	93%	11	Jackson Heights
625,000	583,000	93%	11	Jackson Heights
622,000	620,000	100%	11	Jackson Heights
550,450	550,000	100%	11	Jackson Heights
465,000	365,000	78%	15	Crown Heights/Prospect Heights
411,500	365,000	89%	15	Crown Heights/Prospect Heights
384,000	354,000	92%	16	Sunset Park
360,000	295,000	82%	8	Bedford Stuyvesant

Source: New York City Department of Finance Automated City Register Information System, Final Assessment Roll File, Furman Center for Real Estate and Urban Policy

The use of income from rent regulated buildings to value older co-ops is one of the primary culprits in the persistent undervaluation of those buildings. The use of rent stabilized buildings as comparables was initially seen as a virtue when the law was amended in 1981 because it constrained the rate of property tax growth on co-ops and condos, providing them with some of the protection from annual increases that one- to three-family homes enjoy from the "assessment caps" rules.[7] Moreover, a significant number of co-op buildings were in fact former rental buildings, and the law required co-ops and condos to be compared to rentals to ensure that owners who chose to convert their properties were not penalized for their decision. Regardless of the reasons for the provision, over time the law, as the city interprets it, has generated enormous and persistent disparities in the taxes paid by condo and co-op owners across neighborhoods. Our chapter entitled "Distribution of the Burden of New York City's Property Tax," in our State of New York City's Housing and Neighborhoods 2011 report, contains a more detailed discussion of this history.[8]

2. The Burden Shifting Effect of the Undervaluation of Condos and Co-ops

To appreciate the full effect of the undervaluation of condos and co-ops, it is important to understand how this policy fits into the larger property tax system. New York City's property tax system explicitly provides for drastically different tax treatment of equally valuable properties depending on the kind of property. In 1981, New York State adopted a system that divided property in New York City and Nassau County into four classes, with different rules for the assessment of each class and with different tax rates in each.[9] The system results in widely disparate tax burdens for different kinds of properties of the same value.[10]

At the same time that the legislature created the class system, it fixed the share of the property tax levy each class was to bear, which was basically the share paid in 1981 when the system was adopted.[11] In 1990, the legislature also enacted a cap on any adjustments of the class shares due to changes in market values.[12] The result is highly favorable to the owners of one- to three-family homes (Class 1 properties). As

7 IBO Property Tax Report at 32.

8 Furman Center for Real Estate and Urban Policy. (2012). *State of New York City's Housing and Neighborhoods 2011: Distribution of the Burden of New York City's Property Tax*. Retrieved from http://furmancenter.org/files/sotc/Distribution_of_the_Burden_of_New_York_Citys_Property_Tax_11.pdf

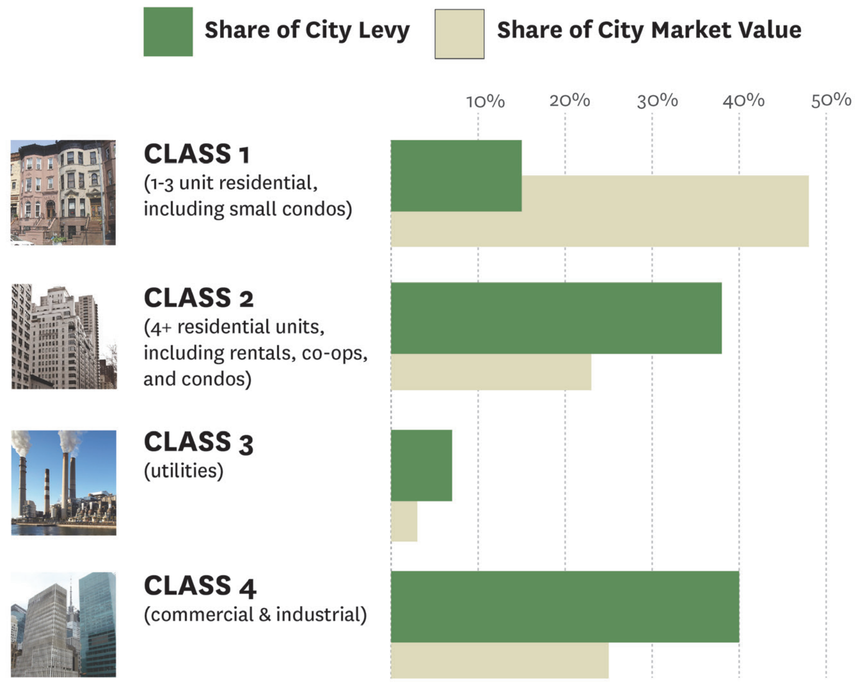
9 IBO Property Tax Report at 9-11.

10 Class 1 includes most residential property of one to three units, such as single-family homes, small apartment buildings, or small stores or offices with one or two apartments attached. It also includes certain vacant land zoned for residential use and most condos under four stories. Class 2 includes all other primarily residential property, such as large multi-family rental buildings, co-ops, and condos over three stories. Class 3 includes property with equipment owned by gas, telephone, or electric companies. Class 4 includes all commercial and industrial property. New York City Department of Finance. Glossary of Property Assessment Terms. Retrieved from www.nyc.gov/html/dof/html/property/property_val_glossary.shtml#T

11 IBO Property Tax Report at 17.

12 IBO Property Tax Report at 17.

Figure 1: Share of Tax Levy and Share of DOF Estimated Value by Tax Class, Fiscal Year 2010-2011



Source: New York City Department of Finance Property Tax Report, Furman Center for Real Estate and Urban Policy

Figure 1 illustrates, those property owners pay a smaller share of the tax levy (15.4%) than their properties' share of citywide market value as calculated by DOF (48.3%).[13] Class 1 is the only class that pays a share of taxes smaller than its share of the city's market value. The remaining three property classes pay a greater share of the total tax bill than their respective share of the city's market value. However, co-ops and condos with more than three units are included in Class 2, along with larger rental properties. Properties in this class are valued based on their income and expenses. If condos and co-ops were valued more accurately, Class 2's share of city market value would likely be higher, and the disparities in tax burden among the four classes would therefore be reduced somewhat.

The primary consequence of the undervaluation of condos and co-ops, though, is within Class 2 itself. Because the share of the tax levy collected from each class in a given year is fixed, when certain properties are undervalued, the tax rate set by the city council to raise that share must increase, effectively shifting the tax burden from undervalued properties to the other properties in the same class.[14] In the case

13 The "market value" referred to here is the values assigned to properties by the Department of Finance. As this brief demonstrates, for certain properties, DOF's valuations may not accurately reflect the true market value.

14 Furman Center for Real Estate and Urban Policy. (2012). *State of New York City's Housing and Neighborhoods 2011: Distribution of the Burden of New York City's Property Tax.* Retrieved from http://furmancenter.org/files/sotc/Distribution_of_the_Burden_of_New_York_Citys_Property_Tax_11.pdf

Table 2: Characteristics of New York City Households by Tax Class and Property Type, 2011

	Citywide	*Class 1*	*Class 2: co-ops built pre-1974*	*Class 2: co-ops built post-1974 and all condos*	*Class 2: rental buildings*
Median Income	$48,040	$58,800	$68,000	$98,000	$40,000
Persons	2.5	3	2	2.1	2.2
% Poverty	17.4	11.9	9.3	10	20.6
% White Householder	41.3	42.4	61.9	57.8	38.2
% Black Householder	22.3	23.8	14.6	9.3	21.4
% Hispanic Householder	23.9	18.7	12.8	10.2	29.5
% Asian Householder	11.5	14.2	9.9	21.2	9.8
% with Children	30.2	37.4	18.4	24.4	26.9
% Receiving Public Assistance	16	10.6	6	4.4	20

Source: New York City Housing and Vacancy Survey, Furman Center for Real Estate and Urban Policy

of Class 2, the other properties are large rental buildings. Shifting the tax burden in this way has distributional consequences. Although we cannot say for certain who bears the ultimate economic burden of the property tax within rental properties, it is likely that some of it is borne by renters and some by the property owner. In rent stabilized properties, the formula used by the Rent Guidelines Board to set the rent ensures that that changes in taxes result in changes in rents. Tenants in Class 2 rentals have very different demographics than the households who live in co-ops and condos: at the median, they make less than half the income of the owners of more recently built co-ops and condos. The burden of the undervaluation of co-ops and condos therefore falls on families already struggling to afford housing in New York City. Tenants in Class 2 rentals are also much more likely to be black or Hispanic and to have children than co-op and condo owners, so the burden of undervaluation may threaten the city's ability to attract and retain a diverse range of households.

Table 2 shows the demographic characteristics of the households living in Class 2 condos and co-ops and those living in Class 2 rental buildings. We highlight those who live in pre-1974 co-ops because those buildings are most likely to be undervalued as a result of the use of rent regulated buildings as "comparables" for many of these properties.

3. Smart Policy?

The distribution of the property tax matters because it affects decisions about land use and development, including the supply of rental housing versus homes for ownership. It also affects how much of the economic burden of supporting New York City's public services and government different classes of taxpayers, such as renters, landlords, homeowners, and real estate investors, must bear. A proper analysis of the various elements of the property tax policies that the state and the city have adopted, like the valuation methodology for condos and co-ops, requires specifying, at the outset, what the aims of the tax system are—what incentives we want the property tax to create for development and maintenance, and who should bear the economic burden of the property tax.

To identify these aims, we look at the basic structure of New York's property tax and the general principles that it reflects, and then evaluate whether the undervaluation of condos and co-ops through the use of the income method makes sense in light of those principles. First, the class share system reflects a policy preference for one- to three-unit residential properties over four-plus unit residential properties and commercial properties. That preference likely arises from a preference for homeownership, at least in part because of the benefits homeownership is thought to bring society. Consistent with such a preference, the property tax law grants a partial exemption (the "STAR" exemption) for owner-occupiers. Moreover, the tax law also includes an abatement for condo and co-op owners designed to bring the taxation of Class 2 homeowners more closely in line with the favorable taxation of owner-occupiers in detached homes.[15] The fact that the abatement was recently revised to exclude pieds–à–terre[16] reinforces this conclusion. Thus, there are numerous ways that New York's property tax system reflects a preference for owner-occupiers over landlords and renters.

Second, state law requires that New York City cap the rate at which assessed values in Class 1 can increase in a single year, or over a five-year period. It also caps the rate of assessment increase for Class 2 properties with fewer than 10 units. One of the early justifications for using rent stabilized buildings as comparables for condos and co-ops was that it would provide them with some of the same benefits as smaller properties in terms of capping property tax increases.[17] These features reflect a preference for preventing sharp increases in property taxes over a short period of time.

Is the undervaluation of condos and co-ops consistent with these two aims? Although the undervaluation of condos and co-ops does result in a lower tax burden for owner-occupiers of these units than for landlords and tenants in Class 2, it is an extremely imprecise way of implementing such a tax preference. As a 2006 Independent Budget Office report documented, once the condo/co-op tax abatement has been taken into account, the effective tax rate for these units can be even less than the tax rate on a Class 1 property.[18] Moreover, the tax benefits of using the income method to value a property vary widely depending on the arbitrary availability of comparable rental buildings and whether rent regulated "comparables" are used. So the use of the income method creates differences in effective tax rates both between Class 2 owner-occupiers and Class 1 owner-occupiers, and between owner-occupiers of Class 2 condos and co-ops located in different neighborhoods or in buildings with different characteristics. For similar reasons, the use of the income method provides only a very poor and uneven tool for stabilizing assessment increases for Class 2 owner-occupiers. Only those buildings built before 1974 are likely to have rent stabilized rental buildings as comparables and thereby to benefit from their slower rate of income growth.

Amending the state law to authorize DOF to use sales prices to estimate the value of co-op and condo buildings would solve the problem we highlight here. However,

15 Reacting to the favoring of Class 1 homeowners, owners of Class 2 condos and co-ops successfully lobbied for the creation of the Cooperative and Condominium Property Tax Abatement Program. IBO Property Tax Report at 34. The co-op/condo abatement provides significant relief to eligible owners, effectively reducing their taxes by between 17.5 and 25 percent in fiscal year 2013, depending on the assessed value of the property. New York City Department of Finance. *Cooperative and Condominium Tax Abatement*. Retrieved from http://www.nyc.gov/html/dof/html/property/coop_condo_abatement.shtml

16 Higgins, M. (2013, March 31).Tax-Abatement Changes Affect Many Unit Owners. *The New York Times*. Retrieved from http://www.nytimes.com/2013/03/26/realestate/tax-abatement-changes-affect-many-unit-owners.html?pagewanted=all

17 IBO Property Tax Report at 32.

18 IBO Property Tax Report at 36.

the undervaluation of condos and co-ops is only one of several significant inequities in the property tax system, detailed and explained in greater depth in the Furman Center's State of New York City's Housing and Neighborhoods 2011 report. Correcting them would not only require significant changes in the law, but would also be politically challenging. But the fact that 50 individual co-op units sold in the past year for more than their entire building's valuation reminds us, once more, of the need to reexamine the fairness and efficiency of the property tax system.

About the Furman Center and the Moelis Institute for Affordable Housing Policy

The Furman Center for Real Estate and Urban Policy is a joint center of the New York University School of Law and the Robert F. Wagner Graduate School of Public Service at NYU. Since its founding in 1995, the Furman Center has become a leading academic research center devoted to the public policy aspects of land use, real estate development, and housing. The Furman Center launched the Moelis Institute for Affordable Housing Policy to improve the effectiveness of affordable housing policies and programs by providing housing practitioners and policymakers with information about what is and is not working, and about promising new ideas and innovative practices.

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