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Should the next mayor offer to cap the property tax levy on 421-a rental properties in order to preserve the affordable units within those buildings?

Property tax expenditures to encourage the preservation of affordable housing have generated controversy in this year's mayoral race. One prominent proposal recommends capping the total annual property tax liability of large rental buildings based on the buildings' rental income, if their owners agree to keep 20 percent of their units affordable by renewing their participation in the city's largest tax-based affordable housing program, known as the 421-a program.

WHY IT MATTERS (CONT'D)

Offering tax breaks to real estate developers may incentivize the construction or preservation of affordable housing, but such subsidies can also deprive the city of much-needed revenue. As the city faces significant budgetary challenges, policymakers must ensure that tax subsidy programs like 421-a are structured as efficiently as possible—giving away no more than is necessary to persuade developers to offer affordable units.

THE BASICS

In fiscal year 2013, New York City granted approximately $1.5 billion in tax incentives for the development and rehabilitation of housing.[1] These tax expenditures represent an alternative to direct appropriations, but have a similar effect on the city's bottom line. The city's largest housing-related tax expenditure is the 421-a program for the construction of new apartment buildings, which cost the city nearly $1.1 billion in forgone revenue in FY2013.[2] Buildings constructed under the 421-a program are exempt from property taxes for 10 to 25 years.[3] Developers in "Geographic Exclusion Areas" (recently expanded to include all of Manhattan and select areas in the outer boroughs) can obtain a 421-a exemption if they make 20 percent of the units they construct affordable—by setting rents at rates affordable to lower-income New Yorkers[4] and subjecting the units to rent stabilization, or by selling the units for below-market prices. Affordable units in rental properties constructed under the 421-a program must remain rent stabilized for 35 years, after which owners are free to rent them at market rates once the existing tenant vacates.[5]

A recent proposal calls for offering a new benefit—a property tax cap—to provide incentives for the owners of 421-a rental properties reaching the end of that fixed period to preserve affordable units within their buildings. The proposal suggests capping the property tax liability of a 421-a building reaching the end of its affordability restrictions at 28 to 31 percent of gross rental revenue for 30 years in exchange for keeping 20 percent of the property's units affordable and subject to rent stabilization.

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1 New York City Department of Finance, Office of Tax Policy. (2013). *Annual Report on Tax Expenditures.* Retrieved from http://www.nyc.gov/html/dof/downloads/pdf/13pdf/ter_2013_final.pdf

2 Nearly half of the FY2013 421-a tax expenditure benefitted rental properties (as opposed to condominium developments).

3 More specifically, participating properties are exempt for a period of time from any increase in property tax liability resulting from construction (i.e., developers still pay property taxes on the value of the land). The exemption is then phased out over time.

4 Typically developers of rental buildings are required to set these rents at a level affordable to a household earning 60 percent of the area median income.

5 The latest amendment to the 421-a program requires landlords to maintain stabilization for existing tenancies upon benefit expiration.

QUESTIONS & CONSIDERATIONS

The property tax is one of the most powerful policy levers the city has at its disposal to affect the behavior of local real estate developers. Because property taxes represent a large liability on any real estate project's balance sheet, even partial relief can be enough to incentivize developers to include affordable housing units in their plans.[6] Calibrating these incentives, however, is a tricky matter. Unless developers believe a program's tax savings outweigh the forgone revenue from the required affordable units, the program will sit unused. If the city sets incentive levels too far beyond the threshold of profitability, however, it will provide an unnecessary windfall to developers. Because the city is not privy to these developers' financing models, market forecasts, and risk tolerances (let alone future market conditions), calibrating tax incentives to be appropriately generous prior to the construction and leasing (or sale) of units is very difficult.

Calibrating incentives designed to be used after a building is built, however, is less difficult. Once a building is constructed and its units rented,[7] it is easier for the city to understand the level of tax relief necessary to encourage an owner to preserve affordable rental units. The rental revenue forgone by offering 20 percent of units for below-market rents is fairly easy to estimate—it is (roughly) the difference between the mandated affordable rents and the market-rate rents being charged in the other 80 percent of units.[8] The city already has access to the actual rents being paid by market-rate tenants in almost all of these properties through the annual Real Property Income and Expense Statements owners file with the Department of Finance.[9] Using these data, policymakers can estimate the true cost to developers of preserving affordable rental units as often as necessary, making it considerably easier to design a well-calibrated tax incentive.

Using a property tax cap to persuade expiring 421-a rental property owners to retain affordable units would not take advantage of the availability of these data to help set appropriately sized incentives. Moreover, the most recent amendments to the 421-a program require that, upon expiration of the benefit, developers keep affordable units affordable for the duration of any existing tenancies. Thus, at least with respect to new 421-a projects, affordability requirements associated with the tax cap would only benefit tenants new to the property after the expiration of initial benefits. Finally, a 30-year property tax cap would provide valuable predictability to property owners, but render the size of the incentive offered unpredictable to the city. Should property tax rates applied to rental buildings raise significantly over the next 30 years, the city could end up providing a subsidy to property owners well in excess of rental revenue forgone by keeping 20 percent of their units affordable.

6 Some have argued that 421-a subsidies are critical to address the disparities in the effective tax rates for rental buildings, relative to single family homes, co-ops, and condos. The Furman Center examined these disparities in two recent publications. See Furman Center for Real Estate and Urban Policy. (2013, July). *Shifting the Burden: Examining the Undertaxation of Some of the Most Valuable Properties in New York City.* Retrieved from http://furmancenter.org/files/FurmanCenter_ShiftingtheBurden.pdf; 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

7 The property tax cap proposal applies only to 421-a rental properties.

8 This is a rough estimate because affordable units may not be as desirable as market-rate units due to their location in the building (e.g., on a lower floor) or level of finish (e.g., less expensive appliances), and thus the market rents they would command might be lower than existing market-rate units.

9 Although the Department of Finance waived the requirement to file a detailed rent roll in FY2012, it is clear it has the capacity and authority to gather these data.

There are, however, certain benefits to using a property tax cap as an incentive to preserve affordable units. First, a cap would, of course, encourage the preservation of affordable units that might otherwise be lost. Second, unlike a tax exemption, a property tax cap pegged to gross rental revenue would adjust with changing market conditions, minimizing the windfalls to developers that might accrue otherwise (though the benefit size could still grow if tax rates were to increase).

Using a property tax cap as an incentive to persuade expiring 421-a rental-property owners to preserve affordable units raises a number of questions. Mayoral candidates should explain why a flat cap should be used instead of a more nuanced assessment of the subsidy needed to make up the difference between the affordable rents and market rents.

More broadly, candidates should say whether they believe the city should make preserving affordable units in 421-a projects a priority, and why. The 421-a rental buildings that contain affordable units tend to be located in the city's most expensive neighborhoods and, accordingly, the subsidy required to make these units affordable to low-income New Yorkers is comparatively high. By subsidizing affordable units in more affluent neighborhoods, the city helps to deconcentrate poverty and promote neighborhood diversity, but at a cost, and those funds could be used instead to generate even more affordable housing. Candidates should explain what they believe to be the right balance between these competing values.