City Council Committee on Finance Hearing on the Recommendations of the Advisory Commission on Property Tax Reform

Testimony given by
Commissioner Preston Niblack

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Good morning, Chair Brannan, members of the Finance Committee, and members of the City Council. I’m Preston Niblack, Commissioner of the Department of Finance.

I’m here today to testify on behalf of the administration of Mayor Eric Adams on the subject of reforming New York City’s system of taxation of real property.

Today I’d like to start with a quick overview of the current system’s main features, highlighting in particular some of the features of the system that were the subject of recommendations by the Advisory Commission on Real Property Tax Reform. The Advisory Commission was empaneled by Mayor de Blasio and Speaker Johnson in 2018. The Commission’s final report was delivered, as you know, in December 2021.

Then I’ll review the Advisory Commission’s recommendations for reform. The Advisory Commission did an excellent job in analyzing the shortcomings of the current system and laying out a plan to make the system fairer and more transparent. Circumstances have changed since the Commission did the bulk of its work before the COVID pandemic. We are reviewing the Advisory Commission's recommendations to make sure we fully understand their impact on New Yorkers and determine whether they should be modified. Also, a review is needed of issues that the Advisory Commission didn't tackle or propose changing. This is work that needs to be done by both the Administration and the City Council.

So today I will also present some additional preliminary analyses of the Commission’s proposals to help members of the public and you, their elected representatives, gain a deeper understanding of the impacts of the Commission’s recommendations for taxpayers.

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As I said, I’ll start with a quick overview of the current system’s main features – highlighting in particular those that were the subject of the Commission’s recommendations.

First, under the Real Property Tax Law, there are four classes of real property subject to taxation.

Class 1 consists primarily of one-, two-, and three-family homes. Class 2 consists of multifamily residential buildings with more than three units. Within Class 2 are two subclasses of particular note in the context of the Commission’s reform proposals: Class 2A, consisting of four- to six-unit rental buildings, and Class 2B, consisting of seven- to ten-unit rental buildings.

Class 3 includes property of regulated utilities. Class 4 consists of commercial properties, including office buildings, stores, hotels, factories, and warehouses, as well as many exempt non-profit properties such as hospitals, churches, and cultural facilities.

Properties are valued differently in each class to determine their taxes. Class 1 is currently the only class in which properties are valued based on the sales price of similar properties.

Class 2 large rental properties and most Class 4 commercial properties are valued based on the income capitalization method, where net operating income is divided by a capitalization rate to determine market value.

One peculiarity of this system is that Class 2 co-op and condo apartments – that is, homeownership properties – must be valued *as if* they are income-producing rental properties without regard to how they are valued in the sales market. This introduces some significant disparities in tax burden between similarly-valued properties that are used for the same purpose – namely, as someone's home. Notably, because of the lack of "comparable rentals" at the highest end of the co-op and condo market, there is a significant degree of compression of values, resulting in lower effective tax rates – that is, taxes paid per $100 of market value – on properties that sell for millions of dollars.

For example, it was widely reported a couple of years ago that a hedge fund billionaire purchased a condo apartment for $240 million, but its property tax in FY21 was only $549,000. That's an effective tax rate of just 23 cents per $100 of market value – compared to an average effective tax rate of 73 cents per $100 of market value for all condos citywide.

Another feature of our current system is that the tax rate adopted by the City Council each year is not applied to the *market* value that DOF has calculated, but rather to a fraction of the market value – the assessed value – under a system known as fractional assessment.

Class 1 properties are taxed based on a target ratio of assessed value to market value of 6% (subject to caps on how quickly they can be increased, discussed further below), while other classes are taxed based on a ratio of 45% of assessed value to DOF market value.

Fractional assessments are a common feature of property taxation in other jurisdictions, but they add a layer of complexity when taxpayers are trying to understand how their tax bill is calculated.

Adding more complexity are statutory caps on the allowable growth in taxable assessed value (the AV growth caps). On Class 1 properties, the caps are a maximum increase of 6% in any given year and a maximum increase of 20% over any five-year period. Class 2A and 2B small rental buildings also have AV growth caps of 8% per year and 30% over five years.

This can create confusion and frustration for homeowners who see their market value flat or even declining but see their assessed value – and hence their taxes – continue to rise until the ratio of assessed value to market value reaches the target for that class.

Just as significantly, the AV growth caps create inequities across properties within the same tax class. A homeowner in a gentrifying neighborhood with rapid growth in market values may see the growth in assessed value of their home lagging the market due to growth caps. This will cause the property to be relatively undertaxed compared to a home in a neighborhood where market values have not grown as rapidly.

Finally, to add yet one more level of complexity and opacity to the whole mix, while the Council adopts one tax rate for the year, there are actually four distinct tax rates, one for each property class. These tax rates are derived from the so-called class shares of the total amount of property taxes billed (known as the tax levy). The class shares system constrains how the total levy is divided among the four classes, limiting the degree to which the relationship among the classes can change, even if the market value of one class is increasing faster than the other classes. It is fiendishly complex, and few people actually understand the mechanics of the calculation.

So, with that brief background on the current system, let me turn now to an overview of the Advisory Commission's recommendations, and how the Commission proposed to address some of the distortions, inequities, and lack of transparency in the current system.

The Advisory Commission's work was guided by a few values and objectives:

First, make the property tax system fairer. We refer to fairness in taxation in terms of both horizontal equity and vertical equity. Horizontal equity means that similarly valued properties that have similar uses should pay roughly equal taxes. Vertical equity means that effective tax rates should be proportional to the value of a property. In the words of the Final Report, the Commission sought "to strip the system of the features that lead to structural inequalities."

Second, make the property tax easier to understand by eliminating elements of the system that make it difficult to understand how your tax bill is calculated.

Third, the Commission sought to ensure that low- and moderate-income homeowners can afford their tax bills and remain in their homes and communities.

Finally, the Commission was charged with crafting a revenue-neutral reform proposal.

To accomplish these objectives, the Advisory Commission proposed four key structural changes to the current system.

First, the Commission proposed the creation of a new residential tax class that would include current Class 1 one- to three-family homes, plus co-ops and condos currently in Class 2 and the small rental buildings currently in classes 2A and 2B. For convenience I'll refer to this as the New Class 1.

Second, properties in the New Class 1 would all be assessed based on sales-based market value. That is, the sales-based valuation currently applied to Class 1 one- to three-family homes would be extended to co-ops and condos, so that their treatment would be uniform. It also would be extended to the valuation of small, four- to ten-unit rental buildings.

Third, the Commission proposed ending the unnecessary and confusing fractional assessments in all classes and simply applying tax rates to market values.

Finally, the Commission proposed doing away with the assessed value growth caps on Class 1 and Class 2A and 2B properties. Instead, changes in market value would be phased in over five years. This is the current practice for market value changes for Class 2 large rental buildings and Class 4 commercial properties.

These four structural changes would result in a vastly simpler, more transparent system that would get rid of many of the inequities in tax treatment that are embedded in the current system, while greatly simplifying the system for taxpayers.

To promote homeownership as a key element of stable communities, and to ensure that low- and moderate-income households can afford their property tax bills, the Commission added two targeted homeowner relief programs on top of its structural reforms: a homestead exemption, and a circuit breaker.

A homestead exemption excludes a portion of the taxable value of a home that is occupied by the owner from taxation. The Commission put forward two possible versions: a 20% flat rate exemption that would phase out as household income rises, and a slightly more complex, graduated marginal rate exemption. Under the flat rate version, a primary resident homeowner with household income up to $375,000 would see 20% of the market value of their home exempted – that is, they would pay tax on 80% of the value of their home. More well-to-do households would pay tax on a progressively larger share of their home value, up to a household income of $500,000 when the exemption would phase out entirely.

A circuit breaker is another common feature of property taxation in many jurisdictions. Its purpose is to ensure that lower-income households can afford their property tax bills by granting the homeowner a credit for property taxes above a certain percentage of their income. The Commission's proposal was to fully exempt property taxes above 10% of income (up to a maximum $10,000 total benefit) for incomes up to $58,000. Owners with an income between $58,000 and $90,550 would receive a declining percentage of the amount by which property taxes exceed 10% of income.

The Commission also recommended replacing the arcane and complicated class shares system with a system in which the relationship between individual class *rates* would be fixed for a five-year period. Any change in the overall tax rate would simply result in proportional changes in each class's rate – if the Council were to lower the property tax rate by 10%, for example, each class's tax rate would go down 10%.

Those were the Commission's key recommendations for reform. Taken together, they would transform a complex and arcane system riddled with inequities and distortions into a simpler, fairer system that would be easier for taxpayers to understand. The benefits in terms of the basic credibility of the system to taxpayers would, not incidentally, be considerable.

What about the remaining classes of property, however? And what did the Advisory Commission *not* do?

The Commission did not recommend any change to the treatment of Class 2 large rental buildings. These are income-producing properties for their owners, and the Commission found – and we agree – that the income capitalization approach to valuing them is the correct one.

But what about the renters themselves? The tax burden on large rental buildings is significantly higher, measured by their effective tax rates (again, the taxes paid per $100 of market value) than it is on other residential property. The Commission recognized and acknowledged that renters pay at least some share of property taxes through their rents. In a tight market such as New York's, owners of unregulated apartments will generally be able to pass along increases in property taxes in the form of higher rents. However, because it is difficult to ensure that any tax reduction would be passed through to renters, the Commission did not make a specific recommendation for renter relief.

The potential impact on renters is of particular concern amidst the current affordable housing shortage and as New Yorkers are already facing rising rents and inflation. Addressing this issue will require careful consideration of potential solutions and caution to avoid any possible adverse implications that would further restrict the availability of affordable housing.

There was also no discussion in the Commission's report on the future of tax incentive programs, such as the recently expired 421a program, which encourage the production of affordable rental housing.

Finally, the Commission did not recommend any change in how Class 4 commercial properties are taxed, finding that as a general matter the tax burden in New York City on such properties was comparable to that in other large cities across the country.

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Now I would like to turn our attention to what taxpayers could expect if the Commission's proposed reforms were enacted and highlight a couple of issues that raise some concerns for us.

In what I'm about to present and discuss, we've modeled what I'll call the baseline reform model, which includes the 20% homestead exemption and the circuit breaker, both which are financed within the system – that is, by using a slightly higher tax rate on the New Class 1 to pay for homeowner relief, rather than funding from an external source or by raising the rate on other property classes.

First, the majority of all properties – 63% (almost 855,000 parcels) -- in the New Class 1 would see a reduction of at least 5% and at least $100 in their property tax compared to currently (as of 2021). The median decrease would be about $1,500 per year, or 30%. A larger share of primary-resident homeowners in the New Class 1 – 73% – would see a decrease in their tax bill. The median reduction for them would be roughly similar both in dollar terms and in percentage terms.

Inevitably, however, in a revenue-neutral approach, reducing the existing inequities in the system means that some owners who are currently relatively overtaxed would pay less under reform – and some who are relatively undertaxed would pay more.

Thus, 28% of all properties in the New Class 1 (about 374,000 parcels), and one in five primary residents, would see an increase in their property tax of at least 5% and at least $100. The median increase would be about $2,000 per year or 36%. A small share of properties would see minimal or no change.

The distribution of reductions and increases matters, obviously. The Advisory Commission's recommended approach would vastly improve both horizontal and vertical equity amongst homeowners compared to the current system.

In terms of horizontal equity, the Commission's recommendations would greatly reduce the disparity in effective tax rates paid by property owners, which currently vary widely. In FY 2021, half of primary resident owner-occupied properties had an ETR of between $0.60 and $1.00 per $100 of market value in FY21. Under reform this range would be reduced substantially, with half of all taxpayers falling between $0.57 and $0.75. This is a huge gain in horizontal equity and would help eliminate the systemic biases embedded in the current tax system – largely through eliminating the distorting effect of AV growth caps.

In terms of vertical equity, the Commission's proposed reforms would also represent a vast improvement. Most taxpayers with household incomes below $500,000 would see a tax reduction, with the largest reductions going to the lowest-income households. In contrast, higher-income households would generally see a tax increase. This correction

in the direction of greater vertical equity arises from two causes: First, by capturing more of the value of high-end co-op and condo apartments under a sales-based valuation approach. Second, by providing targeted homeowner relief to lower-income households to reduce their tax burdens.

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Now, again, it's important to bear in mind that since there were no proposed changes to the remaining classes of property, the revenue neutrality constraint applies entirely within the New Class 1. For this reason, given that more property owners will see a tax decrease than a tax increase, the median decrease would be less than the median tax increase.

Moreover, benefitting primary resident homeowners in the New Class 1 would mean that much of the burden would be shifted onto non-primary residents and other properties. While over 70% of one- to three-family homes, co-ops, and condos are owner-occupied, the rest are largely rented by owners to tenants, and many of these properties would be subject to increases.

In particular, we have concerns about what this would mean for the small, four- to ten-unit rental buildings currently in classes 2A and 2B. Because these buildings also have caps on growth in assessed value, they are often taxed on an assessed value well below the target ratio of 45% of market value. Taxing them based on sales-based market value in the same class with one- to three-family homes, co-ops, and condos would result in a tax increase on 58% of these buildings.

We need to understand the impact of tax reform on renters in the New Class 1 to ensure they are not adversely impacted by tax reform.

These broad issues – the distribution of tax burdens between owners and renters within the New Class 1, and relief for renters in the larger Class 2 buildings – are ones that concern us and that we think require further examination in developing recommendations for a tax reform proposal.

Moreover, the current economic and budget environment, including rising residential and commercial mortgage interest rates and high levels of office vacancies, makes the context for reform more challenging and introduces new complexities and uncertainties in assessing the dynamics of reform proposals on different segments of the City's real property markets, and on revenues. This, too, requires further study.

That said, I want to reiterate our respect and gratitude to the members of the Advisory Commission for their work. Although there are some issues that we think require further study and consideration, the basic framework of their proposal strips away four decades of growing inequity to propose a fundamentally simpler and fairer system. We look forward to working with the City Council to build on the foundation laid by the

Commission's work to create lasting change that will make New York City a fairer place for all its residents.

I look forward to your thoughts and questions.