# AUDIT REPORT

CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
BUREAU OF FINANCIAL AUDIT
**WILLIAM C. THOMPSON, JR., COMPTROLLER**

# Audit Report on the Tax Classification of Real Property in the Borough of Queens by the Department of Finance

*FP04-149A*

**June 2, 2005**

THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
1 CENTRE STREET
NEW YORK, N.Y. 10007-2341

WILLIAM C. THOMPSON, JR.
COMPTROLLER

**To the Citizens of the City of New York**

Ladies and Gentlemen:

In accordance with the Comptroller's responsibilities contained in Chapter 5, §93 of the New York City Charter, my office has examined whether the Department of Finance (Finance) has adequate procedures to ensure that real properties in the borough of Queens that are listed as Tax Class 1 on the assessment rolls are correctly classified. The results of our audit, which are presented in this report, have been discussed with Finance officials, and their comments have been considered in preparing this report.

Audits such as this provide a means of ensuring that property owners are being correctly billed for real estate taxes in accordance with the New York City Real Property Tax Law.

I trust that this report contains information that is of interest to you. If you have any questions concerning this report, please e-mail my audit bureau at audit@Comptroller.nyc.gov or telephone my office at 212-669-3747.

Very truly yours,

William C. Thompson, Jr.

WCT/gr

**Report:** **FP04-149A**
**Filed:** **June 2, 2005**

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*The City of New York*
*Office of the Comptroller*
*Bureau of Financial Audit*

# Audit Report on the Tax Classification of Real Property in the Borough of Queens By the Department of Finance

**FP04-149A**

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## AUDIT REPORT IN BRIEF

This audit determined whether the Department of Finance has adequate procedures in place to ensure that mixed-use properties in the borough of Queens that are listed as Class 1 on the assessment rolls are correctly classified. The scope of this audit covered tax assessments for Fiscal Year 2005.

### Audit Findings and Conclusions

The audit found that Finance does not have adequate procedures in place to ensure that mixed-use properties in the borough of Queens that are listed as Class 1 on the assessment rolls are correctly classified. Although Finance routinely inspects Class 2, 3, and 4 properties to ensure that they are correctly classified on the assessment rolls, it does not conduct such inspections of Class 1 properties. Instead, Finance inspects Class 1 properties only when it is informed by the Department of Buildings that the properties are being altered or renovated.

We identified 107 properties listed as Class 1 on the assessment rolls that appeared to be misclassified. Using Finance guidelines, we determined that these properties should have been classified as Class 4. Had these properties been correctly classified, we calculate that Finance would have billed the owners an additional $884,028 in property taxes for Fiscal Year 2005.

### Audit Recommendations

We recommend that Finance should:

- Inspect the properties identified in this report and confirm whether they are misclassified.

- Make the necessary adjustments to the assessment rolls for the properties that are misclassified.

- Seek an opinion from the Law Department as to whether property owners can be billed for additional taxes owed for prior years that were caused by property misclassifications. If it is determined that the additional amounts can be billed, the Department of Finance should bill the owners accordingly.

- Conduct annual inspections of all Class 1 mixed-use properties and a sample of all other Class 1 properties to ensure that they are properly classified on the assessment rolls.

# INTRODUCTION

**<u>Background</u>**

The Department of Finance (Finance) administers and enforces the tax laws; collects taxes, judgments and other charges; educates the public about their rights and responsibilities with regard to taxes and tax benefit programs in order to achieve the highest level of voluntary compliance; provides service to the public by assisting in resolving customer problems; and protects the confidentiality of tax returns. Finance processes parking summonses and provides an adjudicative forum for motorists who wish to contest them. It also provides collection enforcement services for court-ordered private and public sector debt.

In accordance with the New York City Real Property Tax Law (RPTL), Finance classifies every parcel of property in New York City for real-estate tax purposes. The tax classifications are:

- *Class 1*: Residential properties (with three units or less) and "Mixed Commercial/Residential Use" (mixed-use) properties with (three or less units) provided 50 percent or more of these spaces are used for residential purposes. This includes the following types of primarily residential property: one-, two-, and three-family homes, condominiums of three stories or less that were originally built as condominiums; condominiums of three dwelling units or less that were previously one-, two-, or three-family homes; single-family homes on cooperatively owned land (also known as bungalows); and certain vacant land zoned for residential use or, if not in Manhattan south of 110th Street, vacant land adjoining improved Class 1 property.

- *Class 2*: All other primarily residential properties, including any residential condominiums not in Class 1. This includes co-ops but does not include hotels, motels, or similar property.

- *Class 3*: Real estate of utility corporations and special franchise properties, excluding land and certain buildings.

- *Class 4*: All other properties, such as stores, warehouses, hotels, and any vacant land not classified as Class 1.

Properties are assessed at certain percentages of their full market value based on their classification. In general, Class 1 properties are assessed at six percent of market value and Class 2, 3, and 4 properties are assessed at 45 percent of market value.

The Property Division is responsible for producing a fair, accurate, and legal assessment roll each year. Finance assessors are responsible for valuing properties in their assigned areas. In that regard, assessors assure that properties are assigned to the correct building class and tax class; that physical characteristics of the building, including the square footage, are recorded accurately; and that properties are valued in accordance with assessment roll guidelines and general appraisal rules.

During Fiscal Year 2004, Finance collected $11.4 billion in property taxes. According to Finance records, there were 947,533 taxable properties, consisting of 688,205 Class 1 properties, 179,607 Class 2 properties, 406 Class 3 properties, and 79,315 Class 4 properties.

This is the second of a series of audits currently being conducted on Finance tax classification procedures. The first audit covered the borough of Brooklyn.[1] Audits of Manhattan, Bronx, and Staten Island properties will be covered in separate reports.

**Objective**

The objective of this audit was to determine whether Finance has adequate procedures in place to ensure that mixed-use properties in the borough of Queens that are listed as Class 1 on the assessment rolls are correctly classified.

**Scope and Methodology**

This audit covered tax assessments for Fiscal Year 2005 (July 1, 2004 to June 30, 2005).

In order to fulfill our objective, we reviewed applicable provisions of the RPTL. We met with Finance officials to obtain an understanding of the regulations governing the classification of real property and Finance procedures for ensuring that properties are correctly classified.

Finance provided us with a list of 6,900 Class 1 mixed-use properties in Queens. From the list provided, we randomly selected 1,722 properties in the borough of Queens for review.[2] In September and October 2004, we visited each of the properties to determine whether they were correctly classified. Our determination was based on the percentage of commercial space at each of the properties, since properties with more than 50 percent of the space used for commercial purposes cannot be classified as Tax Class 1—§ 1802 of the RPTL states that "all one, two and three family residential real property, including such dwellings used in part for

[1] Audit Report on the Tax Classification of Real Property in the Borough of Brooklyn by the Department of Finance (FP04-059A), issued August 2, 2004.

[2] The size of the sample was based on our intent to be able to project the sample results at meaningful confidence and precision levels.

nonresidential purposes but which are used **primarily** for residential purposes" are to be classified as Class 1 properties. Properties that are more than 50 percent commercial cannot be considered "primarily for residential purposes." [Emphasis added.] For the properties we noted that were misclassified, we applied formulas provided by Finance to calculate the amount of additional tax due based on the appropriate tax classification for each property.

This audit was conducted in accordance with generally accepted government auditing standards (GAGAS) and included tests of the records and other auditing procedures considered necessary. This audit was performed in accordance with the audit responsibilities of the City Comptroller as set forth in Chapter 5, §93, of the New York City Charter.

**Discussion of Audit Results**

The matters covered in this report were discussed with officials from Finance during and at the conclusion of this audit. A preliminary draft report was sent to Finance officials and was discussed at an exit conference held on March 11, 2005. On March 22, 2005, we submitted a draft report to Finance officials with a request for comments. We received a written response from Finance officials on April 8, 2005.

In its response, Finance stated that it "implemented significant new initiatives and safeguards to ensure adequate procedures are in place to accurately assess all properties in the City of New York." Finance also indicated that it has implemented three of the report's four recommendations, but it did not agree with the recommendation that annual inspections of all Class 1 mixed-use properties and a sample of all other Class 1 properties be conducted to ensure that they are properly classified on the assessment rolls. Finance stated that the law requires only that Class 1 properties be inspected every three years. In any case, Finance indicated that it will be using new technology to complete virtual inspections of 100 percent of properties every year, which is line with the intent of our recommendation.

The full text of the comments received is included as an addendum to this report.

## FINDINGS

Finance does not have adequate procedures in place to ensure that mixed-use properties in the borough of Queens that are listed as Class 1 on the assessment rolls are correctly classified. Although Finance routinely inspects Class 2, 3, and 4 properties to ensure that they are correctly classified on the assessment rolls, it does not conduct such inspections of Class 1 properties. Instead, Finance inspects Class 1 properties only when it is informed by the Department of Buildings that the properties are being altered or renovated.

Based on our inspections, we identified 107 properties listed as Class 1 on the assessment rolls that appeared to be misclassified. Using Finance guidelines, we determined that these properties should have been classified as Class 4. Had these properties been correctly classified, we calculate that Finance would have billed the owners an additional $884,028 in property taxes for Fiscal Year 2005.

***Finance Response:*** In its response, Finance took exception to the amount of additional Fiscal Year 2005 property taxes that the report stated would have been billed to owners had the properties been properly classified. Specifically Finance stated:

"The methodology used . . . to determine the additional tax due for Fiscal Year 2005 contravened the governing statute (RPTL §1805) and case law interpretations of the statute. Real Property Tax Law §1805 requires that all assessment changes, even after a reclassification, be phased in over five years except, assessment changes due to improvements or alterations are not subject to the phase ins.

"Accordingly, the Report grossly overstates that an additional $884,000 in property taxes would have been billed in Fiscal Year 2005. The actual amount is significantly less because State law (RPTL §1805(1) requires that assessment increases be phased in over 5 years. Additionally, since only 82 buildings in the sample are required to be reclassified, the amount of additional taxes collected for the properties identified in this audit is less than $75,000."

***Auditor Comment:*** Although Finance contends that only 82 buildings are to be reclassified and that the amount of additional taxes due for Fiscal Year 2005 is less than $75,000, it did not provide information on which properties it agreed to change to class 4 or when these properties should have been changed. Moreover, Finance did not provide information about any improvements or alterations to the properties, which would have eliminated the requirement for a phase-in period. As Finance pointed out in its response, "the phase in requirement applies in cases of reclassification in the absence of additions or improvement to the property." Clearly, photographs of some of the properties we cited in the audit indicate that these properties underwent major improvements and alterations. Therefore, the phase-in requirement would not be applicable in these cases.

Finance's failure to provide us with the information mentioned above prevented us from determining the validity of the Department's claim that the additional taxes would be less than $75,000. In any case, the salient point is not the amount of money due, rather it is that the properties should be properly classified in accordance with the RPTL.

## Improper Classification of Mixed-Use Properties

Our inspection of the 1,722 sampled mixed-use properties revealed that 72 were misclassified. In addition, during our visits we identified 29 other properties that were misclassified as Class 1 mixed-use that were not in our audit sample. Thus, 101 of the 107 misclassified properties we identified were listed as Class 1 mixed-use on Finance records and should have been listed as Class 4 because more than 50 percent of the properties' space was used for commercial purposes. Had those 101 properties been correctly classified, we calculate that Finance would have billed the owners an additional $853,283 in property taxes for Fiscal Year 2005. Based on the results of our audit sample (72 misclassified properties), we estimate that 289 mixed-use properties were misclassified in the Borough of Queens resulting in underestimated property taxes of $2,368,425.[3]

When we originally conducted our property inspections and issued our preliminary draft, we identified 128 properties that were listed as Class 1 mixed-use on Finance's records but should have been listed as Class 4. We stated that if those properties had been correctly classified, Finance would have billed the owners an additional $1,088,847 in property taxes for Fiscal Year 2005. Moreover, based on the result of our audit sample, we projected that 317 mixed-use properties were misclassified in the Borough of Queens thereby resulting in underestimated property taxes of $2,646,978.

At the exit conference Finance officials asserted and we verified that they reclassified 27 of the 128 properties. As a result, we revised the number of misclassified mixed-use properties to 101 and we are now reporting that the amount of forgone property taxes in Fiscal Year 2005 is $853,283.

While we recognize Finance's efforts to correct its records as recommended in our previous audit of tax classifications in Brooklyn, 101 mixed-use properties still appear to be misclassified in the borough of Queens. Accordingly, we expect that Finance will continue to review all properties that appear to be misclassified and promptly take appropriate action. This, in turn, will ensure that the City bills and collects amounts due from property owners in accordance with the tax laws.

Examples of misclassified properties are as follows:

- <u>110-11 Liberty Avenue</u> was listed on the assessment rolls as a "Primarily Two-Family with One Store or Office" (Tax Class 1, Building Code S2). Our inspection of the property disclosed that the building had a store on the first floor and a photography studio on the second floor. (See Appendix I for a photograph of the property.) Accordingly, Finance should have classified this property as a "Store Building; 2-Story or Store/Office" (Tax Class 4, Building Code K2). For Fiscal Year 2005, Finance billed the owner of this property $2,584 rather than the $10,686 due based on the appropriate Class 4 tax classification.

- <u>89-18 63rd Drive</u> was listed on the assessment rolls as a "Primarily One-Family with One Store or Office" (Tax Class 1, Building Code S1). Our inspection of the property disclosed that the entire building was used as a dental office. (See Appendix II for a photograph of the property.) Accordingly, Finance should have classified this property as a "Professional Building" (Tax Class 4, Building Code O7). For Fiscal

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[3]The precision is +/- 0.82 percent at the 95 percent confidence level for our projection of the number of misclassified properties. In other words, we are 95 percent confident that between 231 and 345 properties were misclassified. The precision is +/- $519,350 at the 95 percent confidence level for our projection of the underestimated property taxes. This means that we are 95 percent confident that the City could have collected additional tax between $1,849,075 and $2,887,775 if all 6,900 properties were correctly classified.

Year 2005, Finance billed the owner of this property $3,861 rather than the $8,478 due based on the appropriate Class 4 tax classification.

- 135-24 Hillside Avenue was listed on the assessment rolls as a “Primarily One-Family with One Store or Office” (Tax Class 1, Building Code S1). Our inspection of the property disclosed that the building had a plumbing business on the first floor and a real estate office on the second floor. (See Appendix III for a photograph of the property.) Accordingly, Finance should have classified this property as a “Store Building; 2-Story or Store/Office” (Tax Class 4, Building Code K2). For Fiscal Year 2005, Finance billed the owner of this property $2,780 rather than the $11,541 due based on the appropriate Class 4 tax classification.

**Improper Classification of Other Class 1 Properties**

During our visits to the sampled properties, we identified six properties that were improperly classified as Class 1 residential that were not in our sample. Had these properties been correctly classified, we calculate that Finance would have billed the owners an additional $30,745 in property taxes for Fiscal Year 2005.

For example, 37-55 91st Street was listed on the assessment rolls as a “Two-Family Residential Building” (Tax Class 1, Building Code B1). Our inspection of the property disclosed that the building was used as a plastic surgery office. (See Appendix IV for a photograph of the property.) Accordingly, Finance should have classified this property as a “Professional Building” (Tax Class 4, Building Code O7). For Fiscal Year 2005, Finance billed the owner of this property $3,120 rather than the $9,111 due based on the appropriate Class 4 tax classification.

As another example, 131-21 Liberty Avenue was listed on the assessment rolls as a “Miscellaneous Two-Family Building” (Tax Class 1, Building Code B9). Our inspection of the property disclosed that the building had an electronics store on the first floor and an office space for rent on the second floor. (See appendix V for a photograph of the property.) Accordingly Finance should have classified this property as a “Store Building; 2-Story or Store/Office” (Tax Class 4, Building Code K2). For Fiscal Year 2005, Finance billed the owner of this property $755 rather than the $11,541 due based on the appropriate Class 4 tax classification.

## RECOMMENDATIONS

Finance should:

1. Inspect the properties identified in this report and confirm whether they are misclassified.

   ***Finance Response:*** “We agree. Finance has inspected all the identified properties and has reclassified properties that Finance agreed were misclassified.”

2. Make the necessary adjustments to the assessment rolls for the properties that are misclassified.

   ***Finance Response:*** "We agree. Finance has made the necessary adjustment to the assessment roll for the properties Finance agreed were misclassified."

3. Seek an opinion from the Law Department as to whether property owners can be billed for additional taxes owed for prior years that were caused by property misclassifications. If it is determined that the additional amounts can be billed, the Department of Finance should bill the owners accordingly.

   ***Finance Response:*** "We agree. On July 23, 2004, the Law Department provided an opinion to Finance which concludes: '. . . the City cannot lawfully bill a taxpayer retroactively for real property taxes imposed following a change in tax class made after the close of the change period defined by section §1512 of the City Charter.' Finance will follow the advice of counsel."

4. Conduct annual inspections of all Class 1 mixed-use properties and a sample of all other Class 1 properties to ensure that they are properly classified on the assessment rolls.

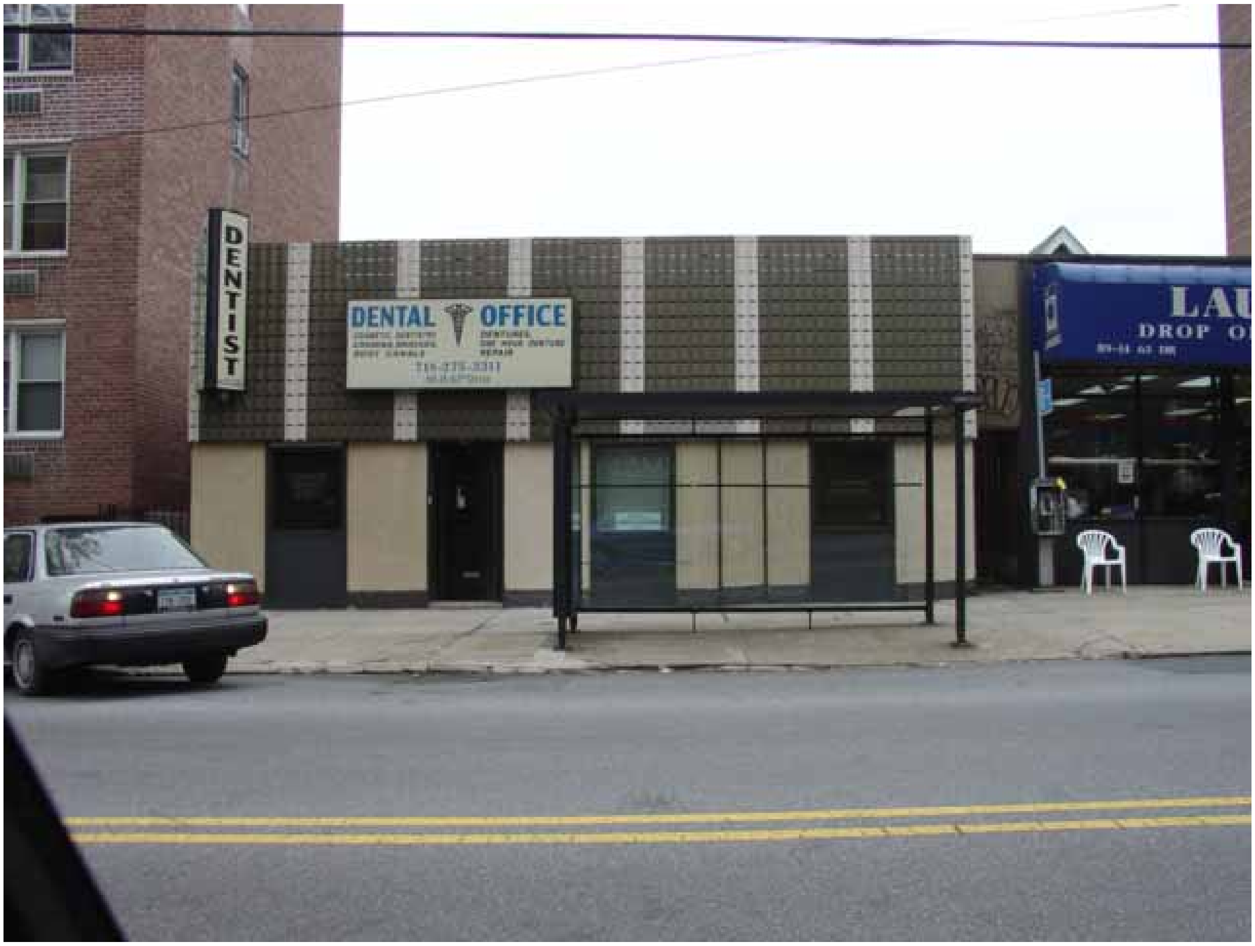
   ***Finance Response:*** "We disagree. By law Finance is only required to inspect Class 1 properties every three years. Finance, through the use of state-of-the-art technology, in effect will be collecting property specific information on an annual basis. Finance is currently working with the Department of Information, Technology and Telecommunication (DoITT) to utilize digital photography data collected from several flyovers of the City that were completed over the last 5 years. Finance will also utilize new technology to obtain digital front face photos of all properties in the City of New York. Together with the flyover pictures and data, these front face photos will change how we do business. The bottom line is that Finance will be completing virtual inspection of all New York City properties every year."

   ***Auditor Comment:*** Our purpose in recommending these inspections is to ensure that properties are properly classified and that the City does not forgo additional property taxes. Therefore, we acknowledge that Finance's using new technologies to complete virtual inspections of 100 percent of properties every year is consistent with the intent of the recommendation.

**APPENDIX I**


<u>110-11 Liberty Avenue:</u> Finance records inaccurately listed this property as a "Primarily Two-Family with One Store or Office" (Tax Class 1, Building Code S2).

**APPENDIX II**



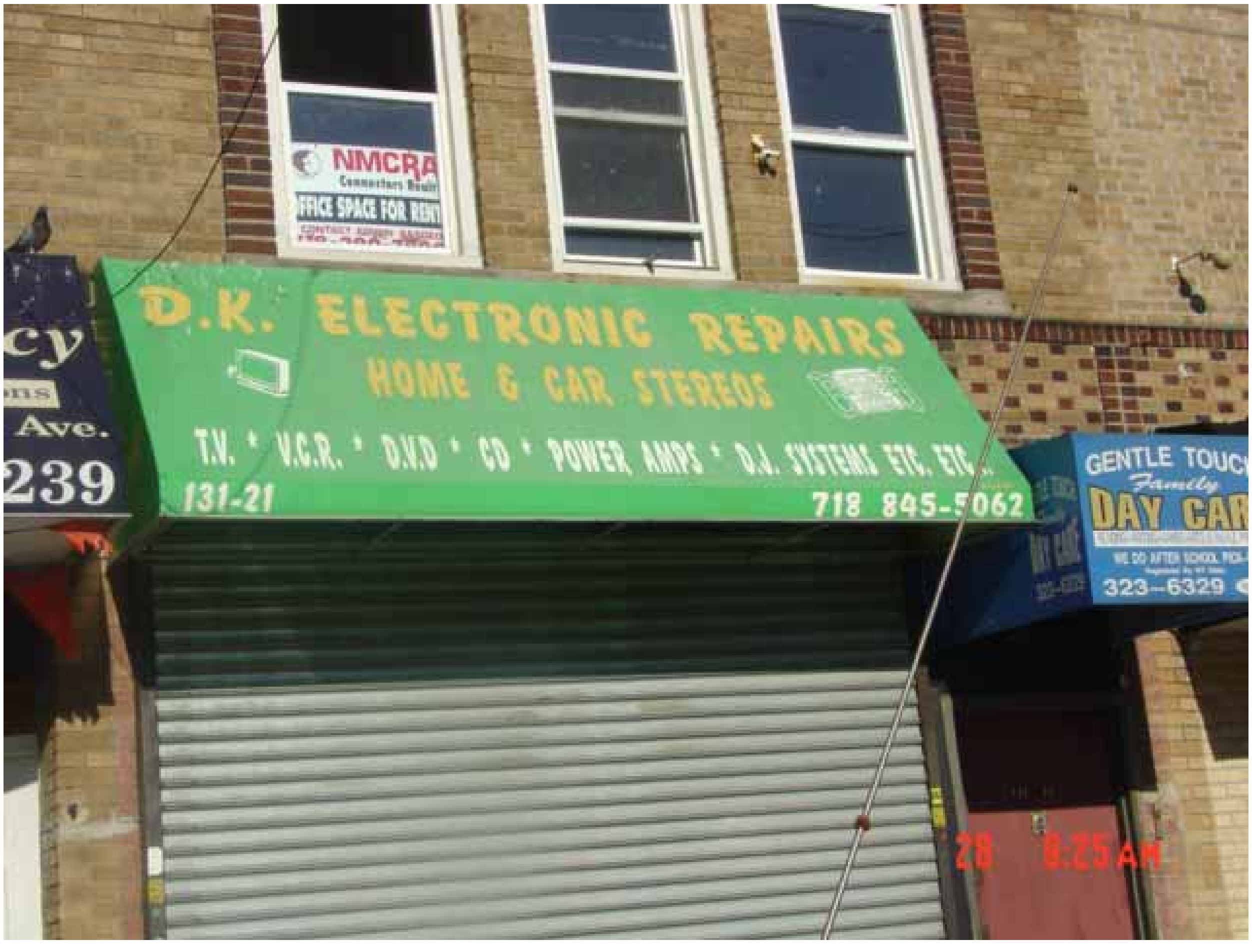

<u>89-18 63rd Drive:</u> Finance records inaccurately listed this property as “Primarily One-Family with One Store or Office” (Tax Class 1, Building Code S1).


<u>135-24 Hillside Avenue:</u> Finance records inaccurately listed this property as "Primarily One-Family with One Store or Office" (Tax Class 1, Building Code S1).

**APPENDIX IV**


<u>37-55 91st Street:</u> Finance records inaccurately listed this property as a “Two-Family Residential Building” (Tax Class 1, Building Code B1).

**APPENDIX V**




<u>131-21 Liberty Avenue:</u> Finance records inaccurately listed this property as a “Miscellaneous Two-Family Building” (Tax Class 1, Building Code B9).

FINANCE
NEW YORK
THE CITY OF NEW YORK
DEPARTMENT OF FINANCE

<u>**HAND DELIVERY**</u>

April 8, 2005

Mr. Greg Brooks
Deputy Comptroller
Policy, Audits, Accountancy & Contracts
Office of the Comptroller
Executive Office
1 Centre Street
New York, NY 10007

**Re: Audit # FP04-149A**
**Draft Audit Report on the Tax Classification of Real Property in the Borough of Queens by the Department of Finance**
**Dated March 22, 2005**

Dear Mr. Brooks,

This letter is the New York City Department of Finance's ("Finance") response to the City of New York Office of the Comptroller ("Comptroller") *Draft Audit Report on the Tax Classification of Real Property in the Borough of Queens by the Department of Finance* ("Report").

At the outset, it is important to note that Finance has implemented significant new initiatives and safeguards to ensure adequate procedures are in place to accurately assess all properties in the City of New York.

ROCHELLE PATRICOF • FIRST DEPUTY COMMISSIONER
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We appreciate the opportunity to review this Report and to comment on the auditor's recommendations. Before addressing the recommendations, however, it is important that we address the oversight by the auditor to properly apply the governing statute's (RPTL §1805) requirements for phasing in tax increases on properties for a change in class in the absence of improvements or alterations. Finance provided a written explanation of the requirements of RPTL §1805 in response to a similar audit issued by your office for properties in the borough of Brooklyn. We will again explain to you how to calculate tax increases for property class changes so that you can accurately capture the correct amounts due in your final report on this audit of the borough of Queens and for the remaining 3 boroughs that you plan on auditing.

The methodology used by the audit staff to determine the additional tax due for Fiscal Year 2005 contravened the governing statute (PRTL §1805) and case law interpretations of the statute. Real Property Tax Law §1805 requires that all assessment changes, even after a reclassification, be phased in over five years except, assessment changes due to improvements or alterations are not subject to the phase ins. There is case law and opinions by the New York State Office of Real Property Services that support Finance's adherence to the requirements of RPTL §1805, *to wit,* the phasing in of property taxes triggered by a reclassification of the property:

> As to an assessment increase resulting from a classification change, it has been explicitly held that such increase is *not* within the scope of division five (*Nuzzolese v. Board of Assessors, County of Nassau*, 172 A.D.2d 611, 568 N.Y.S.2d 149 (2nd Dept. 1991)). Such an increase must therefore be phased in over five years using transition assessments, as provided by subdivision three.[1]

Thus, the phase in requirement applies in cases of reclassification in the absence of additions or improvement to the property (RPTL §1805(5)). Accordingly, the Report grossly overstates that an additional $884,000 in property taxes would have been billed in Fiscal Year 2005. The actual amount is significantly less because State law (RPTL §1805(1)) requires that assessment increases be phased in over 5 years. Additionally, since only 82 buildings in the sample are required to be reclassified, the amount of additional taxes collected for the properties identified in this audit is less than $75,000.

[1] Volume 9: Opinions of Counsel SBRPS No. 60.

The Report suggests that Finance implement four recommendations. Below are the recommendations made in the Report, and Finance's comments:

Recommendation 1:
Inspect the properties identified in this report and confirm whether they are misclassified.

**Finance's Response:**
We agree. Finance has inspected all the identified properties and has reclassified properties that Finance agreed were misclassified.

Recommendation 2:
Make the necessary adjustments to the assessment rolls for the properties that are misclassified.

**Finance's Response:**
We agree. Finance has made the necessary adjustment to the assessment roll for the properties Finance agreed were misclassified.

Recommendation 3:
Seek an opinion from the Law Department as to whether property owners can be billed for additional taxes owed for prior years that were caused by property misclassifications. If it is determined that the additional amounts can be billed, the Department of Finance should bill the owners accordingly.

**Finance's Response:**
We agree. On July 23, 2004, the Law Department provided an opinion to Finance which concludes: "...the City cannot lawfully bill a taxpayer retroactively for real property taxes imposed following a change in tax class made after the close of the change period defined by section §1512 of the City Charter." Finance will follow the advice of counsel.

Recommendation 4:
Conduct annual inspections of all Class 1 mixed-use properties and a sample of all other Class 1 properties to ensure that they are properly classified on the assessment rolls.

**Finance's Response:**
We disagree. By law Finance is only required to inspect Class 1 properties every three years. Finance, through the use of state-of-the-art technology, in effect will be collecting property specific information on an annual basis. Finance is currently working with the Department of Information,

Technology and Telecommunication (DoITT) to utilize digital photography data collected from several flyovers of the City that were completed over the last 5 years. Finance will also utilize new technology to obtain digital front face photos of all properties in the City of New York. Together with the flyover pictures and data, these front face photos will change how we do business. The bottom line is that Finance will be completing virtual inspection of all New York City properties every year.

If you have any questions concerning this response, please feel free to call me at (212) 669-4878.

Sincerely,

Carla Van de Walle
Senior Director
Internal Audit & Special Projects

cc: Martha E. Stark, Commissioner, Department of Finance
Susan Kupferman, Director, Mayor's Office of Operations