

**Recommendations
of the 421-a
Task Force**



**New York City
Department of Housing Preservation
and Development**
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421-a Reform: Executive Summary

Introduction

The 421-a real property tax exemption was created in 1971 and has helped fuel the construction of over 110,000 apartments in New York City. In the twenty-five years since the program's inception, however, the environment for housing development has changed dramatically. Our robust housing market provides an historic opportunity to strengthen the connection between the 421-a Program and the development of affordable housing.

On February 23, 2006, Mayor Michael R. Bloomberg announced the formation of a task force to examine the 421-a Program. Members of the real estate, affordable housing, advocacy, and non-profit communities joined the Department of Housing Preservation and Development, the Office of Management and Budget, the Department of Finance, and Department of City Planning to evaluate the 421-a program and to realign it with today's real estate market, focusing on increasing incentives for the creation of affordable housing.

Between April and October 2006, Task Force members met to examine potential policy options. Staff from the Department of Housing Preservation and Development, the Department of Finance, and the Office of Management and Budget worked together to provide the Task Force members with background information and the analysis necessary to fully evaluate the assets and constraints of the existing 421-a Program.

Each Task Force member participated in one of two smaller working groups representing the two major components of 421-a— the Partial Tax Exemption and the Affordable Housing (or Negotiable Certificates) programs (each program is explained in detail in the attached appendix). The working groups came together to provide further insight into these components and to facilitate the evaluation of the key aspects of each component. The Partial Tax Exemption working group examined the geographic requirements, terms, and level of the tax benefit. The 421-a Affordable Housing Program working group evaluated the efficiency of the negotiable certificates by reviewing their utilization and value generated for the production of affordable housing.

Rationale for Reform

421-a was initially established in an environment of declining property values and a dearth of development activity. The incentive was intended to stimulate new development during a period of slow housing production and declining population citywide. As New York City's housing market began to rebound in the 1980's, changes were made to 421-a that not only helped strengthen the market, but that also encouraged the development of affordable housing. Most significantly, the 421-a Affordable Housing Program was created, for the first time linking the development of affordable housing with tax incentives for market-rate housing.

The market has continued to grow, with levels of housing production not seen for the past three decades, and 421-a benefits are no longer required to stimulate market rate development in certain neighborhoods. The current market provides a historic opportunity not just to provide benefits where they are needed, but also to place greater emphasis on encouraging the development of affordable housing through the 421-a Program. However, the Task Force also recognizes that New York City continues to face a significant housing shortage. Therefore, changes to 421-a must be carefully calibrated to ensure housing production remains economically feasible throughout the City, particularly if the market weakens in the coming years.

Summary of Key Recommendations

Building on the information gathered during the 421-a Task Force meetings, a consensus has emerged around a framework for actions that will appropriately modify 421-a. This framework can reposition the 421-a Program to reflect the current real estate development environment by continuing to maintain incentives for certain areas and housing types in need of continued stimulus, while leveraging greater resources for the production of affordable housing. In addition, the Task Force recommendations can shape a 421-a program that will provide appropriate incentives at any phase of the real estate cycle.

The Taskforce recommends six key programmatic and policy changes to the 421-a Program:

Expand the Geographic Exclusion Area (GEA). Within the GEA, developments are required to provide affordable housing in exchange for 421-a tax benefits. The boundaries were initially established in the mid-1980's within neighborhoods that, at the time, were home to the City's strongest housing market. In 2005 and 2006, in conjunction with major rezonings along the West Side of Manhattan as well as in Greenpoint-Williamsburg in Brooklyn, the GEA was expanded to include these high-growth areas. The Task Force has agreed that further expansion of the GEA into Lower Manhattan, parts of Harlem, DUMBO, Brooklyn Heights, and a large section of the Brooklyn and Queens waterfront could harness substantial resources for affordable housing without compromising the strong housing market in these areas.

Remove automatic extended tax benefits from developments within Neighborhood Preservation Program (NPP) areas and areas eligible for Rehabilitation Mortgage Insurance Corporation (REMIC) loans. Developments within a targeted group of neighborhoods are currently eligible to receive the maximum 421-a benefit—twenty-five years—without providing affordable housing. However, elsewhere in the City, only developments providing affordable housing can receive the twenty-five year benefit. The Task Force feels strongly that incentives for affordable housing should be provided citywide, and therefore recommends the removal of automatic extended benefits from developments built within the NPP and REMIC areas (please see attached map). The Task Force agrees that the market has improved enough to allow developments in these neighborhoods to receive standard fifteen-year 421-a tax benefits unless providing affordable housing.

Set a cap on Assessed Value (AV) eligible for 421-a tax benefits. The Task Force recommends setting a limit on the total amount of tax benefits that any market rate unit may receive. A cap of \$100,000 would be placed on the portion of the AV receiving 421-a tax exemption. A unit with exempt AV above the cap would pay taxes on the share of AV above the cap, but would still receive tax benefits for the exempted value under the cap. Projects providing affordable housing on-site would not be subject to the cap. A limit on the total amount of tax benefit any market rate project can receive serves as a proxy for expanding the GEA to high-value projects within areas of the City in which development is not consistently strong. This would in turn increase the incentive for affordable housing in these areas without threatening needed development. The cap would grow at 3% per year so the share of new units subject to the cap over time would remain roughly the same as it is now.

Increase the Minimum Number of Units for 421-a Eligibility. The Task Force reached agreement on reserving 421-a tax benefits for projects with a minimum of six units, up from the current minimum of three units. Properties with fewer units are already tax advantaged relative to other properties because they are assessed at lower rates than are larger developments. Furthermore, smaller properties are typically owner-occupied, and have trouble complying with the regulatory and administrative requirements associated with the 421-a Program.

Eliminate the Negotiable Certificate Program if a Dedicated Fund for Affordable Housing Can Be Created. The Task Force evaluated two policy options as alternatives to the current 421-a Affordable Housing (Negotiable Certificate) Program. Given the many inefficiencies inherent to the certificate program, the Task Force believes that the better option would be to eliminate the certificate program. However, the Task Force is concerned about the loss of revenue for affordable housing provided by the certificate program, whose funding is not subject to annual appropriations. Therefore, the Task Force believes that elimination of the program is only appropriate if a fund for affordable housing can be established with adequate funding that is insulated from the appropriation process. If such a fund cannot be established, the Task Force recommends modifying the certificate program through programmatic changes that would better leverage funds for affordable housing by increasing the price of certificates.

Review methods and practices for assessing residential properties. Because of constraints due to New York State law, property tax assessments can vary widely between different property types and locations. There was much discussion among Task Force members about the uncertainty that the current law brings to the assessment process and therefore to the marketplace. Consequently, the Task Force recommends that the current methods and practices for assessing residential properties be reviewed. The Administration agrees that assessing properties in a transparent and consistent way would be a significant and important benefit for the City. The Administration will work closely with the industry to examine this issue more fully.

Conclusion

These policy proposals would significantly modify the existing 421-a Tax Exemption Program and 421-a Affordable Housing Program. The proposed changes would encourage the development of affordable housing and significantly increase tax revenues while minimizing any negative impact on the strong level of development throughout the City.

The Task Force agrees that the savings generated by the modification of the 421-a Program should be used to expand the City's affordable housing resources. When Mayor Bloomberg announced the formation of the Task Force, he committed \$200 million in additional funding for the New Housing Marketplace Plan based on expected savings from the reform of the 421-a program. The Task Force believes the savings generated by the proposed changes to 421-a will significantly exceed \$200 million. The bulk of the additional savings would result from the elimination of the Certificate Program; if this program were eliminated, the Task Force recommends that savings be replaced with a dedicated fund for affordable housing that, like revenue from the Certificate Program, would be insulated from the annual budget appropriations process.

In addition to increasing the City's tax base and boosting resources for affordable housing, these programmatic changes would produce substantial social benefits. By creating incentives to produce on-site affordable housing, the new program can improve economic integration within New York City through mixed income developments. By making more funds available to a wider set of affordable housing developers that are protected against economic volatility, more affordable housing can be produced with the same resources. Furthermore, the changes would limit tax incentives to primarily those properties that require benefits for economic feasibility. The Task Force believes that these six major recommendations, if implemented, would shape this tax benefit program to better reflect current and future market conditions throughout the City to the benefit of all New Yorkers.

421-a Reform Recommendation: Expand the Geographic Exclusion Area

Recommendation: Expand the Geographic Exclusion Area (GEA) to high-value neighborhoods with high densities

Rationale

Within the boundaries of the GEA, new construction residential development projects are not entitled to any 421-a tax benefits unless they provide affordable housing either on- or off-site. The GEA was created in 1985 to encourage the development of affordable housing; the original boundaries (roughly 14th Street to 96th Street in Manhattan) were established due to the consensus that market-rate projects in the core of Manhattan did not require tax incentives to spur development.

In 2005 and 2006, the original GEA boundaries were expanded to include several new neighborhoods, including Hudson Yards and West Chelsea in Manhattan and the Greenpoint-Williamsburg waterfront in Brooklyn.

Inside the Manhattan GEA, a project can receive a twenty-year 421-a benefit if it includes an on-site affordable component or it can receive a ten-year benefit if it purchases 421-a Negotiable Certificates.

In the GEA along the Greenpoint-Williamsburg waterfront, a project can receive a twenty-five-year 421-a tax benefit if it includes on-site affordable units; a project can receive a fifteen-year tax exemption if it creates off-site affordable units elsewhere in Community Board 1. No more than two hundred off-site units may generate this fifteen-year tax benefit.

Outside the GEA, new construction projects are entitled to between ten and twenty-five years of 421-a benefits, depending on the location and level of affordability.

Recognizing that the real-estate market throughout New York City neighborhoods has changed since the GEA was first established, the Task Force recommends the expansion of the GEA boundaries to include neighborhoods with substantially high real estate values and significant zoning density. The presence of these two factors is sufficient to encourage development of market-rate housing without providing 421-a tax benefits.

To determine appropriate boundaries for a newly expanded GEA, HPD conducted financial analysis on returns to developers in neighborhoods across the City. This analysis was cross-referenced with maps documenting neighborhoods with significant numbers of housing starts and with zoning maps outlining current densities. The analysis demonstrated to Task Force members where development would be feasible without the tax benefits. This analysis yielded new GEA boundaries that include parts of Harlem, Lower Manhattan, DUMBO, Brooklyn Heights, and segments of the Brooklyn/Queens waterfront. A map of these areas is attached.

The duration of tax benefits would continue to be determined by the same geographic boundaries that are currently in place. In Manhattan below 110th street, a project would continue to be eligible for a twenty-year benefit if it provides affordable housing and would be eligible for a ten-year benefit if it purchases negotiable certificates. In the expanded GEA above 110th Street in Manhattan and in Brooklyn and Queens, projects could receive twenty-five year benefits if providing affordable housing on-site or fifteen-year benefits if purchasing negotiable certificates.

If the certificate program is eliminated, all projects in the GEA would pay full property taxes unless providing affordable housing on-site.

421-a Reform Recommendation: Remove 25-year NPP and REMIC area exemption term

Recommendation: Remove eligibility for developments within NPP and REMIC areas to receive extended benefits without providing affordable housing.

Rationale

The Neighborhood Preservation Program (NPP) areas and areas eligible for Rehabilitation Mortgage Insurance Corporation (REMIC) loans were established in the early 1970's to concentrate development activity in targeted neighborhoods in need of improvement (a map of these areas is attached). This includes many now-thriving neighborhoods, such as Williamsburg in Brooklyn, Jackson Heights in Queens, and much of Harlem. Within these areas, all developments are eligible for an extended twenty-five year 421-a tax benefit, while elsewhere in the City, only projects providing affordable housing can receive the twenty-five year benefit.

Based on analysis by the Task Force, extended benefits are no longer needed in these neighborhoods to encourage market-rate development. Market-rate developments would instead receive the standard fifteen-year benefit. The extended twenty-five-year benefit should be used as an incentive to encourage affordable housing development in these neighborhoods as it is throughout the rest of the City.

Since many of the neighborhoods outside the GEA are NPP and/or REMIC areas, eliminating this twenty-five year benefit for market rate development would create a substantial new incentive for development of on-site affordable housing throughout much of New York City.

421-a Reform Recommendation: Establish an AV Cap

Recommendation: *Set a per unit cap of \$100,000 on the portion of the Assessed Value (AV) eligible for the 421-a tax exemption*

Rationale

New York City has many neighborhoods with concentrations of high-value properties, but with overall sales prices and densities too low for inclusion in the Geographic Exclusion Area. Instead of further expanding the Geographic Exclusion Area into neighborhoods where a complete elimination of tax benefits could dampen private middle-income development, setting a citywide cap on 421-a tax benefits is an effective alternate method of limiting benefits to projects that can remain profitable, even while paying some property taxes.

A cap on the per unit 421-a exemption serves to reduce the excess tax benefit that accrues to high value properties. It also serves to reduce the risk of future excess benefits in areas outside the expanded GEA. A cap on the total amount of tax benefits received by each project would preempt overuse of tax subsidy while minimizing the risk of dampening development. Furthermore, for the high value properties, the Assessed Value (AV) cap provides an increased incentive for on-site affordable housing development because developments providing affordable housing on-site would not be subject to the cap.

The AV cap calculation would be triggered for properties with AV greater than \$100,000 per unit. The AV cap would limit a property's 421-a tax exemption per unit to \$100,000 in Billable Exempt AV, i.e., the increase in AV due to the new construction. A property owner with Billable Exempt AV greater than the cap of \$100,000 per unit would pay taxes on the increment of AV above the cap. However, the project would still receive benefits for the exempted value up to the cap. To provide certainty going forward, the AV cap would be raised by 3% per year.

Currently, an AV of \$100,000 is roughly equivalent to a sales price of \$1,000,000 for a condominium or cooperative apartment.

Of all properties that began receiving 421-a benefits between 2004 and 2006,

- 15% would have been affected by the cap;
- 57% of the affected properties are condos

A cap based on assessed value is an administratively feasible benefit limitation test. The Task Force considered sales price as an alternative limitation, but ruled it out for several reasons. First, sales price is easy to circumvent through long-term leases and through immediate resale. Second, taxes are not calculated based on sales price; therefore, it would be difficult to determine how to limit taxes in response to higher sales prices.

421-a Reform Recommendation: Increase the Minimum Number of Units

Recommendation: Increase the minimum number of units required to qualify a building for 421-a to six.

Rationale

The current 421-a program allows projects that contain three or more units to qualify for 421-a benefits. Properties with fewer than six units account for approximately 59% of new buildings but only 12% of all new units receiving 421-a tax benefits.

These properties are usually owner-occupied and often have difficulty complying with the regulatory and administrative requirements associated with 421-a. In addition, by law, small properties, particularly those with three or fewer units, are assessed at lower rates than are larger properties. Removal of 421-a benefits for this property type is consistent with recent property tax benefit changes, such as the elimination of the 421-b program.

Financial analysis has shown that removal of tax benefits will not be detrimental to the development of three- to five-unit buildings. Three-unit buildings are already assessed at a lower rate than are multiple dwellings, so removal of this tax benefit does not significantly lower the returns to development. The returns to four- and five-unit buildings (which comprise only 2% of all units newly receiving 421-a tax benefits) only minimally decrease without 421-a benefits.

Despite the limited impact of the proposed change on the feasibility of developing these small properties, the Task Force did have some concerns about the effect the elimination of benefits would have on the affordability of homeownership. However, analysis has shown that the household income required to purchase and maintain smaller-unit properties does not increase substantially with the elimination of 421-a. Furthermore, given the lack of price or income limitations in the 421-a Program for these types of properties, the Task Force agreed that homeownership incentives would be better achieved through down-payment assistance and other targeted programs.

421-a Reform Recommendation: Negotiable Certificate Program Options

Recommendation: *Eliminate the Negotiable Certificate Program if a Dedicated Fund for Affordable Housing can be established.*

Rationale

A dedicated fund for affordable housing would provide a more efficient mechanism of directing funds for affordable housing development than does the negotiable certificate program. A dedicated fund would lead to broader participation in the affordable housing market and a more efficient allocation of limited resources than would continuing the existing certificate program.

The 421-a Affordable Housing Program was created in 1985 along with the initial boundaries of the Geographic Exclusion Area (GEA). New housing construction within the GEA can only receive 421-a tax benefits if the developer provides affordable housing on-site, thereby qualifying for extended benefits, or off-site through the purchase of negotiable certificates. Each affordable housing unit created off-site generates between four and six certificates, each of which can grant one market-rate unit within the GEA ten years of 421-a tax benefits. Since its inception, the program has created about 5,500 affordable housing units and has granted tax benefits to over 28,000 market-rate units within the GEA.

Affordable housing developers use certificates to generate equity, usually in conjunction with tax-exempt bond financing. Certificates are sold on the private market at prices ranging between \$11,000 to over \$20,000. Meanwhile, the ten-year tax exemption is worth, on average, over \$100,000 in lifetime tax benefits to each market-rate unit in the GEA that purchases certificates. The certificate program thus leverages only between 15% and 20% of the value of the tax benefit for affordable housing.

The certificates are sold through private transactions between the affordable housing developer and the market-rate developer, creating an inherent risk for both parties. The market-rate developer depends on the affordable housing to complete construction before he can receive tax benefits; he responds to the risk of non-completion by both lowering the optimal purchase price and by paying the bulk of the price only upon completion. Because the affordable housing developer must have sufficient resources for construction until his certificate equity comes in, and because certificates are generally not all sold before construction completes, the pool of affordable housing developers who can use the certificate program is very small. The program additionally favors developers with well-established networks who know how to navigate the program, since most affordable housing developers do not have the networks to connect to market-rate certificate purchasers.

Eliminating the certificate program would require the market-rate developer to pay full taxes unless providing affordable housing on-site. This would capture the tax revenue previously lost through the gap between the certificate revenue and the tax benefit granted; the increased tax revenue would leverage greater resources that could be directed to affordable housing. Requiring market-rate developments to pay full property taxes will also encourage development of on-site affordable housing within the GEA.

Because the certificate program currently provides a stream of affordable housing resources not subject to the annual appropriation process, Task Force members are concerned about establishing an appropriate source of replacement funding. A dedicated fund for affordable housing would need to be carefully constructed in order to protect it from the volatility of the appropriation process.

In the event that a dedicated fund cannot be guaranteed, the Task Force has determined that the certificate program should still be modified in order to increase the funding for affordable housing.

Most existing 421-a certificate projects contain units that are affordable to families at or under 60% of Area Median Income (AMI) and that generate 5 certificates per unit. Many projects also set aside a portion of their units for formerly homeless tenants—such units currently generate 6 certificates each. A very small number of projects have generated housing affordable to families at an average income of 80% AMI—such units currently generate 4 certificates each. This last option has rarely been used, primarily because the higher rent cannot cover the additional equity required when tax credits are not used. The four certificates alone have historically generated less than \$60,000 per unit toward construction.

Changing the ratios for affordable housing certificates would increase the minimum certificate price. The ratios would also encourage the creation of both low- and moderate-income housing. The following outlines the ratio changes:

- 3 certificates for each unit below 60% of AMI. Project developed with tax credits;
- 5 certificates for each unit between 60% and 80% of AMI;
- 4 certificates for each unit between 80% and 100% of AMI

These changes would likely yield certificate prices of \$24,300 to \$25,400.

While these prices are still well below the value of the 421-a tax benefits received by certificate purchasers, the changes would increase the resources for affordable housing without dramatically reducing the willingness of potential certificate purchasers to participate in the 421-a Affordable Housing Program. Certificate prices would increase to about a third of the lifetime tax benefit for a market-rate unit in the GEA, even assuming a cap on tax benefits through limiting the amount of assessed value eligible for 421-a. Compared to eliminating the certificate program, two-thirds of potential tax revenue would still be lost for affordable housing production.

The following steps would address the high transaction costs and increase the transparency of the program:

First: Eliminate the requirement that market-rate units must purchase one certificate for every 1,200 square feet. Regardless of the size of a unit, one negotiable certificate may generate 421-a benefits for one market-rate unit. An AV cap would ensure that tax benefits do not diverge too vastly depending on the size and location of the market-rate unit, but may result in the sale of fewer certificates.

Second: Minimize transaction risks by allowing developers to sell certificates prior to completing construction by bonding the remaining cost of construction. Projects would need to be 80% complete in order to bond and developers would be required to bond 150% of the remaining construction costs.

While the Task Force believes that replacing the certificate program with a secure, dedicated fund for affordable housing would best leverage funding toward affordable housing, modifying the certificate program should capture some additional value for affordable housing from the 421-a benefits. Therefore, if the Certificate Program is eliminated, the dedicated fund established to replace it should capture the level of funding that would be generated by an improved Certificate Program.