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421-a: A Taxing Issue

From attracting jobs to preserving historic structures, tax forgiveness has been a critical tool for policymakers seeking to attract and influence the investment of private capital. Nowhere has this tool been more effectively used than in New York City's efforts to preserve and expand its housing stock. Since its inception, the 421-a partial tax exemption has helped to create over 124,000 units of housing, more than 5,500 of which have been made available to low-income households through the Negotiable Certificate Program.

The housing industry has been dependent upon some form of tax relief in large part to ameliorate flawed real estate assessment policies. By taxing multi-family buildings at levels that consume an undue proportion of forecasted incomes, lenders and developers are discouraged from investing in new multi-family construction. For individual owners, even when unit size and neighborhood location are comparable, cooperative and condominium apartments are often taxed significantly more than are single-family homes and other Class 1 residential dwellings.

The challenge for policymakers is to provide just enough tax forgiveness to achieve desired results while avoiding the prospect of giving away more than is required. This is far more an art than a science and the Administration's 421-a Task Force deserves a great deal of credit for attempting to reconfigure the program to do just that.

Below-Market Mandates

Over the course of the recent debate, some housing advocates have called on the City to use 421-a tax incentives to compensate for affordability gaps in neighborhoods across the City. Going far beyond the Administration's Task Force recommendations, some have called for mandates that up to thirty percent of all units be affordable to households earning no more than 50 percent of the area median income (AMI), or $35,000 per year. This would mean that rents for a family of four could be no more than $885 per month. Only such a proposal, it is urged, would go far enough in countering the effects of rising market pressures in many neighborhoods.

Unfortunately such requirements, while intending to capture excess value and direct it toward the construction of affordable housing, would in fact have many unintended and adverse consequences. While the specter of big developers getting tax breaks from building luxury housing in Manhattan drives much of the debate surrounding 421-a, neighborhoods like Bedford Park and Corona stand to lose the most if such sweeping changes are broadly applied.

An increase in the cost of constructing housing will result in higher costs being passed on to the end renter or purchaser, or where the market is not able to absorb such increases, projects simply will not be built. For example, in Fordham-University Heights, market rents considerably pinch neighborhood incomes and there is a significant unmet demand for more adequate housing. Nearly 40 percent of households already pay more than 50 percent of their income for rent or reside in a building with five or more maintenance deficiencies. Requiring that all new construction set aside 20 percent of units for low-income households will increase the amount that the other 80 percent of families pay for housing. And if new housing production ceases altogether, even more families will be consigned to inadequate housing conditions.

In many areas of New York City, the market, seen as too high, is not in fact high enough to provide the kind of cross-subsidy that such a mandated requirement would depend upon in the absence of deeper subsidies. Neighborhoods with the lowest median household incomes already typically require more subsidies than tax forgiveness alone to encourage new housing construction. A one size fits all strategy that mandates below-market housing citywide through 421-a runs the risk of depriving those neighborhoods most in need of quality housing.

In stronger, middle-income housing markets, encompassing neighborhoods such as Briarwood and Bay Ridge, there is an equal risk of curtailing new construction. CHPC analysis of a 28-unit project recently constructed on Northern Boulevard in Corona found that current market rents of $1,600 per month for a two bedroom apartment would be insufficient to cross-subsidize below-market units, even with 421-a benefits. Current market rents are affordable to about 40 percent of Corona households, meaning that without the mandated inclusion of low-income units, all 28 apartments would be affordable to households earning about $54,000.

In order to ensure that six of the units (20 percent) would be affordable to renters earning no more than 80 percent of AMI, new market-rate rents would need to be increased by 25 percent, or $400 a month. Were rents to increase to this degree, only about 25 percent of current Corona residents (those households earning at least $69,000) could afford the 22 new "market-rate" units, while the six low-income units would be rented to those households with incomes of up to $50,000. Though well intentioned, the mandated inclusion of low-income units without the provision of deeper subsidies will only exacerbate existing affordability gaps.

Task Force Overview

The Task Force has wisely recognized that such a sweeping inclusion of below-market housing, without regard to individual neighborhood markets, would only thwart the development of new housing or raise prices for working families. Instead their recommendations focused on four key areas: the expansion of the Geographic Exclusion Area (GEA), the elimination of the certificate program in favor of a dedicated fund; the elimination of the deepest as-of-right benefits from Neighborhood Preservation Program (NPP) and Rehabilitation Mortgage Insurance Corporation (REMIC) eligible areas, and the elimination of benefits for multiple dwellings with less than six units.

Expanding the GEA

Perhaps the most conspicuous of proposed Task Force changes is an expansion of the GEA. Neighborhoods within the GEA are considered strong enough so as not to require as-of-right tax exemptions in order to spur market-rate housing construction. Instead developers have the option of including affordable units on-site, or purchasing negotiable certificates to finance affordable construction off-site.

The original boundaries, first drawn in 1985 when the City's real estate market seemed safely removed from the crisis conditions of the 1970s, did not foresee the explosion of residential value in areas like Soho, nor did they anticipate the reconfiguration of the City's old industrial waterfront. The GEA should not be overextended simply to counteract the perceived exclusionary effects of increasing real estate values, but redrawing these boundaries to capture new high market areas makes sense.

Eliminating Negotiable Certificates

While expanding the GEA is advisable, eliminating the Negotiable Certificate Program, as the Task Force has recommended, will negate some of the primary benefits of doing so. Instead of having an increased number of GEA developments funding off-site, low-income housing units in high-need neighborhoods, direct housing subsidies would likely be needed to create low-income on-site units in high value areas.

There is certainly much about the certificate program that falls short of expectations, but replacing it with a dedicated fund, which as has been suggested will amount to approximately $300 million over ten years, is not a sound alternative. It is not clear how much subsidy per unit the proposed fund would provide, but a number higher than 3,000 units over ten years seems improbable. Should a fund ultimately be established, we recommend that 80 percent of it be reserved for the high-need neighborhoods that stand to lose the most from elimination of the Negotiable Certificate Program.

The certificate program, even without improvements, has already proven itself an effective tool for creating low-income housing. In the last two years alone, certificate generated equity has produced over 2,000 units of low-income housing. Jackson Development Group recently closed on a 66-unit project on Intervale Avenue in Morissania, affordable to households with incomes below 80 percent AMI. Without the sale of negotiable certificates the project would not have been possible.

Eliminating the Negotiable Certificate Program would also eliminate the possibility of off-site affordable housing. While on-site affordable housing can be advantageous when cross-subsidization from market-rate units makes it possible, it is far more costly than off-site options. 421-a alone, however, is not a powerful enough incentive to make inclusion feasible in most moderate-income neighborhoods. CHPC believes that removing the off-site option would only serve to redirect scarce housing subsidies from high-need communities to high market neighborhoods within the GEA.

This trend is already evident in Greenpoint-Williamsburg, where tax exemptions and zoning bonuses alone are proving insufficient for meeting inclusionary mandates. Without deep government subsidies, it is unclear how many of the projects on the Greenpoint-Williamsburg waterfront will move forward. Eliminating the possibility of using high value development to leverage affordable housing production in lower value markets would curtail new housing production and increase affordability gaps.

The Task Force did recommend improvements to the program in the event that a fund is not created. Its suggestions include changing the ratio of certificates for every one low-income unit from five to three. This alone would vastly improve its productivity. In order to increase the value and competitiveness of the certificate program, however, the City should go beyond this by regulating the number of certificates issued each year and setting a minimum price for their purchase.

In addition, consideration should be given to utilizing one of New York City's not-for-profit housing intermediaries, like the Housing Partnership, or even the New York City Housing Development Corporation, to act as a bank for certificates. This would insure that low-income units are built in a timely way, full value is achieved for the certificates, and the pool of developers involved in the program (which could include greater involvement of not-for-profit developers) is expanded. Furthermore, the certificate program should be targeted to those communities most in need of low-income housing.

Ironically at a time when expanding the GEA seems universally supported and the certificate program has the potential to increase in productivity, the Task Force is recommending its elimination. By improving the certificate program, more low-income units can be generated in neighborhoods throughout the City without a direct outlay of government funds. Rather than doing away with a valuable program, we recommend increasing its value and competitiveness so that new housing will continue to be built.

Eliminating 25-Year As-of-Right Exemptions

The Task Force has recommended eliminating the deepest level of as-of-right, 421-a benefits from weaker market neighborhoods throughout the outer boroughs. Admittedly, the current NPP and the REMIC zone boundaries are outdated, but rather than proposing to redraw them, the Task Force has recommended eliminating them altogether. Doing so would mean that neighborhoods like Bedford Park and Brownsville would receive the same tax breaks as Riverdale and Park Slope.

In some neighborhoods, new market-rate housing is only possible with the extended 25-year benefits. One recently completed, moderately priced 8-unit development on Fulton Street in East New York which did receive the as-of-right, 25-year benefits would have required the developer to contribute nearly $20,000 more per unit in equity without the benefits, making it unlikely that it would have ever been built.

For residents moving into these developments, it will be 15 years rather than 25 years before full taxes are due. The more critical factor, however, is the way in which buildings are financed. Since the present value of the 25-year tax exemption is greater now than in the future, it can help to increase loan-to-value ratios. When that ratio decreases, as it would with only 15-year tax incentives, projects are at risk of not being financed.

The as-of-right, 25-year benefits are especially important to the Bronx, Brooklyn, and Queens. Currently 85 percent of all units with 25-year benefits are located outside of Manhattan. In the Bronx, 70 percent of all 421-a exemptions are 25-year. To avoid eliminating projects in these high-need areas, we recommend establishing new boundaries for areas with the weakest housing markets.

Such boundaries should be easily ascertainable, perhaps corresponding to HUD's newly revised Community Development Block Grant program eligibility tracts, or a similar indicator. Alternately, extended as-of-right eligibility could be applied to all Bronx Community Boards excepting 8, Brooklyn Community Boards 4, 5, and 16, Manhattan Community Board 12, and Queens Community Boards 10 and 12.

421-a Benfits by Exemption Period, FY 2006

	10-year	15-year	20-year	25-year	Total
Bronx		1,833		4,110	5,943
Brooklyn		11,975		5,921	17,896
Manhattan	16,010	1,090	15,001	2,698	34,799
Queens		6,376		5,017	11,393
Staten Island		1,061		526	1,587
NYC	**16,010**	**22,335**	**15,001**	**18,272**	**71,618**

Source: NYC Independent Budget Office's Multiple-Dwelling File based on Finance Department's Real Property Assessment Database; calculations by CHPC

Eliminating Under Six Benefits

Currently the majority of 421-a exemptions go to large-scale projects. Benefits, however, are allowed for small three, four, and five unit projects. While this category of construction is small by Manhattan standards, it is often the mainstay of housing construction in lower-density areas of Brooklyn, Queens and the Bronx. Such construction is critical for many weaker market areas, many located far from the overheated markets in the revised GEA.

The Task Force, citing the relative tax advantage that these small buildings already receive, as well as the difficulty such projects have with regulatory compliance, has proposed that they no longer be eligible to receive 421-a tax benefits. These limited-unit projects oftentimes enable homeownership for moderate-income families seeking the benefits of rental income. Furthermore, these developments are often the only alternative on small and irregularly shaped in-fill lots in lower-density zoning districts.

Rather than discouraging these developments, in a city looking for ways to handle population growth, especially in neighborhoods where illegal units often proliferate, these developments should be accommodated. By providing an important resource for first time homebuyers and new immigrants, owner-occupied buildings like these have helped with the regeneration of neighborhoods like Pelham Bay, Throgs Neck, and Ridgewood.

Additionally, while Class 1 (1-3 unit) properties do receive favorable tax treatment, four- and five-unit buildings do not. In fact, they are taxed just as larger multi-family buildings are and would be disadvantaged without the mitigating benefits of 421-a. The Task Force's concern over "administrative requirements" may be in reference to rent stabilization rules for these units. If this is in fact the case, one solution would be to exempt small properties from stabilization as is done with Partnership homes.

Summary

Just as economic conditions have changed significantly since the inception of 421-a, so too has the intent of the program changed over time. The Task Force is correct to note that the current housing market provides a historic opportunity to more thoughtfully calibrate 421-a to the needs of today's New York City.

As reforms move forward, however, legislators and policymakers should be clear about the objectives at hand. 421-a should seek to encourage the development of all housing and to maximize the number of affordable units. In order to ensure the long-term viability of the program, incentives should be reduced where they are not needed and increased to meet necessary goals.

First and foremost among those goals should be a focus of resources in those areas of the City with underperforming real estate markets. In other words, we must look to the neighborhoods that have been left behind in the current boom market. Ensuring that benefits are maximized in communities like Brownsville and Bedford Park are more important than ever.

As they currently stand, proposed changes jeopardize the advantages that the current program holds for high-need communities without providing viable alternatives. The communities that have the least to lose, those experiencing community renewal and increased prices as an organic outgrowth of the strong real estate market, will absorb an undue amount of public moneys to produce expensive subsidized units.

The Task Force recognizes, and CHPC agrees that the 421-a program should better conform to current market realities. Wisely it has proposed an expansion of the current GEA boundaries. Combined with improvements to the Negotiable Certificate Program, the Administration has an opportunity to vastly increase the production of low-income housing especially for housing production outside of Manhattan. By drawing new boundaries of weaker market neighborhoods and preserving the deepest as-of-right benefits there, areas that need to create new market-rate housing for growing moderate- and middle-income households, will be given that chance. In addition, by reinstating the provision of benefits for small multiple dwellings, areas outside the GEA will not see an increase in the cost of housing construction that they can ill afford.

Finally, the necessity of assessment reform remains. Only by rationalizing and bringing greater transparency to assessment policy will the need for tax exemptions expire. Until then, 421-a should continue to serve as a critical incentive to build market-rate and low-income units.

Perhaps most importantly, extreme requirements of low-income units in all new construction seeking tax forgiveness, which is applied everywhere without distinction, should be avoided. Public policy has proved a poor indicator of market responses. While many would hope that housing construction would be unaffected by such a change, it is not realistic to expect that. Housing construction, for all ranges of household income, continues to be important not just because it provides a needed resource, but also because it is a significant economic driver that the City's economy can ill afford to do without.

–CHPC 421-a Committee

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