New York City Independent Budget Office

Fiscal Brief

January 2012

Boom & Bust:

Commercial Property Sales Are a Key to Revenues From Property Transfer Taxes

Summary

For years the city's real property transfer tax and mortgage recording tax, often referred to collectively as the transfer taxes, were a predictable source of city revenue. In the years leading up to the real estate boom that began in 2004, the transfer taxes generated about $800 million to $900 million annually. Then, from 2004 through 2007, transfer tax revenues grew dramatically beyond expectations and reached $3.3 billion in 2007. This unprecedented growth in transfer tax revenues was a key component in the large budget surpluses the city amassed during the boom years. Likewise, the Metropolitan Transportation Authority, which also receives transfer tax revenues, saw its tax revenues greatly enhanced during the boom years.

With the onset of the recession, transfer tax revenues for New York City plummeted, falling to $982 million in 2010. The transportation authority experienced similar declines. This report looks at the interplay of the real estate market and the transfer taxes and highlights the factors that led to the rise and fall of these revenues. Among the report's findings:

- While the number of commercial sales is much smaller than the number of residential sales, the average value per transaction for commercial sales is much higher. Since commercial transactions are also taxed at a higher rate than residential sales of the same value, commercial real estate activity has a proportionally greater effect on city revenues than its share of total sales value or mortgage originations would suggest.
- The sale of commercial property, which includes rental apartment buildings with four or more units under the city's property transfer tax rules, has been a key to the boom and bust in transfer tax revenues.
- Manhattan office buildings are an important but volatile segment of the commercial real estate market. This can especially be seen through the window of "mega-sales"—buildings sold for $500 million or more and generating at least $8 million in real property transfer tax revenue for the city. In 2005, there was just one mega-sale, in 2006 there were three. In 2007, there were 14 mega-sales, generating $267 million in real property transfer tax revenue. In 2010, there was just a single mega-sale.

There is evidence that transfer tax revenues are beginning to pick up and will continue to grow over the next few years. In fiscal year 2011 there were 43 taxable sales valued at $100 million or more, more than twice the number than in 2010. Still, IBO expects transfer tax revenues will remain well below the record-setting levels of a few years ago.

Click here for appendix table on real estates sales and transfer tax revenues @ www.ibo.nyc.ny.us

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Both New York City and the Metropolitan Transportation Authority (MTA) receive revenue from taxes levied on sales of real property and the recording of mortgages. Receipts from these taxes, known collectively as the transfer taxes, dropped sharply beginning in fiscal year 2008 as a result of the decline in the real estate market.[1] Revenues have since begun to rebound, but are still far below the levels of just a few years ago.

While the decline in the New York City residential real estate market has been amply documented, the more dramatic falloff in commercial real estate transactions has been less closely scrutinized.[2] Commercial transactions are especially important from a fiscal standpoint. While the number of commercial transactions is much smaller than the number of residential sales, the average value per transaction for commercial sales is much higher. Since commercial transactions are also taxed at a higher rate than residential ones of the same value, commercial real estate activity has a fiscal impact which is proportionally greater than its share of total sales revenue or mortgage originations would indicate. IBO's calculations indicate that in 2007, the year that city transfer tax revenue peaked, the share represented by commercial transactions also peaked, at around 65 percent.[3]

This paper examines the interaction between the New York City real estate market and transfer tax revenues, with a focus on commercial real estate.

An Introduction to the Transfer Taxes

Property sales in New York City are subject to a city and state real property transfer tax (RPTT), while new mortgages, whether for purchase or for refinancing, are subject to a city and state mortgage recording tax (MRT). The RPTT and MRT are often referred to collectively as the transfer taxes. Very rapidly growing revenue from the transfer taxes provided both the city and the MTA (see sidebar on page 4 for more details) with a significant fiscal cushion during the real estate expansion, which lasted from 2004 through 2007.

During the expansion, city transfer tax revenue rose as the value and volume of property sales and mortgage originations rose. After hovering around $800 million to $900 million for several years (all figures in this paragraph refer to nominal dollars), the city's RPTT and MRT receipts, not including the MTA portion, passed the $1.0 billion mark in 2003. The total shot up to an astounding $3.3 billion in 2007, before tumbling to $2.5 billion in 2008, $1.2 billion in 2009, and $982 million in 2010. Collections for 2010 were the lowest since 2002. Revenues began to recover in 2011 and IBO projects that collections from the city's transfer taxes will continue to grow over the next few years. Nevertheless, we expect transfer tax revenues to remain well below the record-setting levels of a few years ago.

Transfer Tax Rates. The combined city and state RPTT tax rate for residential sales of $500,000 or less in New York City is 1.4 percent. The next rate bracket is 1.825 percent for residential sales above $500,000 and not exceeding $1 million. Residential sales above $1 million pay a combined rate of 2.825 percent. Commercial sales of $500,000 or less pay a total rate of 1.825 percent, and commercial transactions over $500,000 pay the highest combined city, state, and MTA rate of 3.025 percent.[4]

The combined state, city, and MTA recording tax for mortgages originated in New York City is 2.05 percent for all mortgages under $500,000, 2.175 percent for mortgages of $500,000 or more on one-, two-, and three-family houses and condominiums, and 2.8 percent on commercial mortgages of $500,000 or more. Loans to purchase coop apartments are technically not considered mortgages under current MRT legislation and are not subject to the tax.

The "city" RPTT actually includes two components, one flowing to the city's general fund and the other to the MTA. The general fund portion varies according to the type of property and the sales price. Residential properties are taxed at a rate of 1.0 percent of the sales price when the price is $500,000 or less, while higher-valued properties are taxed at a rate of 1.425 percent. Commercial properties are taxed at a rate of 1.425 percent when the sales price is $500,000 or less, and 1.625 percent when the sales price is over $500,000. Unless otherwise noted, references to city RPTT revenue in this paper refer to the non-MTA portion of the city tax.

The MRT is structured differently from the RPTT. There is a city tax of 1.0 percent of the value of all mortgages under $500,000, and 1.125 percent of the value of mortgages of $500,000 or more. The proceeds of these levies go to the city's general fund.

Unlike the state RPTT, which flows exclusively into the state general fund, the state MRT is distributed to the city's general fund, the MTA, and the State of New York Mortgage Agency (SONYMA). The city portion of the state

Real Property Transfer Tax and Mortgage Recording Tax Rates, by Type of Property

	State Tax			City Tax		
	NYS General Fund	NYC General Fund	MTA/ SONYMA	NYC General Fund	MTA	Combined Tax
Real Property Transfer Tax						
Residential Sales, $500,000 or Less	0.400			1.000		1.400
Residential Sales Between $500,000 and $1 million; and Commercial Sales, $500,000 or Less	0.400			1.425		1.825
Residential Sales, More Than $1 million	1.400			1.425		2.825
Commercial Sales, More Than $500,000	0.400			1.625	1.000	3.025
Mortgage Recording Tax						
All Mortgages Under $500,000		0.500	0.550	1.000		2.050
Residential Mortgages $500,000 or Greater		0.500	0.550	1.125		2.175
Commercial Mortgages, $500,000 or Greater		0.500	0.550	1.125	0.625	2.800

SOURCES: IBO; Department of Finance

MRT is equivalent to 0.5 percent of the value of the mortgage. Unless otherwise noted, references in this paper to the city's MRT revenue refer to the sum of the city and state taxes that flow into the city's general fund.

Data and Methodology. Data on individual real estate sales and the resulting RPTT revenue come from two files provided by the New York City Department of Finance, while the data on aggregate transfer tax revenue (both RPTT and MRT) are from the Mayor's Office of Management and Budget. The first file from the Department of Finance consists of basic sales data, augmented by additional variables from the Department of Finance property assessment data that describe the physical and geographic characteristics of the property beginning in 1984 (however, coop sales are excluded prior to 1990 and missing for 1997 and 1998). The second finance department file, known as e-Tax, provides more detailed information on the RPTT revenue generated by each sale, but only covers the period since 2005.

The analysis uses the gross consideration as the proxy for sales price. The gross consideration is a measure of the total value transferred from the buyer to the seller in exchange for the property. Among other items, gross consideration includes the accrued value of any unpaid real estate taxes or preexisting mortgages that the buyer assumes. The RPTT is computed on the basis of gross consideration, minus certain liens on residential properties.

There are two dates of significance when considering real estate market trends and transfer tax revenues—the sale date and the recording date. Generally, sales are recorded with the City Register within a few months of the sale and transfer tax revenue is received by the city when the sale is recorded, rather than at the time of the sale. As a result, there is a slight lag in transfer tax revenue collections. When presenting trends in property sales, IBO uses the sale date. When estimating the share of transfer tax revenue generated by sales of different kinds of properties, IBO uses the recording date in order to match up with revenue data.

An Overview: The Real Estate Market and Transfer Tax Revenue

The amount of transfer tax revenue collected by the city is closely tied to the value of real estate sales. Both the value of real estate sales and the total amount of transfer tax revenue peaked in 2007, and then began a steep decline. Tax revenue dropped more sharply than the value of property sales, due to a decline in the share of commercial properties in the total, and a precipitous fall in mortgage activity, including refinancing. (While figures are in constant 2010 dollars, nominal values are provided in the appendix.)

Market Activity. The city's real estate market has experienced two major market declines since 1984: one in the late 1980s and early 1990s, and the recent decline, which is now easing. There was also a brief dip in real estate

The MTA and Transfer Taxes

The Metropolitan Transportation Authority (MTA), the main provider of public transportation in New York City and surrounding counties, receives funding from a portion of the city real property transfer tax (RPTT), as well as parts of both the city and the state mortgage recording tax (MRT). The city transfer taxes that are dedicated to the MTA are referred to jointly as the "urban tax," and consist of a 1.0 percent RPTT on commercial sales valued at over $500,000, and a 0.625 percent MRT on commercial mortgages of $500,000 or more. Since the overwhelming majority of commercial properties sell for over $500,000, urban tax revenue closely follows the trend of commercial sales.

The state MRT dedicated to the MTA consists of two parts. The first part, referred to as MRT-1, is a surcharge of 0.3 percent on all mortgages in the 12-county MTA district.[5] The second part, known as MRT-2, is a surcharge of 0.25 percent on mortgages made on one- to six-family properties in the MTA district.[6]

In calendar 2007 (the MTA's fiscal year is the calendar year), when the MTA's revenue from the city and state transfer taxes peaked at $1.58 billion, these taxes accounted for around 39 percent of the transportation authority's total revenue from tax-supported subsidies (all figures in this section in nominal dollars). In 2008, the MTA's revenues from the transfer taxes dropped precipitously, while revenue from some other dedicated taxes rose slightly. The net result was that the share of transfer taxes in total tax-supported subsidies fell to just 26 percent ($855 million out of a total of $3.30 billion). In 2009, transfer tax revenue fell by over half compared with the previous year, at the same time that a series of new dedicated taxes, most notably a regional payroll tax, took effect. With the help of these new revenue sources, total tax-supported subsidies increased to $3.74 billion. However, the transfer taxes accounted for just over 10 percent ($389 million) of the total.[7]

MTA transfer taxes recovered slightly in 2010, to $425 million. Because the other dedicated tax revenues grew at a faster pace, however, transfer taxes as a share of total tax supported subsidies fell below 10 percent. The MTA projects that by 2015 its revenue from transfer taxes will reach $842 million, about 16 percent of the expected total of $5.2 billion in tax-supported subsidies. While this forecast amount for the transfer taxes implies substantial growth from the trough of 2009, it is just over half (53 percent) of the 2007 peak.

Because most of the transfer tax revenue received by the MTA comes from specific property types (large commercial transactions in the case of the urban tax, and one- to six-family family residences in the case of MRT-2), collection levels are particularly sensitive to trends in those submarkets.

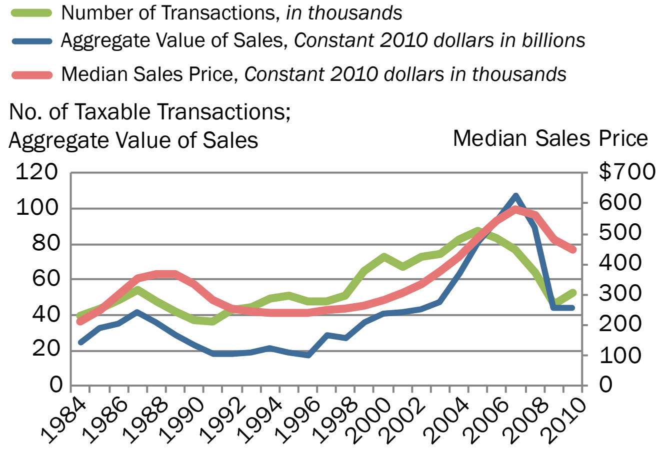
activity—as measured by the number of transactions—following the terrorist attacks of 2001. Between the 2001 slowdown and the most recent decline, the city's real estate market saw a major boom, in transaction volume, aggregate sales value, and median sales price (more representative than the mean which is sensitive to a small number of sales with either very high or very low sales prices).

In declining property markets, the number of transactions typically begins to fall before the average sales price. Sellers are slow to adapt their price expectations to changing market conditions, often holding off before reducing their asking price. Eventually, as market activity slows and unsold inventory increases, sellers will start reducing prices to attract buyers, which in turn, will lead to an increase in the number of transactions.

The last two major real estate downturns followed this pattern, with volume declining before median sales prices turned down, as shown in the Trends in Real Estate Activity chart on page 5. During both the recent downturn and the decline of the late 1980s, the number of real estate transactions began to drop well before any decline in the median sales price. In the late 1980s, the decline in the number of transactions was concurrent with the drop in the dollar value of transactions; modest increases in median prices early in the downturn were swamped by sharp declines in volume. In the most recent downturn, however, continued growth in the median sale price kept the dollar value of transactions rising for two years after the number of sales peaked in 2005, as the market for high-end residential and commercial properties continued to be strong.

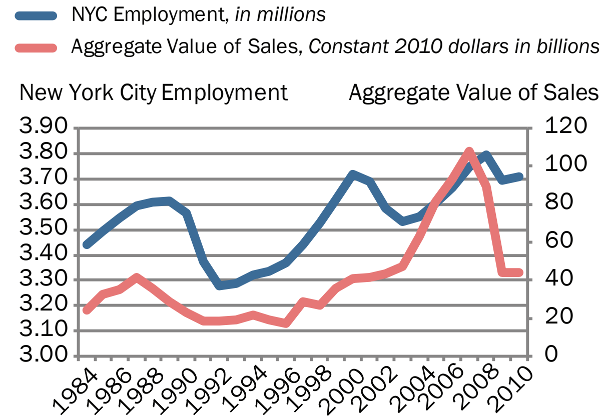
Trends in the real estate market are closely tied to the overall health of the economy. During the period 1984–2010, the aggregate value of real estate sales generally rose and fell in tandem with the level of employment in the city. The exception was in fiscal years 2001–2003, when the

Trends in Real Estate Activity, 1984-2010



SOURCES: IBO; Department of Finance

The Aggregate Value of Real Estate Sales Closely Follows Overall Economic Conditions



SOURCES: IBO; Department of Finance; Moody's

aggregate value of sales continued to increase (albeit slowly), despite a drop in employment. The real estate market was aided during this period by low interest rates and a relaxation of lending standards, factors that would ultimately contribute to a market "bubble" later in the decade.

Transfer Tax Revenue. Overall trends in transfer tax revenue closely mirror the trend in real estate sales volume. Nonetheless, during the recent boom there were times when the revenue from the two taxes diverged from the pattern for aggregate sales volume due to changes in the mix of properties being sold and the role of mortgage refinancing.

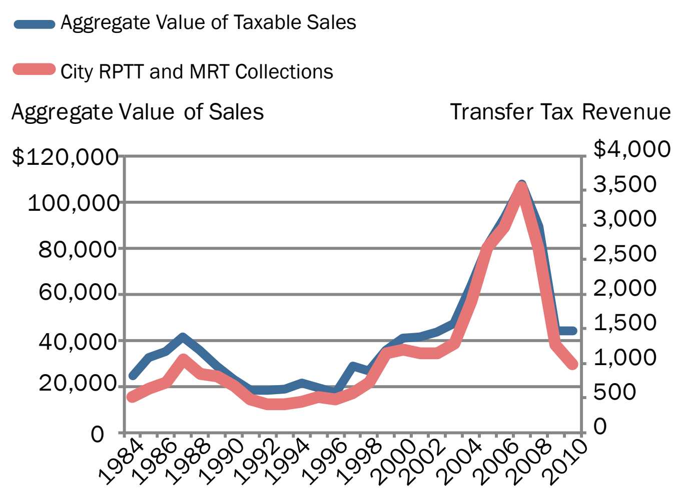
Transfer tax revenues are a function of three factors: the number of transactions (either sales of real property or the recording of a mortgage), the value of individual transactions, and tax rates. Because tax rates are higher on high value transactions (sales and mortgages valued over $500,000), and on commercial transactions, tax revenues vary as the mix of properties being sold and/or financed shifts. For a given aggregate value of sales or mortgage issuance, the higher the share of commercial transactions, the higher the tax revenue.

During the run-up periods prior to the past two major contractions, transfer tax revenue peaked at the same time as the aggregate value of sales (1987 and 2007, respectively). After the 1987 peak, both tax revenues and real estate sales continued in the doldrums for the next 10 years. Sustained growth resumed in 1998, interrupted briefly by a mild decline brought on by the 2001 recession and terrorist attacks. After the peak of 2007, the total value of sales transactions declined roughly 19 percent the following year, while transfer tax revenue fell around 23 percent.

Peak and Decline: A More Detailed Picture

Looking more closely at the peak and decline after 2005, IBO found that the aggregate value of taxable sales, as well as both RPTT and MRT revenues, peaked during the middle quarters of fiscal year 2007 (October 2006–March 2007). Aggregate sales value declined at a moderate pace for three quarters, and then dropped sharply beginning with the third quarter of fiscal year 2008 (January–March 2008). By the last quarter of 2009 (April–June 2009) the aggregate value of sales was just $9.0 billion, off two-thirds from the peak of $29.2 billion reached in the third quarter of 2007. Transfer tax revenue was off three-fourths from its peak. MRT revenue was hit especially hard, as mortgage financing became increasingly difficult to obtain. MRT collections in the April-June 2009 quarter were just $86.3 million, down more than 80 percent from their peak of two years earlier.

Transfer Tax Revenue Peaked in 2007
Constant 2010 dollars in millions



SOURCES: IBO; Department of Finance

Aggregate sales revenue and transfer tax collections fluctuated significantly from quarter to quarter in 2010. Despite a strong second quarter, annual revenue from the RPTT and MRT plunged to $982 million, the lowest level since 2002, and a drop of 21 percent from 2009. The decline in tax revenue occurred even as the total value of real estate sales for the year, $44 billion, was virtually unchanged from the previous year. The combination of stable aggregate sales and declining tax revenue can be explained in part by weak mortgage activity and a shift from the sale of higher-taxed commercial properties to lower-taxed residential properties.

We generally expect that revenue from the RPTT, a tax levied directly on sales, will follow the aggregate value of taxable sales more closely than will the MRT, a pattern shown in the quarterly data from 2005–2010. While there is variation in RPTT rates by sales price and type of property, the tax base is always the "gross consideration," which is usually equal to the sales price. The relationship between MRT and the value of sales is less direct. First, the share of the purchase price that is financed through borrowing varies by transaction, and in some cases is zero. Second, loans to purchase cooperative apartments are technically not mortgages and are not subject to the MRT. Finally, mortgage refinancings are usually subject to MRT, but do not involve a sale.[8]

The Mix of Properties Sold. Commercial properties played a key role during the recent real estate boom and subsequent decline. The increase in the value of commercial sales was the driving force behind the run-up in total sales value that culminated in 2007.

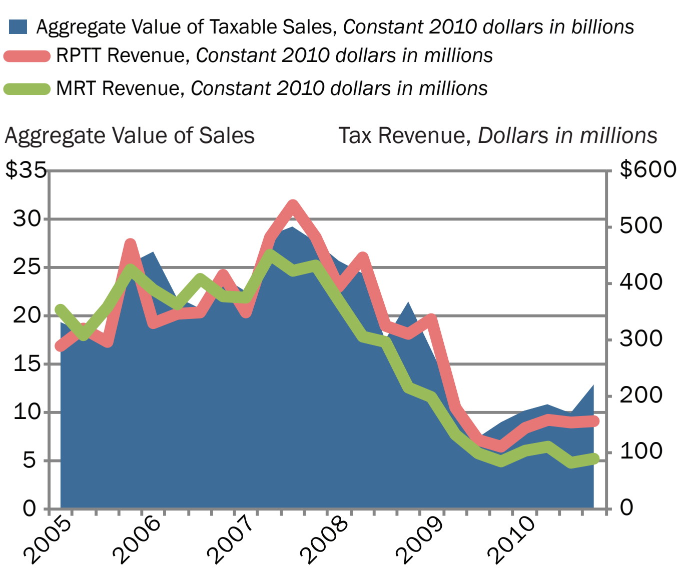
In recent years, between 70 percent and 80 percent of all sales transactions in the city have consisted of residential property, specifically one-, two-, and three-family houses, cooperative apartments, and condominium units. The major categories of commercial property (see sidebar, page 7) have generally made up 10 percent or less of all transactions. However, because the average sales price of commercial properties is much higher than that of residential properties, the share of the dollar value of transactions from commercial properties is higher than their share of transactions.

Quarterly sales data from 2005–2010 indicate that the value of commercial sales peaked in the middle of fiscal year 2007 (October 2006–March 2007), when they exceeded residential sales. By 2009, commercial sales had fallen below 2005 levels. In contrast, residential sales were characterized by marked seasonality (greater activity in April through September than during the rest of the year), but did not experience a major decline until the third quarter of fiscal year 2008 (January-March 2008). Residential sales started to recover in 2009, while commercial sales languished. By 2010, commercial sales were less than 20 percent of the level they had been at their peak, and the share of commercial properties in the total value of taxable sales had declined to under one-fourth.

Transfer Tax Revenue by Property Type. The rise and fall of transfer tax revenue was driven largely by nonresidential transactions, those involving properties other than one-, two-, and three-family houses and individual coop and condominium apartments. The share of RPTT revenue

After Peak, Transfer Tax Revenues Fell Sharply

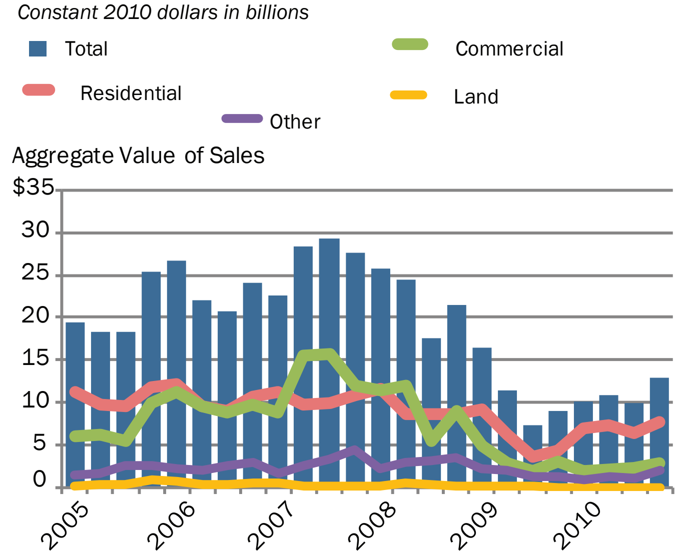
By quarter



SOURCES: IBO; Department of Finance

The Decline in Commercial Sales Was Earlier and More Prolonged Than the Decline in Residential Sales

Constant 2010 dollars in billions



SOURCES: IBO; Department of Finance

Classifying Property for Taxes

For purposes of maintaining an inventory of real property, New York City classifies buildings and land into around 200 building and property classes. The classes are based on a diverse set of criteria, including usage, number of units, building material, and type of ownership. On the other hand, there are only four property classes for administering the property tax—two residential classes, utility properties, and commercial. However, these categories do not match how properties are treated for purposes of the transfer taxes. For example, rental apartment buildings, which are considered residential properties for purposes of the property tax, are subject to transfer taxes at the commercial rate.

In order to understand trends in the transfer taxes, it is useful to parse the two categories, residential and commercial property, into more detailed groups based on property type and usage. The Department of Finance condensed the 200 building and land classes into 41 categories. IBO has merged these categories further, into eight groups:

1. One-, two-, and three-family houses;
2. Residential coops and condominiums;
3. Rental apartment buildings with four or more units (commercial properties for purposes of the transfer taxes);
4. Office buildings;
5. Other commercial properties, including retail, hotels, and commercial condominiums;
6. Industrial properties, such as warehouses, factories, garages, and lofts;
7. Vacant land; and
8. Other.

The first two categories are considered residential for purposes of the transfer taxes, while categories 3 through 6 are commercial. Land may be residential or commercial. The “other” category is partly residential (small buildings with apartments and stores), partly commercial, and also includes a significant number of tax exempt properties owned by government and nonprofit organizations. In discussion of the commercial real estate market, this paper excludes from analysis the small number of commercial properties in categories 7 and 8.

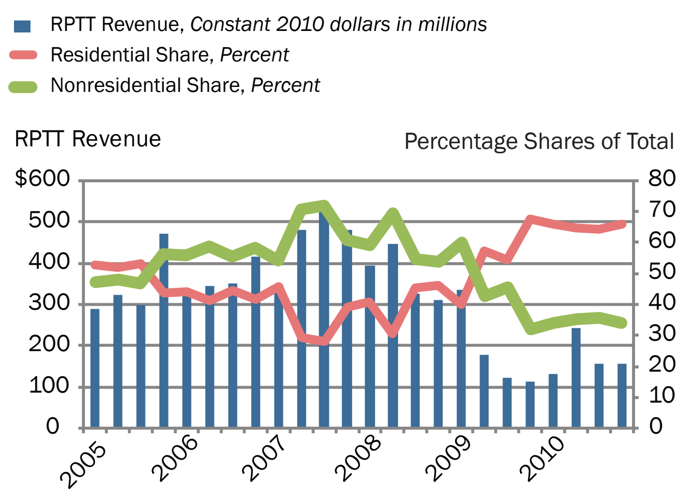
from nonresidential properties peaked at 70 percent in the second and third quarters of 2007, propelled by the sale of Stuyvesant Town/Peter Cooper Village, plus a surge in the sale of Manhattan office buildings. As RPTT collections subsequently declined, so did the share from nonresidential properties. By 2010, just over one-third of RPTT revenue came from transactions other than one,- two, and three-family houses and individual apartment units.

Commercial Property Up Close

In terms of the dollar value of transactions, the most significant types of commercial properties in New York City are rental apartment buildings (ranging from buildings with four units to large complexes with hundreds of apartments) and office buildings. IBO found that even though in a typical year over half of the office buildings sold in the city are located *outside* Manhattan, the average size and sales price of Manhattan buildings is so much larger that they represent around 95 percent of the aggregate sales value of such properties.

IBO estimates that from 2005 through 2010, apartment buildings and Manhattan office buildings together were responsible for 32 percent of RPTT revenue in constant 2010 dollars, compared with 15 percent for other commercial/industrial properties, and 44 percent for one-, two-, and three-family houses and residential apartment units.[9] At the height of the commercial real estate boom in fiscal year 2007, the share of RPTT revenue from the sale of apartment buildings and Manhattan office buildings

As Nonresidential Share Dropped, So Did Real Property Transfer Tax Revenue



SOURCES: IBO; Department of Finance

reached 42 percent of the total, and in the third quarter of the fiscal year (January-March 2007) the share was over half. In 2008, the share dropped to 35 percent, and by 2010 the share of apartment and Manhattan office buildings in RPTT revenues had fallen to just 19 percent.

Overall, sales of Manhattan office buildings contributed 18 percent of total RPTT revenue during 2005-2010, compared with a 14 percent RPTT share for sales of rental apartment buildings. During several quarters, however, most notably the first three quarters of fiscal year 2006 (July 2005–March 2006) and the second quarter of 2007 (October–December 2006, the quarter in which Stuyvesant Town/Peter Cooper Village was sold), apartment buildings provided more RPTT revenue than Manhattan office properties.

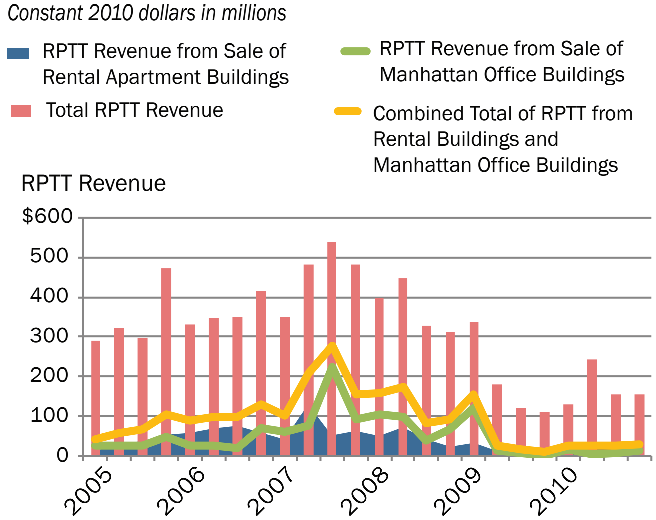
Rental Apartment Buildings. Propelled by low interest rates and expectations of rising residential rents, sales of rental apartment buildings soared in 2006 and 2007, when they contributed about one-sixth of total RPTT revenue. As credit subsequently tightened and rents stagnated, sales of apartment buildings declined sharply.

Long-Term Trends. Sales of apartment buildings in New York City peaked in the mid-1980s, and again in 2006–2007. In both cases, the increase in the value of sales was driven largely by Manhattan transactions, although sales outside of Manhattan also increased.

The aggregate value of rental apartment building sales was relatively high from 1984 through 1987 (a period in which

As the Share of Revenue From Apartment Buildings and Manhattan Office Buildings Peaked, So Did RPTT

Constant 2010 dollars in millions



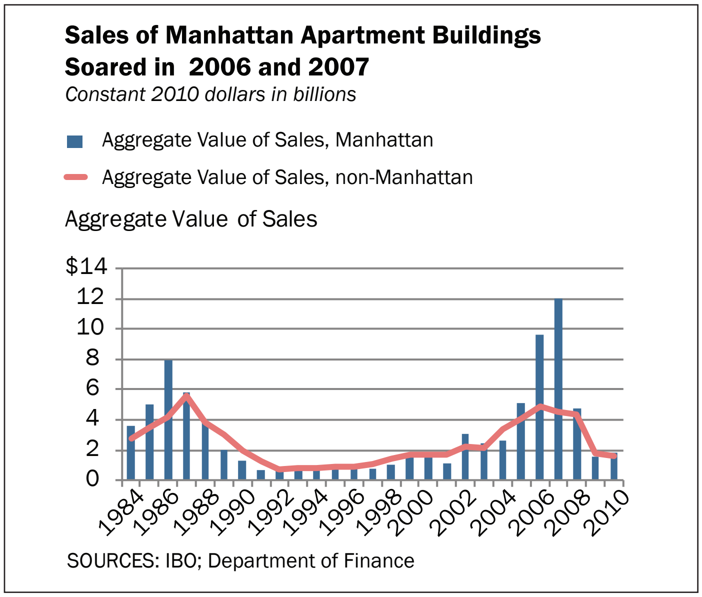
SOURCES: IBO; Department of Finance

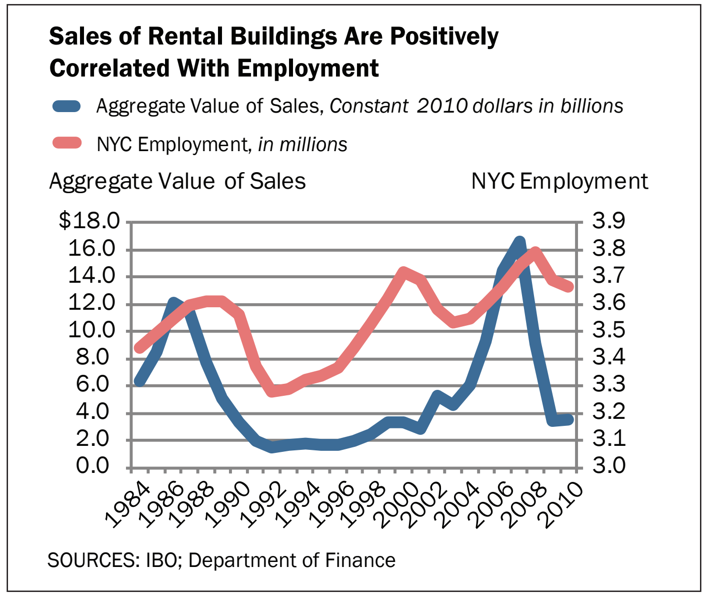
many rental buildings were converted to coops), followed by an extended period of relatively low sales activity. Rental apartment building sales began climbing sharply around 2005. While data on building size are incomplete, the evidence suggests that the median price per square foot, especially in Manhattan, escalated rapidly, and the market became dominated by properties in that borough. In 2003, buildings located in Manhattan accounted for about half of the revenue from sales of apartment buildings citywide, while in 2007, the fiscal year that Stuyvesant Town was sold, the Manhattan share was almost three-fourths. In 2008, the market for rental apartment buildings fell dramatically, primarily due to a 60 percent decline in sales value in Manhattan. A large drop was to be expected following the Stuyvesant "mega-sale," but then in 2009 sales dropped further—by almost two-thirds in Manhattan and over 50 percent in the other boroughs.

What Drives the Market for Rental Buildings? The price of income producing properties, including rental apartment buildings, depends fundamentally on the present value of their future net income stream. Increases in current or expected future rents—for example, spurred by local employment growth or the possibility of removing apartments from rent regulation—raise the value of a building. Lower interest rates also help to push up building prices, as a given rent roll can support a larger mortgage.

Several trends combined to push up the prices of apartment buildings during the last real estate boom. Underlying economic and demographic conditions of the city boosted investor confidence in rental housing, particularly in Manhattan. Some buyers made purchases with the expectation that average rents could be increased substantially, even though rent regulations made this difficult. Interest rates were low by historic standards and loose lending standards allowed buyers with less than stellar credit histories to enter the market.

The *a priori* expectation is that the sale of rental apartment buildings is negatively correlated with mortgage rates and positively correlated with employment (due to the unavailability of data on financing terms of individual transactions in the city's transfer tax records, IBO uses the interest rate on a 30-year fixed rate mortgage as a proxy for commercial interest rates).[10] Low interest rates, which imply a low cost to borrowing money, will stimulate the sale of apartment buildings. Rising employment increases the aggregate income of residents and may also be associated with an influx of individuals looking for housing in the city.





These trends put upward pressure on rents (subject to any binding rent regulations), which subsequently leads to a higher future revenue stream (in present value terms) and hence to an increase in building value.

For the period 1984–2010, IBO found a weakly negative relationship between apartment building sales and mortgage rates (r=-0.28), and a much stronger positive relationship (r=0.66) between total New York City employment and the lagged dollar value of rental apartment building transactions. In the mid-1980s and again in 2007-2008, sales of apartment buildings peaked just ahead of employment.

The general decline in the economy and real estate market after 2007, combined with turmoil in credit markets and tighter lending standards, put a brake on the sale of apartment buildings. Stagnant or declining rents, together with rising vacancy rates, reduced the attractiveness of apartment buildings as an investment. [11]

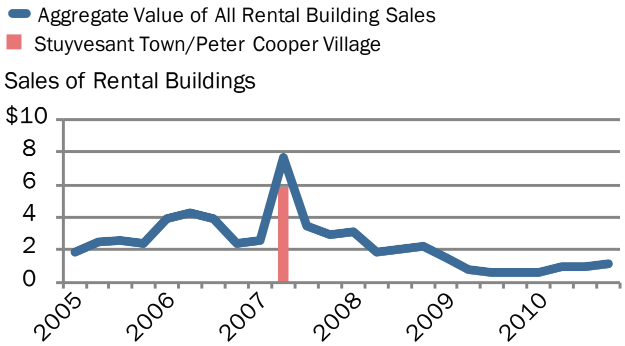
Recent Trends. Sales of rental apartment buildings were consistently over $2.0 billion per quarter from the second quarter of fiscal year 2005 through the first quarter of 2008 (October 2004–September 2007). After the Stuyvesant Town/Peter Cooper Village sale in the second quarter of 2007, the sales of rental apartment buildings dropped sharply. Not only did weak residential rents (a reflection of the economic downturn) put downward pressure on building prices, but the credit crunch made financing much more difficult. After hitting bottom in the second half of 2009, sales slowly began to rise in 2010. The value of sales, however, has remained well below 2005–2008 levels, even excluding the Stuyvesant Town/Peter Cooper Village transaction.

The sale of the Stuyvesant Town/Peter Cooper Village apartments in Manhattan is emblematic of the rise and fall of the market for rental apartment buildings. When Metropolitan Life Insurance Company put the complex up for sale in calendar year 2006, an analysis of the current cash flow indicated that the maximum purchase price that could be justified was $3.5 billion, or about $312,000 for each of the project's 11,232 apartments. The winning bid was $5.4 billion, roughly $481,000 per apartment. The combined impact of the overall decline in property markets, legal barriers to rent deregulation, and a court judgment that some tenants had been overcharged in the past, have since brought the market value of the Stuyvesant Town/Peter Cooper Village complex down to an estimated $1.9 billion, according to a recent appraisal.[12,13]

Sales of rental apartment buildings declined sharply following the Stuyvesant Town/Peter Cooper Village transaction. The aggregate value of sales was below $1.0 billion for six consecutive quarters (October 2008–March 2010), and reached only $1.1 billion during April-June 2010, the last quarter of fiscal year 2010.

Manhattan Office Buildings. IBO's analysis of the office market focuses on Manhattan. While only 47 percent of New York City office buildings sold in 2005–2010 were located in Manhattan, these properties made up 96 percent of the total value of sales in constant 2010 dollars. Sales of Manhattan office buildings peaked in 2007, with an aggregate sales value of over $20.0 billion in constant

Sales of Rental Buildings Peaked with Sale of Stuyvesant Town/Peter Cooper Village in 2007
Constant 2010 dollars in billions



SOURCES: IBO; Department of Finance

2010 dollars, but then fell sharply. These sales generated almost 18 percent of the city's 2007 RPTT revenue. Some recent sales are due to the financial difficulties of owners who bought at the peak of the market. Distress sales may continue to generate a significant amount of market activity, but at prices well below those of the boom years.

Long-Term Trends. Manhattan office buildings are an important but volatile segment of the commercial real estate market. The aggregate value of transactions and the total square feet sold are greatly affected by sales of high-value properties, defined here as sales valued at over $100 million in constant 2010 dollars. (These transactions sometimes involve sales of more than one building.) Spikes in the dollar value of transactions are closely correlated with peaks in the number of sales transactions over $100 million. Between 1984 and 2003 the number of high-value transactions averaged around five per year. From 2004 through 2008 the average number of high-value transactions jumped sharply, to around 24 per year. In 2009, in the midst of a profound slump in commercial real estate, there were only 12 transactions involving Manhattan office buildings valued at over $100 million. Four of these sales involved buildings that had sold for considerably higher prices in the previous two years, and were reportedly motivated by the financial difficulties of the owners. In 2010, the number of high-valued office transactions plunged further, to six.

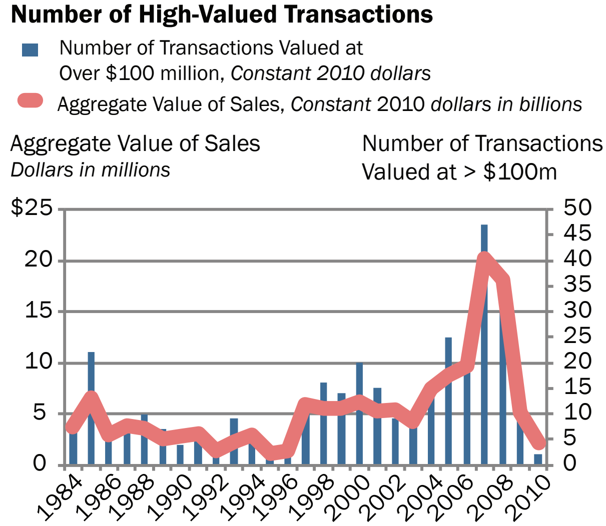
What Drives the Market for Office Buildings? As is true of markets in general, the price and quantity of office space sold results from the interaction of supply and demand. Supply shifts as new office buildings come into the market, existing buildings are demolished, or space is converted to or from office use. Demand shifts in response to current and expected future economic conditions, including interest rates, availability of credit, and changes in employment—particularly in industries that use a lot of office space. Reductions in interest rates increase the size of a mortgage that can be supported by a given monthly payment. Thus, reductions in interest rates increase the value of office buildings, and increases in interest rates lower their value.

There are limitations to measures of the price of Manhattan office space, whether one is using sales data or asking rents. While sales prices of office buildings are readily available, information on the square footage of buildings sold is incomplete, particularly before the late 1990s. This makes it difficult to calculate a reliable sales price per square foot in the early years of our analysis. In terms of rents, data on actual amounts paid for space in specific office buildings are generally not available, but survey data on asking rents are available. While asking rents are not the same as actual rents paid, we generally expect that the two measures will move together.

IBO's analysis of the Manhattan office market uses an average asking rent that combines data from both the midtown and downtown office markets. This series is a produced by the Mayor's Office of Management and Budget with underlying data from the real estate firm Cushman and Wakefield.

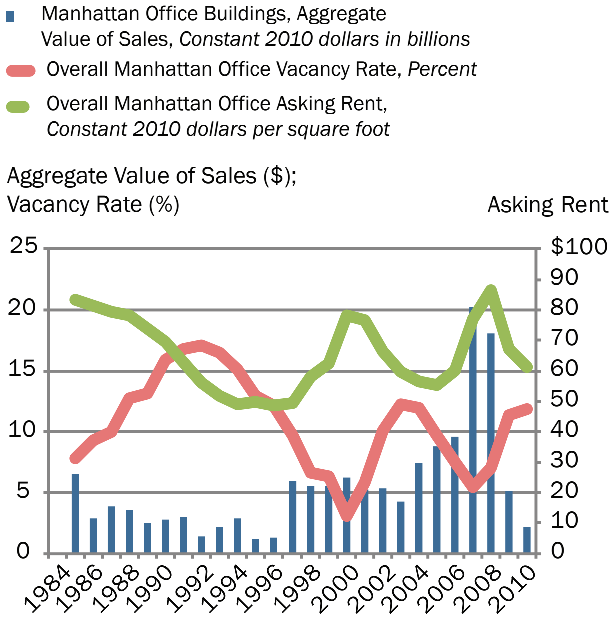
Not surprisingly, the average asking rent for Manhattan office space generally moves in an opposite direction from the vacancy rate. From 1985 through 1992 the vacancy rate moved steadily upward, while rents in real terms declined.

The Total Sales Value of Manhattan Office Buildings Is Closely Related to the Number of High-Valued Transactions



SOURCES: IBO; Department of Finance

Asking Rent for Manhattan Office Space Moves In Opposite Direction from Vacancy Rate



SOURCES: IBO; Department of Finance; Mayor's Office of Management and Budget

From 1993 through 2001 midtown vacancy rates dropped sharply, from about 15 percent to just over 3 percent. Rents in constant dollars were initially stagnant or declining, but by 2001 had almost returned to the level of the mid-1980s.

Vacancy rates rose sharply, and rents fell, after the terrorist attacks and downturn of 2001. After several years of stagnant sales, declining real rents, and rising vacancies, the market began a strong recovery. The aggregate value of sales peaked in 2007, as vacancy rates hit bottom. Asking rents peaked in 2008. In 2009, the market contracted sharply: the number of transactions fell by almost two-thirds, and the aggregate value of sales dropped even more. At the same time, the vacancy rate began to rise, and the asking rent fell.

The Peak and Decline in More Detail. Using quarterly data from fiscal years 2005-2010, IBO found that the aggregate value of Manhattan office market sales peaked at around $8 billion (constant 2010 dollars) in the third quarter of 2007 (January–March 2007), and again in the second quarter of 2008 (October–December 2007). These sales peaks coincided with a period of relatively low midtown office vacancy rates. The subsequent decline in the Manhattan office market followed a pattern frequently seen in real estate markets. Asking rents continued to rise, even as vacancy rates were increasing and the aggregate value of sales was declining. Eventually building owners/sellers developed more realistic price expectations, and asking rents began to fall. By the second quarter of fiscal year 2010 (October-December 2009), the vacancy rate had risen to 12.2 percent, asking rents were almost 30 percent below their peak, and the value of taxable sales was just $255 million.

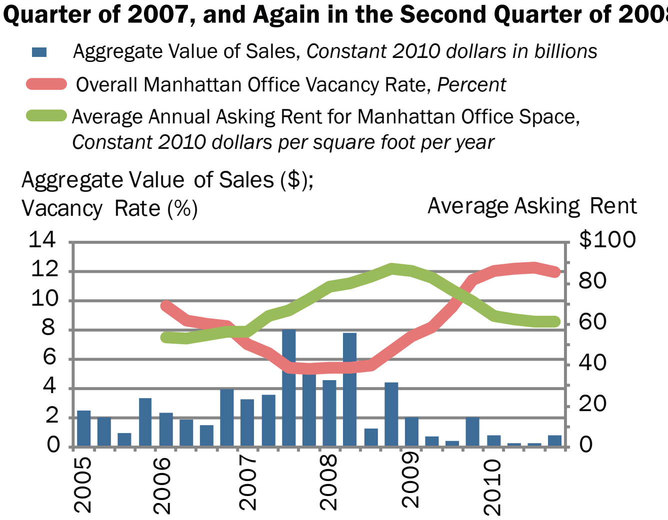
One of the most striking characteristics of the Manhattan office market in recent years has been the rise and fall of mega-sales, property sales that generate very large amounts of transfer tax revenue. For purposes of this paper, IBO defines a transaction as mega-sale if it is valued at $500 million or greater, and generates at least $8 million in city RPTT.[14]

In 2005 there was only one sale of a Manhattan office building that qualified as a mega-sale according to our criteria, and in 2006 there were just three such transactions. But the number of mega sales jumped in 2007 and peaked at 14. These sales generated $267 million in RPTT revenue, around 15 percent of the total. By 2009, the number of office mega-sales dropped to five, and in 2010 the only one was 815 Eighth Avenue, which sold for $590 million and generated $9.6 million in RPTT.[15]

Conclusion

The dynamics of New York's residential real estate market, and its role in the city's economy, have received considerable attention. However, the huge run-up in transfer tax revenue that began in fiscal year 2004 and the subsequent decline from 2008 through 2010 were driven primarily by the commercial side of the market.

Sales of Manhattan Office Space Peaked in the Third Quarter of 2007, and Again in the Second Quarter of 2008



SOURCES: IBO; Department of Finance; Mayor's Office of Management and Budget

Looking Ahead at the Commercial Market

Perhaps the best way to describe the current state of the commercial real estate market in New York City is that there are signs of recovery, but sales activity is not expected to return to the levels of a few years ago anytime soon. This latter conclusion is hardly surprising, given the speculative nature of the market at its peak.

Currently, with unfavorable short-run prospects for office rents and weak employment growth in the sectors that occupy Manhattan office space, prices remain depressed. The market for rental apartment buildings faces similar obstacles. While vacancy rates in Manhattan are still very low by national standards, and rents in some neighborhoods are recovering, the potential for increasing rents by removing apartments from rent regulation is limited.[16]

While the aggregate value of real estate sales is generally pro-cyclical, the difficulties of overextended investors could lead to increased transaction volume, and ultimately, transfer tax revenue. Given the depressed level of prices, however, the number of transactions would have to rise to unprecedented levels in order for tax revenues to approach their 2007 peak.

Is Recovery Underway? The main analysis in this report covers commercial real estate sales and revenues through June 30, 2010, the end of city fiscal year 2010. Press accounts and reports released by real estate firms during the last year suggest that a recovery of commercial property markets has begun. For example, in October 2011 the real estate firm Cushman and Wakefield reported that new office leasing activity in Manhattan during the third quarter of calendar 2011 (July-September) was the highest of any third quarter since 1998. Compared with one year earlier, the overall Manhattan office vacancy rate was down 1.5 percentage points, to 9.3 percent, and overall asking rents were up 4.4 percent, to $56.15 per square foot.

Sales data for fiscal year 2011 (July 2010 through June 2011) and the first quarter of fiscal year 2012 (July-September 2011) support the view that the commercial real estate sector is recovering. There were 43 taxable sales of commercial properties valued at $100 million or greater in fiscal year 2011, compared with 21 in 2010. The largest sale by far was Google's purchase of 111 Eighth Avenue for $1.77 billion in December 2010.[17] In the first quarter of fiscal year 2012 , there were 16 taxable commercial sales valued at $100 million or more. The largest was the sale of the Starrett-Lehigh Building on West 26th Street, which sold for $920 million. Transfer tax revenue was very strong during the first two months of fiscal year 2012 ($201 million for RPTT and $101 million for MRT), but IBO anticipates that the level of collections will be lower during the remainder of the year, as evidenced by weaker collections starting in September 2011.

The recovery in transfer tax revenue since the beginning of fiscal year 2011 has been driven by commercial real estate. In 2011, around 43 percent of the value of taxable sales and 48 percent of RPTT revenue came from commercial properties, compared with only 29 percent and 32 percent, respectively, in 2010. During the first quarter of fiscal year 2012 (July-September 2011), 52 percent of the value of taxable sales and 57 percent of RPTT revenue, came from commercial properties. While at this writing the commercial real estate market seems to be recovering somewhat faster than many had anticipated, the possibility of another global economic downtown lurks in the background.

Around 80 percent of the cumulative decline in the RPTT during 2008-2010 was due to the decline in the sale of commercial properties. If sales of commercial real estate had remained at 2007 levels during the following three years, the city would have received an additional $1.95 billion in real property transfer tax revenue. In contrast, had residential sales remained at their 2007 levels during 2008-2010, the additional tax revenue would have been less than one-fourth this amount, roughly $468 million.

There are many reasons why commercial properties are sold, not all of which are positively correlated with overall economic conditions. However, as this paper has shown, the aggregate value of commercial sales in New York City and the resulting transfer tax revenue have generally been highest when other economic indicators, such as total employment, show a positive trend. We anticipate that during the coming years, transfer tax revenue will follow employment and other macroeconomic variables. Still, even if the economy enters into a vigorous recovery, it is unlikely that the market will support the levels of prices that were observed during the peak.

This report prepared by Alan Treffeisen

Table on Real Estate Sales and Transfer Tax Revenues

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Endnotes

[1]Unless otherwise noted, references to years are to city fiscal years which run from July 1 to the subsequent June 30. They are identified by the ending year.
[2]This paper uses the term "nonresidential" to refer to real estate transactions involving other than individual residential units (houses or apartments). The term "commercial" is used loosely to refer to properties that are not residential, and not bought or sold by government or non-profit entities.
[3]The tax calculation refers only to the real property transfer tax, described in the following paragraph.
[4]Property transactions that qualify as real estate investment trust (REIT) transfers are taxed at one-half the regular RPTT rate. Based on sales data since fiscal year 2005, IBO has determined that these transfers make up less than one-half of one percent of the total value of sales.
[5]Other major transit districts in the state (Buffalo, Rochester, the Capital District and Central New York) are also subject to this surcharge. Outside the transit districts, counties may opt out of the surcharge, a decision that 21 counties have made. In counties which have the surcharge but do not belong to one of the state's five major transit districts, the revenue from the surcharge is directed to the county treasury.
[6]An equivalent transit surcharge also exists in upstate Erie County. All other mortgages in New York State are subject to the 0.25 percent surcharge, with the proceeds dedicated to SONYMA.
[7]The numbers in this paragraph are based on an August 2011 IBO report. The calculation of the shares of transfer taxes in total tax-supported subsidies includes some tax revenues that are ultimately diverted away from the MTA. Because of timing issues, annual transfer tax revenues cited here may differ slightly from those reported by the Department of Finance for the equivalent period.
[8]In a refinancing, the value of an existing mortgage is not subject to MRT when the original lender "assigns" the value to the new loan, However, unassigned mortgages, as well as new debt that is added to the previous loan balance, are subject to the tax.
[9]Unlike the previous section which considered all nonresidential sales (sales other than one to three family houses or an individual residential apartments), this section's more detailed breakdown includes some properties (labeled here as "other") that do not easily fit into one of our seven residential, commercial, and land categories and may be taxed at residential or commercial rates.
[10]We used the average 30-year fixed rate mortgage as a proxy for commercial mortgage rates, which are often variable-rate loans tied to reference rates such as the London Interbank Offered Rate (LIBOR). Since 1990, the average monthly LIBOR rate has been strongly correlated with the 30-year fixed rate mortgage: an R^2 of 0.81 for one-month LIBOR and an R^2 of 0.84 for the 12-month LIBOR. Commercial mortgages typically have a shorter term than residential mortgages, with a balloon payment at the end. Borrowers frequently refinance rather than make the balloon payment.
[11]During the recession, landlords offered concessions, such as a free month of rent, in addition to or instead of lower rents to attract tenants. For example, see "Year End 2009 Manhattan Rental Market Report," or Miller Samuel Inc charts on the Manhattan rental market.
[12]See Bagli, Charles V. "Megadeal: Inside a New York real estate coup." New York Times: December 31, 2006, p. BU1, and Bagli, Charles V. "Stuyvesant Town's Lenders Take Over Property." *New York Times*, October 27, 2010, p. A22.
[13]Another very large rental development, Spring Creek Towers (formerly Starrett City) in Brooklyn, came close to being sold for a price above what could reasonably have been expected based on existing rents. In 2007 a group of investors proposed buying the complex for $1.3 billion, roughly $221,000 for each of the project's 5,881 apartments. The federal government vetoed the sale, in part because of concerns that rents would have had to increase dramatically in order for the deal to work.
[14]Dividing $8 million by 0.1625, the RPTT rate for commercial properties, gives $492.3 million as the corresponding gross consideration. A gross consideration of $492 million or greater is a necessary, but not sufficient, condition for RPTT revenue to reach $8 million, as sales may be exempt from RPTT for a variety of reasons, including sales to or by a government or not-for-profit organization, and transfers to a business entity in exchange for an interest in the business,
[15]815 Eighth Avenue was one of a group of skyscrapers acquired through a highly leveraged purchase by the Macklowe Properties company at the peak of the market in 2007. Macklowe was later forced to give up these properties, as it could not make the loan payments.
[16]In 2009 the New York State Court of Appeals ruled that the owners of the Stuyvesant Town/Peter Cooper Village complex, which had received J-51 tax benefits as an incentive for carrying out property upgrades, should not have deregulated rents through luxury decontrol while receiving the tax benefit. The precedent set by this case has led tenants of other apartment complexes to file suit against their building owners.
[17] The only other of these transactions valued at over $500 million was a $760 million payment to transfer a partial interest in 230 Park Avenue (also known as the Helmsley Building) from a Goldman Sachs investment fund to the money management firm Invesco.