

Will the City's Property Transfer Taxes Remain Flush?

Also available...

President's Tax Panel Has Costly Plan for City

...at www.ibo.nyc.ny.us

LAST MONTH'S REVISION by the Mayor of the city's tax revenue estimates for the current fiscal year by nearly \$2 billion was due in large part to the unexpected strength in two city taxes that are triggered by real estate sales and mortgages. These transfer taxes continue to defy expectations by IBO, the Mayor's budget office, and other forecasters that they will fall from their current unprecedented levels. While IBO continues to project some declines in these tax sources, the adjustments may ultimately prove smaller than previously expected.

In recent years the rise in New York City real estate values has not only created enormous gains for property owners, it has also produced windfalls for the city treasury. Higher property values have pushed up property tax revenue in recent years (even after accounting for the 18.5 percent rate increase), but the rate of growth in the two transfer taxes, the real property transfer tax (RPTT) and the mortgage recording tax (MRT), has been far greater. Combined revenue from the two transfer taxes, which in fiscal year 2000 amounted to \$890 million, was 255 percent higher in 2005, when they accounted for \$2.3 billion.

In recent years, projections by IBO, the Mayor's Office of Management and Budget (OMB) and other forecasters have consistently underestimated the growth in transfer tax revenues. In the city's last fiscal year, which ended June 30, 2005, actual tax revenues exceeded the budgeted amounts by \$3.8 billion. The MRT and the RPTT accounted for \$1.3 billion—35 percent—of this tax windfall. It appears that the forecasts for this year are similarly understated. Over the four months from July through October, which is one-third of the fiscal year, the city has already collected more than half of the transfer tax revenue projected for the entire fiscal year when the budget was adopted last spring. Last month, OMB increased its current fiscal year forecast for the two taxes by 51 percent. (IBO's transfer tax forecast will be included in our Fiscal Outlook report, which will be released later this week.)

There is little mystery as to the primary cause of the growth in these transfer taxes: the continued strength of the city's residential and commercial real estate markets, which has been fueled by very low mortgage interest rates. The low rates have also spurred a boom in mortgage refinancing, as property owners sought to reduce their monthly mortgage payments by locking in historically low interest rates and extract some of the equity in their rapidly appreciating properties. An examination by IBO of recent trends in the growth in revenue from the transfer taxes finds that some of this strength may continue even if the real estate market cools as interest rates rise.

Structure of the Transfer Taxes. The MRT is assessed when real estate mortgages are recorded

with the city and is usually paid by the mortgagee. The RPTT is imposed when the transfer of a deed is registered with the city and is usually paid by the seller of the property. Given the considerable overlap in the types of transactions subject to the two taxes, they are often treated together when discussing city tax revenues.

There are structural similarities as well. For both taxes only a portion of the total liability flows into the city treasury (the focus of this article); the state, Metropolitan Transportation Authority, and other entities, also get portions of one or both of the taxes.

Both the MRT and the RPTT apply to residential and commercial transactions. Both taxes have higher rates for larger transactions. Under the MRT, mortgages under \$500,000 are taxed at 1.0 percent while those over \$500,000 are taxed at 1.125 percent. Under the RPTT, residential sales are taxed at 1.0 percent for sales less than \$500,000 and 1.425 percent when the price is above. Sales of commercial properties—which includes rental apartment buildings—are taxed at 1.425 percent when the price is under \$500,000 and 1.625 percent if over.

But there are also important differences. Despite some overlap, the transactions covered by the two transfer taxes are not identical. Since 1989 sales of coop apartments have been subject to the RPTT. However, there is no MRT liability incurred when financing the purchase of a coop apartment since this financing is technically not a mortgage. But the MRT does apply to refinanced mortgages, although there is not a corresponding deed transfer and therefore no RPTT liability.

Recent Trends. The two transfer taxes have shown wide fluctuations over the years, and they have been notoriously difficult to forecast for city budget purposes. Collections from

each tax were relatively stable in the mid-1990s at about \$100 million to \$200 million annually. In 1998, the revenues began to grow, reaching \$500 million by 2003. Then in 2004 and again in 2005 there were unprecedented increases in both taxes so that by 2005 they each exceeded \$1 billion.

Last spring, both IBO and OMB projected declines in the transfer tax revenues for the current fiscal year (2006). Higher mortgage rates were expected to raise the cost of financing home purchases, resulting in fewer sales and somewhat lower sales prices. The higher rates were also expected to reduce the attractiveness of mortgage refinancing. Both the forecasts assumed that the decline in the volume of transactions was the most important factor behind the expected decrease in transfer tax revenues. Both IBO and OMB projected significant declines of between 30 percent and 40 percent in the two taxes in 2006 from their all-time highs set in 2005.

So far, there has been little sign of the expected decline. In the first four months of the fiscal year, RPTT revenues have totaled \$404 million, 56 percent of the amount expected for the full year in the city’s Adopted Budget.¹ MRT collections have been even stronger, with \$458 million in hand already, 62 percent of the Adopted Budget’s estimate for the full year. As a result of the unexpected strength in both taxes, OMB’s November Financial Plan increased the RPTT for 2006 by 53 percent to \$1.098 billion, which is above the 2005 level. The MRT forecast for 2006 increased by nearly as much, rising 48 percent to \$1.091 billion.

The \$500,000 Cliff. Both taxes have higher rates on transactions over \$500,000. With the rapid appreciation in property values in the city, the number of transactions subject to the higher rates has grown. Barring an unprecedented fall in property values this increase in the share of transactions subject to the higher rates is unlikely to be fully reversed. Thus, at least some of the recent tax revenue growth is probably “locked in” thanks to this “bracket creep.” IBO’s analysis of sales transaction data indicates that in 2000, 89.5 percent of residential transactions subject to the RPTT involved sales below \$500,000.² These sales accounted for 58.2 percent of the dollar value of the transactions. By 2005 the share of smaller sales had declined to 67.3 percent and they accounted for only about one-third of the dollar value of the transactions (35.4 percent).

A similar shift occurred in commercial properties. The share of transactions with sales below \$500,000 fell from 77.4 percent in 2000 to 55.1 percent in 2005. But the change in the share of the dollar value of commercial transactions



Rising Share of RPTT Residential Revenues Come From Sales Over \$500,000

Dollars in millions for Aggregate Sales Price and Tax Revenue

Price Range	Fiscal Year 2000			Fiscal Year 2005		
	Number of Sales	Aggregate Sales Price	Tax Revenue	Number of Sales	Aggregate Sales Price	Tax Revenue
\$1 to \$199,999	38,752	\$4,780.7	\$47.8	16,260	\$2,081.1	\$20.8
\$200,000 to \$299,999	20,081	4,959.4	49.6	15,192	3,901.9	39.0
\$300,000 to \$399,999	7,905	2,739.1	27.4	20,265	7,156.1	71.6
\$400,000 to \$499,999	3,376	1,519.2	15.2	16,339	7,364.8	73.6
\$500,000 to \$599,999	1,896	1,042.3	14.9	9,657	5,325.4	75.9
\$600,000 to \$699,999	1,390	904.7	12.9	6,516	4,238.9	60.4
\$700,000 to \$799,999	926	696.7	9.9	3,856	2,894.4	41.2
\$800,000 to \$999,999	1,427	1,285.0	18.3	4,571	4,108.7	58.5
\$1,000,000 to \$1,999,999	1,724	2,423.9	34.5	5,590	7,922.1	112.9
Over \$2,000,000	853	3,710.6	52.9	2,951	12,884.9	183.6
Total	78,330	\$24,061.7	\$283.4	101,197	\$57,878.4	\$737.6

SOURCE: IBO using data from Department of Finance, real property transfer data file (SAL1).

below \$500,000 was less dramatic, falling from 13.5 percent to 5.8 percent.

Unlike the brackets in the personal income tax, where income in lower brackets is taxed at lower rates, in the transfer taxes, once the \$500,000 threshold is exceeded, the entire value of the transaction is taxed at the higher rate. Crossing the threshold by \$1.00 increases the tax by 42.5 percent. For commercial transactions, although the cliff is less steep, it is still significant with a 14.0 percent rate once the transaction crosses the \$500,000 threshold.

With such steep cliffs, particularly for residential sales, tax revenues have grown even faster than sales prices. From 2000 to 2006, the aggregate dollar value of residential RPTT transactions grew by 140.5 percent, but the tax revenue from these sales grew by 160.3 percent. If residential RPTT revenue had grown only as fast as the aggregate value of residential sales, revenue would have been \$56 million lower. Looked at another way, if residential transactions were taxed at a uniform rate of 1.0 percent, the increase in RPTT residential revenue between 2000 and 2005 would have been \$116 million less than the \$454 million the city actually collected.

Moreover, the upward shift in the distribution of prices has been so sharp that even if prices were to fall as steeply as in the early 1990s, a large proportion of transactions are likely to remain subject to the higher rate. The median residential sales price fell by about 14 percent from fiscal years 1990 to 1995. A similar one-time adjustment to all sales prices today would still leave 25 percent of the transactions and 57 percent of the aggregate sales prices subject to the higher rate. Six years ago, only 42 percent of the aggregate sales were taxed at the higher rate. Nor is such an across the board price reduction very

likely. While the overall median sales price fell by 14 percent between 1990 and 1995, the median price for sales over \$500,000 actually rose by 5 percent over the same period.

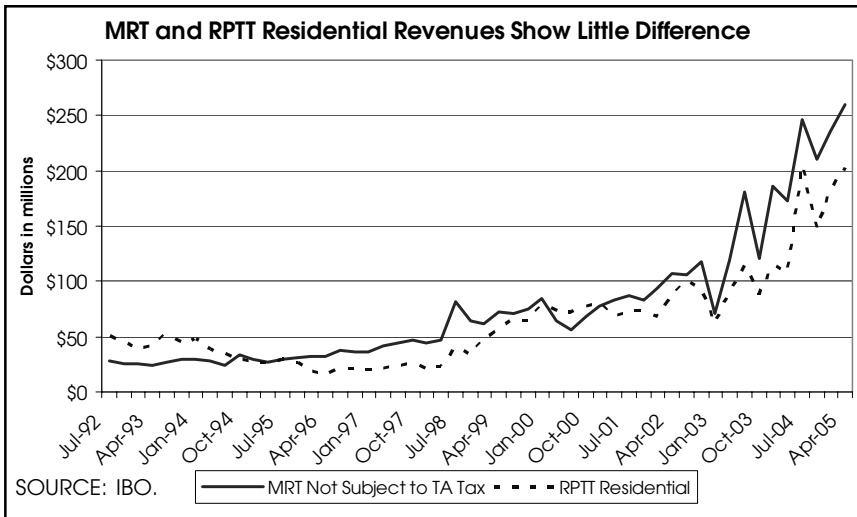
The Importance of Commercial Transactions.

Commercial transactions are a large but volatile part of the base for the transfer taxes. Although much of the discussion regarding

the explosion in transfer tax revenues in recent years has focused on residential transactions, commercial transactions have contributed to the recent growth and remain an important factor, particularly when projecting future transfer tax revenues. With the city economy expected to continue its recovery, revenue from commercial transactions is likely to partly offset projected declines in residential transfer tax collections.

Revenue from RPTT commercial transactions has grown robustly in the last two years, after little growth from 2000 through 2004. With residential sales growing steadily throughout the period, the share of total RPTT revenue from commercial transactions has fallen from 50 percent in 2000 to 42 percent in 2005. Because these commercial transactions are much larger on average than residential sales (\$2.2 million versus \$572,000 in 2005), the share of transactions is much smaller (13 percent) than either the share of revenue or the share of aggregate sales (36 percent).

Commercial transactions and hence revenues are subject to much greater volatility than residential transactions. The larger size of commercial transactions accounts for much of this volatility. In some quarters, revenue from literally a handful of very large transactions can account for 20 percent or more of all transfer tax revenues. For example, in January 2002, three sales totaling \$3.5 billion were recorded that yielded \$57 million in RPTT revenue. These three sales alone accounted for 35 percent of all RPTT revenue in the January to March quarter that year. A similar concentration occurred in May 2005, when 13 very large transactions were recorded, one of them the resale of a building cited in the January 2002 example, accounting for 21 percent of collections in the April to June 2005 quarter—the largest RPTT revenue quarter in the



city's history.

With the information available to IBO, it is not possible to distinguish between commercial and residential MRT revenue as precisely, although the data indicate that commercial transactions account for a somewhat smaller—but more volatile—share of MRT revenue than of RPTT revenue. As a proxy for MRT commercial revenue, IBO uses the share of MRT revenue subject to the additional “urban tax” for transit purposes. The urban tax applies to commercial mortgages over \$500,000. Thus, IBO’s measure excludes revenue from commercial mortgages below \$500,000. The share of revenue collected on mortgages subject to the higher MRT rate has zigzagged over time, ranging between 19 percent and 30 percent of all MRT revenue since 2000.

Although financing costs play an important role in commercial and residential real estate markets, the commercial market is also strongly influenced by expectations about the local business climate, particularly the outlook for employment growth in city industries that rent office space. Assuming the city economy will continue its recovery from the 2001-2002 downturn, revenues from commercial sales are likely to mitigate a sharp fall in collections from residential sales.

The Role of Re-Financing. With historically low mortgage rates, many local homeowners have refinanced their mortgages one or more times in recent years. IBO and other revenue forecasters have assumed that refinancings, which are subject to the MRT, have accounted for a major portion of the growth in mortgage tax revenue. If this is correct, MRT revenue should fall sharply if mortgage rates increase, as widely expected over the next 12 to 18 months. But the contribution of refinancings to mortgage tax revenue may be overstated.

Often these transactions are structured so that the tax is only due on the “cash out” that is withdrawn from the equity in the property, and not on the full amount of the new mortgage. The data needed to fully analyze the role of refinancings in MRT growth is not available. One alternative is to compare the trend in MRT collections from residential transactions with RPTT residential transactions. Because there is no RPTT revenue generated from refinancings, one would expect that the trend in collections from the two taxes would differ if refinancings were a major factor in the growth of the MRT. (As a proxy for MRT residential transactions we use MRT revenue not subject to the additional

urban mortgage tax, which except for a presumably small amount of commercial mortgages under \$500,000 are residential mortgages.)

Since the mid-1990s, this subset of MRT revenue has been higher than the residential RPTT revenue nearly every quarter. In percentage terms, however, the MRT exceeded the RPTT by a greater margin in the years 1995 through 1998—the difference was 40 percent or more each quarter in those years—than it has in the last three years when the quarterly difference has averaged about 25 percent. Because MRT and RPTT collections have moved largely in tandem in recent years and the gap between the two series has narrowed in percentage terms, this suggests that refinancings may have played less of role in MRT growth than conventionally believed. If their role has been overestimated, then the impact on future MRT revenue may be less than expected if anticipated mortgage rate increases cause a fall off in mortgage refinancing.

Written by George Sweeting

END NOTES

¹ Note that RPTT collections reported for 2006, as well as the 2004 and 2005 figures in the chart, are net of large accruals shifting some revenue processed after the start of the fiscal year back to the prior year when the transactions occurred. The unusually large accruals were necessitated by the installation of the ACRIS computer system by the Department of Finance, which temporarily slowed processing and delayed recognition of some tax revenue.

² A similar analysis of MRT transactions is not possible due to the conversion to the ACRIS system. The finance department can no longer supply analysts with the types of data files of individual transaction records needed for analysis of the distribution of mortgage types and sizes and the distribution of liability. Our distributional analysis of MRT trends is limited to the estimates derived from comparing MRT revenues for transit purposes—the “urban tax”—with MRT revenues dedicated to the city’s general fund.

You can receive IBO reports electronically—and for free. Just go to www.ibo.nyc.ny.us