Affordable Housing Institute

Taxation of residential property: The US experience

Presented at conference:

"Fiscal measures in relation to property in Ireland"

David A. Smith, Founder

Affordable Housing Institute

15 May 2009

Affordable Housing Institute and David A. Smith

- Developing successful affordable housing financial ecosystems worldwide
  - Ecosystem = mixture of laws, programs, entities, markets
  - Get the economics and incentives right, housing will follow
- Non-profit consultancy
  - "Pro-bono/ low-bono investment banker"
  - Worked in Egypt, India, Ireland, Kenya, South Africa, Sri Lanka, Turkey, UK
- Structured finance as applied to housing affordability
  - Public-private partnership, roles of government
  - www.affordablehousinginstitute.org
  - Advisor to Ireland's Affordable Homes Partnership (www.ahp.ie)
- 2008: Gates Foundation grant (research, two years)
- David Smith: 30+ years finance of affordable housing
  - For-profit (Recap Advisors, www.recapadvisors.com)
  - Special service asset management for major banks
  - Affordable housing blog, http://dasblog.org

Structure of this talk

1. Three levels of US government relative to property
   - Federal, state, and local
2. The US fabric of tenures and incentives
3. The US approach to residential taxation
   - Real estate taxes and local budgets
4. Interesting US innovations
5. Snapshot comparison, US and Ireland

Discussion

- Addendum: the capital markets crisis and what it is doing

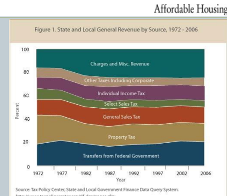
1. Three levels of US government and their relationship to residential property

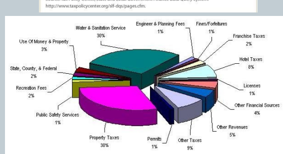
1. Federal: capital markets, income taxes
   - Government Sponsored Enterprises (GSEs)
   - Deduct mortgage interest, real estate taxes
   - Capital gains on sale of primary residence
2. State: Bridge between Federal and local
   - Tax-exempt mortgage revenue bonds (MRBs)
     - Housing finance agencies
   - "Anti-snob-zoning" overrides of local zoning
3. Local: use and taxation of land and property
   - Real estate taxation ('rates')
   - Zoning

- For homeowners, most visible and immediate is local

Local budgeting and real estate taxes

- Localities are enterprises
  - Have to balance books
- Provide services
  - Public schools (free)
  - Police, fire
  - Roads, infrastructure
- Collect revenues
  - Property taxes
  - Water & Sewer
  - "Tax the tourist"
    - Hotels, taxicabs
  - "Revenue sharing"
    - State or Federal → city





Millbrae, California: 2002 municipal revenue sources

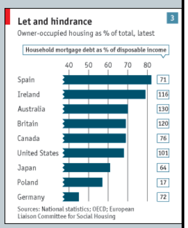
Levels of government and their revenue sources

	Federal	State	Local
Inc tax rate	**15-35%**	**0-9%**	0-4% (NYC)
Cap gains	**10-25%**	0-5%	--
Real estate	--	--	**1-3%/ value**
Sales/ VAT	--	**0-9%**	0-3%
Water-sewer	--	--	**$250-750**
Rubbish	--	--	--
Share	65%	15%	20%

2. The US fabric of tenures and incentives

Affordable Housing Institute

- *Homeownership*: 69% → 67%
  - Stated public policy goal
  - Mortgage interest deduction
  - As markets urbanize, ownership increasingly means condo
- *Market rental*: 25% → 27%
  - Active marketplace, many players
  - REITs, professionalized publicly traded owners
  - Professional management companies
    - 170,000 apartments nationwide
- *Affordable rental*: 6%
  - Public-private model predominates (4½%)
  - Direct public ('council housing'), 1½%
    - Antiquated, ossified, in need of comprehensive overhaul
  - *Affordability always requires government money*



Zoning and land use: The US approach

Affordable Housing Institute

- Zoning is 95% a *local* decision
- Overall city/ town master zoning map
  - Many categories, all customized by locality
  - Retail, commercial, industrial (subcategories)
  - Single-family, multi-family, density
  - FAR limitations, setback requirements
- Single-family homeownership ('homestead') preferred
  - Minimum size lots (e.g. ½ acre, 1 acre, 2 acres)
- Development other than per zoning requires variance
  - Local hearings (abutters-of-the-abutters), acrimonious
- Conservation easements
  - Charitable deductions

3. The US approach to residential taxation

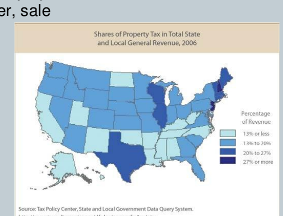
Affordable Housing Institute

- Local government is an independent entity
  - Its own taxation (principally real estate)
  - Many services provided by local municipal monopoly
    - Water, sewer, rubbish, sometimes utilities (up thru cable TV)
  - Its own budget (schools, fire/ police, utilities)
    - "Revenue sharing" from state tax revenues
- Many US households choose where to live based on quality of public schools
  - When they have school-age children, many people move
  - Localities compete on school quality
  - City council and school committee are political hot seats
- Real estate taxes are principal local revenue source
  - Not shared with state or national government
  - If anything, "revenue sharing" goes the other way

Real estate taxes, US basics

Affordable Housing Institute

- All real estate taxes are kept by the locality
  - Core source of local/ municipal budget
    - Pay for schools, police/ fire
    - Not water/ sewer (metered, paid by household)
- All real estate taxes are annual payments
  - Little or nothing related to transfer, sale
- All land is taxed
  - Developed or undeveloped
  - Assessment on market value
  - Reassessment on:
    - Change in zoning (up or down)
    - Sale
    - Formal improvements
  - Rates vary by asset class
    - Commercial > residential > agricultural



California is odd because of Proposition 13

Property taxation, local level: Part 1, basic local budget algebra

Affordable Housing Institute

- The imperative: balance the local budget
  - Because localities use annual real estate taxes as an integral revenue source …
  - … they set rates every year to plug their budget gaps
- The mechanics: Real estate taxation is done *Ad valorem*
  - "On the basis of value"
  - Taxes (T) = Assessment (A) times millage rate (MR)
  - Assessment = 'fair market value' of each property
    - Reassessments are done periodically
  - 'Millage' = 'dollars of tax per thousand of valuation'
    - A millage rate of 27 means a property assessed at €200,000 would pay annual real estate taxes of €5,400
- Therefore: budget hole (BH) divided by total assessed value = desired rate
  - BH = T = MR * A

Property taxation, local level: Part 2, "no taxation without representation!"

Affordable Housing Institute

- Real estate taxes allow localities to game their citizens
  - Budget hole gets bigger? Raise the millage rate
  - Real estate values drop? Raise the millage rate
  - Got asset values you want to favor? Change their fractional assessment
    - Different assets are differently taxed
    - Residential may be taxed at fraction (<100%) of assessment
    - Business normally taxed higher
    - … Except when it's relocating into the neighborhood ☺
- How can taxpayers force localities to cut their budgets?
  - Cap millage rates
  - California's Proposition 13 (1978, taxpayer revolt)
    - Thirty years later, *massive* distortions in state/ local budgeting
- Taxpayer resistance: Massachusetts Prop 2½
  - Taxes may not exceed 2½% of assessed value
  - May not increase more than 2½% per year
  - Localities may vote "Prop 2½ override"

How it looks to the homeowner (US median home price: $230,000)

Affordable Housing Institute

- Tax use, not activity
- Annual occupancy costs (typical)
  - Water and sewer, personal consumption, $250-$1,250/ year
  - Utilities, personal consumption $600-$2,000/ year
  - Real estate taxes, 1-3%, $2,300-$7,000/ year
    - Deductible against personal income tax
  - Mortgage interest (say 6.5%), $15,000/ year
    - Deductible against income tax (save $5,000)
      - Primary residence only, not second home, not vacation home
- Sale
  - No capital gains tax up to $500,000 gain
    - Primary residence only
    - Capital gains tax rate 15-20%
  - No transfer taxes
    - Except (briefly) New York State (10% "Cuomo tax")
  - No sales taxes or VAT on property transfers

4. Interesting US initiatives relative to residential property

Affordable Housing Institute

- PILOTs: Payment In Lieu Of Taxes
  - Formula payment, tied to property feasibility
    - Usually for affordable rental
    - Or new industry moving in
  - Usually a percentage of property's rental income
  - Unintended consequence, can be higher than *ad valorem* taxation
- Popular in high-value, high-tax jurisdictions
  - Massachusetts Chapter 121A
  - New York City Article V, J-51
  - New Jersey 55:16
- Redevelopment Areas
  - Snapshot a geographic area, sum up total assessed value
  - Siphon a percentage (e.g. 10%) of the increase in real estate taxes into a targeted Housing Set Aside Fund
    - Very popular in California, other appreciating urban areas

4. Interesting US initiatives relative to residential property

Affordable Housing Institute

- Linkage: in exchange for zoning permission, build or fund affordable housing
  - Redevelopment areas
  - Housing Set Aside Funds
- First-time homebuyer incentives
  - Homeownership tax credits (e.g. Washington DC)
  - Housing Economic Recovery Act (HERA) for subprime
- Community Preservation Act
  - Surcharge on local taxes → ring-fenced fund to buy greenfield
  - Matched by state funding?

Interesting US initiatives: local government can use land and zoning

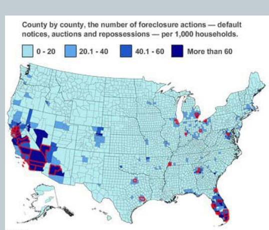
Affordable Housing Institute

- Up-zoning = increased value
  - Change zoning to allow more homes per hectare
    - This raises the land's value
    - Some of that increase in value can be "turned into" housing affordability
    - Have the developer create some affordable homes
  - "Tax on planning gain"
- "Inclusionary zoning"
  - Allow higher density → more homes → more value → some of new homes are deeded back to be affordable housing
    - Require that some (15%?) of all new homes be affordable
    - Could be homeownership, or rental
  - Capture a portion of the value increase from zoning
    - UK: Section 106
    - Ireland: Part V
    - US: Chapter 40B (Massachusetts), override local zoning
  - Sometimes mandated by judicial decisions (e.g. *Mount Laurel*)
- Or government can contribute land directly
  - … Trade that for some additional affordable homes

The subprime shakeout and its impact on municipal budgets and taxation

Affordable Housing Institute

- Foreclosures are concentrated
  - Michigan, Arizona, Nevada, Florida, California
- Municipal budgets are under pressure
  - → Millage rates go up, and taxpayers squawk
  - Cutbacks in local services
- Neighborhood Stabilization Program (NSP) funds
  - To buy foreclosed properties
  - Or patch municipal deficits?



5. Snapshot comparison of systems The US and Ireland

Affordable Housing Institute

	USA	***Ireland***
Rates on homes?	Yes, annual	No
Annual rates	1-3% of value	--
Rates commer.?	Yes	Yes
Rates on land?	Yes, by value	No
Reassessments?	Annually, or sale	Transport line
VAT on building	No	Yes, 13½%
Transfer tax	No	Yes, 6-7%
Water & Sewer	Pay, local utility	
Rubbish	Free (in rates)	Bin charges
Tax upzoning?	On reassess	€10,000/ home

Discussion

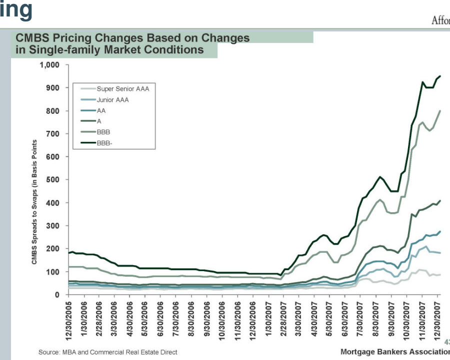
Taxation of residential property: The US experience

Presented at conference:
"Fiscal measures in relation to property in Ireland"

David A. Smith, Founder
Affordable Housing Institute
15 May 2009

Addendum: The capital markets crisis and what it's doing in the USA

The capital markets crisis and what it's doing



The mis-pricing of risk … returns with a vengeance

- Housing bubble? Risk grossly under-priced
- Home prices are a function of risk spread
  - Price is a function of its occupancy cost
  - … which is a function of its financing cost
  - … which is a function of its risk spread
  - When spreads skyrocketed, home prices fell
- Securitization led to losing touch with the assets
  - Extended value chain → investors unable to inspect assets
  - Tranching/ slicing → difficult to restructure, loss-mitigate
- Uniquely, the GSEs had infinite credit subsidy
  - 'Credit subsidy' = loan loss reserve (established by OMB)
  - FHA is rationed by law
  - Purely private companies are rationed by market forces
  - Until recently, GSEs were not rationed …

"Catastrophe is a precondition to fundamental financial reform"

- Crises lead to expanded/ improved rules
  - 1907 Panic → Federal Reserve Banks
  - 1929 Black Tuesday → SEC regulation
  - 1966 US riots → HUD housing programs
  - 1986 S&L bailout → RTC, FIRREA (appraisers)
  - 2002 Enron → Sarbanes-Oxley reporting
  - 2008 GSEs → The "Paulson Doctrines"
- The US has a distributed homeownership safety net
  - Entities that will respond to support affordability
  - Federal Home Loan Banks
  - State housing finance agencies (HFAs)
- Increased importance of permanent affordable rental
  - Workforce housing
  - Especially in coastal, growing-population areas

The "Paulson doctrine(s)" … "by their works ye shall know them"

Affordable Housing Institute

1. Prevent the Second Great Depression
2. Keep the GSEs in the loan-buying business
3. Intrude as little as possible in corporate governance
4. Support the debt holders
5. Discourage reliance (moral hazard)
6. Disrupt as few other markets as possible
7. Ignore depressed prices in favor of intrinsic value
8. Keep the optics good
9. Except as otherwise provided, let the market work

The post-bailout bank … and post-bailout housing finance

Affordable Housing Institute

- Banking on value
  - Immediate-clearance price is not the only indicator of value
  - Can be depressed through short-selling panic runs
  - 'Intrinsic value' derived from objective methodology
- Everyone is a regulated institution now
  - Not just deposit-taking institutions
- The Bank of Glass: scalable transparent granularity
  - *Granularity.* Every asset specifically visible
  - *Transparent.* Every security holder can see every other position
    - Drill down right through waterfalls
  - *Scalable.* Roll up, aggregate
  - Imagine Google Earth …
    - Dial your focus, dial your granularity
  - The only robust structures will be Banks of Glass

Whither Fannie Mae and Freddie Mac?

Affordable Housing Institute

- All this is pure speculation …
- Private GSEs are valuable … if under control
  - Limit their credit subsidy
  - Tighten capital requirements
    - Amounts relative to gearing
    - Narrow the non-cash forms of acceptable capital
      - MSRs, deferred tax assets
  - Limit their ability to mismatch maturities
    - Prepayment risk, interest-rate risk
  - Stronger regulatory oversight (FHFA with teeth)
- More targeting, stronger affordability goals
  - Expand affordability at the margin
    - First-time homeownership
    - Increase rental, particularly workforce housing (global challenge)
- Will they call it Frannie?

Affordable Housing Institute

Discussion

Affordable Housing Institute

Taxation of residential property: The US experience

Presented at conference:

"Fiscal measures in relation to property in Ireland"

David A. Smith, Founder
Affordable Housing Institute
15 May 2009