AUDIT REPORT

CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
BUREAU OF FINANCIAL AUDIT
WILLIAM C. THOMPSON, JR., COMPTROLLER

Audit Report on the Tax Classification of Real Property in the Borough of Brooklyn by the Department of Finance

FP04-059A

August 2, 2004

THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
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WILLIAM C. THOMPSON, JR.
COMPTROLLER

To the Citizens of the City of New York

Ladies and Gentlemen:

In accordance with the Comptroller's responsibilities contained in Chapter 5, §93 of the New York City Charter, my office has examined whether the Department of Finance (Finance) has adequate procedures to ensure that real properties in the borough of Brooklyn that are listed as Tax Class 1 on the assessment rolls are correctly classified. The results of our audit, which are presented in this report, have been discussed with Finance officials, and their comments have been considered in preparing this report.

Audits such as this provide a means of ensuring that property owners are being correctly billed for real estate taxes in accordance with the New York City Real Property Tax Law.

I trust that this report contains information that is of interest to you. If you have any questions concerning this report, please e-mail my audit bureau at audit@Comptroller.nyc.gov or telephone my office at 212-669-3747.

Very truly yours,

William C. Thompson, Jr.

WCT/gr

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AUDIT REPORT IN BRIEF

This audit determined whether the Department of Finance has adequate procedures in place to ensure that properties in the borough of Brooklyn that are listed as Class 1 on the assessment rolls are correctly classified. The scope of this audit covered tax assessments for Fiscal Year 2004.

The audit found that Finance does not have adequate procedures in place to ensure that properties in the borough of Brooklyn that are listed as Class 1 on the assessment rolls are correctly classified. Finance routinely inspects Class 2, 3, and 4 properties to ensure that they are correctly classified on the assessment rolls, but it does not conduct such inspections of Class 1 properties. Instead, Finance inspects Class 1 properties only when it is informed by the Department of Buildings that the properties are being altered or renovated.

We identified 135 properties listed as Class 1 on the assessment rolls that appeared to be misclassified. Using Finance guidelines, we determined that of these properties, 134 should have been classified as Class 4 and one should have been classified as Class 2. Had these properties been correctly classified, we calculated that Finance would have billed the owners an additional $904,667 in property taxes for Fiscal Year 2004.

INTRODUCTION

Background

The Department of Finance (Finance) administers and enforces the tax laws; collects taxes, judgments and other charges; educates the public about its rights and responsibilities with regard to taxes and tax benefit programs in order to achieve the highest level of voluntary compliance; provides service to the public by assisting in customer problem resolution; and protects the confidentiality of tax returns. Finance processes parking summonses and provides an adjudicative forum for motorists who wish to contest them. Finance also provides collection enforcement services for court-ordered private and public sector debt.

In accordance with the New York City Real Property Tax Law (RPTL), Finance classifies every parcel of property in New York City for real-estate tax purposes. These tax classes are as follows:

- *Class 1*: Consists of residential properties (with three units or less) and "Mixed Commercial/Residential Use" (mixed-use) properties with (three or fewer units) provided 50 percent or more of these spaces are used for residential purposes. This includes the following types of primarily residential property: one-, two-, and three-family homes, condominiums of three stories or less that were originally built as condominiums; condominiums of three dwelling units or less that were previously one-, two-, or three-family homes; single-family homes on cooperatively owned land (also known as bungalows); and certain vacant land zoned for residential use or, if not in Manhattan south of 110th Street, vacant land adjoining improved Class 1 property.

- *Class 2*: All other primarily residential properties, including any residential condominiums not in Class 1. This includes co-ops but does not include hotels, motels, or other similar property.

- *Class 3*: Includes real estate of utility corporations and special franchise properties, excluding land and certain buildings.

- *Class 4*: Includes all other properties, such as stores, warehouses, hotels, and any vacant land not classified as Class 1.

Properties are assessed at certain percentages of their full market value based on their classification. In general, Class 1 properties are assessed at eight percent of market value and Class 2, 3, and 4 properties are assessed at 45 percent of market value.

The Property Division is responsible for producing a fair, accurate, and legal assessment roll each year. Finance's assessors are responsible for valuing properties in their assigned areas. In that regard, assessors assure that: properties are assigned to the correct building class and tax class; physical characteristics of the building, including the square footage, are recorded accurately; and properties are valued in accordance with assessment roll guidelines and general appraisal rules.

During Fiscal Year 2003, Finance collected $9.9 billion in property taxes. According to Finance records, there were 940,091 taxable properties, consisting of 684,934 Class 1 properties, 175,132 Class 2 properties, 388 Class 3 properties, and 79,637 Class 4 properties.

Objective

The objective of this audit was to determine whether Finance has adequate procedures in place to ensure that properties in the Borough of Brooklyn that are listed as Class 1 on the assessment rolls are correctly classified.

Scope and Methodology

This audit covered tax assessments for Fiscal Year 2004. We met with Finance officials to obtain an understanding of the regulations governing the classification of real property and Finance procedures for ensuring that properties are correctly classified.

From the Verizon Superpages and the Group Health Incorporated Provider Directory we compiled a list of addresses of medical offices in Brooklyn. We compared this list to Finance's records to determine the tax class of each of these properties. We identified 1,110 properties that were occupied by medical office(s) and were classified as Class 1 by Finance. Of the 1,110 properties, 579 were classified on Finance records as mixed-use properties. We visited each property to determine whether they were properly classified. Our analysis was based on the New York City Real Property Tax Law, which utilizes the percentage of commercial space at each of the properties—properties with more than 50 percent of the space used for commercial purposes cannot be classified as Tax Class 1. Of the 1,110 properties, we noted that 91 appeared to be misclassified. In addition, during our visits we identified another 44 properties, not on our list, which appeared to be misclassified.

For the 135 properties we noted were misclassified, we applied formulas provided by Finance to calculate the amount of additional tax due based on the appropriate tax classification for each property.

Although the results of our audit tests are not projectable to the entire population of Class 1 properties, they provided us a reasonable basis to assess Finance's procedures for classifying Class 1 properties in the borough of Brooklyn.

This audit, covering Brooklyn properties, is the first of a series of audits of Finance tax classification procedures. Audits of Manhattan, Queens, Bronx, and Staten Island properties will be covered in separate reports.

This audit was conducted in accordance with generally accepted government auditing standards (GAGAS) and included tests of the records and other auditing procedures considered necessary. This audit was performed in accordance with the audit responsibilities of the City Comptroller as set forth in Chapter 5, § 93, of the New York City Charter.

Discussion of Audit Results

The matters covered in this report were discussed with Finance officials during and at the conclusion of this audit. A preliminary draft report was sent to Finance officials and was discussed at an exit conference held on May 19, 2004. On May 21, 2004, we submitted a draft report to Finance officials with a request for comments. We received a written response from Finance on June 11, 2004.

In its response, Finance noted that it "is well on its way toward implementing a comprehensive program for modernizing New York City's property tax structure." In addition, "significant new initiatives and safeguards have been implemented to ensure adequate procedures are in place to accurately assess all properties in the City of New York."

Finance agreed to partially implement or indicated that it has implemented three of the report's five recommendations. Finance did not agree with the recommendation that annual inspections of all Class 1 mixed-use properties and a sample of all other Class 1 properties should be conducted to ensure that they are properly classified on the assessment rolls. Finance stated that the law requires only that Class 1 properties be inspected once every three years. With regard to the report's recommendation to develop a formal process to ensure that it is notified of building permits issued, Finance claimed that such a process is already in place. These issues as well as our comments are discussed in the body of this report.

Finance also stated that the audit methodology did not match the recommendations in the report. In that regard, Finance stated that "the auditors did not walk around neighborhoods to find incorrectly classified properties. Instead, the auditors examined telephone books in search of doctor's offices and matched those addresses against properties classified by Finance as mixed-use" to determine whether properties were misclassified. It appears that Finance misunderstood the audit recommendation pertaining to inspections of Class 1 properties. We did not recommend that Finance "walk around neighborhoods to find incorrectly classified properties." Rather, we recommended that Finance conduct annual inspections of all Class 1 mixed-use properties and a sample of all other Class 1 properties. In any case, Finance indicated that it will be using new technologies to complete 100 percent virtual inspections of properties every year, which is line with the intent of our recommendation.

The full text of the comments received is included as an addendum to this report.

FINDINGS AND RECOMMENDATIONS

Finance does not have adequate procedures in place to ensure that properties in the Borough of Brooklyn that are listed as Class 1 on the assessment rolls are correctly classified. Finance routinely inspects Class 2, 3, and 4 properties to ensure that they are correctly classified on the assessment rolls, but it does not conduct such inspections of Class 1 properties. Instead, Finance inspects Class 1 properties only when it is informed by the Department of Buildings that the properties are being altered or renovated.

Based on our inspections, we identified 135 properties listed as Class 1 on the assessment rolls that appeared to be misclassified. Using Finance guidelines, we determined that of these properties, 134 should have been classified as Class 4 and one should have been classified as Class 2. Had these properties been correctly classified, we calculate that Finance would have billed the owners an additional $904,667 in property taxes for Fiscal Year 2004.

> ***Finance Response:*** "As you know, Real Property Tax Law §1800 requires that all assessment changes, even after a reclassification, be phased-in over five years. As a result, the audit overstates the additional property taxes that would be payable in Fiscal Year 2004 if you are correct that the properties should be reclassified. If all 122 properties were reclassified, Finance would bill less than $200,000 not $904,667."

> ***Auditor Comment:*** Although Article 18 of the RPTL provides for phasing-in assessment changes for property being reclassified from other classes into Class 1, the statute makes no such provision for reclassifications from Class 1 to Classes 2 or 4. Moreover, §1805(5) provides that properties that have been improved upon or added onto are not subject to any limitations and subsequent phasing-in requirements. In fact, Finance acknowledged this rule in its Fiscal Year 2003 Annual Report, in which it stated, "There are no limitations on assessment increases resulting from new construction, alterations." Building Department records for 10 of the properties studied by the auditors indicate that all 10 had undergone additions or improvements and so could be assessed in full without any phase-in or limitations. Thus, between the absence of a phase-in requirement for property being reclassified out of Class 1 and the exception from a phase-in for any properties which underwent additions or improvements, we maintain that if the 135 properties were correctly classified, Finance would have billed the owners an additional $904,667 in Fiscal Year 2004.

In response to our request, Finance inspected 13 of the 135 properties that we believed were misclassified. Finance officials agreed that all 13 properties, including the three examples discussed below, were misclassified.

These issues are discussed in more detail in the following sections of this report.

Improper Classification of Mixed-Use Properties

As mentioned earlier, 579 of the 1,110 Class 1 properties that were occupied by medical office(s) were classified on Finance's records as mixed-use. Our inspections of the 579 properties revealed that 63 were misclassified. In addition, during our visits we identified 37 other properties that were misclassified as Class 1 mixed-use that were not on our list of 1,110 properties. Thus, 100 of the 135 misclassified properties we identified were listed as Class 1 mixed-use on Finance records. Had these properties been correctly classified, we calculated that Finance would have billed the owners an additional $582,145 in property taxes for Fiscal Year 2004.

For example, 415 Avenue P was listed on the assessment rolls as a "Primarily One-Family With One Store or Office" (Tax Class 1, Building Code S1). Our inspection of the property disclosed that the building was used as a medical center. (See Appendix I for a photograph of the property.) Accordingly, Finance should have classified this property as a "Professional Building" (Tax Class 4, Building Code O7). For Fiscal Year 2004, Finance billed the owner of this property $2,401 rather than $12,209 due based on the appropriate Class 4 tax classification.

As another example, 105 Oriental Blvd. was listed on the assessment rolls as a "Primarily One-Family With One Store or Office" (Tax Class 1, Building Code S1). Our inspection of the property disclosed that the building had a medical office on the first floor and a nail salon on the second floor. (See Appendix II for a photograph of the property.) Accordingly, Finance should have classified this property as a "Store Building; 2-Story or Store/Office" (Tax Class 4, Building Code K2). For Fiscal Year 2004, Finance billed the owner of this property $3,208 rather than $14,447 due based on the appropriate Class 4 tax classification.

Improper Classification of Other Class 1 Properties

Of the 1,110 Class 1 properties that were occupied by medical office(s), 531 were classified on Finance's records as Class 1 residential use. Our inspections of the 531 properties revealed that 28 were misclassified. In addition, during our visits we identified another seven properties that were misclassified as Class 1 residential that were not on our list of 1,110 properties. Thus, 35 of the 135 misclassified properties we identified were listed on Finance records as Class 1 residential use. Had these properties been correctly classified, we calculate that Finance would have billed the owners an additional $322,522 in property taxes for Fiscal Year 2004.

For example, 3099 Coney Island Avenue was listed on the assessment rolls as a "Two-Family Residential Building" (Tax Class 1, Building Code B3). Our inspection of the property disclosed that the building was used as a medical center. (See Appendix III for a photograph of the property.) Accordingly, Finance should have classified this property as a "Professional Building" (Tax Class 4, Building Code O7). For Fiscal Year 2004, Finance billed the owner of this property $2,003 rather than $16,062 due based on the appropriate Class 4 tax classification.

Recommendations

Finance should:

1. Inspect the remaining 122 properties and determine whether they are misclassified.

   Finance Response: "We have. We assigned the 122 properties to a team of 10 assessors for on-site inspections. We are compiling the information from the assessors' review and will advise you of which properties, if any, should be reclassified.

   "For your information, the Assistant Commissioner for Property and the Commissioner visually inspected almost half of the properties on the list. Finance will share the information that they gathered as well.

   "Finally, in addition to the results of the physical inspection, Finance has determined the zoning classification for each of the properties. We will only re-classify properties where more than 50 percent of the square footage is commercial and the underlying zoning does not allow for the use as of right. According to Finance's records, 6 of the 122 properties are located in areas zoned commercial. Only 46 of the properties are located in areas with a commercial overlay."

   Auditor Comment: The RPTL and Zoning Resolution do not support Finance's contention that when the underlying zoning allows properties' use "as-of-right," mixed-use properties are not commercial for tax purposes—even if more than 50 percent of their square footage is used for commercial purposes.

   Section §1802(1) of the RPTL states that Class 1 properties include "all one, two and three family residential real property, including such *dwellings used in part for nonresidential purposes but which are used primarily for residential purposes.*" (Emphasis added). The Zoning Resolution does not provide any exception to the RPTL's express requirement that for a property (other than vacant land) to be included in Class 1, it must be used primarily for residential purposes. In addition, neither the Zoning Resolution generally, nor the specific provisions concerning vacant land, have any effect on the proper tax classification of mixed-use property. Finance itself has argued, "First and foremost . . . if more than 50 percent of the building square footage were residential, then the building would be deemed residential for property tax purposes." Conversely, buildings in which less than 50 percent of the square footage is devoted to residential use must be deemed commercial for property tax purposes, in accordance with RPTL §1802(1).

   We are pleased that Finance will inspect the remaining 122 properties and determine whether they are misclassified. However, we urge Finance to reconsider its position on the classification of mixed-use properties to ensure that it is in compliance with the RPTL and that the City bills and collects all property taxes that are due.

2. Make the necessary adjustments to the assessment rolls for the 13 properties it inspected during the audit as well as any of the 122 properties that are misclassified.

   Finance Response: "As stated above, Finance will only reclassify properties where more than 50 percent of the square footage is commercial and the underlying zoning does not allow for the use as of right."

   Auditor Comment: As stated previously, the RPTL and Zoning Resolution do not support Finance's contention that mixed-use properties are not commercial for tax purposes when more than 50 percent of their square footage is for commercial use. Therefore, properties in which more than 50 percent of the square footage is devoted to commercial use, regardless of the underlying zoning, must be classified and assessed for real property tax purposes as either Class 2 or Class 4.

3. Seek an opinion from the Law Department as to whether property owners can be billed for additional taxes owed for prior years that were caused by property misclassifications. If it is determined that the additional amounts can be billed, the Department of Finance should bill the owners accordingly.

   Finance Response: "We have. Finance asked the Law Department for an opinion on May 27, 2004. Finance will follow the advice of counsel in connection with whether or not owners can be billed for properties that should have been reclassified in previous years.

   "Finance's Counsel has reviewed the law and has opined that we do not have the authority to go back to recoup possible lost taxes. This is consistent with the Law Department's finding as it related to the assessment scandal that cost the City almost $160 million in revenue. We are awaiting the Law Department's determination."

   Auditor Comment: We are pleased that Finance has requested an opinion from the Law Department, as recommended. However, we question the opinion of Finance's Counsel since under §11-206 of the New York City Administrative Code, the Finance Commissioner "may correct any assessment or tax" which resulted from a mistaken tax classification designation. Moreover, we contend that the New York City Administrative Code authorizes the retroactive increase of an assessment or tax that had been based on an incorrect description in the assessment rolls.

4. Conduct annual inspections of all Class 1 mixed-use properties and a sample of all other Class 1 properties to ensure that they are properly classified on the assessment rolls.

   Finance Response: "We disagree. By law, Finance is only required to inspect Class 1 properties every three years. Therefore, an annual inspection for these properties is not warranted. Instead, Finance is doing, and will do more than ever, to ensure the accuracy of the data that we will collect about properties. Working with the

Department of Information, Technology and Telecommunication (DoITT), Finance will utilize digital photography data collected from several flyovers of the City that were completed over the last 5 years. Finance will also utilize new technology to obtain digital front face photos of all properties in the City of New York. Together with the flyover pictures and data, these front face photos will change how we do business. The bottom line is that Finance will be completing a 100 percent virtual inspection of New York City properties every year."

Auditor Comment: Our purpose in recommending these inspections is to ensure that the City does not forgo additional property taxes on misclassified properties. Therefore, we acknowledge that Finance's approach using new technologies to complete 100 percent virtual inspections of properties every year is in line with the intent of the recommendation.

<u>Other Issue</u>

As previously stated, Finance inspects Class 1 properties when it is informed by the Department of Buildings that the properties are being altered or renovated. During our inspections we noted that ten of the 135 properties that we believed were misclassified had recently undergone structural changes. From Department of Buildings records we determined that four of these properties had new building construction permits and the other six had alteration permits. However, it appears that either the Department of Buildings did not make Finance aware of these facts or Finance ignored the information since these properties were not reclassified. In either case, Finance and the Department of Buildings should better coordinate their efforts to ensure that the City receives the appropriate taxes from its taxable properties.

Recommendation

5. Finance, in conjunction with the Department of Buildings, should develop a formal process to ensure that Finance is notified of all permits issued for new construction and alterations of Class 1 properties. Finance should then inspect the properties and make any necessary tax classification changes on the assessment rolls.

Finance Response: "Finance already works closely with the Buildings Department (Buildings) on permit notification. At least once per month Finance receives a download of recently filed permits for new construction and major renovation. In addition, Finance, Buildings and the City Planning Department ('City Planning') are currently working on a project that will allow for real time synchronization of data between the three agencies.

"Only 41 of the 122 properties filed a permit with buildings indicating a change in the use of the property. In those instances and if appropriate, Finance should have changed the building and tax class of the properties without an inspection.

"In the case of another 18 properties, the owner filed a work permit but indicated no change in use for zoning purposes. In those instances, Finance should have investigated whether a change was appropriate. In 77 of the cases, or almost 60 percent of the cases, the owner did not file a work permit at all and Finance does not believe a permit was necessary."

Auditor Comment: We question Finance's assertion that it "already works closely with the Buildings Department." Clearly, Finance's recognition that it should have changed the building and tax class of 41 of the 122 properties that filed a building permit belies its statement about working closely with the Department of Buildings. Therefore, we reiterate our recommendation.

APPENDIX I

<u>3099 Coney Island Avenue</u>: Finance records inaccurately listed this property as a "Two-Family Residential Building" (Tax Class 1, Building Code B3).

415 Avenue P: Finance records inaccurately listed this property as a “Primarily One-Family With One Store or Office” (Tax Class 1, Building Code S1).

APPENDIX III

<u>105 Oriental Boulevard</u>: Finance records inaccurately listed this property as a "Primarily One-Family With One Store or Office" (Tax Class 1, Building Code S1).