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 Manhattan by the Department of Finance

FP05-131A

November 21, 2005

THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
1 CENTRE STREET
NEW YORK, N.Y. 10007-2341

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 audited the adequacy of the Department of Finance's classification procedures for real properties in the borough of Manhattan listed as Tax Class 1 on the assessment rolls.

Under the New York City Real Property Tax Law, Class 1 properties are those that either contain three residential units or less, or contain some commercial usage provided that 50 percent or more of the property is used for residential purposes. We audit agency procedures such as this to ensure that they are in accordance with applicable law and result in the correct determination of revenues due the City.

The results of our audit, which are presented in this report, have been discussed with Department of Finance officials, and their comments have been considered in preparing this report. Their complete written response is attached to this report.
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/fh

Report: **FP05-131A**

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AUDIT REPORT IN BRIEF

This audit determined whether the Department of Finance has adequate procedures in place to ensure that mixed-use properties in the borough of Manhattan that are listed as Class 1 on the assessment rolls are correctly classified. The scope of this audit covered tax assessments for Fiscal Year 2005.

Audit Findings and Conclusions

The audit found that Finance does not have adequate procedures in place to ensure that mixed-use properties in the borough of Manhattan that are listed as Class 1 on the assessment rolls are correctly classified. Although Finance routinely inspects Class 2, 3, and 4 properties to ensure that they are correctly classified on the assessment rolls, 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 33 properties listed as Class 1 on the assessment rolls that appeared to be misclassified. Using Finance guidelines, we determined that these properties should have been classified as Class 4. Had these properties been correctly classified, we calculate that Finance would have billed the owners an additional $1,485,999 property taxes for Fiscal Year 2005 and subsequent years.

Audit Recommendations

We recommend that Finance should:

- Inspect the properties identified in this report and confirm whether they are misclassified.
- Make the necessary adjustments to the assessment rolls for the properties that are misclassified.

- 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.

INTRODUCTION

Background

The Department of Finance (Finance) administers and enforces the tax laws; collects taxes, judgments and other charges; educates the public about their 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 resolving customer problems; and protects the confidentiality of tax returns. Finance processes parking summonses and provides an adjudicative forum for motorists who wish to contest them. It 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. The tax classifications are:

- *Class 1*: Residential properties (with three units or less) and "Mixed Commercial/Residential Use" (mixed-use) properties (with three or less 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 similar property.

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

- *Class 4*: 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 six 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 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; that physical characteristics of the building, including the square footage, are recorded accurately; and that properties are valued in accordance with assessment roll guidelines and general appraisal rules.

During Fiscal Year 2004, Finance collected $11.4 billion in property taxes. According to Finance records, there were 947,533 taxable properties, consisting of 688,205 Class 1 properties, 179,607 Class 2 properties, 406 Class 3 properties, and 79,315 Class 4 properties.

This is the fourth of a series of audits currently being conducted on Finance tax classification procedures. The first audit covered the borough of Brooklyn[1], the second audit covered the borough of Queens[2], and the third audit covered the borough of Bronx[3]. Audit of Staten Island properties will be covered in separate report.

Objective

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

Scope and Methodology

This audit covered tax assessments for Fiscal Year 2005 (July 1, 2004 to June 30, 2005).

In order to fulfill our objective, we reviewed applicable provisions of the RPTL. 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.

Finance provided us with a list of 747 Class 1 mixed-use properties in Manhattan. We selected all 747 properties in the borough of Manhattan for review. In May and June 2005, we visited each of the properties to determine whether they were correctly classified. Our determination was based on the percentage of commercial space at each of the properties, since properties with more than 50 percent of the space used for commercial purposes cannot be

[1] Audit Report on the Tax Classification of Real Property in the Borough of Brooklyn by the Department of Finance (FP04-059A), issued August 2, 2004.

[2] Audit Report on the Tax Classification of Real Property in the Borough of Queens by the Department of Finance (FP04-149A), issued June 2, 2005.

[3] Audit Report on the Tax Classification of Real Property in the Borough of Bronx by the Department of Finance (FP05-120A), issued June 30, 2005.

classified as Tax Class 1—§ 1802 of the RPTL states that "all one, two and three family residential real property, including such dwellings used in part for nonresidential purposes but which are used **primarily** [Emphasis Added] for residential purposes," are to be classified as Class 1 properties. Properties that are more than 50 percent commercial cannot be considered "primarily for residential purposes." For the properties we noted that 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.

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 officials from Finance 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 August 18, 2005. On September 13, 2005, we submitted a draft report to Finance officials with a request for comments. We received a written response from Finance officials on September 26, 2005.

In its response, Finance stated that it "continues to implement significant initiatives and safeguards to ensure adequate procedures are in place to accurately assess all properties in the City of New York." Finance also indicated that it has implemented two of the report's three recommendations, but it 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 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 every three years. In any case, Finance indicated that it will be using new technology to complete virtual inspections of 100 percent 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 mixed-use properties in the borough of Manhattan that are listed as Class 1 on the assessment rolls are correctly classified. Although Finance routinely inspects Class 2, 3, and 4 properties to ensure that they are correctly classified on the assessment rolls, 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. Consequently, 33 mixed-use properties were listed as Class 1 on the assessment rolls that appeared to be misclassified.

Improper Classification of Mixed-Use Properties

Our inspection of the 747 mixed-use properties revealed that 33 were misclassified. These properties should have been listed as Class 4 because more than 50 percent of the properties' space was used for commercial purposes. Had those 33 properties been correctly classified, we calculate that Finance would have billed the owners an additional $1,485,999 in property taxes for Fiscal Year 2005 and subsequent years (based on each year's tax rate and the assessed value of the properties).[4]

Examples of misclassified properties are as follows:

- 718 Madison Avenue was listed on the assessment rolls as a "Primarily Two-Family with One Store or Office" (Tax Class 1, Building Code S2). Our inspection of the property disclosed that the building had a store on the first, second and third floors, and an office on the forth floor. (See Appendix I for a photograph of the property.) Accordingly, Finance should have classified this property as a "Store Building; Two-Story or Store/Office" (Tax Class 4, Building Code K9). For Fiscal Year 2005, Finance billed the owner of this property $48,888 rather than the $234,084 due based on the appropriate Class 4 tax classification.

- 308 East 59 Street 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 entire building was used as a store. (See Appendix II for a photograph of the property.) Accordingly, Finance should have classified this property as a "Store Building; Two Story or Store/Office" (Tax Class 4, Building Code K2). For Fiscal Year 2005, Finance billed the owner of this property $17,002 rather than the $74,301 due based on the appropriate Class 4 tax classification.

- 1016 Madison Avenue 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 four floors were used as an art gallery and two floors were used as an apartment. (See Appendix III for a photograph of the property.) Accordingly, Finance should have classified this property as a "Store with apartments above" (Tax Class 4, Building Code K4). For Fiscal Year 2005, Finance billed the owner of this property $117,708 rather than the $435,397 due based on the appropriate Class 4 tax classification.

- 205 East 26 Street was listed on the assessment rolls as a "Primarily Two-Family with One Store or Office" (Tax Class 1, Building Code S2). Our inspection of the property disclosed that the building had a nail salon on the first floor and acupuncture and foot reflexology on the second floor. (See Appendix IV for a photograph of the property.)

[4] We recognize that according to Real Property Tax Law §1805, Finance will have to phase-in the additional taxes over a five-year period. The $1,485,999 that was calculated assumed that the properties were always correctly classified as class 4 properties, therefore, no phase-in would have been required.

Accordingly, Finance should have classified this property as a “Store Building; Two-Story or Store/Office” (Tax Class 4, Building Code K2). For Fiscal Year 2005, Finance billed the owner of this property $4,991 rather than the $20,061 due based on the appropriate Class 4 tax classification.

Finance Response: In its response, Finance stated that “Of the 33 properties Finance has subsequently inspected, 7 required no change in classification, 9 required partial changes, and 17 were as indicated by the Comptroller’s audit.” Finance also took exception with the amount of additional Fiscal Year 2005 property taxes that the report stated would have been billed to owners had the properties been properly classified. Specifically Finance stated:

“Although this audit acknowledges that Real Property Tax Law §1805 will require that Finance phase in any additional taxes owed on misclassified properties over a five-year period, it is our view that the audit nonetheless over estimates taxes owed on such properties based on the unwarranted assumption that those properties found to have been misclassified in the audit, were always misclassified and therefore would have generated taxes beyond those permitted under RTPL §1805.”

“Finance estimates that additional taxes totaling $205,924 are owed on these properties rather than hypothetical estimate of $1,485,999.”

Auditor Comment: The fact that the $1,485,999 stated in the report could not have been collected for Fiscal Year 2005 but requires a phase-in period does not alter the fact that Finance agrees that 26 of the 33 properties cited in the report are misclassified. These properties will bring in an additional $1,362,064 annually, once the phase-in period is complete. In addition, although Finance believes that we make an “unwarranted assumption” that the properties cited were always misclassified we are certain that one of the properties (718 Madison Avenue) has been used in its entirety as commercial property for at least 10 years. Obviously, this property should be paying its full tax amount.

Recommendations

Finance should:

1. Inspect the properties identified in this report and confirm whether they are misclassified.

   Finance Response: “We agree. Finance has inspected all the identified properties and has reclassified properties that Finance agreed were misclassified.”

2. Make the necessary adjustments to the assessment rolls for the properties that are misclassified.

Finance Response: "We agree. Finance has made the necessary adjustments to the '06/'07 tentative assessment roll for the properties Finance agreed were misclassified."

3. 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. Through the use of state-of-the art technology, Finance will in effect be collecting property specific information on an annual basis. The agency is currently working with the Department of Information, Technology and Telecommunication (DoITT) to utilize digital photography data collected from several flyovers of the City that were completed over the last five 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 photos and data, these front face photos will change the way we do business. As result, Finance will be completing virtual inspection of all New York City properties every year."

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

APPENDIX I

<u>718 Madison Avenue:</u> Finance records inaccurately listed this property as a "Primarily Two-Family with One Store or Office" (Tax Class 1, Building Code S2).

APPENDIX II

<u>308 East 59 Street:</u> Finance records inaccurately listed this property as “Primarily One-Family with One Store or Office” (Tax Class 1, Building Code S1).

APPENDIX III

<u>1016 Madison Avenue:</u> Finance records inaccurately listed this property as "Primarily One-Family with One Store or Office" (Tax Class 1, Building Code S1).

APPENDIX IV

<u>205 East 26 Street:</u> Finance records inaccurately listed this property as a "Two-Family with One Store or Office" (Tax Class 1, Building Code S2).

FINANCE
NEW • YORK
THE CITY OF NEW YORK
DEPARTMENT OF FINANCE

BY FAX AND HAND DELIVERY

September 26, 2005

Mr. Greg Brooks
Deputy Comptroller
Office of the Comptroller
1 Centre Street
New York, NY 10007-2341

Re: Audit Report on the Tax Classification of Real Property in the Borough of Manhattan by the Department of Finance FP05-131A

Dear Mr. Brooks:

Thank you for the opportunity to respond to the City of New York Office of the Comptroller ("Comptroller") Draft Audit Report on the Tax Classification of Real Property in the Borough of Manhattan by the New York City Department of Finance ("Finance").

The Department of Finance continues to implement significant initiatives and safeguards to ensure adequate procedures are in place to accurately assess all properties in the City of New York. The agency is committed to maximizing its human and technical resources to meet this objective. The Department of Finance appreciates the efforts of your audit staff and past acknowledgment of the agency's progress made through the use of new technologies.

Although this audit acknowledges that Real Property Tax Law §1805 will require that Finance phase in any additional taxes owed on misclassified properties over a five-year period, it is our view that the audit nonetheless over estimates taxes owed on such properties based on the unwarranted assumption that those properties found to have been misclassified in the audit, were always misclassified and therefore would have generated taxes beyond those permitted under RPTL §1805. Accordingly, the Comptroller's audit of 747 mixed-use properties has determined that 33 were misclassified as Class 1 and should have been classified as Class 4. Assuming these properties were always misclassified, which is a "worst case" but not necessarily realistic assumption, the audit suggests a loss of $1,485,999 in property taxes for Fiscal Year 2005 and subsequent years.

Of the five sample properties specifically cited as being misclassified as Class 1 rather than Class 4, further inspection by the Department of Finance, as recommended by the audit, revealed that four (4) of the five (5) were misclassified as indicated, however, one (1) should remain Class 1 for the present. Of the 33 properties Finance has subsequently inspected, 7 required no change in classification, 9 required partial changes, and 17 were as indicated by the Comptroller's audit. Finance estimates that additional taxes totaling $205,924 are owed on these properties rather than the hypothetical estimate of $1,485,999.
The report suggests that Finance implement three recommendations. Below are the recommendations and Finance's comments:

Recommendation 1:

Inspect the properties identified in this report and confirm whether they are misclassified.

Finance's Response:

We agree. Finance has inspected all the identified properties and has reclassified properties that Finance agreed were misclassified.

Recommendation 2:

Make the necessary adjustments to the assessment rolls for the properties that are misclassified.

Finance's Response:

We agree. Finance has made the necessary adjustments to the '06/'07 tentative assessment roll for the properties Finance agreed were misclassified.

Recommendation 3:

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's Response:

We disagree. By law, Finance is only required to inspect Class 1 properties every three years. Through the use of state-of-the art technology, Finance will in effect be collecting property specific information on an annual basis. The agency is currently working with the Department of Information, Technology and Telecommunication (DoITT) to utilize digital photography data collected from several flyovers of the

City that were completed over the last five 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 photos and data, these front face photos will change the way we do business. As a result, Finance will be completing virtual inspection of all New York City properties every year.

Finance appreciates the efforts of your audit staff as it completes these audits of the five boroughs, and it's assistance in providing information on the properties inspected so that we can conduct further inspections and make the necessary adjustments. I have attached the Property Division's report on its inspection of the properties cited in this audit for your review and consideration.

If you have any questions concerning this response, please feel free to call me at (212) 669-4878.

Sincerely,

Michael Koslow

Michael Koslow
Audit Coordinator

Cc: Martha E. Stark, Commissioner, Department of Finance
Rochelle Patricof, First Deputy Commissioner, Department of Finance
Dara Ottley-Brown, Assistant Commissioner, Property, Department of Finance
Att.