

AUDIT REPORT



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

Audit Report on the Implementation of 421(a) Incentive Program Tax Benefits For Properties in Manhattan by the Department of Finance

FR08-123A

October 6, 2009



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 responsibilities of the Comptroller contained in Chapter 5, §93, of the New York City Charter, my office has audited the Implementation of 421(a) Incentive Program Tax Benefits For Properties in Manhattan by the Department of Finance.

The Section 421(a) program provides tax exemption benefits to owners of residential real property who construct new multiple dwellings or convert, alter, or improve existing buildings for residential use. The Department of Finance is responsible for calculating and implementing tax benefits granted under the program. We audit City tax incentive programs such as this as a means of ensuring that the programs are being administered in accordance with applicable laws and regulations.

The results of our audit, which are presented in this report, have been discussed with officials of the Department of Finance, 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,

A handwritten signature in cursive script that reads "William C. Thompson, Jr.".

William C. Thompson, Jr.

WCT/fh

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*The City of New York
Office of the Comptroller
Bureau of Financial Audit*

**Audit Report on the Implementation of
421(a) Incentive Program Tax Benefits for
Properties in Manhattan by the Department of Finance**

FR08-123A

AUDIT REPORT IN BRIEF

We performed an audit on the implementation of 421(a) incentive program tax benefits for properties in Manhattan by the Department of Finance. The Section 421(a) program provides tax exemption benefits to owners of residential real property who construct new multiple dwellings or convert, alter, or improve existing buildings for residential use. The Department of Housing Preservation and Development (HPD) is responsible for administering the program and issuing a certificate-of-eligibility to property owners it deems eligible and who meet program requirements. The Department of Finance (Department) is then responsible for calculating and implementing tax benefits granted under the program.

The program was created in 1971 under legislation authorized by Section 421(a) of the New York State Real Property Tax Law as a means of encouraging housing development in the City. Exemptions are granted for a period of up to three years for construction, and either 10, 15, 20, or 25 additional years on a sliding scale, depending on the property's location in the City, whether construction is carried out with substantial government assistance, and whether requirements for affordable housing have been met. In Fiscal Year 2009, 37,485 properties received \$607 million in tax benefits.

Audit Findings and Conclusions

The Department is inaccurately calculating tax exemption benefits under the Section 421(a) program. As a result, for our sample of 50 properties, the City has lost more than \$15 million in real estate tax revenue from the date that properties were originally granted tax exemptions until Fiscal Year 2008. Moreover, certain properties overpaid \$1.2 million in taxes. Furthermore, we estimate that the Department could underbill approximately \$130.2 million in additional taxes for the sampled properties in future years throughout the remaining terms of the exemption benefits. The Department also lacked reliable program records and written procedures for calculating tax information. Finally, certain Department files lacked required documentation.

Audit Recommendations

This report makes a total of 10 recommendations. The major recommendations are that the Department should:

- Review and adjust the calculations of taxable assessed values and taxes due for the 50 sampled properties, and for all other properties.
- Recoup \$9,896,149 in real estate taxes from 37 properties.
- Recoup \$4,849,389 in improperly allowed real estate tax benefits for two properties.
- Adjust base year assessed value calculations for four properties as required by program rules and recoup \$442,010 in lost real estate taxes.
- Implement adequate internal controls to ensure that all program information is accurately recorded in FAIRTAX and the hardcopy property files (e.g., property cards, etc.). In that regard, information in FAIRTAX and the property cards should be periodically reconciled.
- Prepare formal written policies and procedures for calculating assessed values and exemptions. Ensure that appropriate Department staff is instructed in program policies and procedures.

INTRODUCTION

Background

The Section 421(a) program provides tax exemption benefits to owners of residential real property who construct new multiple dwellings or convert, alter, or improve existing buildings for residential use. The Department of Housing Preservation and Development (HPD) is responsible for administering the program and issuing a certificate-of-eligibility to property owners it deems eligible and who meet program requirements. The Department of Finance (Department) is then responsible for calculating and implementing tax benefits granted under the program.

The program was created in 1971 under legislation authorized by Section 421(a) of the New York State Real Property Tax Law as a means of encouraging housing development in the City. Exemptions are granted for a period of up to three years for construction, and either 10, 15, 20, or 25 additional years on a sliding scale, depending on the property's location in the City, whether construction is carried out with substantial government assistance, and whether requirements for affordable housing have been met. In Fiscal Year 2009, 37,485 properties received \$607 million in tax benefits.

A tax exemption temporarily exempts a property from incurring additional property taxes if eligible improvement work increases the property's taxable assessed value.¹ After a property is deemed eligible for program benefits, it may receive up to three years of exemptions from the date that construction begins. Property owners who are eligible for program benefits must still pay annual taxes on the assessed valuation of the land and any improvements that were effective during the "base year," which is the tax year preceding construction, the year in which a property becomes eligible for exemption benefits.

A property owner must submit a certificate-of-eligibility to the Department in order to obtain a tax exemption. The Department's Commercial Exemptions Unit oversees the program and records information about a property's tax status in an information technology application known as FAIRTAX. In addition, tax information is manually recorded in "property cards." The taxable status date—the date on which assessed value and tax classification are fixed for all properties—is January 5 of each year. According to Department guidelines, properties for which construction has commenced and are deemed eligible for program benefits by January 5 may start to obtain exemptions on July 1, the first day of the upcoming fiscal year. For properties

¹ A property's taxable assessed value is derived by calculating a percentage of its market value and consists of economic components and physical changes to the property. However, since New York State law limits assessment increases except for physical changes, any assessed value changes based on increases in the economic component of the market value must be phased in over a five-year period (i.e., "equalization"). During this period, a property's assessed value is known as its "transitional assessed value." For purposes of tax collections, taxable assessed value is the lower of the actual or transitional assessed values less actual or transitional exemptions.

deemed eligible for benefits and for which construction commences after January 5, exemptions will start on July 1 of the following fiscal year.

Objectives

The objectives of this audit were to determine whether the Department:

- is implementing tax exemptions appropriately under the Section 421(a) program, and
- is calculating tax benefits accurately.

Scope and Methodology

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This audit was conducted in accordance with the audit responsibilities of the City Comptroller as set forth in Chapter 5, §93, of the New York City Charter.

The scope of this audit covered properties in Manhattan receiving tax exemption benefits under the Section 421(a) program in Fiscal Year 2008.

We reviewed New York Real Property Tax Law Section 421(a) (Exemption of New Multiple Dwellings from Local Taxation) and subsequent amendments, and Department guidelines for “Instructions for Exemptions and Abatement Application for Owners.” We conducted a walkthrough of Department procedures and reviewed the organization chart to understand how exemptions are monitored and implemented under the program. We also conducted a walkthrough of the Department’s Financial Information Technology Unit, which administers FAIRTAX, to understand how exemptions are calculated. We documented our understanding of these procedures.

In order to evaluate the Department’s internal controls, we interviewed Department officials, including the Senior Director for Government Affairs, Accounting Unit Manager, Commercial Exemptions Unit Supervisor and Exemption Coordinator, Assistant Commissioner of Management Information Systems, and the Project Manager and Computer Specialists from the Financial Information Systems Unit.

We obtained from the Department a list of 11,559 Manhattan properties that were receiving tax exemptions in Fiscal Year 2008. The total amount of the exemptions was \$3,330,804,813.

We categorized the total population of Manhattan properties by the terms of the exemption benefits (i.e., 10, 15, 20, and 25 years). For each exemption term, we calculated the total assessed value of the associated properties. Based on the total assessed value, exemption term, and associated number of properties, we selected a random sample of 50 properties from

our population. The amount of the exemptions in Fiscal Year 2008 for the 50 sampled properties totaled \$515,597,112.²

We reviewed and analyzed documentation for each sampled property's tax status. These included written files (i.e., "property cards" that record the year prior to construction—aka the base year—base year assessed values, construction start and completion dates) and electronic information from FAIRTAX (i.e., equalization, exemptions, taxable assessed values, physical change histories, etc.). We tested the reliability of the property card information by comparing the construction start dates with that of the dates noted in the certificates-of-eligibility issued by HPD, since Department officials stated that the property cards represented the source documents to be used for obtaining base years, base year assessed values, and construction start and completion dates. We also reviewed documentation to ensure that preliminary and final certificates-of-eligibility were maintained in Department files.

We assessed the reliability of the information in FAIRTAX used for calculating tax exemption benefits by testing the data with the formulas and methodology obtained from the Department and the information recorded on the property cards. Specifically, we verified the accuracy of base year information contained in the property cards by ascertaining whether the information was consistent with 421(a) program regulations, which stipulate the base year as the year immediately preceding construction start date. In addition, we calculated exemptions, taxable assessed values, and corresponding taxes due, and compared our results with the data in the FAIRTAX Record Book History Screens for all 50 properties in our sample. We discussed the results of our initial testing with Department officials and sought explanations for our test results, which we noted in a memorandum. Based on the explanations, we made any necessary adjustments to conform to Department procedures for calculating exemptions. Finally, we compared our calculations of real estate taxes due with the amounts of taxes actually collected as shown in FAIRTAX Payment History Detail Screens.

The results of the above tests, while not statistically projected to their respective populations, provided a reasonable basis for us to determine whether the Department is implementing and calculating exemptions appropriately.

Discussion of Audit Results

The matters covered in this report were discussed with Department officials during the course of this audit. However, Department officials declined our request for a specific meeting on January 15, 2009, to discuss our preliminary findings and substantiate the disparate calculations. Accordingly, a preliminary draft report was sent to Department officials on June 15, 2009, and was discussed at an exit conference on July 9, 2009. We responded to certain information provided by Department officials at the exit conference by revising the preliminary draft of this report. Those revisions were reflected in our draft report, which was submitted to the Department on August 20, 2009, with a request for comments.

² The cumulative value of the exemptions for the 50 sampled properties from the date that eligibility was originally established until Fiscal Year 2008 totaled \$3,363,699,428.

We received written comments from the Department on September 3, 2009. In their response, Department officials strongly disagreed with the report's findings. Specifically, Department officials stated that "this audit's observations and calculations were either misinformed or faulty, while its conclusions that Finance's administration of 421a has cost the City \$15 million in lost revenue are either unsubstantiated or can be completely refuted by publicly available records and data."

Also, according to the response, "at a July 9th exit conference, Finance staff gave a detailed explanation of the agency's calculation of 421a benefits for this audit's sample of 50 Manhattan properties during FY 2008. The briefing included verification that the calculations were accurate . . . [and] we expected that our analysis would result in a completely revised and corrected audit report. Unfortunately, this draft audit did not correct most of those errors."

The Department's specific comments and our rebuttals are contained in the relevant sections of this report. However, the nature of the Department's response calls for the following general comments.

Much of the Department's response was predicated on its insistence that the formula and methodology we used for calculating 421(a) benefits were inaccurate. However, the formula and methodology were, in fact, obtained in meetings and discussions with Department officials. After we subsequently applied the Department's methodology, we identified significant differences between the taxes due on the assessed values of the sampled properties and the actual taxes collected by the Department. Although we brought this matter to the attention of Department officials, we did not obtain any alternative formulae or methodologies by which the Department could substantiate its calculations. Indeed, the Department's response lacked any quantitative evidence to support the Department's contention that its calculations were accurate.

In addition, the Department's response attempted to obfuscate the issues raised in this report by refusing to produce detailed calculations for deriving the amounts of 421a benefits as shown in the Department's FAIRTAX system, focusing on outdated calculations in the preliminary audit report rather than on current calculations in the draft audit report, neglecting to provide substantiating records to support physical changes to properties, using irrelevant information about base years from the preliminary audit report, claiming documentation was provided when in fact it was not; misunderstanding the audit process, providing information that was previously withheld from the auditors, and misconstruing an audit finding by erroneously claiming that 421(a) benefits were administered concurrently with an unrelated tax benefit.

We are particularly concerned that the Department's response deals considerably with the content of the preliminary draft of our report, which is an informal document that is intended to permit an agency to provide explanations or clarifications of potential audit findings. To the extent that the Department presented credible information to us at the exit conference, we complied with audit procedures by revising the subsequent draft report accordingly. Nevertheless, in its response, the Department continued to argue with portions of the preliminary draft findings that were not present in the formal draft report. Clearly, this was an attempt to further obfuscate the issues raised in this report.

The Department disagreed with eight of our ten recommendations, partially agreed with our recommendation to implement adequate internal controls, and agreed with our recommendation to prepare formal written policies and procedures for calculating assessed values and exemptions. The Department's response is included as an addendum to this final report.

FINDINGS AND RECOMMENDATIONS

The Department is inaccurately calculating tax exemption benefits under the Section 421(a) program. As a result, for our sample of 50 properties, the City has lost more than \$15 million in real estate tax revenue from the date that properties were originally granted tax exemptions until Fiscal Year 2008. Moreover, certain properties overpaid \$1.2 million in taxes. The Department has therefore not appropriately implemented tax exemptions under the 421(a) program.

Of \$15,187,548 in lost revenue, \$9,896,149 is attributed to systemic problems with calculating taxable assessed values for 37 sampled properties. An additional \$5,291,399 in lost revenue is attributable to specific problems with implementing and calculating exemptions for six properties. We estimate that the Department could under-bill approximately \$130.2 million in additional taxes for the sampled properties in future years throughout the remaining terms of the exemption benefits. The Department also lacked reliable program records and written procedures for calculating tax information. Finally, certain Department files lacked required documentation.

These matters are discussed in greater detail below.

More Than \$9 Million in Lost Real Estate Tax Revenue

The Department is not appropriately implementing tax exemption benefits and calculating real estate taxes under the Section 421(a) program. As a result, the City did not collect \$9,896,149 in real estate tax revenue. (See Appendix I) Furthermore, the Department could under-bill approximately \$115.8 million in additional taxes for the properties in future years throughout the remaining terms of the exemption benefits.³

Under the program, real estate taxes must be paid on a property's taxable assessed value, which is the assessed value less any exemption. The Department uses FAIRTAX to electronically calculate taxes due based upon the properties' taxable assessed values. We calculated the 421(a) benefits due for our sampled properties using the methodology provided us by the Department, and the data recorded on the Department's "property cards." We then compared our calculations to the calculations in FAIRTAX and to the actual tax amounts paid by the property owners, as reflected in FAIRTAX, for the appropriate periods.

We determined that the Department incorrectly calculated the taxable value of 48 sampled properties in accordance with the methodology provided us by the Department. As a result, the Department failed to collect \$9,896,149 in real estate tax revenue for 37 properties, from the year in which the properties initially obtained tax benefits to Fiscal Year 2008. For 11 properties, the Department collected excess tax revenue totaling \$1,239,558.

³ Our estimate of future tax revenue under-billed is based on each property's current equalization and tax rate. The actual amount of under-billed revenue may be reduced or increased by future changes in equalization and tax rates.(See Appendix I)

For example, for block and lot no. 1071/42, we determined that between 1995 and 2008, the Department should have assessed and collected real estate taxes totaling \$1,936,927. However, the amount of tax collected according to FAIRTAX was \$1,821,327—\$115,599 less than assessed. In another example, for block and lot no.1624/33, we determined that between 1989 and 2008, the Department should have assessed and collected real estate taxes totaling \$12,237,470. However, the amount of tax collected according to FAIRTAX was \$12,886,341—\$648,872 more than assessed.

Although we based our calculations of assessed value, exemptions, and taxable values on the methodology provided by the Department, our calculations differed significantly from those of the Department. Furthermore, information contained in FAIRTAX was inconsistent. Although Department officials initially agreed to our request for a meeting to resolve these discrepancies, the Department cancelled the meeting and never explained the disparate calculations. As noted above, we estimated that the Department could under-bill some \$115.8 million if our recommendations are not implemented.

Recommendations

The Department should:

1. Review and adjust the calculations of taxable assessed values and taxes due for the 50 sampled properties, and for all other properties.

Department Response: “Finance disagrees. It is very difficult to respond to audit recommendations like these that offer no specific back-up reasons, data or documentation. However, absent that detail, Finance did analyze changes between the June 15th document we reviewed for the exit conference and this draft audit, dated August 20th. We have provided an appendix (marked Appendix A) to this letter, which offers a helpful comparison.

“As a double-check, I asked the agency group reviewing this draft audit to take another hard look at the calculations in Finance’s files. In preparation of this response letter, the group has sampled several properties from the audit team’s original sample, applying the proper formulae, process and methodology. Once again, after thorough review, we stand by the calculations and the values in our systems.”

Auditor Comment: In contrast to the Department’s contention, we affirm that our independent calculations of assessed value, exemptions, and taxable values, were based on the methodology provided by the Department on numerous occasions. If the Department believes that it has properly calculated the exemptions for the 50 sampled properties, those calculations and their substantiating methodology should have been made available during and throughout the course of the audit. However, they were not.

We also point out that the Department’s Appendix A is an irrelevant document because it highlights revisions that we previously agreed to and were incorporated in the draft audit report. The inclusion of this document in the response is an indication that the

Department may not be fully cognizant of the City's audit process, a problem that may also signify internal control deficiencies that beset the Department's implementation of 421(a) program benefits.

2. Ensure that all taxable assessed values are properly recorded in FAIRTAX.

Department Response: "Finance disagrees. As for recommendation #2, this same review has assured us that all taxable assessed values are properly recorded in all Finance database systems, including Fairtax, which is the database that serves as the final destination for information collected from several different internal Finance databases."

Auditor Comment: As ascertained in the audit, the loss by the City of more than \$15 million in tax revenue is an indication that taxable assessed values are not being properly recorded in FAIRTAX. The Department's belief that all taxable assessed values are properly recorded in FAIRTAX is inconsistent with the Department's partial agreement to our recommendation #8, which calls for the Department to "implement adequate internal controls to ensure that all program information is accurately recorded in FAIRTAX."

3. Recoup \$9,896,149 in real estate taxes from 37 properties.

Department Response: "Finance disagrees. As for recommendation #3, Finance can obviously not "recoup" revenue from property owners absent a calculation that shows that benefits were granted in error.

Auditor Comment: We again assert that our independent calculations of assessed value, exemptions, and taxable values were based on methodology provided on August 5, 2008, by Department officials and subsequently confirmed. Either the Department should provide proof that our calculations are wrong or recoup the lost tax revenue from the 37 properties.

More Than \$5 Million in Additional Real Estate Taxes Lost Because Exemptions Were Improperly Implemented and Calculated

In addition to the systemic problems that we previously described, we identified the following specific problems with implementing benefits and calculating tax exemptions for six sampled properties.

- \$4,849,389 in taxes were not collected for two properties that obtained exemptions although there was no evidence in FAIRTAX that dwellings were newly constructed, converted, altered, or improved. Therefore, taxes should have been billed and collected.
- \$442,010 in taxes that were not collected for four properties that were receiving exemptions under unrelated exemptions.

As a result of these problems, \$5,291,399 in real estate taxes was lost.

\$4,849,389 in Lost Revenue Because of No Evidence of Physical Changes

Our review indicated that two sampled properties with tax exemptions totaling \$39,234,339, lacked evidence in FAIRTAX of any physical changes that would have warranted their eligibility for obtaining exemptions.⁴ Accordingly, the Department should not have implemented the tax exemption benefits and should have billed the properties \$4,849,389 in taxes. One property (block and lot no. 829/5) had a physical change of “zero” dollars and one property (block and lot no. 1599/1039) had a physical change of minus \$1.00.

Property Tax Law Section 421(a), subsection 1(c) provides exemptions for multiple dwellings that “include new residential construction and the concurrent conversion, alteration or improvement of a pre-existing building or structure.” However, given that the physical changes did not reflect construction or improvements, the Department should not have permitted the exemptions for the two properties to be implemented. Furthermore, since the two properties will respectively continue to obtain tax exemptions totaling approximately \$120 million for up to 20 and 25 years, we estimate that the City could under-bill in excess of \$14.4 million in taxes, if this is not corrected. (See Appendix II)

At the exit conference, Department officials explained that the physical change for sampled block and lot no. 829/5 was recorded with block and lot no. 829/1 after the two sites were merged. But the substantiating documentation indicated that the merger took place on September 16, 2008—after the conclusion of our audit period.

The Department did not provide any explanation for the lack of physical change for block and lot no. 1599/1039.

Recommendations

The Department should:

4. Review the assessments of properties with large annual variations in market and assessed values. Adjust taxable assessed values and associated exemptions for wide variations in market and assessed values that cannot be adequately substantiated.

Department Response: “Finance disagrees. Your draft audit notes that at the exit conference, Finance officials provided substantiating documentation indicating that a reapportionment and merger of a large tax lot included in this section – BBL: 1/829/5, one of several lots within a large residential development in Chelsea – had definitively taken place. The nature of lot mergers – wherein the values of several “child” lots are often merged into one “mother” lot – is that large value variations result after mergers are

⁴ In a related matter, we noted significant differences between the amount of the physical changes for all 50 properties, which totaled more than \$501 million, and the market value of the properties, which increased by only \$7.8 million. Department records and FAIRTAX lacked any information to substantiate the wide disparity between the value of the property improvements and their corresponding market value.

recorded. After the merger occurs, the child lots – like the one in the sample -- no longer exist in current records; that is, all the values and benefits on that lot accrue to a new, different and larger lot. Even though the audit team was provided general background information on lot mergers and details about this specific merged child lot at the exit conference, it nevertheless chose to stand by this particular recommendation. The reason offered is that “the merger took place on September 16, 2008 -- after the conclusion of our audit period.”

It is entirely standard for the Fairtax database to only note such mergers after they occur and fully take effect, but other property records do indicate that Finance was fully aware of the ongoing construction at this site. The audit report makes the incorrect claim that “the physical changes do not reflect construction or improvements,” when Finance records indicate that assessors first added value for physical changes to this lot in FY 2005. Our records also show the “mother lot” building – now known as 804 6th Avenue -- was partially occupied in 2008, the audit year in question and the year the building filed a legally-mandated Real Property Income and Expense Statement with Finance

“Contrary to the draft audit’s claim, the other lot mentioned in this recommendation section (1/1599/1039) was also explained at the exit conference as another child lot that had been similarly involved in a properly-recorded merger.”

Auditor Comment: If in fact, block and lot nos. 829/5 and 829/1 were merged in Fiscal Year 2005 but not recorded as such in FAIRTAX until Fiscal Year 2008, one would expect that each lot would continue to show separate physical changes until Fiscal Year 2008. However, “child lot” 829/5 did not reflect any physical changes even though it was assessed and granted exemptions between Fiscal Years 2005 and 2008. We also note that the Department’s list of properties receiving 421(a) exemption benefits in Fiscal Year 2008 continued to include block and lot 829/5.

Regarding block and lot 1599/1039, Department officials did not provide any written documentation to substantiate its merger with another lot.

5. Recoup \$4,849,389 in improperly allowed real estate tax benefits for the two properties.

Department Response: “Finance disagrees. As for recommendation #5, as we note in recommendation #3, given that our calculations were correct, no legal basis exists to ‘recoup’ benefits. The audit team’s rejoinder that the merger cannot be considered in its conclusions because the Chelsea lot merger did not appear in Fairtax until September, 2008 is quite extraordinary.”

Auditor Comment: As previously noted, the Department did not provide any documentation or other proof to substantiate its calculations. Notwithstanding this problem, if the merger actually occurred in Fiscal Year 2005 but was not recorded in Department records until September 16, 2008, then physical changes for block and lot 829/5 should have been reflected in FAIRTAX between Fiscal Years 2005 and 2008.

However, since no physical changes were recorded in FAIRTAX, we maintain that the Department should recoup the improperly allowed real estate tax benefits to the property.

**\$442,010 in Lost Revenue for Properties
Not Eligible for 421(a) Benefits**

We identified four sampled properties (block and lots nos. 1859/1003, 1083/29, 1672/17, and 1083/37) that were deemed eligible for 421(a) program benefits while receiving tax exemptions under other, unrelated programs. The Department permitted the properties to continue obtaining the unrelated exemptions for three to ten years before obtaining exemptions under the 421(a) program. But after the properties began to obtain 421(a) exemptions, the Department did not recalculate the base year assessed values for the properties at the higher amounts that would have been effective under 421(a) program rules.

Accordingly, the taxable assessed values of the properties from their base years until they started to obtain program benefits should have totaled \$4,330,372 rather than “zero” dollars as the Department calculated. As a result, the Department failed to collect \$442,010 in real estate taxes from these properties. (See Appendix III.) This situation could have been avoided had the Department ceased providing the unrelated exemptions and implemented 421(a) tax exemptions as soon as the properties were eligible to obtain those benefits. This is required under Property Tax Law Section 421(a), subsection 2(c), which states that:

Such multiple dwellings shall be eligible for exemption from taxation pursuant to this section only if: (i) exemption from taxes is not availed of concurrently under any other law and that on or after July first, nineteen hundred seventy-six no preliminary certificate of eligibility or certificate of eligibility issued under this section may be rescinded . . . to avail the property of the benefits of tax exemption . . . under the provisions of any other law.

We note that the four properties were granted certificates-of-eligibility or had construction start dates after July 1, 1976. Accordingly, the Department should have ceased providing the unrelated exemptions and implemented 421(a) tax exemptions as soon as the properties were eligible to obtain those benefits. Given that the 421(a) benefits were not implemented in a timely manner, the base year assessed values were understated and associated real estate taxes for the properties underbilled.

Recommendations

The Department should:

6. Adjust base year assessed value calculations for the four properties as required by program rules and recoup \$442,010 in lost real estate taxes.
7. Immediately implement benefits for those properties that attain program eligibility. In that regard, the Department should cease providing benefits that may have been provided to a property under any other benefit program.

Department Response: “Finance disagrees. At the exit conference, Finance’s Assistant Commissioner for Legal Affairs made clear that there is no legal basis for these two recommendations. As required by law, Finance does not now grant 421a benefits concurrently with any other property tax exemption or abatement. And the audit sample did not include any properties where improper, concurrent benefits were discovered.

Instead, the difference here seems to be grounded in a basic misreading of the law. The auditors seem to believe that a given property ‘becomes eligible’ for 421a benefits as soon as it is *applies* or is even *approved for* those benefits. However, deeming benefits as implemented as of an application or approval date would create an arbitrary standard. Finance believes that the law allows other exemptions or abatements to be received on a property up to and until the fiscal year for which HPD grants and Finance implements a new 421a exemption.” (Emphasis in original.)

Auditor Comment: We did not allege—as the Department incorrectly contends—that 421(a) benefits were administered concurrently with other exemption benefits. Our calculations are based on implementing benefits as soon as HPD grants a certificate-of-eligibility in accordance with Property Tax Law Section 421(a), subsection 2(c).

Alternatively, if the Department chooses to implement 421(a) benefits after it ceases implementing the other exemption benefits, the Department must recalculate the base year assessed values for the properties at the appropriate amounts that would have been effective under 421(a) program rules. As an example of this problem, for block and lot 1083/29, the Department designated 1998/1999 as the base year, when the property’s taxable value was \$605,941. However, the base year for this property should have been 2000/2001 (the year preceding construction as noted in Department records) when the taxable value was \$654,091—an increase of \$48,150.

Other Issues

We identified other internal control problems with the manner in which the Department administers and calculates tax benefits under the program.

Inconsistent Program Records

Certain program information recorded in FAIRTAX is inconsistent with the information in the manual property cards. Specifically, information contained in the FAIRTAX Record Book History Screens about base year amounts for 22 sampled properties whose lots were apportioned into smaller parcels, differed from that recorded in the manual “property cards.” For example, block and lot no. 1171/121 was apportioned into lots 1401–2029. Information recorded in the property card showed the base year amount of parent lot 121 as \$697,900. However, information recorded in the record book history showed the base year value as \$2,070,000. In another example, block and lot no. 1032/58 was apportioned into lots 1001–1553. Information recorded in the property card showed the base year value of parent lot 58 as \$1,471,765. However, information recorded in the record book history showed the base year

value as \$666,000. In a final example, block and lot no. 1042/37 was apportioned into lots 1101–1524. Information recorded in the property card showed the base year value of parent lot 37 as \$564,600. However, information recorded in the record book history showed the base year value as \$621,000.

As a result of these inconsistencies, the accuracy of FAIRTAX as a source for recording base year assessed values—a key element in ensuring that program exemptions are properly implemented—is uncertain. This problem further highlights another aspect of the Department’s lack of adequate internal controls that hinder the Department’s ability to properly calculate and monitor taxable assessed values, exemptions and taxes due.

Furthermore, we identified inconsistencies within FAIRTAX between the Record Book History Screen that shows a property’s taxable assessed value and corresponding taxes due and the Payment History Detail Screen that shows taxes actually paid. For example, for block and lot no. 151/1, the Record Book History Screen showed that taxes due were \$9,371,679, whereas the Payment History Detail Screen showed that taxes paid totaled \$8,263,730. In another example, for block and lot no. 839/1104, the Record Book History Screen showed that taxes due were \$352,838, whereas the Payment History Detail Screen showed that taxes paid totaled \$492,411.

No Written Procedures for Calculating Tax Information

The Department lacks written procedures for calculating program benefits and taxes. Department officials described the program’s methodology for calculating actual and transitional assessed values, exemptions, and taxable values. However, as described in this audit report, we found errors in the way that taxable assessed values, exemptions, and taxes were calculated when we applied the Department’s methodology to our analyses. Written procedures for calculating taxable values and benefits are therefore an important internal control for ensuring that these calculations are carried out accurately and consistently.

Documentation Lacking

For the 50 sampled properties, 35 (70%) files lacked certain required documentation such as preliminary and final certificates-of-eligibility. In eight cases, the files lacked both preliminary and final certificates-of-eligibility, a deficiency that might nullify the eligibility of these properties for obtaining 421(a) benefits. Maintaining these documents in the appropriate files is necessary for the Department to substantiate that a property is eligible to obtain benefits under the program.

Recommendations

The Department should:

8. Implement adequate internal controls to ensure that all program information is accurately recorded in FAIRTAX and the hardcopy property files (e.g., property cards, etc.) In that regard, information in FAIRTAX and the property cards should be periodically reconciled.

Department Response: “Finance agrees (partially) . . . Finance can only *partially* agree with #8. As noted below, many changes recommended here are being implemented in our Exemptions division independent of this audit. On the other hand, the recommendation that ‘all program information’ be recorded in Fairtax is not realistic. In the current budget climate, Finance’s resources do not allow the agency to plan and implement the long-term and expensive IT systems upgrade that this recommendation would require.” (Emphasis in original.)

Auditor Comment: The Department has apparently misunderstood the recommendation’s salient point—that all program information in FAIRTAX be *accurately* recorded. Recording information accurately is vital to the effective functioning of the 421(a) program and other tax exemption programs. The Department’s presumption that this critical requirement can only be carried out under a “long-term and expensive IT system upgrade” is indeed troubling.

9. Prepare formal written policies and procedures for calculating assessed values and exemptions. Ensure that appropriate Department staff is instructed in program policies and procedures.

Department Response: “Finance agrees.”

10. Record and properly maintain all supporting documentation in Department files and ensure that all required documentation, including certificates-of-eligibility, is submitted for all properties. If valid certificates are not submitted, the Department should not implement program benefits for those properties. Likewise, the Department should revoke any program benefits for properties that lack the required documentation.

Department Response: “Finance disagrees. The only recommendation in this section with which we take strong issue is #10; if anything, the internal research conducted around this audit has only assured us that Finance is keeping very good records, with valid certificates of eligibility required from HPD before we implement benefits. We are also pleased to note that the audit team did not believe that any revenue has been lost due to our current internal procedures.”

Auditor Comment: The Department did not provide any evidence to show that all required certificates-of-eligibility were contained in Department files. Furthermore, despite the Department’s assertion, we found that the Department lacks appropriate internal controls—a key deficiency which resulted in the City losing more than \$15 million in real estate tax revenue for the sampled properties. The deficient internal controls that we identified included the inability to substantiate appropriate formulas by which to calculate tax exemptions, the lack of proper records to support physical property changes, program records indicating inconsistent base year property values, and the lack of written procedures for calculating exemptions.

Summary of Additional Taxes Due from Uncollected or Improperly Calculated Real Estate Taxes

Exemption Period	#	Block	Lot	Tax Due (based on audit figures)	Tax Paid (from FAIRTAX payment history screen)	Audit Calculated Taxes Underpaid	Audit Calculated Taxes Overpaid	Comment
10 YEARS	1	1171	1480	\$ 10,419	\$ 11,020		\$ (602)	
	2	1032	1491	\$ 2,216	\$ 865	\$ 1,351		
	3	1042	1416	\$ 74	\$ 15	\$ 59		
	4	515	1028	\$ 173	\$ 42	\$ 131		
	Sub-total				\$ 12,882	\$ 11,943	\$ 1,540	\$ (602)
15 YEARS	5	151	1	\$ 10,834,911	\$ 8,263,730	\$ 2,571,181		
	6	1624	33	\$ 12,237,470	\$ 12,886,341		\$ (648,872)	
	7	1859	1003	\$ 398,052	\$ 272,846	\$ 125,205		Note 2
	8	424	1003	\$ 31,383	\$ 16,994	\$ 14,389		
	9	424	1004	\$ 25,677	\$ 15,924	\$ 9,753		
	10	424	1005	\$ 27,104	\$ 14,574	\$ 12,530		
	11	424	1006	\$ 56,347	\$ 30,251	\$ 26,096		
	Sub-total				\$ 23,610,943	\$ 21,500,660	\$ 2,759,154	\$ (648,872)
20 YEARS	12	42	22	\$ 2,269,723	\$ 2,337,248		\$ (67,525)	
	13	1070	29	\$ 462,837	\$ 370,411	\$ 92,426		
	14	1105	29	\$ 900,615	\$ 902,157		\$ (1,542)	
	15	826	1	\$ 1,521,976	\$ 1,498,095	\$ 23,881		
	16	1563	4	\$ 4,681,785	\$ 4,421,348	\$ 260,437		
	17	839	1104	\$ 1,808,958	\$ 492,411	\$ 1,316,547		
	18	795	1	\$ 1,263,783	\$ 1,252,239	\$ 11,544		
	19	807	1003	\$ 226,833	\$ 39,156	\$ 187,677		
	20	565	9021	\$ 1,820,354	\$ 1,461,722	\$ 358,631		
	21	1242	9055	\$ 394,266	\$ 325,543	\$ 68,723		
	22	775	44	\$ 1,193,416	\$ 1,124,559	\$ 68,857		
	23	1071	42	\$ 1,936,927	\$ 1,821,327	\$ 115,599		
	24	1051	1003	\$ 529,784	\$ 335,896	\$ 193,888		
	25	944	45	\$ 1,356,462	\$ 1,086,405	\$ 270,058		
	26	248	15	\$ 2,165,341	\$ 1,519,387	\$ 645,954		
	27	1557	25	\$ 1,033,527	\$ 1,051,387		\$ (17,860)	
	28	833	1102	\$ 628,476	\$ 325,940	\$ 302,537		
	29	775	46	\$ 809,264	\$ 802,867	\$ 6,397		
	30	1083	29	\$ 510,445	\$ 517,238		\$ (6,794)	Note 2
	31	1672	17	\$ 221,805	\$ 242,261		\$ (20,456)	Note 2
	32	1624	45	\$ 584,660	\$ 403,001	\$ 181,659		
	33	829	5	\$ -	\$ -	\$ -		Note 1
	34	462	35	\$ 1,054,425	\$ 983,397	\$ 71,028		
	35	1033	109	\$ 772,969	\$ 556,936	\$ 216,033		
	36	745	1302	\$ 712,559	\$ 616,635	\$ 95,925		
	37	390	1102	\$ 274,768	\$ 226,956	\$ 47,812		
	38	839	1102	\$ 101,292	\$ 540,152		\$ (438,860)	
	39	1083	37	\$ 257,400	\$ 264,178		\$ (6,777)	Note 2
	40	1051	1002	\$ 33,336	\$ 20,238	\$ 13,098		
	41	829	1	\$ 2,608,327	\$ 238,336	\$ 2,369,991		
42	377	30	\$ 196,768	\$ 173,644	\$ 23,124			
43	1436	122	\$ 762,427	\$ 770,993		\$ (8,565)		
44	97	1302	\$ 196,654	\$ 103,585	\$ 93,069			
45	833	1103	\$ 8,638	\$ 30,343		\$ (21,705)		
46	807	1002	\$ 3,236	\$ 466	\$ 2,771			
Sub-total				\$ 33,304,038	\$ 26,856,456	\$ 7,037,666	\$ (590,084)	
25 YEARS	47	1745	1002	\$ 129,611	\$ 39,306	\$ 90,305		
	48	1960	1110	\$ 21,342	\$ 17,102	\$ 4,241		
	49	1942	1032	\$ 11,002	\$ 7,760	\$ 3,243		
	50	1599	1039	\$ -	\$ -	\$ -		Note 1
	Sub-total				\$ 161,956	\$ 64,168	\$ 97,788	\$ -

Total Taxes Underpaid / Overpaid for all 50 properties	Underpaid	Overpaid	Net Effect - Taxes Still Due
	\$ 9,896,149	\$ (1,239,558)	\$ 8,656,591

Note 1 For these properties, certain years were reported under a different finding: No Physical Changes

Note 2 These properties were receiving exemptions under a different exemption code (excludes years under a different exemption code) in certain years

Summary of the Estimated Potential Under-Billing Due to Improperly Calculated Real Estate Taxes

Exemption Period	#	Block	Lot	Currently in Exemption Year (in Fiscal Year 2008)	Number of Exemption Years Remaining	Fiscal Year 2008 Actual Equalization	Fiscal Year 2008 Tax Rate	Future Amounts Under-billed
10 Years	1	1171	1480	4	6	\$ (20,583)	11.93%	\$ 33,971
	2	1032	1491	1	9	\$ -	11.93%	\$ 73,765
	3	1042	1416	0	10	\$ -	11.93%	\$ 1,853
	4	515	1028	1	9	\$ 1	11.93%	\$ 622
							Sub-total	\$ 110,211
15 Years	5	151	1	15	0	\$ 2,475,000	11.93%	\$ -
	6	1624	33	15	0	\$ (2,070,000)	11.93%	\$ -
	7	1859	1003	15	0	\$ (1,346,300)	11.93%	\$ -
	8	424	1003	3	12	\$ (3,619)	11.93%	\$ 58,857
	9	424	1004	3	12	\$ (2,961)	11.93%	\$ 48,154
	10	424	1005	3	12	\$ (3,124)	11.93%	\$ 50,835
11	424	1006	3	12	\$ (6,496)	11.93%	\$ 105,679	
							Sub-total	\$ 263,525
20 Years	12	42	22	2	18	\$ (9,220,000)	11.93%	\$ (52,000,398)
	13	1070	29	4	16	\$ (10,710,000)	11.93%	\$ (49,263,031)
	14	1105	29	2	18	\$ 2,385,000	11.93%	\$ 33,092,937
	15	826	1	7	13	\$ 315,000	11.93%	\$ 15,590,135
	16	1563	4	11	9	\$ 1,620,000	11.93%	\$ 17,895,358
	17	839	1104	3	17	\$ 6,659,550	11.93%	\$ 56,743,360
	18	795	1	5	15	\$ (450,000)	11.93%	\$ 10,013,808
	19	807	1003	0	20	\$ 34,105	11.93%	\$ 9,895,958
	20	565	9021	9	11	\$ 1,080,000	11.93%	\$ 16,066,832
	21	1242	9055	6	14	\$ (7,695,000)	11.93%	\$ (34,947,433)
	22	775	44	6	14	\$ 1,755,000	11.93%	\$ 20,102,410
	23	1071	42	9	11	\$ 1,665,000	11.93%	\$ 15,955,779
	24	1051	1003	5	15	\$ (2,128,250)	11.93%	\$ (4,527,245)
	25	944	45	6	14	\$ 2,745,000	11.93%	\$ 23,805,439
	26	248	15	10	10	\$ (180,000)	11.93%	\$ 7,047,495
	27	1557	25	7	13	\$ 540,000	11.93%	\$ 10,425,520
	28	833	1102	0	20	\$ 765,000	11.93%	\$ 14,160,872
	29	775	46	5	15	\$ 855,000	11.93%	\$ 10,591,454
	30	1083	29	6	14	\$ 1,440,000	11.93%	\$ 12,324,594
	31	1672	17	2	18	\$ (900,000)	11.93%	\$ (257,688)
	32	1624	45	6	14	\$ (405,000)	11.93%	\$ 3,203,874
	33	829	5	0	0	\$ -	11.93%	Note 1
	34	462	35	10	10	\$ 450,000	11.93%	\$ 4,967,714
	35	1033	109	5	15	\$ 675,000	11.93%	\$ 7,248,001
	36	745	1302	6	14	\$ 593,100	11.93%	\$ 5,663,752
	37	390	1102	5	15	\$ (180,000)	11.93%	\$ 1,270,294
38	839	1102	3	17	\$ 206,100	11.93%	\$ 3,265,217	
39	1083	37	6	14	\$ 661,500	11.93%	\$ 4,750,017	
40	1051	1002	5	15	\$ 1,329,750	11.93%	\$ 8,011,394	
41	829	1	2	18	\$ (10,971,000)	11.93%	\$ (63,606,189)	
42	377	30	6	14	\$ (76,500)	11.93%	\$ 674,943	
43	1436	122	7	13	\$ (92,500)	11.93%	\$ 690,631	
44	97	1302	2	18	\$ 8,370	11.93%	\$ 984,100	
45	833	1103	3	17	\$ -	11.93%	\$ 174,838	
46	807	1002	1	19	\$ -	11.93%	\$ 162,530	
							Sub-total	\$ 110,177,269
25 Years	47	1745	1002	3	22	\$ 630,000	11.93%	\$ 5,219,629
	48	1960	1110	12	13	\$ 12,829	11.93%	\$ 60,582
	49	1942	1032	12	13	\$ 1,942	11.93%	\$ 24,233
	50	1599	1039	0	0	\$ -	11.93%	Note 1
							Sub-total	\$ 5,304,444
Grand Total							\$	115,855,448

* Note: In order to estimate the potential under-billing due to improperly calculated real estate taxes, since there were no base year differences, it was necessary to perform calculations based on fixed data. In other words, for each exemption year beyond fiscal year 2008, in order to calculate exemptions and taxable value of property we had to hold the fiscal year 2008 Actual Equalization and Tax Rate at a constant since that information does not yet exist.

Department of Finance / Section 421(a) Tax Incentive Program
Summary of Properties with Little To No Physical Changes Recorded in FAIRTAX System

20-YEAR PROPERTY				
Property: Block 829 Lot 5	Situation: FAIRTAX system shows no equalization or physical changes			
Fiscal Year	Exemptions Granted by DOF	Tax Rate	Taxes Due	
2004/05	\$ 9,976,500	12.22%	\$ 1,219,128	
2005/06	\$ 12,030,300	12.40%	\$ 1,491,757	
2006/07	\$ 10,275,300	12.74%	\$ 1,309,073	
2007/08	\$ 6,945,300	11.93%	\$ 828,574	
Total (To Date)	\$ 39,227,400		\$ 4,848,533	

Future Exemptions that will be granted (note 1):

Total Exemptions granted to date after completion of construction (i.e. fiscal years 2007 and 2008)	\$ 17,220,600		
Average Exemptions that will be granted for the next 10 yrs @ 100%			\$ 86,103,000
Average Exemptions that will be granted for the next 2 yrs @ 80%			\$ 13,776,480
Average Exemptions that will be granted for the next 2 yrs @ 60%			\$ 10,332,360
Average Exemptions that will be granted for the next 2 yrs @ 40%			\$ 6,888,240
Average Exemptions that will be granted for the next 2 yrs @ 20%			\$ 3,444,120
Total Future Exemptions that will be Granted			\$ 120,544,200
Additional Taxes Due at 2007/08 Tax Rate of 11.93%			\$ 14,380,923

25-YEAR PROPERTY				
Property: Block 1599 Lot 1039	Situation: FAIRTAX system shows property had -\$1 in physical changes.			
Fiscal Year	Exemptions Granted by DOF	Tax Rate	Taxes Due	
2005/06	\$ 68	12.40%	\$ 8	
2006/07	\$ 3,378	12.74%	\$ 430	
2007/08	\$ 3,493	11.93%	\$ 417	
Total (To Date)	\$ 6,939		\$ 856	

Future Exemptions that will be granted (note 1):

Total Exemptions granted to date after completion of construction (i.e. fiscal years 2006, 2007 and 2008)	\$ 6,939		
Average Exemptions that will be granted for the next 18 yrs @ 100%			\$ 41,634
Average Exemptions that will be granted for the next 1 yr @ 80%			\$ 1,850
Average Exemptions that will be granted for the next 1 yr @ 60%			\$ 1,388
Average Exemptions that will be granted for the next 1 yr @ 40%			\$ 925
Average Exemptions that will be granted for the next 1 yr @ 20%			\$ 463
Total Future Exemptions that will be Granted			\$ 46,260
Additional Taxes Due at 2007/08 Tax Rate of 11.93%			\$ 5,519

Note 1: Future exemptions were calculated using the total exemptions granted to date after completion of construction. The yearly average was then multiplied by the remaining number of benefit years times the exemption rate.

SUMMARY

Questionable Exemptions granted in the years following completion of construction

Exemption Length	Block	Lot	Exempt.	Taxes Due*
20 Years	829	5	\$ 39,227,400	\$ 4,848,533
25 Years	1599	1039	\$ 6,939	\$ 856
Total			\$ 39,234,339	\$ 4,849,389

Future Exemptions that will be granted:

Exemption Length	Block	Lot	Exempt.	Taxes Due*
20 Years	829	5	\$ 120,544,200	\$ 14,380,923
25 Years	1599	1039	\$ 46,260	\$ 5,519
Total			\$ 120,590,460	\$ 14,386,442

* The 2007/08 tax rate was used to calculate future taxes that will be due.

Appendix III

Department of Finance / Section 421(a) Tax Incentive Program
 Summary of Properties that Received Exemptions Under a Different Exemption Code While Already Approved for 421-a Benefits

# of Exemption Years	Block	Lot	Base Year (Eligible for 421-a benefits as of this year)	Different Exemption Code Used:		Taxable Value of Property in Years Under Different Exemption Code:			Tax Due on Taxable Value (a)*(b)
				Year (denotes a fiscal year)	Code	Audit Calculated (a)	DOF Values (from Record Book History)	Tax Rate (b)	
15	1859	1003	1989/1990	1989/1990	1021	\$ 18,328	\$ -	9.54%	\$ 1,748
				1990/1991		\$ 23,332	\$ -	10.00%	\$ 2,333
				1991/1992		\$ 18,328	\$ -	10.63%	\$ 1,948
				1992/1993		\$ 18,328	\$ -	9.91%	\$ 1,816
				1993/1994		\$ 18,328	\$ -	10.37%	\$ 1,901
				1994/1995		\$ 18,328	\$ -	10.55%	\$ 1,934
				1995/1996		\$ 18,328	\$ -	10.81%	\$ 1,981
				1996/1997		\$ 18,328	\$ -	11.06%	\$ 2,027
				1997/1998		\$ 18,328	\$ -	11.05%	\$ 2,025
1998/1999	\$ 18,328	\$ -	10.74%	\$ 1,968					

Sub-total Tax Lost in Years Using Different Code \$ 19,682

Sub-total Taxable Value Lost \$ 188,284

20	1083	29	1998/1999	1998/1999	2280	\$ 605,941	\$ -	10.24%	\$ 62,048
				1999/2000		\$ 629,791	\$ -	9.99%	\$ 62,916
				2000/2001		\$ 654,091	\$ -	9.77%	\$ 63,905
	Sub-total Taxable Value Lost \$ 1,889,823					Sub-total Tax Lost in Years Using Different Code \$ 188,869			
	1672	17	2001/2002	2001/2002	2280	\$ 450,000	\$ -	9.71%	\$ 43,695
				2002/2003		\$ 450,000	\$ -	10.68%	\$ 48,060
				2003/2004		\$ 450,000	\$ -	11.43%	\$ 51,435
	Sub-total Taxable Value Lost \$ 1,350,000					Sub-total Tax Lost in Years Using Different Code \$ 143,190			
	1083	37	1998/1999	1998/1999	2280	\$ 309,515	\$ -	10.24%	\$ 31,682
1999/2000				2280	\$ 310,685	\$ -	9.99%	\$ 31,034	
2000/2001				2280	\$ 282,065	\$ -	9.77%	\$ 27,552	

Sub-total Tax Lost in Years Using Different Code \$ 90,268

Sub-total Taxable Value Lost \$ 902,265

Total Taxable Value Lost	\$ 4,330,372	Total Tax Lost in Years Under Different Code	\$ 442,010
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September 3, 2009

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**Re: Implementation of 421a Incentive Program
Tax Benefits for Properties in Manhattan by the
Department of Finance (FR08-123A)**

Dear Mr. Graham:

Thank you for the opportunity to provide the Department of Finance's official response to the above-referenced audit.

Finance welcomed the opportunity to be audited on 421a, which as you note, is New York City's most valuable residential property-tax exemption. The exemption itself has been subject to legislative amendment in nearly every year since its original adoption in 1971. Those changes, both substantive and technical, have increased the program's complexity, making 421a quite challenging to administer and implement. Adding to this difficulty is the fact that two agencies – the Department of Housing Preservation and Development (HPD) and the Department of Finance (Finance) -- are specifically charged with different but related 421a functions.

I offer this history and background as proper context for an audit that would have proven challenging for any audit team. At a July 9th exit conference, Finance staff gave a detailed explanation of the agency's calculation of 421a benefits for this audit's sample of 50 Manhattan properties during FY 2008. The briefing included verification that the calculations were accurate. As we said at the time, given that Finance staff had detailed several miscalculation errors found in the audit team's findings and refuted all of the resulting claims of a \$15 million revenue loss, we expected that our analysis would result in a completely revised and corrected audit report.

Unfortunately, this draft audit did not correct most of those errors. Instead, the latest draft has for the most part simply removed the original miscalculation reasons offered by the auditors (the latest report has fewer pages than the previous draft -- from 13 to 10 -- while recommendations have been reduced from 14 to 10) but has kept most of the original report's estimates of revenues lost due to program administration errors. Meanwhile, the previously enumerated "errors" have now been grouped into a catch-all category called "Uncollected/ improperly calculated real estate taxes." These curious edits to the original audit document will be analyzed further among the draft audit's ten recommendations below, along with Finance's responses, in italics.

Furthermore, your draft audit does not indicate that the audit team was granted otherwise unfettered access to agency records and staff. Unfortunately, it appears that the audit team limited itself to data available from the Fairtax database and did not make additional inquiries for information available in other Finance databases (for example, data on merged properties). As a result, the audit wrongly concludes that Finance fails to keep such records and granted exemptions that were not warranted.

Recommendations Part I: More Than \$9 Million in Lost Real Estate Tax Revenue

1. Review and adjust the calculations of taxable assessed values and taxes due for the 50 sampled properties. *Finance disagrees.*
2. Ensure that all taxable assessed values are properly recorded in FAIRTAX. *Finance disagrees.*
3. Recoup \$9,896,149 in real estate taxes from 37 properties. *Finance disagrees.*

This section of the audit report is the one most affected by the edits noted above.

It is very difficult to respond to audit recommendations like these that offer no specific back-up reasons, data or documentation. However, absent that detail, Finance did analyze changes between the June 15th document we reviewed for the exit conference and this draft audit, dated August 20th. We have provided an appendix (marked Appendix A) to this letter, which offers a helpful comparison. For example, the audit team had originally misunderstood the date of the first year under which 22 different sampled properties' 421a calculations began -- known as the "base year." At the July 9th conference, Finance staff corrected the audit team's error, providing both the statute and case law supporting our base-year calculations.

As you can note from this appendix, the "incorrect base year" reason, which had accounted for well over half of the lost revenue in the preliminary findings, has disappeared from the audit. However, the draft audit continues to report lost revenues (over \$8 million) for these same properties. The values have been shifted to "uncollected/improperly calculated real estate taxes," with generally only modest changes in reported error amounts. This audit report neither explains nor

Graham Response Letter, Audit FR08-123A
Page 3

substantiates those changes nor does it explain the alleged calculation errors for the other 26 properties previously placed in this vaguely-worded category.

As a double-check, I asked the agency group reviewing this draft audit to take another hard look at the calculations in Finance's files. In preparation of this response letter, the group has sampled several properties from the audit team's original sample, applying the proper formulae, process and methodology. Once again, after thorough review, we stand by the calculations and the values in our systems.

As for recommendation #2, this same review has assured us that all taxable assessed values are properly recorded in all Finance database systems, including Fairtax, which is the database that serves as the final destination for information collected from several different internal Finance databases.

As for recommendation #3, Finance can obviously not "recoup" revenue from property owners absent a calculation that shows that benefits were granted in error.

Recommendations Part II: Over \$5 million in Additional Real Estate Taxes Lost Because Exemptions Were Improperly Implemented and Calculated

4. Review the assessments of properties with large annual variations in market and assessed values. Adjust taxable assessed values and associated exemptions for wide variations in market and assessed values that cannot be adequately substantiated. *Finance disagrees.*
5. Recoup \$4,849,389 in improperly allowed real estate tax benefits for the two properties. *Finance disagrees.*

Your draft audit notes that at the exit conference, Finance officials provided substantiating documentation indicating that a reapportionment and merger of a large tax lot included in this section – BBL: 1/829/5, one of several lots within a large residential development in Chelsea — had definitively taken place. The nature of lot mergers – wherein the values of several "child" lots are often merged into one "mother" lot – is that large value variations result after mergers are recorded. After the merger occurs, the child lots – like the one in the sample -- no longer exist in current records; that is, all the values and benefits on that lot accrue to a new, different and larger lot. Even though the audit team was provided general background information on lot mergers and details about this specific merged child lot at the exit conference, it nevertheless chose to stand by this particular recommendation. The reason offered is that "the merger took place on September 16, 2008 -- after the conclusion of our audit period."

It is entirely standard for the Fairtax database to only note such mergers after they occur and fully take effect, but other property records do indicate that Finance was fully aware of the ongoing construction at this site. The audit report makes the incorrect claim that "the physical changes did not reflect construction or improvements," when Finance records indicate that assessors first added value for

physical changes to this lot in FY 2005. Our records also show the “mother lot” building – now known as 804 6th Avenue -- was partially occupied in 2008, the audit year in question and the year the building filed a legally-mandated Real Property Income and Expense Statement with Finance.

Contrary to the draft audit’s claim, the other lot mentioned in this recommendation section (1/1599/1039) was also explained at the exit conference as another child lot that had been similarly involved in a properly-recorded merger.

As for recommendation #5, as we note in recommendation #3, given that our calculations were correct, no legal basis exists to “recoup” benefits. The audit team’s rejoinder that the merger cannot be considered in its conclusions because the Chelsea lot merger did not appear in Fairtax until September, 2008 is quite extraordinary.

Recommendations Part III: \$442,010 in Lost Revenue for Properties Not Eligible for 421(a) Benefits

6. Adjust base-year assessed value calculations for the four properties as required by program rules and recoup \$442,010 in lost real estate taxes. *Finance disagrees.*
7. Immediately implement benefits for those properties that attain program eligibility. In that regard, the Department should cease providing benefits that may have been provided to a property under any other benefit program. *Finance disagrees.*

At the exit conference, Finance’s Assistant Commissioner for Legal Affairs made clear that there is no legal basis for these two recommendations. As required by law, Finance does not now grant 421a benefits concurrently with any other property tax exemption or abatement. And the audit sample did not include any properties where improper, concurrent benefits were discovered.

Instead, the difference here seems to be grounded in a basic misreading of the law. The auditors seem to believe that a given property “becomes eligible” for 421a benefits as soon as it is *applies* or is even *approved for* those benefits. However, deeming benefits as implemented as of an application or approval date would create an arbitrary standard. Finance believes that the law allows other exemptions or abatements to be received on a property up to and until the fiscal year for which HPD grants and Finance implements a new 421a exemption.

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Recommendations Part IV: Other Issues

8. Implement adequate internal controls to ensure that all program information is accurately recorded in FAIRTAX and the hardcopy property files (e.g. property cards, etc). In that regard, information in FAIRTAX and the property cards should be periodically reconciled. *Finance agrees (partially)*
9. Prepare formal written policies and procedures for calculating assessed values and exemptions. Ensure that appropriate Department staff is instructed in program policies and procedures. *Finance agrees*
10. Record and properly maintain all supporting documentation in Department files and ensure that all required documentation, including certificates-of-eligibility, is submitted for all properties. If valid certificates are not submitted, the Department should not implement program benefits for those properties. Likewise, the Department should revoke any program benefits that lack the required documentation. *Finance disagrees*

We agree with two out of these last three recommendations, although Finance can only *partially* agree with #8. As noted below, many changes recommended here are being implemented in our Exemptions division independent of this audit. On the other hand, the recommendation that "all program information" be recorded in Fairtax is not realistic. In the current budget climate, Finance's resources do not allow the agency to plan and implement the long-term and expensive IT systems upgrade that this recommendation would require.

However, as we have noted, 421a is a complicated exemption, and we agree that there is room for administrative improvement. As part of our agency's ongoing efforts to improve transparency and efficiency, Finance's Payment Operations division will be creating new business rules and a streamlined system for batch processing that will allow us to create new internal controls, better reconcile our records and better instruct our staff in this critical program's workings. All of these changes will make 421a an exemption more easily understood by Finance staff, outside observers like yourselves as well as the general public.

The only recommendation in this section with which we take strong issue is #10; if anything, the internal research conducted around this audit has only assured us that Finance is keeping very good records, with valid certificates of eligibility required from HPD before we implement benefits. We are also pleased to note that the audit team did not believe that any revenue has been lost due to our current internal procedures.

Conclusion

As we have outlined above, this audit's observations and calculations were either misinformed or faulty, while its conclusions that Finance's administration of 421a has cost the City \$15 million in lost revenue are either unsubstantiated or can be completely refuted by publicly-available records and data.

Thank you and if you have any questions, please feel free to get back in touch with me.

Sincerely,



Michael Hyman
Acting Commissioner

C: Jeffrey Kay, Mayor's Office of Operations
George Davis III, Mayor's Office of Operations
Rochelle Patricof, First Deputy Commissioner, Finance
Leslie Zimmerman, Assistant Commissioner – Payment Operation
Dara Jaffee, Assistant Commissioner – Legal Affairs
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