April 12, 2021

New York City Department of Housing Preservation and Development issues new Article XI real property tax exemption term sheet

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The New York City Department of Housing Preservation and Development ("HPD") recently issued a new term sheet for its Housing Preservation Opportunities Program, which offers partial exemptions from real property taxation to owners who agree to long-term affordable housing requirements.

Under Article XI of the Private Housing Law of the State of New York ("Article XI"), which in New York City is administered by HPD, the City Council may exempt real property from taxation for up to forty years in return for an agreement to rent only to eligible tenants at affordable rents. Article XI is one of the most important tools available to the City to preserve existing affordable housing, including in entirely unregulated properties.[1]

Activity in the Article XI program slowed substantially during the COVID-19 pandemic and the ensuing fiscal challenges, with uncertainty around deal terms and exemption levels slowing deal activity. This new term sheet is a clear sign that the Article XI program is a priority and reflects a renewed focus on the program at HPD.[2] In many respects, the new term sheet is consistent with past requirements for Article XI exemptions that may not have been formalized. That said, the new term sheet sets clear exemption levels, mandates assumptions for cost-benefit analysis, and requires aging in place, physical needs assessments, and other requirements that owners seeking Article XI exemptions should be sure to include in their planning.

Ownership structure

The Private Housing Finance Law (the "PHFL") provides that in order to qualify for an Article XI exemption, the project must be owned by a housing development fund company ("HDFC"), a

[1] "In a Switch, Buyer of $1.2 Billion in Market-Rate Apartments Opts for Rent Limits," *Wall Street Journal*, July 30, 2019.

[2] Note that for projects benefiting from project-based subsidy, such as Housing Assistance Payment ("HAP") contracts, the existing HUD MF Term sheet remains in effect.

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particular type of New York corporation typically formed under both the PHFL and the Not-for-Profit Corporation Law of the State of New York, which is subject to the supervision of HPD. This is most often accomplished by a nominee structure, whereby the HDFC holds bare legal title to the real property, while a for-profit entity, usually a limited liability company or limited partnership, holds the beneficial and equitable interest, pursuant to a nominee agreement between the for-profit entity and the HDFC.

Minimum affordability restrictions

Under long-standing interpretation of the PHFL, a minimum of two-thirds of the units must be affordable to households at or below 165% of Area Median Income ("AMI"). In application however, HPD typically insists upon AMI levels that are significantly lower, often with a range of AMIs within each project. The restrictions agreed upon by HPD and the owner are memorialized in a regulatory agreement recorded against the property, which, among other things, subjects the property to rent stabilization even beyond the term of the exemption.

Exemption sizing and term

Under the Article XI program, the owner pays a gross rent tax ("GRT"), which is calculated as a percentage of the gross potential residential and commercial income (i.e., the rent roll rent). The term sheet divides projects into two categories—***Method 1*** (regulated or rent stabilized projects) and ***Method 2*** (projects that are, or could become, unregulated). In each case, the term sheet sets forth a GRT exemption level and several adjustment factors that could increase or decrease the exemption (see the chart in the appendix).

The term sheet requires that all exemptions, and the accompanying affordability restrictions, have a term of forty years, which is the maximum term permitted under the PHFL. In the past, projects have often employed terms of thirty years.

Prioritized projects

Under the new term sheet, consistent with past practices, HPD will prioritize projects with the following characteristics:

- Significant portion of units going beyond minimum affordability requirements (aka 50% AMI or 30% AMI units)
- Vacant units that can be leased up immediately
- Immediate rehabilitation or repair needs
- Inability to meet standard DSCR or Income-to-Expense ratios
- Significant portion of units that will have rents reduced for existing tenants
- Geographic diversity

Other requirements and considerations

- The term sheet notes that owners without a "demonstrated track record of successfully owning and operating regulated affordable housing projects" are required to contract with a property manager approved by HPD and/or a qualified firm to monitor compliance, which may present some opportunities for experienced management companies and other housing organizations.

- As noted in the chart, all projects must have 10% or 20% homeless set aside, as applicable
- Owners must provide an Integrated Physical Needs Assessment ("IPNA") from a firm prequalified by HPD's sister agency, the New York City Housing Development Corporation.
- Requirements with respect to Aging in Place, Prevailing Wage, Sponsor Disclosures, and Tenant Notification remain consistent with the prior term sheet and past practices.
- As has traditionally been the case, the project must have support from the Council member in whose district the project is located.
- Post-closing, the owner must request a Certificate of Eligibility be issued by HPD.
- The Article XI regulatory agreement will have a term at least as long as the exemption period, and contains provisions granting HPD supervisory oversight in connection with the operations of the property, including but not limited to tenant approvals and restrictions on refinancing and transfers.

What's next?

The release of this term sheet presents key opportunity for repositioning multifamily properties in New York City, in particular for rent stabilized properties that may be struggling under current circumstances. Our team at Nixon Peabody has deep experience with Article XI and multifamily preservation transactions as well as a variety of financing executions for such assets.

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Project Type	***Rent Stabilization Status / Preferential vs. Legal Rents***	***Exemption Level***	***Exemption Adjustment Factors***	***Income & Rents***[i]	***Homeless Set-aside***
Method 1: Restricted Average Current Rents < 60% AMI[ii]	Rent stabilized, or preferential rents are roughly equal to legal rents	5% GRT (subject to adjustment in HPD's discretion)	<u>*Downward*</u> Based on 1.05 Income-to-Expense and 1.25 DSCR[iii] Needed to finance immediate physical needs (per IPNA and Aging in Place) Committing to additional policy goals (homeless) <u>*Upward*</u> If NPV of exemption > $50,000 per dwelling unit	Attempt to mirror to current rents while achieving deepest affordability, rent rollbacks may be requested	10%
Method 1: Restricted Average Current Rents > 60% AMI		15% GRT[iv] (subject to adjustment in HPD's discretion)			
Method 2: Unregulated or potential rent increase	No current rent restrictions, or a potential for rent increases (or loss of stabilization)[v]	10% GRT for Years 0–5[vi] Cost Benefit GRT for Years 6–40[vii]	<u>*Downward*</u> Based on 1.05 Income-to-Expense and 1.25 DSCR <u>*Upward*</u> If Cost Benefit GRT is > 10% GRT then Cost Benefit GRT applies for all 40 years	Attempt to mirror to current rents while achieving deepest affordability, rollbacks may be requested may be requested Either (i) at least 30% at or below 60% AMI with at least 15% of all units at or below 50% AMI, or (ii) 20% homeless set aside	10% (or 20% if elected)

[i] All restricted rents must be at least 10% AMI below market rents for the neighborhood. 10% marketing bands will apply for units below 80% AMI, and 20% marketing bands will apply for units above 80% AMI.

[ii] The average AMI would be calculated employing an imputed AMI based on in-place collected rents for any unrestricted units, although Method 1, as noted, is intended primarily for fully rent stabilized projects.

[iii] By targeting a DSCR of 1.25 we suspect some performing but struggling properties may benefit from this downward adjustment.

[iv] Owners often use a rule of thumb that unabated properties pay 17% GRT, meaning this a relatively modest abatement absent such adjustment.

[v] This would include (a) projects with existing 421a or J-51 benefits which are expiring, (b) projects with 421-a that does not require affordable units, and (c) projects where a substantial portion of the preferential rents are significantly lower than legal rents.

[vi] Note that the treatment of the first five years is an entirely new concept for the Article XI program. If the existing tax exemption is deeper than the proposed GRT, the existing tax exemption will stay in place for the first 5 years of the regulatory agreement and the Article XI tax exemption will have a 35-year term. The cost benefit analysis values the affordability for 40 years, and the tax exemption for 35.

[vii] Cost Benefit Assumptions include (a) 8% discount rate, and (b) 7.5% turnover rate for RSL units and 15% for unregulated units. Market rents must be supported by a third-party Market Study or appraisal (unless based on in-building market rents or HPD's own system and/or more informal comparisons), and assume growth of 3.5%.