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Tax Update: Capitalizing on tax-class 2A and 2B properties

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Multifamily residential deals have always been complex in New York City, but with elevated interest rates, ongoing regional bank turbulence and the loss of the 421a incentive program it is nearly impossible to make residential projects pencil out. Despite these stiff headwinds, developers have found a way to create much-needed new housing in the city, notably by embracing projects that fall in the class 2A and 2B tax categories.

Unlike 421a deals, which required a significant affordable housing component, tax class 2A and 2B properties are fully market rate—meaning that there is no cap to future rent growth under current rules. There is, however, a cap to the growth of taxes on the properties, enabling developers to invest in these assets, enhancing existing units, or adding additional units up to a total of 10 per building. Class 2A and 2B redevelopments are one of the few types of residential projects whose economics make sense.

New York City's property tax system is complicated , comprising several classes of properties with various tax rates and regulations. Tax class 2A and 2B properties enable investors to acquire a property at a very low tax basis with a cap on tax increases of 8% per year, or 30% combined, over a five-year period. In a city in which taxes are a huge hurdle to development, this tax structure provides predictability to an investment.

Real estate taxes are typically the single largest line item for owners, and can increase significantly each year. The city's property tax system is based on the principle of market value assessment, wherein properties are assessed at their estimated market value.

New York City classifies properties into four main tax classes: Class 1, Class 2, Class 3 and Class 4. Each class encompasses various types of properties, including residential, commercial, industrial and mixed-use properties. Tax class 2A refers to rental buildings with three or fewer residential units. Tax class 2B consists of rental buildings with more than three residential units up to 10.

Due to the capped assessments, most properties in tax class 2A and 2B fall below the threshold of 45% of the building's market value, creating an arbitrage between market value and taxes. Importantly, these caps remain in-place even if the building is converted to condominiums. The tax class is passed to the purchaser of an individual unit, offering homebuyers a major incentive that often results in an advantageous sales price for the seller.

These types of projects are necessarily very small, and they only started to gain the attention of investors and developers in recent months as they offer a way to meet enormous market demand for units while also providing an investment hedge in a tax-burdened marketplace.

At S3, we've seen a significant increase in financing for the redevelopment of portfolios of four- to 10-unit properties. As one of the most active construction lenders in New York City, S3 has been closing about six deals each month, and class 2A and 2B properties are (not surprisingly) one of the most popular loans in the firm's books at the moment.

For many investors, there is an opportunity to amass a portfolio of these properties and sell them collectively at a premium at a time when so many rent regulated properties have lost value.

New York City is compromised by lack of affordable housing, so every possible unit we can add to the city's supply is a benefit. S3 Capital has originated nearly 600 loans since it was founded by Joshua Crane and Robert Schwartz in 2013, and while we are a national lender, the vast majority of our deals are made in Brooklyn, Queens and the greater New York metro area as well as parts of Southwest Florida. We originated about 300 421a loans prior to the program's expiration, and that volume has pivoted towards class 2a and 2b properties.

While this does not in any way address the broader need for large-scale residential development, it does provide an avenue for new units in the wake of the expiration of the 421a tax abatement program.