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How Taxes, Regs Influence Investors

Tax increases, rent-control rules and other regulations adopted or proposed by major cities recently could drive investors to secondary markets — a trend that's already playing out in the multi-family sector.

That's the upshot of a forthcoming **Newmark** report titled "Commercial Real Estate Policy Challenges: Navigating an Environment of Increasing Taxes and Regulations." The report, to be released on Wednesday, cites the potential for property-tax hikes as cities struggle to plug gaping budget holes caused by the coronavirus pandemic.

"In addition to stricter regulations around commercial real estate, many U.S. jurisdictions are increasingly looking to high-end commercial property as a source of more tax revenue, especially as state and local budgets are crunched by the current economic crisis," the report says.

Newmark highlights recent or pending tax increases or rule changes in New York, Chicago, San Francisco, Seattle and Washington. A move by officials in Seattle to approve a real estate tax increase effective this year "led to record-setting sales numbers in 4Q 2019, as buyers and sellers attempted to close deals before the increase took effect," the report noted.

In Manhattan, multi-family sales fell about 50% to $3.6 billion last year, according to **Real Estate Alert's** Deal Database, after a new state law severely restricted owners' ability to convert rent-stabilized units to market rates, effectively devaluing any property with rent-regulated apartments. And in Washington, owners rushed to close deals last year ahead of a sharp increase in recording and transfer taxes, to 5% from 2.9%, resulting in a spike in third-quarter sales.

California, meanwhile, has a statewide initiative on the November ballot to repeal Proposition 13, which caps increases in assessed value at 2% annually, and replace it with a system based on current market value. In Chicago and San Francisco, politicians are debating proposals to increase city real estate taxes.

Sandy Paul, senior managing director of national research at Newmark, said secondary markets already have benefited in recent years from investors seeking higher yields — particularly for purchases of multi-family properties. Increasing taxes and regulations in "gateway cities" are emerging as another factor prompting investors to look elsewhere, he added.

"Investors are going to make a statement by where they do and do not place capital," Paul said. "If values on New York multi-family assets decline, then investors will be less incentivized to build there in the future and they'll be less incentivized to maintain current assets. If investors are less incentivized to maintain their assets, that's a negative for tenants. The point is that unduly burdensome regulations are bad for both investors and tenants."

The trend already is apparent among multi-family investors. From 2015 to 2019, primary markets accounted for just 31% of investment in apartment properties nationwide, down from 41% during the prior five-year period, the report shows.

Newmark research director **Bethany Schneider** said that many of the rent-control laws nationwide are being touted as efforts to keep rental housing affordable. "What really needs to happen to improve affordability is an increase in supply across America," she said. "There's just not enough supply for the growing population, and that's what led to this problem."

The report urges investors to work with local, state and federal officials to find compromises before laws are passed. Paul pointed to positive regulations aimed at solving the housing shortage and promoting economic development — for example, the federal opportunity zone program, which provides tax breaks for investors in development and redevelopment projects.

"It's generally better for the industry and better for public policy-making as a whole if these issues can be addressed before the point of additional taxes and regulations," Paul said. "We would like to see more collaboration." ❖