Government of the District of Columbia
Office of the Chief Financial Officer

Natwar M. Gandhi
Chief Financial Officer

MEMORANDUM

TO: **The Honorable Vincent C. Gray**
Chairman, Council of the District of Columbia

FROM: **Natwar M. Gandhi**
Chief Financial Officer

DATE: **December 16, 2008**

SUBJECT: **Fiscal Impact Statement - "Gateway Market Center and Residences Real Property Tax Exemption Act of 2008"**

REFERENCE: **Bill Number 17-730 – Committee Print dated November 17, 2008**

Conclusion

Funds are not sufficient in the FY 2009 through FY 2012 budget and financial plan to implement the abatement authorized by the proposed legislation. The proposed abatement would reduce the FY 2009 sales tax revenue collections by $250,000 and would reduce the sales and real property collections by $352,743 in the FY 2009 to FY 2012 budget and financial plan period.

Background

The proposed legislation would amend D.C. Official Code §47-2005 to provide up to $250,000 in sales tax exemption for goods purchased in the construction of the described project, known as the "Gateway Market Center and Residences," a mixed-use development to be constructed at 1240 - 1248 4th Street, N.E, on the lots 5, 800, 802, 809, parcels 129/9, 129/32 of square 3587. The tax exemption certification would expire when the $250,000 limit has been attained or on December 31, 2011, whichever occurs earlier.

The proposed legislation would also amend D.C. Code § 47-4600 to add a new subsection that would freeze property taxes for Gateway Market Center and Residences for ten years, then would provide for 10 percent per year escalation on the property taxes for an additional ten years until the property taxes reach the level that they would have been without the abatement. The property tax abatement is contingent upon the following conditions:

- The property is retained by Sang Oh & Company, Inc., its assignees, or successors;

- The property is used for a mixed-use development as described by its Land Disposition/Purchase Agreement (DC-DHCD Contract No. 2004-3) between Sang Oh & Company, Inc. and the District of Columbia, dated February 26, 2004;
- Twenty percent of the residential units are set aside as affordable housing for household incomes of no more than eighty (80) percent of the Area Median Income in perpetuity;
- The mixed-use development includes a 100-seat community meeting room, an office for Advisory Neighborhood Commission 5B and a Metropolitan Police Department community work station for the Fifth District, all rent-free in perpetuity; and
- Gateway Market Center, LLC, complies with its First Source and LSDBE commitments as set forth in the "Application for Economic Assistance" to the District government.

Financial Plan Impact

Funds are not sufficient in the FY 2009 through FY 2012 budget and financial plan to implement the abatement proposed by the legislation. The proposed abatement would reduce the FY 2009 tax collections by $250,000 and would cost $352,743 in the FY 2009 through FY 2012 financial plan period. The proposed legislation recognizes the revenue impact of the abatement, and makes its implementation subject to inclusion in an approved budget and financial plan.

Table 1
Estimated Impact to the Budget and Financial Plan of B17-730, FY 2009 – FY 2012
Gateway Market Center and Residences Real Property Tax Exemption Act of 2008

	FY2009	FY 2010	FY 2011	FY 2012	FY 2009 - FY 2012
Land[a]	$6,688,450	$6,930,730	$7,073,990	$7,275,000	
Improvements [b]			$9,338,980	$9,604,350	
Residential [c]			$5,096,642	$5,241,465	
Commercial			$4,242,338	$4,362,886	
Total Assessed Value	$6,688,450	$6,930,730	$16,412,970	$16,879,350	
Class 1 Tax Obligation [d]			$33,071	$34,010	$67,081
Class 2 Tax Obligation [d]	$117,736	$122,219	$131,374	$135,278	$506,607
Total Tax Bill	$117,736	$122,219	$164,445	$169,288	$573,688
Actual Taxes Paid	$117,736	$117,736	$117,736	$117,736	$470,945
Value of the Abatement	0	$4,482	$46,709	$51,552	**$102,743**
Sales Tax Exemption	$250,000				**$250,000**
Total Negative Fiscal Impact	**$250,000**	**$4,482**	**$46,709**	**$51,552**	**$352,743**

Source: Office of Revenue Analysis Calculations

[a] The FY 2009 Land Value is the publicly available assessed value for this property. The land value is expected to grow by 3.62%, 2.07%, and 2.84% in the subsequent three fiscal years.

[b] According to the developer, the property is breaking ground in 2009. Construction of large projects typically takes an average of 24 months to complete. The value of the improvement is calculated by using the observation that the land value of the developed properties in this neighborhood is 43.1 percent of the total value.

c The residential and commercial value calculations are based on the square footage on the P.U.D. application approved on September 29, 2008. The P.U.D. application shows that 55 percent of the total area would be residential.

[d] This property is currently classified as Class 2 and taxed at $1.65/$100 for the first $3 million of value and at $1.85/$100 for any value above. The analysis assumes that it will be rezoned as mixed-use with 55% of the value, which also now includes improvements, and will be taxed at Class 1 rates of at $0.85/$100 starting in FY 2011.

Additionally, the abatement would continue to have a fiscal impact beyond FY 2012. Between FY 2013 and FY 2029 (the year the abatement expires), it would reduce the total real property tax collections by the District of Columbia by an additional $986,182.

Table 2
Estimated Impact to the Budget and Financial Plan of B17-730, FY 2013 – FY 2029
Gateway Market Center and Residences Real Property Tax Exemption Act of 2008

	Land	Improvements	Total	Class 1 Tax Obligation	Class 2 Tax Obligation	Tax Bill	Actual Taxes Paid	Fiscal Impact
FY 2013	$7,379,716	$9,742,595	$17,122,311	$34,500	$137,311	$171,811	$117,736	$54,075
FY 2014	$7,524,006	$9,933,084	$17,457,090	$35,175	$140,113	$175,288	$117,736	$57,552
FY 2015	$7,729,662	$10,204,589	$17,934,251	$36,136	$144,107	$180,243	$117,736	$62,507
FY 2016	$7,979,739	$10,534,737	$18,514,476	$37,305	$148,964	$186,269	$117,736	$68,532
FY 2017	$8,238,353	$10,876,155	$19,114,508	$38,514	$153,986	$192,500	$117,736	$74,764
FY 2018	$8,505,801	$11,229,236	$19,735,037	$39,765	$159,179	$198,944	$117,736	$81,208
FY 2019	$8,782,392	$11,594,388	$20,376,780	$41,058	$164,551	$205,608	$117,736	$87,872
FY 2020	$9,068,447	$11,972,034	$21,040,481	$42,395	$170,106	$212,501	$129,510	$82,991
FY 2021	$9,431,185	$12,450,915	$21,882,100	$44,091	$177,150	$221,241	$142,461	$78,780
FY 2022	$9,808,433	$12,948,952	$22,757,384	$45,854	$184,476	$230,330	$156,707	$73,623
FY 2023	$10,200,770	$13,466,910	$23,667,680	$47,689	$192,095	$239,784	$172,378	$67,406
FY 2024	$10,608,801	$14,005,586	$24,614,387	$49,596	$200,019	$249,615	$189,616	$60,000
FY 2025	$11,033,153	$14,565,810	$25,598,962	$51,580	$208,260	$259,840	$208,577	$51,263
FY 2026	$11,474,479	$15,148,442	$26,622,921	$53,643	$216,830	$270,473	$229,435	$41,038
FY 2027	$11,933,458	$15,754,380	$27,687,838	$55,789	$225,743	$281,532	$252,378	$29,154
FY 2028	$12,410,796	$16,384,555	$28,795,351	$58,020	$235,013	$293,033	$277,616	$15,417
FY 2029	$12,907,228	$17,039,937	$29,947,165	$60,341	$244,654	$304,995	$304,995	$0
Total						$3,874,008	$2,887,827	**$986,182**

Source: Office of Revenue Analysis Calculations
[a] The property value is expected to grow by 1.96% in FY 2013. The annual growth rate in the property values is expected to gradually increase during this period to reach 4% by FY 2029.

Methodological Appendix

Markets value an income generating equity by taking into consideration the future income from that equity and the rate by which we discount future earnings. This discount rate takes into consideration the opportunity cost of investment, the inflation rate, and the risks associated with that equity.

Real property markets work in similar ways. The value of a property depends on its *net operating income* and the *capitalization rate*.[1] The net operating income is the future income from a property—in the case of a rental building, it is the rental income the owner expects to collect from this building over the lifetime of the building. The owner then discounts the future net operating income by the capitalization rate. The capitalization rate tends to increase when the real interest rate, which is the opportunity cost of investing, increases. The capitalization rate also increases when the inflation rate increases. This is because inflation reduces the purchasing power of future income. Finally, the capitalization rate increases when the property markets become riskier. This is because by holding the property, the owner exposes himself to risks specific to property markets.

The Office of Tax and Revenue ("OTR") collects data both on net operating income and on capitalization rates. According to OTR, the net operating income in the Gateway Marketplace neighborhood has increased by an average of 22.9 percent between FY 2006 and FY 2009, and the gross capitalization rate has gone down from 7.20 percent to 6.32 percent.

According to the assessment reports for this neighborhood, over the next decade, the net operating income is expected to grow at rates more in line with the rest of the city at an average rate of 2.9 percent. As the risk in property market increases, the capitalization rate is expected to gradually increase to 6.50 percent. The growth in the capitalization rate will be muted over this period—that is, the capitalization rate will not quickly increase to its FY 2006 levels, because interest rates and inflation are expected to stay low given the current massive inflow of funds engineered by the federal government to help financial markets and the recessionary outlook.

Table 3
Expected Property Values and Growth Rates in the Gateway Marketplace Neighborhood
FY 2009 – FY 2012

	FY 2009	FY 2010	FY 2011	FY 2012
Net Operating Income	$57,100,000	$58,800,000	$60,300,000	$62,200,000
Annual Percentage Change	33.50%	2.90%	2.70%	3.00%
Capitalization Rate	6.32%	6.45%	6.49%	6.50%
Value of real property in the neighborhood	$879,100,000	$910,940,000	$929,770,000	$956,190,000
Annual Percentage Change	21.50%	3.62%	2.07%	2.84%

Source: Office of Tax and Revenue and Office of Revenue Analysis

Table 3 shows the estimated growth rate of the value of real property in the neighborhood where the Gateway Marketplace property is located. The value of all real property in this neighborhood is estimated by dividing net operating income by the capitalization rate. The annual growth rates calculated from

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[1] Specifically, the value of a property is calculated as $V = \frac{NOI}{c}$ where *NOI* is the net operating income and *c* is the capitalization rate. This calculation is an approximation, since it assumes that the property has an infinite life. Given the relatively long life of commercial and multi-unit residential buildings, this approximation is reasonable.

these values, as depicted in the last line of Table 3, are used to estimate the estimate the Fiscal Impact presented in Table 1.