

Business Better (Season 2, Episode 16): Developing Philly: The State of Philadelphia's Tax Abatements in 2022

Speakers: Christopher Jones and Nathan Farris

Steve Burkhart:

Welcome to Business Better, a podcast designed to help businesses navigate the new normal. I'm your host, Steve Burkhart. After a long career at global consumer products company, BIC, where I served as vice president of administration, general counsel and secretary, I'm now Of Counsel in the Litigation Department of Ballard Spahr; a law firm with clients across industries and throughout the country. Our new series, Developing Philly will explore issues that are top of mind for developers, landowners and commercial property managers throughout the Philadelphia region. We'll focus on land use, development tax, and other pressing topics.

Steve Burkhart:

We'll bring in guests who are in the trenches, working hard each day to continue developing Philly. In today's episode, we discuss the 2022 changes to the city of Philadelphia's commercial and residential tax abatements. Those changes mean that the abatement for commercial developments now is more valuable than the abatement for residential projects. We discuss questions related to the new rules and how the city's office of property assessment answered some of the questions via regulation. Participating in this discussion is Christopher Jones of counsel in Ballard's Philadelphia office, and Nathan Farris, an associate in Ballard's Philadelphia office. So now let's turn the episode over to Chris Jones.

Christopher Jones:

Hello, I am Chris Jones, the co-leader of Ballard Spahr's tax practice group, and someone who does work in all things tax; federal, state and local tax. And I am here with Nathan Farris.

Nathan Farris:

Hi all. Yeah, it's Nathan Farris. I am in the firm's real estate department, but I like to think of myself as an administrative law lawyer. I do pretty much any administrative law litigation that touches on real estate. So that's a lot of zoning and land use stuff, historical commission works, tax appeals, and I also do a fair bit of condemnation work.

Christopher Jones:

And so today we are here talking about changes to the city of Philadelphia's tax abatement rules. Very quickly, some background. The rules changed in 2022. For a long time, there has been a 10 year tax abatement that's applicable to improvements, both commercial and residential improvements. And what that means is when you build a new project in Philadelphia, for 10 years, the land is subject to tax, but the improvements are not. In 2022 or effective January 1st, 2022, those rules were changed. So now the commercial properties get 90% of the improvements abated, whereas residential properties start out with 100% of the improvements abated, but then that gets phased out. So it's a hundred percent in year one, 90% in year two, and so on. This was a huge change. It was actually supposed to come into play January 1st, 2021. It ended up getting pushed back for a year.

Christopher Jones:

So there's been a lot of discussion in the real estate community in Philadelphia about exactly what that's going to mean, how it's going to affect projects and all that. But one big thing that stood out to us is that for a long time, it really didn't matter whether you got the abatement under the commercial abatement ordinance or the residential abatement ordinance. And that's

because, again, they were all just 100% of the improvement value was abated for 10 years. But with this change, it really matters. It matters whether you're considered a residential project or a commercial project. And for many projects, that's going to be really straightforward and simple, but primarily in the case of residential real estate, it's not quite that simple. There has been guidance here and there that would indicate that residential real property is treated as commercial. This used to pop up on OPA's website.

Christopher Jones:

There actually was an Excel spreadsheet that summarized the abatements that said that. And likewise, the form that you used to apply for abatements indicates that if property is subject to BIRT; the Business Income & Receipts Tax, it's treated as commercial. So I think that a lot of us thought that's where things may have stood, but it was never clear. And a lot of times, I think to be cautious, at least the people that I work with, we'd file both just in case. And then you knew that one of them was going to get granted and they were both going to be the same.

Christopher Jones:

But heading into 2022, it now is the case that the commercial abatement is more valuable than the residential abatement. So we were on standby to see what would happen. And in fact, at the end of 2021, we got a set of guidance from OPA.

Nathan Farris:

Chris, I was a little surprised when we found these guidances, just because we are always trolling for these sorts of things on the city's website. But as you mentioned, the changes to the 10 year tax abatement, when the legislation passed, it was seismic. There was a significant debate about whether or not this was going to chill development activity in the city and the right levels at which to adjust them. And then there was a big fight about when the changes would become effective. And so we all still had this issue of like, how are they going to decide whether or not which category you fit into? Are you residential? Are you commercial?

Nathan Farris:

And OPA put out these regulations that governed that, and nobody really seemed to be talking about it, but we did. And so I think it's worth just explaining what these regulations said, and then we can talk about what we did to get some clarity on some outstanding issues. So these draft regulations came out, I think, in November of 2021. And the biggest thing they did was help explain how OPA was going to classify your project now, because, as Chris mentioned, it didn't used to matter whether you got the commercial or the residential abatement, but now it really matters because the commercial abatement is more valuable than the residential abatement.

Nathan Farris:

And the test is pretty simple. The OPA says that they're going to look at the predominant use of the property and then measure predominant use based on square footage. And there's some complicated formulas about what gets included in the square footage formula, but the basics are relatively straightforward. If 50 or more percent of your property is being used for residential purposes, they're going to treat that as predominantly residential, so the entire project is going to be treated as residential.

Nathan Farris:

So that means that under these regs, if you have a new mixed use development in the city of Philadelphia, that's 51% residential units by square footage and 49% commercial space by square footage, the entire property is going to be treated as residential, and you'll get the less valuable residential abatement. Philadelphia has a procedure whenever one of its agencies issues regulations. Any member of the public who's affected by them can request that there be a hearing on those regulations.

Nathan Farris:

And the requesting that there be a hearing actually does stay the effective date of those. So we put together a memo and we had a bunch of questions that we thought these regulations raised and a few issues we had and some suggested changes. So we submitted that to the office of property assessment, and they gave us a hearing date. And Chris ably went before OPA and explained our issues with it. We did get some really good changes that I think really helped clarify how OPA was going to treat these new regs, and I think are developer friendly.

Nathan Farris:

So I think our clients will be pleased, even if they weren't aware that we were doing it, that we helped them out. Chris, I think we should maybe go through the different issues that we've found and explain what the issues were and how OPA has told us they're going to handle them.

Christopher Jones:

Yeah, so first, just as a real procedural thing, OPA clarified that they're only going to apply these new rules for applications that are filed on or after January 1st, 2022. So that was a helpful clarification, just wasn't in the initial draft and something that we got them to say. The biggest issue that we saw was how this could be applied in the case of condominiums. And that's because sometimes in the proposed regulations, it was not always clear whether when they were going to apply the 50% test for predominant use, that Nathan was talking about. That applied to a property, to a project, and in some cases, they would use the term building.

Christopher Jones:

And it just wasn't always clear. So we asked OPA to say, what happens if you've got a mixed use project that has a commercial condo where, say, 100% of the square footage is commercial and then a residential condo where 100% of that square footage is residential. Again, it just to us was not clear how the abatements would work in that case. And we wanted them to say, no, that in fact, when they're applying that predominant use test, they do so to each condo unit separately.

Christopher Jones:

And in fact, that's what they did in the final regulation. So that was very helpful, I think. We'll talk at the end about some planning opportunities, but I think that was... It was a really helpful clarification. We suspected that was where they would come out, but it was good to get actual clarification of that.

Nathan Farris:

Chris, would you say, look, I just want to make sure, I think it's fair to say in the wake of that, we know now you can use a condo structure as a work around. In other words, you can make sure that if your project is less than 50% commercial, you can protect the value of the commercial abatement for the commercial space by creating a mixed use condo. Right. I think that's the sort of bottom line from that change, right?

Christopher Jones:

Yes. And obviously that doesn't come without its own cost, but that is certainly a work around here. That's one that's going to, that would allow the commercial abatements still to be used and still to have some value in mixed use projects. And another issue that we talked about was the start date for residential abatements. One of the things that... I mentioned up at the top about how there was some guidance out there that would indicate that a rental residential project was subject to the commercial abatement. One of the reasons why that made sense is because the ordinance for each has a little bit of varying language in the start date provisions. So in the residential abatement, it starts the first day of the month following the settlement and the issuance of the CO. The commercial abatement always starts January 1st of the year following the issuance of the CO.

Christopher Jones:

So the commercial one was much clearer, and I think when you apply it to a residential rental property, certainly one that has a lot of units, that settlement language doesn't necessarily fit in quite as well as what it might. So as part of our suggestion, we said, just please help us figure out what this means. Is it like the commercial one where it's going to come into play January 1st? Or is there some other time when the residential abatement's going to kick in? They answered that question in the updated regulations by saying that the residential abatement. So if you have a project that is the predominant use is residential, that that abatement will start the first day of the month after the issuance of the CO. So again, I think that's a clear answer, might lead to some confusion as we'll talk about at the end, but they did answer that question, again, I think they gave us some helpful clarity.

Nathan Farris:

Yeah. Chris, one unanswered question, we always knew this is going to be a difficult assignment for OPA, but the question I have is, is OPA right about this? And let me just put some meat on that bone, because I do think this is hard. When you think about a multi-tenant rental residential apartment complex, right, I'm not exactly sure how you classify that because there's some obvious appeal to the argument that it's clearly a residential property. The tenants are living there, they're using this as their primary residents. There's no way that you can say this isn't a residential property. But from the perspective of the owner, it's a commercial property, right? As you said at the top, they're going to be subject to business income and receipts tax. And this is your field. So you can tell me, but I assume for most owners of multi tenant apartment buildings, the income from that's going to be treated as ordinary income on federal taxes, right?

Nathan Farris:

So this is an income stream. It's clearly commercial revenue to the owner of that. So I think that an owner has a pretty strong case that opiates predominant use test based on square footage, isn't consistent with the abatement legislation, right? That they could say, in fact, you need to treat our building, our apartment complex that has tenants that we're leasing to in it as a commercial space, because from our perspective, it is commercial. This is our business. I don't know. I don't envy our friends at OPA this one, because I think it's a tough issue.

Christopher Jones:

Right. And I think that we knew that was going to be an issue the minute that the residential abatement became less valuable than the commercial abatement. We knew that that was going to be an issue and it would not have surprised us, I think, in discussions to think that OPA would come out with a way of giving these large rental residential projects the less valuable abatement. And I'm not even necessarily being cynical, but even some of the discussions at city council about changing the abatement regulations, there was no doubt that the primary target was residential property. So it didn't necessarily surprise us. But as part of that, I did a lot of digging into the language and I think my takeaway is that there was guidance out there that would come out exactly with what you're saying before, that was like, look, this is really a business property because the owner of this property's paying tax on it, the owner of this property has ordinary income.

Christopher Jones:

That's really what this is, like in the grand scheme of things, it's more of a business property than it is a residential. But if you really dig into the language, I think OPA at least has an argument. And I'll be curious to see where it goes because I would argue that a residential rental property fits into both ordinances, that it is both a property that is commercial and that's for the reasons that you said the owner of it is paying business income and receipts tax and they're generating business income. But it also is residential because it's a property that consists of dwelling units and it has people living there.

Christopher Jones:

So again, I don't think we are necessarily surprised with where OPA came out here. I do think there's room to challenge it. And I think that at the very least there's ambiguity, which always could leave open some room to challenge it, and it wouldn't

surprise me to see someone challenge it because like I said, OPA went the path that would grant the less valuable abatement to some of these mixed use projects. And because of that, they're leaving themselves open for somebody to raise their hand and say, wait a minute. I don't think that's right. I think I should get the more valuable of the two abatements.

Nathan Farris:

And I think we'll almost certainly see litigation eventually because it's almost inevitable in my mind that somebody is going to have a project that has a significant chunk of it, but less than 50% that's commercial and for whatever reason, they didn't put on the condo structure. So they're going to get issued the residential abatement. And they're going to say, whoa, hold on here. Our project is X percentage commercial, at least that percent should get the commercial abatement and at least under these regs, it doesn't. And that could be a huge amount of money over 10 years if the value of the property is high enough. So I think it'll almost for sure get... and you brought up a good point, Chris, as I'm thinking about how this litigation would go, I think you're certainly right.

Nathan Farris:

That it would be a surprise to the city council people who passed this legislation, if it didn't cover multi-tenant apartment complexes because unsurprisingly some of the political issues that were at play here were gentrification, right? There was a concern that the tenure tax abatement had actually been so effective that it had created all these new apartment buildings that were displacing low income individuals in transitioning neighborhoods. So I think part of this was an attempt to address those issues by ratcheting back the residential abatement to try and slow that pace. So I certainly think that would be an issue in litigation. Right? What was intended to be caught up in this definition of residential properties?

Christopher Jones:

Yeah, absolutely. So we've been talking mostly about the 10 year abatement that applies to improvements upon completion, but there also is an abatement that is in effect for 30 months that applies during the construction period. And one of our issues that we talked about in the proposed regs related to that abatement, right?

Nathan Farris:

Right. Yeah. So another question we wanted to get an answer to is people call it different things either the 30 month abatement or the developer's abatement, but the bottom line is during construction for 30 months, the value of new residential construction is abated. And the way OPA has always treated that in the past for mixed use projects is they just look at how much of it is commercial and how much of it is residential and they give you that percentage, whatever percentage they say is residential that's abated during the 30 months and the commercial improvements you got to pay on. And it's like a funny feature because currently the way it works or at least before January one, 2022, if you had a mixed use project, you would not pay taxes on the residential portion during construction, assuming construction took less than 30 months, you would pay taxes on the land and the commercial portion of your assessment.

Nathan Farris:

And then when you completed your project, you wouldn't pay taxes on any of the improvements because that was all abated under the 10 year abatement and it didn't matter if you were commercial or residential. But now we were saying, okay, OPA, if you're going to use this predominant use test for the purposes of the 10 year tax abatement, are you also going to use that for the purposes of the developer's abatement of 30 month abatement? So that if I have a property that is predominantly residential, it's 52% residential or whatever, do I not have to pay taxes on the commercial side on that 48%? Because you're going to treat this property as if it's residential. So under the 30 month abatement shouldn't I also get abatement for that piece? And OPA said, no, unsurprisingly also.

Nathan Farris:

Chris, it's not surprising, but all of their answers resulted in the city collecting more taxes. That's not true, they could have taken a more aggressive position on the condo one, but OPA said, I actually understand where they're coming from on this one. Their basic position is these regulations affect the 10 year tax abatement. They have nothing to say about how we apply the 30 month abatement. So I understand where they're coming from.

Christopher Jones:

I understand where they're coming from. And particularly the first piece of the predominant use does make things easier in a lot of ways of not having to draw these lines in between the same project. But the theory of that one does at least to some extent, arguably contradict the theory of saying no, that the 30 month abatement only applies to that residential piece, because in some way, by doing that, you're implicitly saying that a chunk of that project is commercial, but yet you're not going to give the more valuable commercial abatement to that piece of the space once it's completed. So it's almost that it becomes, it takes on a new character when it's completed, as opposed to during the construction period. All of these is what I think will end by talking about they're all going to have some implementation difficulties and record keeping difficulties, but not shocking to see where they came out with that one, slightly disappointing. And like you said, I think it is lacking a coherent theory maybe, but we'll see where it goes.

Nathan Farris:

I like that. It's one of these magical things that happens in law sometimes where all of a sudden it's transformed, right? So during construction it's whatever percentage commercial and whatever percentage residential, and that's how we apply the 30 month abatement. But then the moment you get your CO, magically the predominant use test applies and we're going to, I'm being facetious obviously, we engage in these sorts of legal fictions as layers all the time.

Christopher Jones:

Right, right.

Nathan Farris:

Right. There's nothing unusual about this. But I do think there is some tension in the way OPA is applying these two statutes.

Christopher Jones:

So that's where OPA came out with the final regulations that were published earlier this year. You can find those at the department of records site. And that includes our written submission that we had and notes from the hearing and then where they came out with everything finalized. I think that leaves us, where are we going to go? And what are we going to see? What are the big takeaways in light of the final regs? And what are we already seeing in 2022, is people are adjusting to the new regs.

Nathan Farris:

So I think the obvious big issue, the thing that's going to drive this the most is we're going to see a lot more mixed use condominiums unless there's some overarching reason not to, you'd be a little silly not to use the condo structure if you have a mixed use project, because otherwise you'd be leaving money on the table, right? If you're not conduiting it up, you're not going to get the value of that commercial abatement for your commercial space. So I think we're going to see a lot more condos, but I do think that there are some challenges there because typically I see my developer clients, they don't decide on the ownership structure early in the development process because in some ways it doesn't matter to them, but here I think you're going to need to decide pretty early or at least know pretty early that you're going to be using the condo structure, because it's going to affect your proforma.

Nathan Farris:

As you're modeling out the taxes, you're going to be paying, you got to think about what the taxes are going to be on your commercial space versus your residential space now. So you need to know ahead of time if you're going to use the condo structure so that you can walk in that more valuable abatement for your commercial space. And there'll be costs associated with that obviously, our condo colleagues are probably going to have a lot more work to do all of a sudden.

Christopher Jones:

Yeah. To your point, sometimes we get calls from clients really early in the process. And I think in that case, we will certainly have that discussion as far as, yeah, let's think through what this would look like if you're able to separate it into multiple units and what do we think the value of the abatement would be in that case, as opposed to just going straightforward, and assuming that more than 50% of the square footage is residential, where you'd be in that case. And we don't always get calls that early, sometimes it's much further down the road and it might be harder to call an audible and to switch things up at that point. And I think we'll see some of that though again, because there is enough value here that it is going to be the driver of a lot of discussions. Sometimes in the past you've seen mixed use condos, but a lot of times that was driven by other concerns and other issues. And in this case, this will be one of the drivers of it. Even if there's no other factors there that would indicate that a condo structure makes sense.

Nathan Farris:

There are things to think about as you're doing the condo structure, right? Because it adds another layer to your development. So, there's obviously costs, right? You got to prepare the condo docs, you got to record them, so there's that, but then there's an ongoing issue, right? You have an association that's managing this condo and there could become issues, especially if you're going to sell the commercial unit to what would've been a tenant. And if you're going to then piece up your residential portions and sell that out, who's controlling the association? Those could be issues moving forward. And you could end up with operational issues that you have to deal with through the association because you now have a condo structure where you never planned to.

Christopher Jones:

Another big issue I just think we're going to see is record keeping. And this goes both with the developers and then with OPA itself. We already see some of this where there's issues getting abatements put into place, there's issues with some of the timing. But we'll see these projects where maybe there's a commercial condominium unit one and residential condominium unit two. And they're both completed at the same time. But even though that's the case, the residential abatement kicks in on October 1st of some year, whereas the commercial abatement doesn't kick in until January 1st of the following year. And then when you put on top of that, the 30 month abatement, where if a project goes on beyond 30 months, it comes back on the tax rolls. If not, you're still only worried about that distinction between the commercial residential.

Christopher Jones:

And then you're looking down the road and you're going to have to go in year six and say, okay, this abatement is in year six, but it doesn't burn off until November 1st of some year, October 1st of some year, whereas the other one is on the calendar year. And just keeping track of that is going to be, it already is a headache. It's going to create more and more headaches and underlying all this is the fact that land values' remaining subject attacks. It's not going to be this clean process. It's going to be adding headaches to an already complicated process.

Nathan Farris:

Yeah. So I have two thoughts there on this one, I totally agree with you that this is going to cause administrative headaches. So just to give an illustration, the way this is going to get applied is the residential abatement is going to start the month after your CO is issued. But it is often the case in a large development that you get multiple COs on a rolling basis, right? So you could have lots of different abatement lengths within the same building. You could have a 30 story building with hundreds of

different abatements ending at different times. So I absolutely agree, that's going to be a real challenge for OPA. It also presents some complicated valuation issues. Just thinking about valuing the asset, you then have to know your tax load is going to change, say you have 300 different abatements ending at different times.

Nathan Farris:

That's going to change your tax load as each one of those abatements burns off, your tax load is going to increase. So you have to account for that in your proforma, which is not easy to do. There's just a lot of record keeping you have to do. And I think you touched on it too. It also creates really challenging issues around how you value the land underneath the condo. I've dealt with this in the past OPA often because they have 500,000 properties or something like that to assess each year. They'll get the total market value assessment, right? They'll say this condo unit, we know it's worth \$5 million. It's a really nice condo. We know it's worth \$5 million because of the comps. And then they'll just assign a fixed percentage of value to the land. They'll say 10% of that \$5 million goes to the land.

Nathan Farris:

So land's worth \$500,000. But that means that within the same structure, you'll have different land values, even though it's the exact same land under there, right? A higher up unit is going to be worth more, so it's going to have a higher land value than a unit lower down. And that only gets compounded when you add in mixed use issues, right? How do you value the land under a commercial space versus a residential space? So I think you're going to see some challenging issues. And I think we'll see a lot of tax appeals because it's just going to be hard to get that land value right. And the land values when you've got an abatement, that's what you're paying on. Especially the commercial.

Christopher Jones:

Yeah, that's what I was going to say is in addition to keeping the condo lawyers busy, taxpayer lawyers will also be kept busy. So as you said, every time a question gets answered in this space, another question gets asked and that's what makes it interesting and also keeps us busy.

Nathan Farris:

That is the fun part of the law, always developing. Pun intended.

Christopher Jones:

All right. So this has been the first episode of Developing Philly. If anyone has any issues they'd like us to discuss, feel free to reach out, and we will be back with more topics.

Steve Burkhart:

Thanks again to Christopher Jones and Nathan Farris. Make sure to visit our website, www.ballardspahr.com, where you can find the latest news and guidance from our attorneys. Subscribe to the show in Apple podcasts, Google play, Spotify, or your favorite podcast platform. If you have any questions or suggestions for the show, please email podcast@ballardspahr.com. Stay tuned for a new episode coming soon. Thank you for listening.