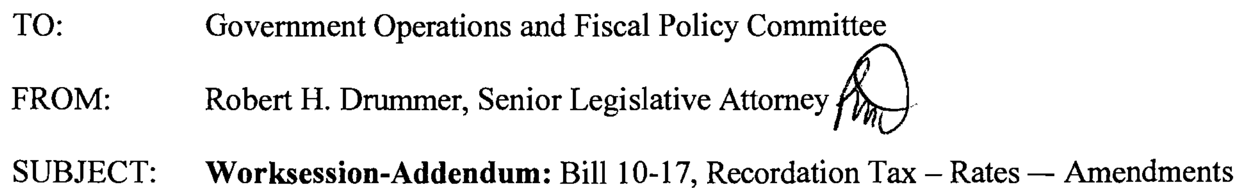
GO Item 1
May 4, 2017
Worksession
ADDENDUM

MEMORANDUM

May 2, 2017



TO: Government Operations and Fiscal Policy Committee

FROM: Robert H. Drummer, Senior Legislative Attorney

SUBJECT: **Worksession-Addendum:** Bill 10-17, Recordation Tax – Rates — Amendments

We received extensive comments from the Apartment and Office Building Association of Metropolitan Washington (AOBA) opposing the Bill after the packet went to print. See the AOBA comments at ©1.

This packet contains:	Circle #
AOBA Opposition to Bill 10-17	1

TO: **Councilmember Nancy Navarro, Chair,**
Committee on Government Operations and Fiscal Policy

Councilmember Sidney Katz, Member
Committee on Government Operations and Fiscal Policy

Councilmember Hans Riemer, Member
Committee on Government Operations and Fiscal Policy

FROM: **Nicola Y. Whiteman, Senior Vice President of Government Affairs**
Apartment and Office Building Association of Metropolitan Washington

DATE: **May 2, 2017**

RE: **Oppose Bill 10-17 Recordation Tax - Rates – Amendments**

The Apartment and Office Building Association of Metropolitan Washington (AOBA) is a non-profit trade association whose members include owners and managers of more than 112,000 apartment units and over 33 million square feet of office space in suburban Maryland, of which more than **57,000 apartment units and over 24 million square feet of office space are located in Montgomery County.**

AOBA strongly opposes Bill 10-17 Recordation Tax - Rates – Amendments, which proposes to increase the recordation tax premium component of the recordation tax. ***This measure will almost triple the recordation tax premium for commercial and multifamily propertie***s as most are valued at more than $1 million. Property owners could thus face, for example, a staggering increase from $1.55 (2015 rate) to an additional $3.55 for each $500 or fraction of $500 of the amount over $2,000,000 in a just a few years.

The proposal will ***unfairly*** impose a second, significant increase to the recordation tax rate on AOBA members and other businesses that already bear a disproportionate share of the County's tax burden. The non-residential sector, for example, accounts for approximately ***67.1%*** of energy tax revenues. AOBA supports across the board tax enhancements that are universally applicable but cannot support a proposed structure that intentionally targets businesses.

The 2017 proposed tax hike follows the Council's 2016 decision to significantly raise both the school increment and recordation tax premium ***in addition*** to a record increase to the property tax rate. The 2016 increase was a shock to the real estate market, especially a weak commercial office market, and the 2017 proposal is pending as the market continues to struggle.

A second recordation tax increase will undermine the County's economic development goals and serve as a disincentive to needed investment in the County. Annual tax increases primarily borne by businesses sends the wrong signal that MONTGOMERY COUNTY IS CLOSED FOR BUSINESS.

TAX INCREASES UNDERMINE THE COUNTY'S AFFORDABLE HOUSING GOALS

The proposal will increase the costs associated with the purchase and sale of rental housing.

Rising interest rates and higher transaction costs: AOBA cautions the Council that the impact of this misguided proposal must also be considered along with other changing market conditions. Notably, the loan period for many multifamily properties averages 7 to 10 years, making refinancing a frequent, and if this proposal passes, more expensive occurrence. Higher recordation rates, in addition to projected increases to interest rates and rising operating expenses (i.e. increases to electric and water rates in addition to numerous surcharges, among others) should raise alarms about the ability to preserve and operate the County's existing rental housing stock.

Draft Rental Housing Study Policy Recommendations – Tax *Incentives*: At the same time a tax increase is before the Council, the same government is also considering real property tax abatement and exemptions as a tool for preserving and incentivizing affordable rental housing. (See Policy Recommendation, page 32.) Real property taxes can account for 22% of operating expenses so real property tax ***credits*** not increases can serve to preserve existing and incentivize the development of new rental housing.

Tax proposal paints bull's eye on real estate investment trusts ("REITs"): Many of the apartment communities in Montgomery County are owned by REITs and other investment ventures that rely on stable markets so that they can buy and sell properties quickly. REITs are already hesitant to invest in this County, given the high taxes and uncertainty regarding the future of the County's rental housing laws. An increase to recordation taxes could further dissuade REITs from investing in the County.

Government regulation and policies, such as the current proposal can limit access to housing by increasing the costs of producing new and preserving existing housing. See 14 Million Households "Priced Out" By Government Regulation, "NAHBV Economics estimates that 14 million American households are priced out of the market for a new home by government regulations that, on average, increase the new home price by 24.3%." This does not include, for example, costs such as the impact fee here in the County. **For multifamily properties, the percentage can be as much as 30%.**

TAX HIKE PUNISHES NOT HELPS ALREADY FRAGILE OFFICE MARKET

The struggling office market is already facing high vacancy rates that create the risk of ***declining property values and tax revenues***. Another proposed recordation tax increase will thus do little to address the challenges plaguing the office market sector and may in fact result in a net decrease in projected revenue. For example, the proposal could scare away potential purchasers already skittish about acquiring challenged properties. Adopting a second recordation tax increase will encourage many to instead look to neighboring jurisdictions where the tax burden is more reasonable, making development and reposition deals more attractive.

Montgomery County is not an island. Consider, for example, that Prince George's County is aggressively working to attract new residents and businesses through a variety of regulatory policies and incentives. The County is also an increasingly attractive market due to a number of factors including, for example, cheaper land and the availability of jobs for persons choosing to relocate to the County. Prince George's County is indeed "Primed for Business." See, for example, Five Key Takeaways from DC's Q1 Office Market, Banister, April 4, 2017. https://www.bisnow.com/washington-dc/news/office/five-takeaways-from-dcs-q1-office-market-72927. **"The relative lack of affordable metro-centric developments in other locations may be a catalyst for Prince George's County** ...," JLL director of U.S. office research Scott Homa said. "**Natural economic forces are driving government tenants to Prince George's** and will likely continue to do so over the long term, especially with this [Trump] administration focused on reining in the cost of government."

How will the fairly new Montgomery County Economic Development Corporation, whose mission includes business retention and expansion and removing barriers, respond to existing and prospective businesses concerned about seemingly annual tax increases in the County?[1] Will businesses continue to "Choose Montgomery?" Will they be able to afford to "Choose Montgomery?"

THE PERFECT STORM:
Higher Recordation Tax and Troubled Financial Markets

Understanding the full impact of the proposed increase requires the Council to first carefully consider how many commercial loans are structured as well as anticipated developments in the financial market. First as noted, many of these loans are for 7 to 10-year terms, thus making refinancing and exposure to a high recordation tax rate a frequent occurrence. Secondly, the proposed increase comes at a time when financial markets are predicting additional challenges ahead due to the storm brewing around commercial mortgage backed securities (CMBS) loans.[2]

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[1] https://thinkmoco.com/about-mcedc/who-we-are/ "Business retention and expansion efforts continue to be our priority. We are engaging with businesses across the county to add value and remove barriers as needed, knowing that the greatest job growth will be generated by those businesses already located in the region."

[2] Real estate's ticking bomb: Who gets hurt, CNBC, Olick, Diana, March 10 2016 ("Commercial mortgage backed securities (CMBS) are bonds sold to investors"); US Commercial Mortgage Backed Securities FAQs ("CMBS are bonds, which are backed by commercial real estate collateral."); Refinancing CMBS loans could prove difficult, Greater Fort Wayne Business Weekly, Lipp, Linda, March 30, 2017 ("While $6.7 billion in maturing CMBS debt is

The Council should be mindful that many of these CMBS loans, which were hugely popular in 2007 and many of which are 10-year balloon mortgages, were due in the fourth quarter of 2016 and 2017 for refinancing.[3] Given the strict defeasance and prepayment penalties, the only time to refinance is within the narrow 6-month period before maturation. A second, substantial increase to the County's recordation taxes could stand in the way of, or change the structure of, refinances for these commercial loans, and lead to catastrophic default. If unable to refinance these properties, building owners may be forced to sell properties and at prices far below the loan amount. ***This will result in lower recordation tax collections and revenues earmarked for the various capital projects and rental assistance programs.***

AOBA also cautions the Council that owners planning to refinance CBMS loans already face a challenged financial market. CMBS loans are essentially bonds and some industry analysts are questioning whether there will be sufficient investor demand for these loans.[4] Additionally, the ability to refinance assumes an owner has sufficient equity in a property. Those properties which have not been able to sufficiently increase rents and income and thus increase property values will find refinancing much more challenging.[5] We know, given the current state of the

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coming due this month, the figure is minuscule compared to what's coming. ***Over the next six months alone, about $61.1 billion in debt will come due.*** But almost 6 percent of the maturing debt is past due on payment and 10.5 percent is in special servicing, according to data from market research firm Trepp. Difficulty in refinancing is the key culprit. ***Tighter regulations in the financial markets have made it more difficult and more expensive to refinance these loans,*** said attorney Daniel Martin, a partner in McDermott Will & Emery in New York. Loans that were originated more than 10 years ago may have been at 75 percent to 80 percent, loan to value. It's much harder to borrow that much today.")

[3]Projected CMBS Issuance for 2017 Under $80 Billion, Bell, Diana, Jan 19, 2017 ("While 2016 brought choppiness to the CMBS market, rising interest rates and risk retention rules in 2017 may pose headwinds to the sector this year, sources say. ...Rising interest rates will be a concern for CMBS financiers watching their bottom line... Approximately 30 percent of $47 billion in Fitch-rated CMBS loans maturing this year could default. ... The firm says expects "significant delinquencies" in those loans, citing high leverage levels. ... About $112 billion in CMBS loans is scheduled to come due in 2017, according to research firm Trepp, with another $17.6 billion slated to mature in 2018. Office and retail loans account for the bulk of the balances, Trepp analysts say"); Banks to Fed: We've Tightened Commercial Real Estate Lending, Drake, Martin, May 6, 2016 ("CMBS is also facing a looming maturity wall - i.e. the wave of securitized loans that will need refinancing over the next six months."); Real estate's ticking bomb: Who gets hurt ("CMBS tends to have a 10-year life span, at which point the debt matures and real estate owners ***have*** to refinance the loans.")

[4]Real estate's ticking bomb: Who gets hurt ("CMBS tend to have a 10-year life span, at which point the debt matures and real estate owners have to refinance the loans. These maturities are expected to surpass $400 billion annually this year and in 2017, according to CBRE, a real estate services firm. That is $100 billion more than last year. *CBRE "conservatively" estimates that 18 percent of loans this year and 29 percent of loans next year could have problems refinancing, due to lack of investor demand for the bonds. This translates into about $43 billion in potentially troubled loans over these two years.*" "We think some of these are going to be remonetized through asset sales, but some will certainly hit the foreclosure list ...""); Coming Due: How CMBS Market Will Handle $300B Maturing 2015-2017, January 7, 2015, Colomer, Nora ("The amount of commercial mortgage debt maturing is set to spike this year, when loans taken out during the height of the real estate bubble start coming due. *Between 2015 and 2017, more than $300 billion will need to be refinanced.*")

[5]Wall of CMBS Loan Maturities Shrinks, Remains Daunting, Commercial RealEstate Direct, January 19, 2016, ("Healthy real estate market fundamentals have enabled many owners to increase rents and income, which has contributed to an increase in property values and made refinancing easier than it otherwise would be. Borrowers have taken advantage of the strong market fundamentals, the availability of debt capital and relatively low interest rates to defease CMBS loans and refinance properties before their underlying loans mature.") While owners of challenged properties will still be able to refinance a property, they might face, for example, higher interest rates.

commercial office market in Montgomery County, that this is a reality for many property owners. In other words - the perfect storm.

BACKGROUND

Q1 2017 JLL REPORT – SUBURBAN, MD VACANCY RATES[6]				
"No office buildings were under construction in Montgomery County and only one office development was under construction in the Suburban Maryland region in the first quarter. No office buildings will be completed in 2017; the next office building isn't scheduled to deliver until the third quarter of 2018."[7]				
Submarket	**Total Vacancy**	**Class A**	**Class B**	**Class C**
Montgomery County	16.3%	17.3%	15.4%	16.3%
Bethesda CBD	9.5%	7.5%	11.4%	15.8%
Bethesda - Rock Spring	28.1%	26.4%	42.3%	N/A
Burtonsville	9.2%	N/A	9.2%	N/A
Chevy Chase	11.3%	3.9%	16.7%	N/A
Clarksburg	3.5%	N/A	3.5%	N/A
Gaithersburg	13.7%	13.7%	13.3%	20.6%
Germantown	15.8%	14.5%	15.8%	26.1%
Kensington	9.6%	N/A	2.5%	11.7%
North Rockville	9.9%	6.6%	15.3%	N/A
Shady Grove	18.6%	17.5%	21.9%	10.9%
Park Potomac/Tower Oaks	25.1%	27.4%	28.5%	3.4%
Rockville Pike Corridor	16.6%	21.9%	9.3%	20%
Downtown Silver Spring	14.6%	11.8%	20.7%	14.5%
North Silver Spring	16.5%	23.8%	14.9%	N/A
Wheaton	25.9%	N/A	N/A	25.9%

MONTGOMERY COUNTY COMPREHENSIVE ECONOMIC STRATEGY
MARCH 2016

- "It is clear, however, that diversifying the County's business sector portfolio beyond those tied to the federal government while exploring new opportunities to better leverage federal institutions for private sector investments will strengthen the economy. For this to happen, a full commitment to private sector success is required. Businesses must not be seen as an afterthought; the County must wholeheartedly embrace the success of its private sector. This must involve existing businesses, ensuring that they are satisfied with the County's commitment to them and to their expansion.")

[6] Q1 2017 JLL Report – Suburban, MD Vacancy Rates, http://www.us.jll.com/united-states/en-us/Research/US-Suburban%20Maryland-Office-Insight-Q1-2017-JLL.pdf?705bc663-0f4c-4170-8ce8-5a8d7b0cc94d
[7] Q1 2017 JLL Report – Suburban, MD Vacancy Rates, p. 1

- **STRATEGY 1.1.4. Tax and Regulatory Policies: Ensure County Tax and Regulatory Polices are Supportive of Business Attraction and Expansion, Especially as They Affect Targeted Markets.**

SOBERING NEWS

State of the Commercial Real Estate Market in Montgomery County

Excerpts: Montgomery County Planning Department's June 2015 Office Market Assessment

"**High vacancies also threaten the financial viability of individual buildings.** They pressure each landlord who has vacant space to lower rents or increase concession packages in order to lure tenants, undercutting the building's cashflow and thus its market value. **As more buildings are affected, these depressed values could have negative implications for the property tax base of the county, the City of Gaithersburg, and the City of Rockville.**" Page 1.

'**Projected occupancy rates do not suggest any near-term relief in these problems.** Only significant increases in office-based employment, office building demolitions or conversions to other uses could make a dent in the county's nearly 11 million square-foot vacant office inventory." Page 2.