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How Widespread is Abuse of the Individual Apartment Improvement Increase Loophole?

A White Paper By
The Association for Neighborhood & Housing Development
and the Housing Rights Initiative

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An obscure provision called the Individual Apartment Increase (IAI) has become one of the most contentious battlegrounds in the legislative struggle currently taking place between tenants and landlords in Albany. This loophole, like many others, was enacted in 1994 when a Republican-controlled New York State Senate forced the Democratic-controlled New York State Assembly to pass major weakening provisions in the rent regulation system. As a result of those changes, [recent data](#) shows that thousands of rent stabilized apartments have been taken out of the system each year, contributing to a 77% increase in the number of New York City residents in homeless shelters over the past ten years. By 2016, 72.8% of low- and moderate-income households were considered rent burdened. Since control of the New York State Senate shifted to Democrats in 2018, tenants and their allies in Albany are expecting to implement major changes in the 2019 legislative year to close the loopholes and expand much needed renter protections.

A review of available data shows the IAI system to be not only open to rampant fraud, but fundamentally designed and legally used to drive speculation and displacement.

The Individual Apartment Improvement (IAI) rent increase loophole is an under-examined mechanism that allows landlords to collect a significant, permanent rent increase on a vacant apartment in return for making physical improvements to that apartment. The landlord lobby argues that the IAI system is an appropriate way of improving the quality of the housing stock by [encouraging landlords to make modest physical improvements](#) on vacant units before they are rented out again. But **a review of available data shows the IAI system to be not only open to rampant fraud, but fundamentally designed and legally used to drive speculation and displacement.**

HOW DO IAIs WORK?

The IAI provision allows a landlord to raise the rent on an unoccupied rent regulated apartment by making physical improvements to the apartment. The owner is able to pass the cost of improvements to the next tenant by raising the monthly rent an amount equal to 1/40th of the total cost of the improvements if the building has fewer than 35 units, or 1/60th of the total cost of improvements if the building has 35 units or more. For example, if a new tenant moves into an apartment in a 30-unit building where the legal apartment rent should have been set at \$1,000 a month under current guidelines, but the landlord spent \$20,000 on physical improvements to the apartment while it was vacant, then the monthly rent can be set at \$1,500 (1/40th of \$20,000 is \$500). This formula allows for dramatic rent increases.

Physical improvements eligible under the rules can include, for example, new bathroom fixtures, new kitchen appliances, and new flooring. Costs associated with maintenance, such as plumbing, sanding floors, and painting are not considered to be improvements and cannot be counted towards an IAI

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How Do IAI's Work?

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For Example....

Legal Rent Under
Current Guidelines
\$1,000



After \$20,000 of physical
improvements to the
apartment while vacant



Rent With IAI Provision
\$1,500



increase. An IAI rent increase can be taken in addition to any other rent increase to which the landlord is statutorily entitled.

An IAI increase is unilaterally imposed by the landlord. A landlord does not have to seek permission or provide any proof of expenses to the state agency that oversees rent regulation – Housing and Community Renewal (HCR) – in order to apply the IAI rent increase. The increase is simply added onto the apartment rent when a new tenant first moves in.

WHAT DO WE KNOW ABOUT THE IMPACTS OF IAI's?

There is no comprehensive data about the actual scope and scale of IAI's impacts, in large part because no agency tracks them. The system relies wholly on user self-certification and does not require landlords to proactively request permission for an increase from the New York State agency for Homes and Community Renewal (HCR), or even submit proof after the fact of the expenses on which an IAI is based. And because the work is performed in vacant apartments, the new tenant is in no position to know if their new rent is legally justified.

With the creation of the HCR's special Tenant Protection Unit (TPU) in 2012, the agency began to conduct a small amount of retroactive auditing of IAI increases. What they have found is cause for concern:

- The [New York Times reported](#) that a 2014 audit by the Tenant Protection Unit “found through more than 1,100 landlord audits that, in as many as 40 percent of cases, landlords did not have proof of apartment improvements used to justify rent increases, state officials said.”
- While the TPU does not regularly share information publicly, it consistently reports [successful enforcement actions](#) against landlords charged with abusing the IAI program.

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While it is troubling that there may be fraud in a significant percentage of IAI cases, recent data from the housing watchdog group Housing Rights Initiative (HRI) points to an even more fundamental problem with the IAI system.

As part of their investigative work, which has led to multiple class action lawsuits, HRI recently began collecting official HCR rent histories for apartments where HRI had reason to believe that the landlord had used an IAI to collect a rent increase during a recent vacancy. HRI's rent history database is unusually large, and the HCR only releases rent

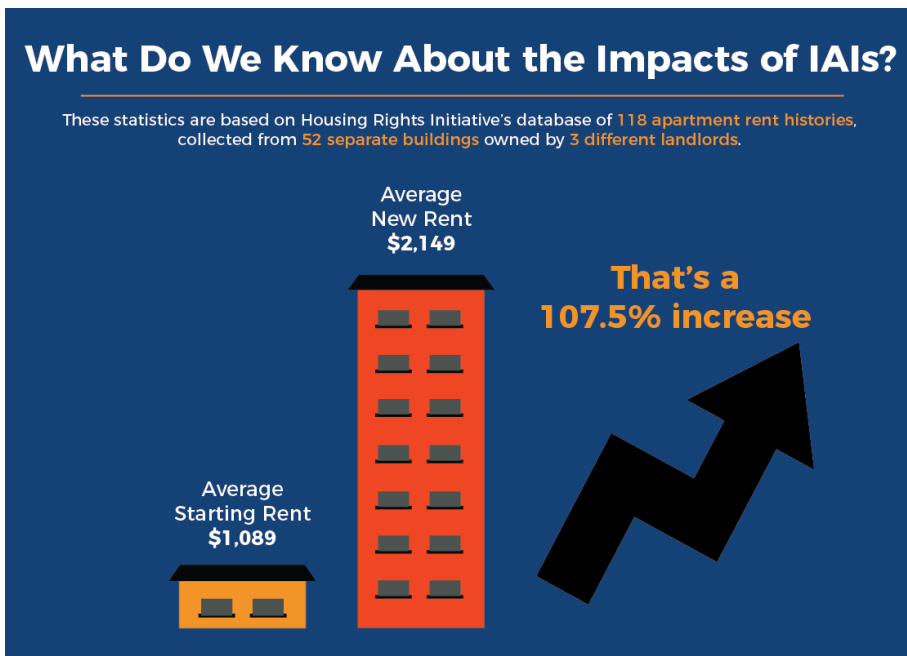
histories on request of the actual current tenant of an apartment, so they are difficult to collect. HRI's database of 118 apartment rent histories, collected from 52 separate buildings owned by three different landlords shows that **the average starting rent was \$1,089 and the average new rent was \$2,149, representing a 107.5% increase that averaged \$1,060.**

This finding from the HRI data suggests that landlords are not using IAIs to make modest physical improvements – they are using them to drive major rent increases, even doubling rent levels.

It appears that the **IAI formula itself actively incentivizes landlords to significantly increase rents and remove apartments from rent regulation.** Even if the IAI loophole is used with no fraud, the formula allows a major, sudden, permanent increase in rent for a relatively small investment in the apartment.

HOW DOES THE IAI SYSTEM FUEL SPECULATION?

New York is a city of renters with 2.1 million rental apartments. Many of those apartments – 1.4 million – are rent regulated. **The rent regulation system is designed to give tenants some stability in a real estate market so tight that, without rent regulation, the interests of tenants and landlords would be extraordinarily unbalanced.** The fundamental logic of rent regulation is that the free market cannot reasonably balance the interests of landlords and tenants if the apartment vacancy rate is exceptionally low; if an apartment badly needs repairs or if a landlord is withholding basic services, the tenant would



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need to think long and hard before leaving because the vacancy rate for moderately-priced apartments is minuscule. For this reason, the rent regulation laws only exist if the vacancy rate is below 5%, and regularly sunsetted only reestablished by the state legislature when the low vacancy rate is reconfirmed.

Rent regulation is intended to keep rent levels predictable, contributing to both individual and neighborhood stability. It's a crucial measure for working- and middle-class neighborhoods in a city where neighborhood after neighborhood is seeing rising property values and rising rents.

As a recent ANHD blog pointed out the fundamental mechanism of rent regulation preserves affordable apartments and neighborhoods by disincentivizing real estate speculation.

The central mechanism of rent regulation is straightforward: tenants are entitled to a written lease, annual rent increases are set by a publicly-appointed board, tenants can only be evicted for good cause, and when there is a vacancy, the increase for the next tenant is moderated. At its core, rent regulation is meant to discourage real estate speculation and preserve tenant and neighborhood affordability by limiting landlord and investor profit expectations to a reasonable rate of return based on existing tenancies. **It counteracts a speculative approach from overly-aggressive real estate investors, who would otherwise be motivated to buy buildings with the expectation of evicting existing tenants to take advantage of rising market rents in many neighborhoods.** The fact that rent regulation exists encourages real estate investors to only buy and sell buildings for a price that can provide a reasonable profit while still respecting the modest rent increases that the law allows. This is designed to dampen the speculative impulses of investors by keeping a building's cost, profitability, and affordability in balance every time a building is sold and resold.

As a [recent ANHD blog](#) pointed out the fundamental mechanism of rent regulation preserves affordable apartments and neighborhoods by disincentivizing real estate speculation. The IAI provision undermines this basic logic of the rent regulation system. Because it is open-ended and can be applied on an apartment-by-apartment basis, the IAI loophole is the most important mechanism that developers and landlords use to increase rental income in an existing rent regulated building. For this reason, **IAIs play a key role in encouraging real estate speculation since IAIs allow buyers and sellers to assume that a building's rent roll can be increased dramatically.**

A [statement by a prominent real estate broker](#) in an industry newspaper makes explicit the connection between rent increase loopholes and real estate speculation, saying that if the current proposals to close the rent increase loopholes are enacted then, "Properties containing a high percentage of 'deeply stabilized' units (units leased at less than 50% of market rent) stand to lose the most in perceived value because investors will attribute less value to future upside. They will be forced to focus more on the property's current yield and ability to be financed." In other words, buildings will be more likely to be bought and

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sold for what they are actually worth based on the rent roll with the current tenants in place, not what they could be worth if the current tenants are pushed out. **The IAI provision clearly undermines the goals of the rent regulation system – even before fraud and abuse are factored in.**

WHAT DOES IAI FRAUD LOOK LIKE?

Previous reports have pointed out why the IAI system is [encouraging of landlord fraud](#). A class action lawsuit generated [in 2017 by HRI against Stellar Management](#) shows how IAI fraud works. The lawsuit quotes a separate lawsuit filed against the founder of Stellar Management, Laurence Gluck, by a partner for inflating IAI-related improvements and paints a clear picture:

“Specifically, Gluck entered into a fraudulent secret arrangement with contractors performing renovations on the apartments ... pursuant to which the contractors inflated the prices charged for the renovations. The difference between the actual costs and the inflated costs -- approximately \$40,000 per apartment -- was credited to Gluck to be used at his discretion.... 4. Additionally, in furtherance and in aid of this scheme, at Gluck’s direction and under his supervision, employees of Stellar Management assisted Gluck in concealing this secret arrangement by keeping a second set of financial records tracking the overpayments made in connection with [the subject buildings] the true value of the services, and how funds were reallocated to other ventures. 5. The [subject buildings] are not the only instance where Gluck has perpetrated this fraudulent scheme.

| | | | |
|------|-------------------|------------|--------|
| 2011 | RS | 07/27/2011 | 896.29 |
| | TENANT: | | |
| 2012 | RS | 07/23/2012 | 896.29 |
| | TENANT: | | |
| 2013 | RS | 05/17/2013 | 896.29 |
| | TENANT: | | |
| 2014 | RS | 07/30/2014 | 896.29 |
| | TENANT: | | |
| 2015 | RS | 06/29/2015 | 896.29 |
| | TENANT: | | |
| 2016 | PE | 07/28/2016 | EXEMPT |
| | HIGH RENT VACANCY | | |

An example of a rent history from one tenant in a Stellar Management building shows what a de-regulated rent history looks like in the image to the left.

As this rent history shows, the last registered legal rent was \$896.29. “Exempt” indicates that the apartment was removed from rent stabilization. According to the class action lawsuit, for Stellar Management to have legally exempted this apartment, it would have had to have performed considerable apartment improvements to get the rent over \$2,700, which was the deregulation threshold at the time. To calculate an individual apartment improvement claim, you first take into account the maximum non-IAI vacancy allowances. In the case of this apartment, the difference is between the legal rent and the \$2,700 deregulation threshold – which could only be explained by IAIs –and Stellar Management would have had to have done \$90,000+ in apartment improvements.

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The HRI class action lawsuit asserts that the expense claims for the apartments in the lawsuit are suspicious because of:

- **Lack of visual evidence** of improvements in the apartments in question;
- **Building permits** that appear insufficient to justify the full scope of the work; and
- **Questionable invoices** submitted to the court by Stellar Management through the discovery process fail to justify the full costs.

Beyond clear evidence of fraud and abuse, even legal IAIs are not being used to encourage basic investment and maintenance, but to enact extreme rent increases between tenancies.

HRI research, as reported in [The Real Deal](#), also found evidence of at least five shell companies used by Stellar to further exploit the IAI system. As recent [New York Times expose](#) on the fraudulent real estate practices of Donald Trump's father Fred Trump shows some landlords have routinely created shell construction companies through which they pay themselves to perform inflated or fictitious apartment improvements. **If a tenant files an overcharge complaint, the landlord can justify those improvements and subsequent rent increases by furnishing fake or padded invoices and canceled checks made out to their shell companies.**

CONCLUSION

Legislation to [repeal the IAI loophole](#) has been introduced by the Chair of the Senate Committee on Housing. And indeed, eliminating IAIs is an important step towards restoring the function and purpose of the rent regulation system as a whole. **Beyond clear evidence of fraud and abuse, even legal IAIs are not being used to encourage basic investment and maintenance, but to enact extreme rent increases between tenancies.** And the fact that such a loophole exists in the system encourages the very speculation rent regulation is designed to prevent.

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ACKNOWLEDGEMENTS

Report Authors: Benjamin Dulchin, *Executive Director at The Association for Neighborhood & Housing Development (ANHD)* & Aaron Carr, *Executive Director at Housing Rights Initiative (HRI)*

Report Design: Melanie Breault, *Communications Associate at ANHD*

About the Association for Neighborhood and Housing Development:



ANHD is a coalition of community groups across New York City. We use research, advocacy, and grassroots organizing to support our members in their work to build equity and justice in their neighborhoods and city-wide. ANHD values justice, equity and opportunity. We believe in the importance of movement-building that centers marginalized communities in our work. Since our founding in 1974, ANHD has been

helping to make New York City's community development and grassroots neighborhood-based groups among the most effective in the country by providing comprehensive training, robust capacity-building and apprenticeship programs, and high-impact policy research. ANHD's non-profit members have built over 123,000 units of affordable housing in our city's most distressed neighborhoods; worked directly with tenants and homeowners to save thousands of at-risk affordable apartments and homes; and consistently shaped the housing and economic development policy landscape to better meet the needs of low- and moderate-income New Yorkers.

www.anhd.org | comms@anhd.org | [@ANHDNYC](https://twitter.com/ANHDNYC)



HOUSING RIGHTS INITIATIVE

About the Housing Rights Initiative:

Housing Rights Initiative takes a proactive and systematic approach to targeting, investigating, and fighting fraudulent real estate practices and connecting tenants to legal support. HRI's data-driven model identifies properties where there is a high probability of systematic fraud. We launch investigations and generate class action lawsuits against predatory real estate companies. Through a legal mobilization effort, HRI lays the

foundation for tenants who have been defrauded by their landlords, to seek redress and secure their rights under the law.

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