Valuation of Subsidized Housing as Applied to Assessment Criteria

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Topic Outline

- Overview of subsidized housing and low income housing tax credit programs
- Uniform Standards of Professional Appraisal Practice (USPAP) in terms of low income housing valuation
- Difference in definitions of market value between federal government and assessing authorities
- Impact on those differences on valuation techniques used by the fee appraiser and the Assessor
  - Rent amounts
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- Demonstration of valuation techniques

Overview of Low Income Rental Housing Tax Credit Program

The Low Income Rental Housing Tax Credit program (LIHTC) is a federal (United States) income tax program designed to give incentive to developers/investors to provide affordable housing in certain geographic or economic areas. These incentives are in the form of tax credits which are a *direct income tax reduction on- the investor's tax return.*

The tax credit program was originally implemented in 1986 on a short-term basis and later was made a permanent program by the Congressional Revenue Reconciliation Act of 1993. Currently, the LIHTC has been responsible for producing between 70,000 and 100,000 rental apartment units a year nationally. Approximately 50% of the total apartment units produced in 1992, 1993 and approximately 1/3 in 1994 were financed by federal low-income housing tax credits.[1]

The value of the tax credits which a potential investor/developer of a project can receive is determined by either the construction cost or the rehabilitation cost of the project and may best be calculated by an accountant or financial advisor familiar with the tax credit program and the tax basis of the investor. The tax credits are distributed evenly over a ten-year period, but the project must be held

[1] Pennsylvania Housing Finance Agency

in the low income housing program for 15 years or a severe ***recapture penalty*** will be imposed on the credits already received by the investors.

In return for the tax credits, the owners must keep the housing project in the low income program which, in essence, places caps on the amount of rent management may charge for an apartment unit. The amount of rent which a project may charge per apartment rental unit varies from area to area and is set by the state agency responsible for overseeing the tax credit program. In most instances, the capped rent is lower than "market" rent attained in non-tax credit projects in the area.

The potential tenant must qualify to occupy the rental apartment unit by meeting certain economic parameters determined on the basis of the median income for the project's particular geographic area and by the number of people in the tenant's household.[2]

The LIHTC is a rapidly growing federally sponsored program which is a win-win situation for both investors and the community in which they are located. This program is open to new housing development as well as renovation/rehabilitation projects. In addition to bettering the community aesthetically, the availability of the tax credit program encourages new or renovated housing for lower income families in areas where market rents do not provide the financial incentive for developers to invest in providing housing. In return for offering below market rents, the investor/developer/landlord gets tax credits to apply against his federal (U.S.) income tax liability.

Subsidized housing is ultimately real estate, subject to the market forces of supply and demand, location characteristics, market acceptance, etc. While many of the motivating forces driving the development process have historically been driven by intangible value, appraisers must consider the underlying real estate qualities and values.[3]

Uniform Standards of Professional Appraisal Practice

Advisory Opinion AO-14 of the Uniform Standards of Professional Appraisal Practice (USPAP) recognizes that in valuing low-income housing, there are likely to be multiple valuation scenarios which should be considered.[4] *Market value* typically includes both tangible (i.e., real estate -- land and buildings) and intangible value (i.e., contributory value of tax credits and/or low interest financing). To meet the requirement of valuation for assessment purposes, appraisers and assessors must carefully define the portion of the bundle of rights they are appraising.[5]

AO-14 begins with the standard definition of market value, which is "the *most probable price* in terms of cash; or in terms of financial arrangements equivalent to cash; or in such other terms as may be precisely defined; if an estimate of value is based on submarket financing with unusual conditions or

[2] The specific rental requirements are available from the state agencies overseeing the local programs

[3] *Affordable Housing Valuation*, "Student Handbook", Appraisal Institute, 1997

[4] *Appraisals for Subsidized Housing*, Uniform Standards of Professional Appraisal Practice (USPAP), Appraisal Standards Board, 1997

[5] Ibid.

incentives, the terms of such financing must be clearly set forth, their contributions to or negative influence on value must be described and estimated, and the market data supporting the valuation estimate must be described and explained."[6]

In the case of low-income housing, a complete market value appraisal is the value of the total property, which is real property and intangible assets. This usually requires an analysis of the real estate value, as well as the intangible benefits of ownership of a low-income development.

However, USPAP does NOT mandate full market value appraisals in all circumstances. For certain types of appraisal assignments in which a legal definition of market value has been established and takes precedence, the *Jurisdictional Exception* may apply.[7] For example, in the area of ad valorem taxation, in those jurisdictions which do not assess intangible assets, their definition is applicable and permits the appraiser and assessor to consider the value of the tangible assets only.[8]

Subsidies and incentives that encourage housing for low- and moderate income households may create intangible property rights in addition to real property rights. Low Income Housing Tax Credits are an example of an incentive that results in intangible property rights that are not real property but might be included in the appraisal.[9]

Market Value Definition for Financing Purposes

There are different techniques of valuing a real estate project which has Low-Income Housing Tax Credits (LIHTC) associated with it, depending on the purpose of the appraisal, i.e., mortgage financing, insurance, or ad valorem taxation. The question with which the appraisal community must wrestle is whether or not the contributory value of the federal tax credits should be included in the market value appraisal of the real estate.

Guidelines from the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board (FRB), and the Office of the Thrift Supervision (OTS) state that appraisals of projects which are constructed or rehabilitated with tax credits ***can*** consider the market value impact of these credits or low interest rate loans, assuming that these non-realty items are transferable and/or survive a sale of the property.

[6] *Uniform Standards of Professional Appraisal Practice*, Appraisal Standards Board, 1997. (Italics added)

[7] "If any part of these standards (USPAP) is contrary to the law or public policy of any jurisdiction, only that part shall be void and of no force or effect in that jurisdiction.", USPAP, *Jurisdictional Exception,* Appraisal Standards Board, 1997

[8] Op Cit.

[9] Ibid.

A summary of the OCC release is:

> "When a regulated financial institution obtains an appraisal for an affordable housing project, the appraisal should contain a market value estimate that reflects the real estate collateral and typical interests in the real estate on a cash or cash equivalent basis. The agencies' appraisal regulations permit the appraiser to include in the market value estimate any significant financial assistance that would survive sale or foreclosure, such as the value of LIHTC, subsidies, and grants. "[10]

The impact of these regulations is that the value associated with the tax credits can be added to the value of the project's real estate (i.e., capitalized net operating income). In many cases, it is this recognition of the additional value of the non-realty items which makes the project feasible. That is, if the value of the tax credits plus the value of the underlying real estate (land, buildings) is greater than construction-rehabilitation costs, the lender can then provide mortgage financing for a financially feasible project (see example to follow).

It should be noted that, the *valuation* of the tax credits, i.e., the mathematical impact of the tax credits on income tax liability, is typically outside the expertise of the real estate appraiser and should be left to the developer's accountant or financial advisor. However, this information should be shared with the appraiser to ensure proper application by the appraiser of the contributory value of the tax credits and/or low interest rate financing.

Assessor's Definition of Market Value

The applicable techniques of appraising real property with federal low income housing tax credits associated with it (LIHTC) varies depending on the underlying jurisdictional definition of market value. When appraising a LIHTC project for financing purposes, as discussed above, it has been determined by the Office of the Comptroller of the Currency, et al, that the value of the credits may be considered in estimating market value under certain circumstances. A lender may be able to provide financing which includes the real estate and the tax credits, which are a non-realty item. However, *for real estate tax assessment purposes*, the value attributable to tax credits may or may not be subject to ad valorem taxation. The assessor and appraiser must understand the local assessment statute to ascertain what is to be included in ad valorem taxation.

For example, investment tax credits are defined as "direct credits against federal income tax, equal to a percentage or portion of the investment in a qualified property, that can be taken when certain depreciable property with a useful life of at least four years is placed in service during the taxable year."[11] These tax credits should be considered as a financing tool, and not tangible real estate.

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[10] OCC 12 C.F.R. Part 34; FRB 12 C.F.R. Part 225; FDIC 12 C.F.R. Part 323; and OTS C.F.R. Part 564

[11] *The Dictionary of Real Estate Appraisal*, Third Edition, The Appraisal Institute, 1993

Intangible value is defined as "a value that cannot be imputed to any part of the physical property, e.g., the excess value attributable to a favorable lease or mortgage, the value attributable to goodwill".[12] The total value of an affordable housing development is derived from the real estate and the non-realty items -- indirect or direct government subsidies, tax benefits or other concession/restriction exchanges.[13] The most current example of an intangible value is the value attributable to the tax credit benefits of a low-income housing tax credit project.[14]

Following are two examples of assessment statute restrictions on the valuation of these types of projects:

According to Pennsylvania General County Assessment Law, 72 P.S. 5020-201, only real property may be valued for tax assessment purposes. This section of the law is fairly detailed as to what is considered real property.[15] The contributing value of the income tax credits, if any, should not be subject to ad valorem taxation by the Commonwealth, county, or local municipality.

Maryland law is somewhat similar. Section 8-101 of the Annotated Code of Maryland, "Classification of Property", Section 8-104, "Valuation of Real Property" and Section 8-107, "Valuation of Personal Property", enumerates the classes and subclasses of property subject to assessment. These include real property (land and buildings, marshland, agricultural land, woodland, country clubs, planned developments, railroads, public utility real property), and personal property (stock in business i.e., inventory, distilled spirits, and railroad and public utility personal property). Again, intangibles and non-realty or non-personal property items are not subject to ad valorem taxation.

Confusion arises because the tax credits have some value in the secondary market. They can be sold, traded, etc. However, the tax credits are not real estate. This is similar to a residential mortgage in that mortgages are bought and sold in the secondary market. Their value to investors is based on the underlying interest rates of the loans. If mortgage rates drop, the packaged loans with higher rates become more valuable. The value of these loan packages is not, and should not be included in the value of the real property. Similarly, why include income tax credits?

Tax credits are an example of intangible benefits found in low-income housing.[16] The existence of the LIHTC is directly related to Federal Income Tax Code. The desire of the local jurisdictions to subject income tax credits to property tax assessment would be analogous to them placing additional value on a residence because it contains an in-home office which receives favorable treatment in the IRS tax code, or additionally taxing a property receiving historical tax credits. Tax credits are not real estate and should not be taxed by the local jurisdiction as such.

[12] Ibid.

[13] *Affordable Housing Valuation*, "Student Handbook", Appraisal Institute, 1997

[14] Ibid.

[15] For example, "All real estate, to wit: Houses, house trailers, buildings, lands, lots of ground and ground rents, trailer parks and parking lots, mills and manufactories of all kinds, furnaces, forges, bloomeries, distilleries, sugar houses, malt houses, breweries, tan yards, fisheries, wharves, all office type construction of any kind,..." The definition continues this enumeration of real estate for two pages in the statute.

[16] *Affordable Housing Valuation*, "Student Handbook", Appraisal Institute, 1997

Another aspect to this discussion is that developers of low income tax credit projects also tend to qualify for low interest loans, sometimes as low as 1%. While the impact of the loan may make the property more valuable to the owner, it should not have an impact on market value of the *real estate component* for property tax assessment purposes. Commonly used definitions of market value use the phrase "the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale."[17] That definition excludes consideration of the low interest loan.

Many low-income housing tax credit projects have some sort of rental assistance or limitations. These *should* be considered in valuing the property for tax assessment purposes. If there is a cap on rents received, or a cap on the amount of net income the owner can retain, these impediments to achieving market terms and market incomes must be realized in the valuation of the real estate. It should be improper to impute market-level rents when, in fact, the subject property does not legally have the ability to achieve those rents. All restrictions should be considered, as long as they are related to the operation of the subject's *real estate*.[18]

It is imperative that the appraiser and assessor fully understand the underlying state or local valuation statute(s) and any applicable case law which would help define what exactly is to be included in the valuation of property for ad valorem purposes. Some jurisdictions would include tax credits for ad valorem taxation, while others may exclude it.

Valuation Techniques

Due to the severe recapture penalties and requirements imposed by the federal government, as well as the development incentives for owning these properties, it is rare that the real estate underlying these types of multi-family housing is ever transferred. If a low-income housing tax credit project transfers, it is typically due to management issues or monetary default. Either condition might result in a transaction that would not necessarily be arm’s length transaction. Should a LIHTC project transfer as a “market” transaction, it is important to note that the seller (previous owner) is required to post a security bond to insure that, should the new owner (buyer) take the project out of the low-income housing program, monies are available for payment of IRS recapture amounts and penalties. This requirement is not typical to the definition of a "market" transaction.

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[17] *USPAP*, 1997

[18] The question arises about selectivity of which attributes should be considered as part of the appraisal process for ad valorem purposes. For example, rent restrictions, which tend to suppress the real estate value, should be considered for ad valorem valuation, but favorable financing and tax credits, which may enhance overall market value, should be eliminated from ad valorem taxation, depending on the jurisdictional requirements. The answer to this dichotomy is found in the jurisdiction’s statutory definition of market value and property rights subject to ad valorem taxation. Clearly, many jurisdictions have differentiated the “sticks” of the bundle of rights to include discrete items for ad valorem property taxation.

Low income housing tax credit projects are generally initially set up under a partnership format; general partner and limited partners. The general partner serves as the operator of the project and the limited partners supply the equity financing. These limited partnerships (LPs) can be sold on the secondary market; there are syndication companies which facilitate the orderly transfer of limited partnerships. Generally, the LPs are sold at the inception of the project based on the lump sum present value of tax credits available to the limited partners. As the project ages towards the end of the 10-year tax credit life, the value of the LPs drops correspondingly, based on the remaining balance of the tax credits available to the buyer. It is the interest of the general partner which constitutes the underlying real estate (i.e., land and buildings of the multi-family project) and it is this interest which is subject to recapture and penalties.

In the LIHTC program, there is *incentive* to the developer/owner/general partner to enter the program in the form of fees and tax credits, and there is *disincentive* to leave the program, in the form of recapture of the tax credits and penalties. These projects are not typically sold or transferred. How then, can a valuation which corresponds to the definition of market value be attained in the appraisal?

Rent Levels

Low-income housing tax credit properties are legally bound to certain rent levels by agreement between the developer/sponsor and the state governmental regulatory agency and the federal government. In return for agreeing to rent restrictions, the developer is entitled to collect a fee for the project construction (based on initial costs) and an annual management fee for operation of the property. In addition, once the initial financing and regulatory period expires, the owner may, if he chooses, convert the property to a "market rent" based project. At that point, the owner can charge whatever rents the market will allow.

If the property is sold during the 15-year period from project inception, the restricted rent requirements are transferred to the new owner and must continue for the remainder of the period. If they are not, the tax credit amounts the original owner (general partner) received are subject to recapture and penalty by the Internal Revenue Service so there is a strong incentive to keep the project in the low-income housing program.

As such, the property in encumbered by these rent restrictions generally for a period of 15 years from inception into the program. In terms of assessment and appraisal technique, this is similar to being encumbered by a long-term lease or other type of long-term income restriction. *Depending on the taxing jurisdiction's statue and case law, the underlying real estate valuation may be dependent on applying the restricted rents, not market rents, into the valuation analysis.*

Capitalization Rate Derivation

It is important to understand the purpose of the appraisal when deriving capitalization rates. If the project is new and the developer has received a low interest loan as a debt service subsidy (typically a 1% assumable loan), *and* the purpose of the appraisal is for financing, the appraiser may account for the leverage advantage of the low interest loan in the calculation of a mortgage-equity analysis. Again, this is based on the underwriting stipulations of the Office of the Controller of the Currency (OCC) and other federal agencies, as discussed previously.

For ad valorem tax assessment purposes, however, it is again important to fully understand the underlying assessment statute and case law when considering any special financing or debt service. Also as discussed above, such special financing may or may not be subject to ad valorem taxation. If not, then the appraiser and assessor should only consider capitalization rate derivation from local sales transactions and from *typical* financing terms for market-based projects.

For those jurisdictions that can consider the application of a low interest loan or special financing in the valuation for ad valorem purposes, it is important to apply the terms of the loan correctly and to analyze the results of the capitalization rate derivation with an eye towards the definition of market value. The example below illustrates an area of misconception in the valuation process which must be considered carefully by the appraiser and assessor. This example considers that the developer/owner has received a 1% assumable loan as part of the benefits package (including low-income housing tax credits) to offer below market rental rates in the area.

For demonstration purposes, assume the following parameters:

Market value of the real estate	$960,000
1% assumable loan balance	$850,000
Indicated Mortgage Constant	5.52%
Equity Dividend Rate	10.0%
Market financing terms	
Loan-to-Value Ratio	70%
Interest Rate	8.5%
Amortization period	20 years
Indicated Mortgage Constant	10.41%
Equity Dividend Rate	10.0%

From these terms, the following capitalization rates are derived using the Band Of Investment (Mortgage-Equity) methodology:

1 % Assumable Loan
Capitalization Rate Calculation

Loan	$ 850,000	89%	x	0.0552	=	0.0491
Equity	$ 110,000	11%	x	0.1000	=	0.0110
	$ 960,000	100%				0.0601

Overall Capitalization Rate 6.0%

Market Terms
Capitalization Rate Calculation

Loan	70%	x	0.1041	=	0.0729
Equity	30%	x	0.1000	=	0.0300
	100%				0.1029

Overall Capitalization Rate 10.3%

Assuming net operating income of $98,900, the two scenarios produce the following valuation conclusions:

Scenario	Net Operating Income	Capitalization Rate	Indicated Value
1% Assumable Loan	$98,900	6.0%	$1,650,000
Market Terms Loan	$98,900	10.3%	$960,000

So, which capitalization rate would the assessor and appraiser apply in those jurisdictions which permit the ad valorem taxation of special financing components? Clearly, in applying these two rates to the same net operating income, the rate derived using the 1% assumable loan, (capitalization rate of 6.0%) will result in the higher indicated value; in this example, $1,650,000 versus $960,000.

However, the appraiser and assessor ***must*** consider the underlying definition of market value very carefully at this point. Most jurisdictions have the phrase *most probable price* in their definition. This is in contrast to the alternative of *highest possible price*. If the jurisdictional definition is *most probable price*, then **market** terms must be incorporated since a typically informed buyer would not assume a low interest loan if it causes him/her to pay a significantly higher price; i.e., $960,000 vs. $1,650,000.

Example of Valuation Conclusions

The following appraisal analysis has been developed to demonstrate the impact of the valuation of income tax credits on market value.[19] The subject of this analysis is a 46-unit rehabilitation-renovation multi-family apartment project subject to low income housing tax credits to the developer/owner.

Upon c complete investigation of the local market for comparable sales, rentals, expenses and cost data, as well as market trends for multi-family housing, coupled with the developer's construction cost estimates, the appraisal analysis concludes the following valuation parameters:

Income Approach	$940,000	$20,400 per unit
Sales Comparison Approach	$980,000	$21,300 per unit
Cost Approach	$2,120,000	$46,100 per unit

The reconciled market value of the ***real estate*** portion of the subject property was estimated as $960,000. Clearly, the project does not meet the requirements of Financial Feasibility in terms of Highest and Best Use since the development costs, as estimated in the Cost Approach, far outweigh the market-perceived value of the project.

At this point, the contributory value of the federal income tax credits should be considered if the appraisal is being completed for financing to OCC, et al, requirements. In this example, the tax credits are worth a total of $2,519,000 and can be taken as $251,900 per year on the investor's income tax return, according to the developer's financial consultant. As part of the appraisal assignment, syndicators and government regulators and other market participants were interviewed to ascertain the market's perception of the present value of these credits, should the right to receive them be transferred in the secondary market. A 14% discount rate was deemed reasonable to account for the lump sum present value of the tax credits at project inception. Applying the math, this is equal to $1,310,000.

Now, when accounting for the contributory value of the federal tax credits, the project *does* make financial sense, as shown below:

Reconciled Market Value of Real Estate	$ 960,000
Contributory Value of Tax Credits	$ 1,310,000
Total Market Value	$ 2,270,000

[19] This information has been taken from an actual appraisal, with references to the actual project deleted for confidentiality. This information, although deemed accurate, is to be used solely as a demonstration example and not to be relied on for any other use.

The indicated market value of the real estate and the non-realty (federal income tax credits) equals $2,270,000. As this is more than the indicated cost as estimated in the Cost Approach of $2,120,000, the project is financially feasible, once the federal income tax credits are given consideration. However, in jurisdictions which do not permit the taxation of intangible assets, a value of only $960,000 may be applicable for ad valorem purposes.[20]

Conclusions

When valuing a property, it is important to fully understand the purpose/function of the appraisal because that will determine for the appraiser what components must be considered and how they are to be analyzed. Local assessment laws and/or the appropriate federal regulatory agencies' requirements may not necessarily permit or allow these components to be considered in the final valuation conclusions. Neither the *highest* possible value of the subject property, nor the market value for *financing* the property are necessarily reflective of ***market value*** for ad valorem purposes. Local statute, case law and administrative regulations should be closely examined to determine the proper methodology for ad valorem taxation.

[20] This would hold in jurisdictions which base ad valorem assessments on value-in-exchange. In those areas in where value-in use is the underlying methodology, this may not be the case.