STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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August 4, 2003

TO INTERESTED PARTIES:

GUIDELINES FOR THE VALUATION OF PROPERTIES FINANCED WITH LOW-INCOME HOUSING TAX CREDITS

In an interested parties letter dated June 23, 2003, staff announced that draft guidelines for the valuation of properties financed with low-income housing tax credits were available on the Board's website. In the letter, staff asked interested parties to review the draft and to submit proposed changes to it, with a cut-off date of July 21 for submitting the proposed changes.

On August 19, 2003, staff will hold an interested parties meeting, the purpose of which is to discuss the proposed changes to the draft. The meeting will be at Board Headquarters (450 N Street, Sacramento, Room 122); it will begin at 9:30 a.m. and end around noon. A matrix that summarizes the proposed changes, with staff's responses to them, is available on the Board's website. The matrix will serve as the basis for discussion at the interested parties meeting.

If agreement regarding final guidelines text cannot be reached at the August 19th meeting, unresolved issues will be taken to the Property Tax Committee on September 24, 2003, for resolution.

Thank you for your continuing interest in the project. The matrix and all other project documents are available at the Board's website at http://www.boe.ca.gov/proptaxes/lowincome.htm; if you have any questions or comments, please contact either Paul Lane (916-324-5828; Paul.Lane@boe.ca.gov) or Mark Nisson (916-324-0295; Mark.Nisson@boe.ca.gov)

Sincerely,

/s/ Dean R. Kinnee

Dean R. Kinnee, Chief
Assessment Policy and Standards Division

DRK:pl

No.	Draft Ref Page/Line		Source	Comment/Proposed Language	SBE Staff Position
1.	1	29-30	Marcus A. Griffin, for Robert N. Klein and Klein Financial Corporation	While tax credits are claimed over a 10-year period, the compliance period is actually 15 years. During this period, if a project fails to remain in compliance with the tax credit rules, or an ownership interest is sold, the tax credit investor faces recapture of all or a portion of the tax credits previously claimed, with interest. In other words, unlike the receipt of income from property, the claiming of tax credits includes a "contingent" liability through the 15-year tax credit period. While your text references the compliance period beginning on page 2, line 35, the guidelines do not factor this liability into the valuation approach.	It is true that the income stream from the tax credits is not risk free; under certain conditions, some or all of the credits could be recaptured, or disallowed, by the IRS, to the financial loss of equity investors. You describe this circumstance as a "contingent liability." However, the rate used to discount the future credits to present value reflects this risk; that is, the estimated present value of the remaining tax credits is a risk-adjusted value.
2.	4	21-22 (A)	Michael M. Stein, Michael M. Stein, Inc.	The primary error is the statement at page 4 lines 21-22 that 4% credits are not subject to competitive allocation. This is not true. Only credits allocated under a state's annual tax exempt bond cap are exempt. (See IRC Section 42(h)(4).) Nine-percent credits for new construction and rehabilitation treated as a new building, and 4% credits for existing building and federally subsidized buildings are all subject to the state's annual cap unless financed by tax exempt bonds.	Staff will clarify the statement at page 4 lines 21-22. Only some four-percent credits are not subject to competitive allocation.

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3.	4	21-22 (B)	Michael M. Stein, Michael M. Stein, Inc.	This distinction is important because many credit allocations are made to existing buildings, some of which may start a second generation of tax credits when the compliance period (15 years) for their existing tax credits expire. This category includes buildings which get priority allocations under the TCAC "at risk" category, generally existing low income properties which are at risk of conversion to market rate projects. As this category comprises the large inventory of HUD Section 236, 202, 221(d)(3) BMIR [below-market interest rate] and RD [Rural Development] Section 515 projects, which have financing factors not addressed in your analysis, they are worthy of some comment here. In many cases these projects in addition to Section 8 vouchers may have project based Section 8 rental subsidy contracts with contract rents at a lower rate than the vouchers. Also, as part of the new tax credit syndication, the existing HUD loan may be repaid but certain HUD subsidies will be continued. For example, under Section 236, HUD enters into an interest reduction payment (IRP) contract with the owner to pay the difference between the face rate of the loan and what the debt service would be if the rate were 1%; this contract runs for the life of the loan. Under recent federal legislation, this subsidy can continue (at the same monthly amount) if the loan is refinanced and the project kept low income. The value of this subsidy should be considered.	The appraiser should review “second round” subsidy projects on a case-by-case basis in order to determine the effect of the new subsidy on the property’s regulatory structure. The property should then be valued in accordance with the existing regulatory regime—considering both restrictions and benefits. As we noted in the guidelines, in some cases, for example, where a new round of subsidy money is used to rehabilitate a project, if the rehabilitation does not constitute “new construction,” there may be no legal grounds for reassessment under California property tax law.
4.	4	21-22 (C)	Michael M. Stein, Michael M. Stein, Inc.	For general reference, Novogradac & Company, LLP [a consulting and accounting firm specializing in affordable housing matters], publishes with annual updates a detailed analysis of the tax credit program called the Low-Income Housing Tax Credit Handbook. (See www.taxcredithousing.com.) An excellent source for current market prices for tax credits is the Tax Credit Advisor which regularly polls all the major syndicators. (See www.housingonline.com.)	Staff will add the additional sources of information that you have provided to the guidelines.
5.	8	fn 8	Michael M. Stein, Michael M. Stein, Inc.	The correct citation in footnote 18 at page 8 is section 42(h)(6)(F).	Noted.

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6.	10	38 (A)	Marcus A. Griffin, for Robert N. Klein and Klein Financial Corporation	We strongly disagree that the remaining tax credits should be included in the assessed value. As mentioned within your guidelines, the tax credit program, as regulated by the California Tax Credit Allocation Committee ("CTCAC'), uses tax credits to fill the financing gap created by the rent restrictions imposed on a property. CTCAC, in its financial feasibility analysis, allocates tax credits based on the difference between total costs and the financing sources available to the project. *In other words, the tax credits pay for unsupportable project costs.* Their value is offset by the development costs they support. The credits therefore have a net value of $0 from a property valuation perspective.	Staff acknowledges that the proceeds from the tax credits subsidize the project and that without the subsidy, these projects would not be built, because the restricted rents do not provide an adequate return on purely private capital. Nevertheless, as we discuss in the guidelines, the tax credits provide a return to equity owners of a tax credit project, and this return derives from an ownership interest in taxable real property, not from an intangible asset or right separate from real property. One must be an equity owner in order to claim the tax credits. Hence, in staff's view, the value component derived from the unused tax credits is a taxable value.
7.	10	38 (B)	Marcus A. Griffin, for Robert N. Klein and Klein Financial Corporation	Furthermore, the bulk of tax credit financed properties apply for a welfare exemption under California Revenue and Taxation Code 214(g), because the properties have a managing general partner that is a nonprofit, IRC section 501(c)(3) entity. Penalizing the properties that choose to pay property taxes on these units is an unfair tax policy. Inevitably, if the valuation of tax credits were implemented, several of the properties currently paying property taxes, or newly developed properties otherwise intending to pay property taxes, would be restructured around a section 501(c)(3) as a managing general partner to avoid the additional tax burden valuing tax credits would impose	The valuation question is separate from the exemption question. Whether or not a property qualifies for an exemption from property taxes should not influence its method of valuation for assessment purposes. First, a property is assessed; second, and independently, an exemption determination is made. Relatedly, the valuation question is separate from the ownership question. How a property is owned should not determine how it is valued, although, as is the case here, the form of ownership may determine a property's exemption status.
8.	10	38 (C)	Marcus A. Griffin, for Robert N. Klein and Klein Financial Corporation	Projects with for-profit developers would unfortunately become infeasible. Without for-profit developers, California could never have reached the scale of the affordable housing delivery system in place today. With some notable exceptions the nonprofits have not been able to reach the scale that is essential to meaningfully address California's affordable housing crisis. The for-profit sector, with its superior access to capital and credit, is critical to reach the necessary scale. Rendering for-profit projects infeasible through the imposition of property taxes on tax credits would reduce the production of an already scarce resource.	Whether or not the tax credit underwriting process favors not-for-profit ownership over for-profit ownership is a policy question, not a valuation question.

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9.	10	43	Marcus A. Griffin, for Robert N. Klein and Klein Financial Corporation	The statement that the tax credits derive solely from an ownership interest in real property, not from an intangible asset or right as that term is used in section 110, or from some other extra project source" is not accurate. While the recipient of the tax credit is the owner of the property, the tax credits are only available based on the use of the property, rather than the existence of the property's improvements. To be eligible for tax credits, the property' s units must be rented to individuals with incomes that are below a statutory income limit. The rent charged to affordable tenants must also be below a statutory maximum rent. By complying with these rules, along with many other regulatory requirements, a project is eligible for the tax credits. In fact, each year, to claim tax credits on IRS Form 8608, an owner must certify that the property is in compliance with these rules. For these reasons, the existence of the improvements does not in itself generate tax credits.	A fundamental assumption of the definition of market value for property tax purposes, as expressed in Revenue and Taxation Code section 110, is that "both the buyer and the seller have knowledge of all of the uses and purposes to which the property is adapted and for which it is capable of being used, and of the enforceable restrictions upon those uses and purposes." In other words, value depends on use. As described in the guidelines, the market value of a tax credit project should be based on a full consideration of the project's regulatory structure—"benefits and burdens"—and on the net economic effect of this framework. This includes a recognition of any restrictions on use.
10.	11	1	Marcus A. Griffin, for Robert N. Klein and Klein Financial Corporation	The corollary described does not accurately reflect the nature of tax credits. Tax benefits, in the form of depreciation and other tax deductions, are quite different than tax credits. When Congress developed the tax credit program, it provided a special status to tax credits. Unlike other tax benefits, tax credits do not reduce an investor's basis in the asset, having no impact on the calculation of gain on sale when an asset is disposed. Likewise, the claiming of tax credits on an investor's federal tax return is not taxable income. Congress provided this special tax status because, without this status, the value of the tax credits would be greatly reduced and projects would not be feasible.	Staff's position is not that low income housing tax credits are identical to other forms of income tax benefits, such as depreciation or other allowed deductions. Our position is that LIHTC's are a form of income tax benefit. There are many forms of income tax benefits that differ from each other in minor or major ways. Our argument is that the tax benefits of real property are part of the market value of real property. For example, one does not adjust the sale price of an apartment property to account for "depreciation, " even though, all else being equal, the property would have sold for less if it could not be depreciated. The depreciation benefit is reflected in the sale price and is considered part of the property's market value. We argue that the same is true for LIHTC's; they are a tax benefit whose value is part of the market value of the real property.

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11.	11	15	Marcus A. Griffin, for Robert N. Klein and Klein Financial Corporation	Tax credits are not the equivalent of grant proceeds. Grants are income for federal tax purposes while, as mentioned above, tax credits are not taxable income. Tax credit investors must generally be repaid their capital and any exit taxes due on that capital upon resale for any excess depreciation that flowed to these investors.	Government could subsidize low income housing directly through a budgeted expenditure (grants) or indirectly through a tax expenditure (LIHTC's). Primarily, it is government's current policy to do the latter. But in both cases, the result is the same: government funds are provided to develop low income housing. In a nutshell, we do not see why a low income housing project developed using the first financing mechanism (a government grant) should be taxable, while another low income housing project developed using the second financing mechanism (LIHTC's) should be nontaxable.
12.	14	7	Marcus A. Griffin, for Robert N. Klein and Klein Financial Corporation	If tax credits are to be valued … the discount rate should be the yield rate determined at the property level. Yield rates quoted by industry sources reflect the yield to the corporate investor, after the payment of syndication costs and the establishment of operating reserves. If a corporate investor requires an 8% return, the actual return at the property level is somewhere between 10% and 13%. Your discussion addresses the impact of syndication costs on yield, but the example provided ignores this effect, and uses an investor level yield. For an assessor to estimate a project level yield, he should divide the published investor yields by 75%-80% to arrive at the project level yield, to factor in the syndication costs and operating reserves of approximately 20-25%.	The guidelines propose the following: (1) The value of a tax credit project has two components: a) the present value of the outstanding (i.e., unclaimed) tax credits and b) the present value of the income (net of allowed expenses) generated by the operating property. (2) The outstanding tax credits should be discounted using a rate that reflects the net proceeds to the project, that is, at a rate net of syndication costs. In other words, the costs of syndication are not part of the value of the real property. This discount rate should be derived from the primary and secondary markets for tax credits. (3) The net operating income from the property should be discounted using a rate developed using the band of investment. This rate is developed "at the property level." It is a weighted average of the required returns on debt and equity, with the weighting determined by the proportion of financing provided by each source. The debt rate is taken directly from the subject property's debt financing. The equity rate is fixed at 8 percent for reasons we discuss in the draft guidelines.

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13.	14	13-15	Chuck Brough, Madera County	On page 14 of your draft, at lines 13-15, you state that the "estimated present value of the remaining tax credits should be adjusted, if necessary, for syndication costs..." Wouldn't syndication costs be a one-time, first year charge, with mere management expenses attributable in the remaining years?	Staff is somewhat unsure of this and wants to find out more about it at the IP meeting. If the rate used to discount the future credit amounts is net of syndication costs, then no adjustment should be necessary. If this is not the case, an annual adjustment might be necessary. The important point is that only the net syndication proceeds—that is, the amount that actually goes into developing the project—should be included in project value.
14.	15	5	Marcus A. Griffin, for Robert N. Klein and Klein Financial Corporation	The net operating income valued by an assessor should be reduced by the required debt service payments on soft loans. Similar to tax credits, the soft loans subsidize development costs in excess of what a property's restricted income can support. Furthermore, since the repayments are made to municipalities, this portion of the cash flow should be excluded from the income stream since these payments represent a *non-economic* return of capital and a submarket interest rate to the public entities. The payments are paying down a non-economic debt that does not create any current value for 55 years or at least until all non-economic debt is amortized. In fact, this debt retirement creates phantom income that the partnership can only handle by offsetting its depreciation rights, thus further reducing the project's economic value.	Under Property Tax Rule 8, "The Income Approach," the income to be capitalized is prior to any deductions for debt service; that is, in a property tax valuation, a deduction for debt service is not allowed. So, what you propose is contrary to Rule 8, and there is no authority to exclude LIHTC properties from the provisions of Rule 8. We realize that below-market-interest-rate financing is a form of subsidy. But to repeat our basic principle: we believe that the market value of subsidized a housing property should reflect both the benefits and burdens of the regulatory scheme to which the property is subject.
15.	15	26	Marcus A. Griffin, for Robert N. Klein and Klein Financial Corporation	In determining the residual value of a project, the net return to the owner must be reduced by any soft loans and any accrued interest on the soft loans projected to be outstanding at the hypothetical sales date, following the argument in the previous point.	See staff response immediately above.

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16.	15	35 (A)	Marcus A. Griffin, for Robert N. Klein and Klein Financial Corporation	In determining the proper discount rate to value the income generated by a property, it is not appropriate to penalize an owner of a low income housing tax credit property for accessing a below-market interest rate on tax exempt bonds and soft loans from cities (buy using the proposed band-of- investment technique). For low-income housing tax credit properties to be feasible, particularly those financed by tax-exempt bonds, below-market interest rates are utilized to achieve higher leveraging, minimizing the financing gap. Because the lower interest rates translate into greater leverage, the property does not generate additional net income via the lower interest rates, only greater debt. The lower interest rate is used to support debt that is not feasible on the conventional market; it is not created to enhance profitability. In arriving at an appropriate discount rate for valuing the net income of the property, an assessor should begin with the prevailing market capitalization rate for conventional multifamily rental properties.	Again, in staff's view, the market value of a subsidized housing project logically should reflect the project's regulatory framework in its full aspect—the economic pluses as well as the economic minuses. The primary pluses are the subsidies, which generally appear as housing tax credits, below-market debt financing, or both. The primary minuses are the restrictions on property use, the most significant of which is the restriction on rents. If the economic negatives are recognized in the valuation, but not the positives, the result is not market value. In determining market value, a typical buyer would consider both aspects and attempt to determine their net economic effect. Although not stated directly, what you seem to propose is that tax credits or below-market debt should not contribute to a property's market value. But there is no legal authority for exempting the subsidy portion.

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17.	15	35 (B)	Marcus A. Griffin, for Robert N. Klein and Klein Financial Corporation	This discount rate should first be adjusted upward for the appropriate assessment rate. Then, the discount rate should be adjusted upward to reflect the following impacts on value: (a) the restrictions on future income growth caused by rents being limited to increases in median income rather than subject to change in market conditions; (b) the lack of marketability of affordable housing investments, given the recapture of tax credits that would occur if a property were sold during the 15-year tax credit compliance period; (c) exposure to increases in utility allowance and operating expenses while not benefiting from increases in rental revenue via increases in area median income and (d) the cost of the increased administrative burdens relating to complying with state and Federal compliance and reporting requirements. In our experience, the impact of these factors is an increase in the discount rate of between 4%-5% over the first 17 years and 3% thereafter. The compliance period is 15 years after all of the tax credit units have been constructed and placed in service. Additionally, the compliance and reporting burdens continue for 55 years given state and local government regulations and compliance agreements. At 17 years, plus sufficient time to buyout the tax credit investor, which may take 2-3 years, only the tax credit investor administrative burden is eliminated. All other compliance and administrative audit and reporting costs continue. Given the complexity of accurately constructing a 55-year cash flow model, given the multi-layer financing structures many tax credit properties employ, we suggest an alternative method be available to property tax assessors. Under an alternative structure, a traditional "capitalization rate" approach could be used. Under this approach, an assessor would determine the prevailing cap rate in the subject property's market for conventionally financed rental properties. The assessor would then adjust the cap rate.	To briefly summarize your proposed method of income capitalization: (1) Use direct capitalization, not yield capitalization; that is, generate a value indicator by capitalizing the next year's restricted income by an overall capitalization rate rather than by discounting the projected income over the 55-year restricted period by a discount, or yield, rate. (2) Develop the overall capitalization rate by starting with an overall rate derived from the sale of an unrestricted, but otherwise comparable, property and add premia to this rate for the factors you mention. Comments: (1) Staff has recommended yield capitalization as the proper method in the valuation of other forms of subsidized housing (e.g., Section 236 and Section 515 housing) in addition to the present case. Yield capitalization allows an explicit distinction between the restricted income period and the time at which the property's use is no longer subject to restriction. From a valuation standpoint, this distinction is more significant, and probably better measurable, as the end of the restriction period becomes nearer in time, but it is theoretically correct in all cases, even when the restricted income period has decades to run. (2) Yield capitalization also allows the development of a capitalization rate using the band of investment technique. The band of investment allows the development of a rate that takes explicit account of any subsidized financing present, which is an important aspect of how we think the market value of subsidized housing should be estimated. The band of investment is authorized in Property Tax Rule 8, the rule that governs the application of the income approach for property tax purposes. (3) Based on the above, we would criticize your proposal on two primary grounds. First, as stated, we think yield capitalization presents a better model for valuing restricted income properties, and, for this reason, is theoretically superior. Second, even setting aside the yield capitalization versus direct capitalization question, your method of developing an overall capitalization rate is problematic. Your proposed adjustments to an overall rate derived from the sale of an unrestricted, but otherwise comparable, property appear to have no market basis. Further, there is no authority in Property Tax Rule 8 for developing a capitalization rate in this manner.

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18.			James Silverhood, Affirmed Housing Group	[F]ive states are in favor of valuing LIHTC properties with attention to the restrictions and without including any component of value relating to the tax credits. In one case, the Washington Court of Appeals has stated: "...the BTA [Board of Tax Appeals] erred in holding that the federal tax credits received by the appellants should be included in the assessed value of the projects. *Tax credits are intangible personal property and thus are not subject to real property taxation.*" [Emphasis added.] Very similar language is found in court cases in the four other states. In addition, there is no evidence that any other authoritative body (i.e. Internal Revenue Service, Generally Accepted Accounting Principles, etc.) has ever considered or intended intangible personal property to be subject to property taxes. At best, the LIHTC's are intangible benefits which do not affect the monthly income or expenses or the "beneficial or productive use" of the project. In fact, no California appellate court case has ever held that federal low income housing tax credits were a taxable intangible benefit. Finally, under section 212 of the Revenue and Taxation Code, "intangible assets and rights shall not enhance or be reflected in the value of taxable property." Accordingly, LIHTC's should not be used to increase the fair market value of the property under Revenue and Taxation Code section 212. I believe it is fair to say, based on the aforementioned cases and other information presented, that any reasoned approach will require consideration of the restrictive covenants under which LIHTC properties operate. Though some would obviously argue the point, I also think it fair to say that the most reasoned approach would exclude any value attributable to the tax credits. We recommend that the Committee adopt a position that excludes the consideration of the low income housing tax credits from the purposes of valuation of property taxes.	Staff has reviewed the cases cited. The opinions of courts outside California are of interest, but they are not determinative or binding in California. Property tax law varies significantly from state to state. To staff's knowledge, there has been no holding from a California court regarding the taxability of low income housing tax credits. Staff's position is that the present value of unused (i.e., unclaimed) tax credits should be included in the assessed value, and we have included arguments in support of this position in the guidelines. In all likelihood, this issue will go before the Property Tax Committee for resolution.