



STATE OF CALIFORNIA

See LTAs 2002/041 and 2005/044

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October 1, 1998

TO COUNTY ASSESSORS:

No. 98/51

ISSUES IN THE VALUATION OF SECTION 515  
MULTIFAMILY HOUSING PROJECTS

**Introduction**

Recently, taxpayers have contested a number of assessors' valuations of low income multifamily housing projects financed under the federal government's "section 515" program. While the taxpayers' appeals have involved a core of common issues, assessors have approached those issues from different positions. Thus, the purpose of this letter is to promote uniformity in the treatment of section 515 properties by examining several of the issues that arise in the appraisal of these properties.

**Background**

The purpose of the section 515 program is to give lower-income households access to rental housing that they could not otherwise afford. Regulatory agreements between the federal government and project owners impose rent restrictions and other limitations on an owner's uses of the property. In exchange, the government agrees to provide the owner with certain benefits, including a long term, low interest loan.

In general, an owner must rent the units to low-income families. Further, to make the units affordable, the rents that an owner may charge are restricted to that amount which, collectively, will enable him or her to (1) cover operating expenses and the annual debt service on the loans and (2) earn a maximum 8 percent annual return on equity. Additional restrictions include the establishment of a reserve account, into which the owner must deposit any rent that exceeds the restricted amount; no prepayment of the mortgage; and no transfer of the property without approval of the government.

In exchange for these restrictions, the government finances the project under terms very favorable to the owner. Specifically, the government makes available long-term loans that cover as much as 97 percent of the cost of construction or acquisition. Even more significantly, the government subsidizes the interest on the loans such that the owner's effective interest rate is reduced to 1 percent.

In addition to the benefits inherent in the section 515 program itself, owners may qualify for federal and state income tax credits. To ensure that the total amount of government assistance to developers of low-income housing projects is not overly generous, however, properties that benefit from federally subsidized financing (e.g., section 515 properties) are eligible for only a portion of the credits that they could receive without the financing subsidy.

### **Issues**

Investors purchase or develop low-income housing projects in anticipation of periodic money benefits. That is, investors in these projects are motivated by the expectation that their financial rewards, including income tax credits, will significantly outpace their operating expenses.

Since low-income housing properties are acquired in anticipation of money income, and since restrictions on resale effectively limit the availability of reliable sales data for comparable properties, the income approach is the preferred approach.<sup>1</sup> Even where taxpayers and assessors have agreed on the general approach, however, several issues arise as to the specific application of that approach. Primarily, those issues involve (1) the calculation of the net income to be capitalized, including the proper treatment of the interest subsidy, and (2) the derivation of the capitalization rate that is used to convert the net income into an indicator of present value. An additional issue that arises is how to account for the effect upon value of any federal or state income tax credits.

### **Calculation of Net Income**

As discussed below, a property in the section 515 program must be valued in consideration of the contractual restrictions imposed upon the use of the property. Further, in a valuation based on income, interest subsidy payments made by the government on behalf of an owner should not be considered as income.

### **Restrictions on Use**

Section 402.1 requires an assessor to consider the effect upon value of any enforceable restrictions to which the use of the land may be subjected. The Attorney General concluded in 1976 that, for properties in the Department of Housing and Urban Development's (HUD) section 236 program, the rental limitations and other restrictions contained in the contract between the federal government and the owners constitute "use restrictions" within the meaning of section 402.1.<sup>2</sup>

The section 515 program is similar to the section 236 program in most essential respects. Specifically, a project under either program is subject to limitations on both the rents that may be charged and the owner's ability to resell the property. Thus, although the Attorney General in 1976 addressed only section 236 projects, the same analysis may be applied to section 515 projects; it is just as true for section 515 projects as it is for section 236 projects that the net income to be capitalized is that which may be generated considering the restrictions on use that

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<sup>1</sup> See Rule 8(a).

<sup>2</sup> Attorney General Opinion No. CV 75/267, April 21, 1976.

are imposed by the contract with the government. As indicated above, for section 515 properties this will generally be an amount that will enable the owner, after paying operating expenses and servicing the mortgage debt, to earn 8 percent on his equity contribution to the project.

### **Treatment of Interest Subsidy**

Revenue and Taxation Code section 402.9, enacted in 1978, provides that in valuing section 236 projects the assessor shall not consider as income any interest subsidy payments made to a lender on such property by the federal government. The enactment of section 402.9 partially negated previous Board instruction on the valuation of section 236 projects.<sup>3</sup>

The Legislature opted not to expressly subject valuations of low-income housing projects under other federal programs, including the section 515 program, to the provisions of section 402.9. However, the lack of express direction from the Legislature as to the valuation of projects under other federal programs does not sanction inconsistent treatment of projects that are similarly situated. Thus, to promote assessment uniformity, assessors' income-based valuations of section 515 properties should be performed in such a way as to exclude from gross return the interest subsidy payments made by the government. Further, as discussed below, when gross return is calculated in this way the debt component of an overall capitalization rate derived by the band-of-investment method, in accordance with Property Tax Rule 8, will necessarily reflect the owner's actual (i.e., subsidized) cost for the debt portion of the overall investment.<sup>4</sup>

### **Capitalization Rate**

The present worth of a future income stream depends, in part, on the capitalization rate at which the future income is discounted.<sup>5</sup> The capitalization rate, in turn, may be derived either (1) by measuring sales prices of recently sold comparable properties against the respective income streams that could reasonably have been anticipated from each on the date of sale; or (2) by computing a weighted average of the capitalization rates for debt and for equity capital.<sup>6</sup>

### **Market-Derived Rate: Adjustment for Cash Equivalency**

Under the first of these methods, wherein the resultant capitalization rate is said to be "market-derived," the sales prices of the comparable properties must be adjusted, if necessary, to their cash equivalents.<sup>7</sup> That is, since the validity of a market-derived capitalization rate depends in part on an accurate representation of the investments being made by market participants, an appraiser must adjust the stated sales prices for both (1) non-cash items, such as vehicles or other

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<sup>3</sup> As to section 236 projects, LTA No. 76/157, dated September 24, 1976, advised assessors to include in the gross income to be processed any interest subsidy payments made by the government to a lender on behalf of a project owner.

<sup>4</sup> In LTA No. 77/173, dated December 14, 1977, the Board advised that assessors could calculate the gross income of a section 236 project by either method: (1) with the interest subsidy-in which case the debt component of the overall capitalization rate, derived by the band-of-investment method, would reflect current market indications of the cost of debt; or (2) without the interest subsidy-in which case the debt component of the overall capitalization rate would reflect the owner's actual cost for the debt portion of the overall investment.

<sup>5</sup> See, generally, rule 8, subsection (b).

<sup>6</sup> See, generally, rule 8, subsection (g).

<sup>7</sup> Rule 8, subsection (g)(1).

property. that may have been exchanged for the income-producing property; and (2) any extraordinary financing arrangement that could reasonably be assumed to have impacted what the investor was eventually willing to pay for the property.

For section 515 properties, an issue that has arisen with respect to arriving at an appropriate market-derived capitalization rate is whether the sales prices of comparable properties should be adjusted for the federally subsidized financing that, in part, makes such properties viable for investors. This issue is moot, however, since the favorable financing for these properties is common to all of them. Thus, although the favorable financing inherent in a section 515 property is certainly attractive to investors, it does not artificially inflate what investors offer. To the contrary, we know that the impact of the favorable financing on the agreed-upon sales prices simply reflects what is typical in the market for these properties. Thus, adjusting the sales prices of comparable section 515 properties for the federally subsidized financing is not only unnecessary under rule 8, but results in misrepresentations of the overall investments made in such properties.

### **Band of Investment Method: Debt Component**

In general, a market-derived rate is preferred when adequate data are available as to the sales prices and income streams of properties that are comparable to the subject. Since such data are usually not available, however, this sort of "direct" derivation of a capitalization rate is the exception rather than the rule.

The second method of deriving a capitalization rate, the "band-of-investment method," produces a weighted average of the rates of return required by the individual debt and equity components of the overall investment in the property. For section 515 properties, the primary issue that arises is the estimate of the rate for the debt component. Specifically, the issue is whether the appraiser should use (1) a rate that is, as stated in rule 8, "appropriate to the California money markets," or (2) a rate that reflects the investor's actual cost as to the financed portion of the overall investment.

The assertion in favor of the first approach relies on the apparent mandate of rule 8. However, the phrase "appropriate to the California money markets" should not be construed so narrowly that it would require the use of a debt component that bears little or no relationship to the net income that is forecast for the overall investment. That is, since the favorable financing available for a section 515 property would not be obtained except for the corresponding restrictions on income, the use of a "market" rate for debt results in an overall rate that relates, theoretically, to the income from the property as if the restrictions on income were absent. But since those restrictions are in fact inherent in the investment, and since it has already been established that the income to be capitalized is the restricted income, the rate for debt in the band-of-investment method of estimating an overall capitalization rate for these properties must be the subsidized rate (i.e., the investor's effective rate of 1 percent).

### **Low Income Housing Tax Credits**

The Low Income Housing Tax Credit program, put in place by the Tax Reform Act of 1986, is intended to provide incentives for private investment in housing for low-income families at a

time when many of the traditional tax benefits for real estate development, such as accelerated depreciation, have been eliminated. State housing agencies are charged with the responsibility for establishing an allocation process to parcel out tax credits.

In establishing the tax credit program, Congress recognized that a private sector developer may not receive enough rental income from a low-income housing property to (1) cover the costs of developing and operating the project, and (2) provide a return to investors sufficient to attract the equity investment needed for development. To spur investment, Congress authorized the states, within specified limits, to allocate tax credits to qualifying housing projects. After a state allocates tax credits to a developer, the developer typically offers the credits to private investors, who use the credits to offset taxes otherwise owed on their tax returns. The money that private investors pay for the credits is paid into the projects as equity financing. This equity financing is used to fill the gap between the development costs of the project and the non-tax credit financing sources, such as mortgages, that could be expected to be repaid from rental income.

Under the program, and subject to many limitations and qualifications, low-income housing projects developed after 1986 may be awarded tax credits, often in amounts up to 9 percent of development costs, excluding land. Since section 515 properties already benefit from federally subsidized financing, these projects are eligible for lesser awards.

Regardless of the amount of the award, the issue that arises with respect to the treatment of low-income housing tax credits in the appraisal of section 515 properties for property tax purposes is whether, like the government-provided interest subsidy discussed above, the credits should be excluded from gross return in an appraisal based on the income approach. As discussed below, for section 515 properties developed after 1986, the award of tax credits is so integral to their development that the credits should be considered in estimating an investor's gross return.

Typically, a tax credit award is a prerequisite to the post-1986 development of a low-income housing project. That is, the tax credit award is a necessary incentive for a developer to go forward with a project. Moreover, to obtain that award, a developer must enter into a binding agreement with the state housing credit agency.<sup>8</sup> Importantly, the agreement - which specifies among other things the amount of the award and the types of buildings to which the award applies - is binding on all successors in interest to the developer.

As a further indication of the importance of the tax credits to these projects, in virtually every case investors will take whatever steps are necessary to avoid a disallowance (i.e., recapture) of any credits that were previously awarded. Thus, if a property is sold, investors typically post a bond insuring that the new owner will receive the same tax credit awards that the prior owner would have been eligible to receive.

In summary, then, the award of tax credits should not be excluded from gross return in an income-based valuation of a section 515 project that was developed after 1986. The tax credits are typical in the market for these properties, and to the extent that they have impacted what an investor would offer, they should be reflected in an income-based valuation.

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<sup>8</sup> In California, the agency responsible for allocating the tax credits is the California Tax Credit Allocation Committee.

**Summary**

- Almost invariably, the income approach to value will be the preferred method of appraising a section 515 property. Both the fact that investments in these properties are made in anticipation of money income and the general unavailability of data on sales of comparable properties mean that a valuation based on income will be the most appropriate approach.
- In estimating the net income to be capitalized, the appraiser should consider the effect upon value of the restrictions inherent in the regulatory agreement with the federal government. Thus, the government-provided subsidy of the interest on the financed portion of the investment must not be considered in the appraiser's estimate of the gross return that would be anticipated by an investor in a property.
- If the capitalization rate is estimated by reference to sales prices and incomes of comparable section 515 properties, then those sales prices should not be adjusted to their "cash equivalents." The fact that the subsidized financing is common to all of these properties means that such an adjustment is unnecessary.
- Although the preferred method of estimating a capitalization rate is by reference to sales prices and incomes of comparable properties, such data is, typically, unavailable. Thus, as a practical matter, the band-of-investments method will be used to estimate a capitalization rate. For section 515 properties, the fact that the financing subsidy is common to all of them means that the subsidized rate (i.e., the owner's effective rate of 1 percent) should be used rather than a "market" rate, which would be atypical for investments of these properties.
- Income tax credits are integral to most investments in section 515 properties developed after 1986. Thus, the presence of the credits should be considered in an appraisal base on income.

Questions about the information contained in this letter should be addressed to our Real Property Technical Services Unit at (916) 445-4982.

Sincerely,

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