STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
PROPERTY AND SPECIAL TAXES DEPARTMENT
450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0064
916 445-4982 ● FAX 916 323-8765
www.boe.ca.gov

June 23, 2003

TO INTERESTED PARTIES:

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

Letter to Assessors No. 2003/037 announced a project to develop guidelines for the valuation of properties financed with low-income housing tax credits. A draft of the guidelines is now available at the Board's website (www.boe.ca.gov/proptaxes/ptcwplan03.htm). Staff will also provide hard copies of the guidelines on request.

Please review the draft and submit your proposed changes to it (as alternative text, strikeout-underline format is preferred, referencing the draft's page and line number where the change would occur) by July 21, 2003. Submit your proposed changes, by mail or e-mail, to Mark Nisson (916-324-0295; Mark.Nisson@boe.ca.gov) or Paul Lane (916-324-5828; Paul.Lane@boe.ca.gov).

On August 19, 2003, staff will meet with interested parties at Board Headquarters (450 N Street, Sacramento, Room 122) to discuss the guidelines. The meeting will begin at 9:30 a.m. and last until noon. Prior to the meeting, a matrix that summarizes the proposed changes to the guidelines will appear on the Board's website. At the meeting, we hope to reach agreement regarding the final text for the guidelines, but if this is not possible, any unresolved issues will be taken to the Property Tax Committee on September 24, 2003, for resolution.

This letter and all future documents regarding the project will appear on the Board's website. If you have questions or comments, please contact Mr. Nisson or Mr. Lane at the above phone numbers or e-mail addresses.

Sincerely,

/s/ Dean R. Kinnee

Dean R. Kinnee, Chief
Assessment Policy and Standards Division

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Guidelines for the Valuation of Properties Financed with Low-Income Housing Tax Credits

This document provides guidance regarding the valuation of multifamily rental housing financed with low-income housing tax credits, extending the discussion in LTA No. 98/51, "Issues in the Valuation of Section 515 Multifamily Housing Projects." In terms of general organization, we first provide an overview of how the low-income housing tax credit program operates; we then discuss the valuation of properties financed with low-income housing tax credits.

Overview: Low-Income Housing Tax Credits

A part of the 1986 Tax Reform Act, the federal low-income housing tax credit (LIHTC) program is about 15 years old. The Act's tax credit provisions, which took effect December 1, 1987, were subsequently codified as section 42 of the Internal Revenue Code (IRC).[1] Originally scheduled to end December 1, 1989, the tax credit program was extended in 1990, 1991, and 1992, and received permanent authorization in 1993.

Since inception, about 1.2 million housing units have been built with tax credits, and the tax credit program is now the primary federal program promoting the production of low-income housing. In California, there is a state low-income housing tax credit program that is similar to the federal program and designed to supplement it. We discuss the federal program first; the state program is discussed separately below.

Under IRC section 42, taxpayers may take a credit against federal income taxes for qualified expenditures involving low-income housing projects.[2] Low-income housing tax credits may be used in conjunction with the acquisition, minor rehabilitation, major rehabilitation or new construction of qualifying low-income housing. The tax credits are claimed by project owners over a 10-year period; in return, the owners agree to rent the units to low-income occupants, to restrict project rents for a prescribed period in accordance with IRC Section 42 and applicable state law, and to adhere to other regulatory provisions.

In the sections below, we discuss the following major aspects of the low-income housing tax credit:

- Tax credit allocation and compliance
- Threshold project eligibility requirements
- Maximum tax credit amount

[1] The Internal Revenue Code is Title 26 of the United States Code.

[2] A tax credit is different from a tax deduction. A tax credit directly reduces the amount of an income taxes liability, whereas a tax deduction only reduces the amount of income against which taxes are levied. In other words, a tax credit reduces taxes in the full amount of the tax credit, but a tax deduction reduces taxes only in the amount of the deduction multiplied by the taxpayer's marginal tax rate.

- Syndication of limited partner/tax credit interests
- State low-income housing tax credits

Tax Credit Allocation and Compliance

Each year, the federal government allocates a fixed amount of low-income housing tax credits to each state. In general, under current law, each state receives an annual federal tax credit allocation of $1.75 per capita. The annual allocation provides a 10-year stream of tax credits in the amount of the annual allocation. That is, if a state's allocation of tax credits were $10,000,000 for a given year, that year's allocation would produce 10 years of credits at $10,000,000 per year.

Under IRC section 42, each state must adopt a "qualified allocation plan" for distributing its annual share of tax credits. Section 42 prescribes certain criteria that must be followed in each state's allocation plan (e.g., at least 10 percent of the credits must be reserved, or set side, for allocation to not-for profit developers/sponsors). The statute, however, gives the states considerable discretion to establish additional criteria, under the reasoning that, ultimately, the credits are better allocated at the state level.

California currently receives about $50 million annually in federal low-income housing tax credits. The state's allocating agency is the California Tax Credit Allocation Committee (TCAC), a unit of the State Treasurer's Office. TCAC reviews applications from project developers/sponsors and allocates the state's federal tax credits competitively in two annual funding "rounds," using the prescribed criteria in IRC section 42 and the additional state criteria contained in TCAC's regulations. [3] A project receiving federal tax credits first receives a "preliminary reservation," which becomes a "final allocation" after certain conditions are met. Unless a project receives a "carryover allocation," the project must be completed within the year of credit reservation. TCAC receives applications for about four times the amount of tax credits annually available. [4]

In addition to credit allocation and underwriting, tax credit allocating agencies, with assistance from the IRS, are responsible for the compliance monitoring of tax credit projects. In California, TCAC performs the compliance function, which, essentially, requires periodic audits, in the office and the field, to certify the maintenance of project eligibility requirements and rent restrictions, the proper management of the property, including maintenance of replacement and operating reserve accounts, and general project habitability. [5] The compliance status of a project holds legal and financial significance. If a project is not in compliance, TCAC notifies the IRS, which may take

[3] To review California's allocation criteria, see Title 4, California Code of Regulations, Sections 10315, 10325, and 10326.
[4] Actually there are two types of federal tax low-income housing tax credits—the 9-percent credits and the 4-percent credits. Only the 9 percent credits are subject to competitive allocation, and the annual federal ceiling refers to the 9-percent credits. This is discussed further below.
[5] This is not a small task in a state with about 2,000 operating tax credit projects.

action to "recapture" previously claimed tax credits to the financial loss of the general partner, limited partners, or both.[6]

Threshold Project Eligibility Requirements

Under IRC section 42, tax credits are available only to owners of "qualified" low-income projects. In order for a project to qualify for tax credits, it must meet a threshold "minimum set-aside test," which can be satisfied in either of two ways:

- 20 percent or more of the units must be occupied by individuals with incomes of 50 percent or less of area median income adjusted for household size (the "20-50 set aside test") or
- 40 percent or more of the units must be occupied by individuals with incomes of 60 percent or less of area median income adjusted for household size (the "40-60 set aside test").

Thus, there is no federal requirement to dedicate all units of a project to low-income occupancy; a mixture of market-rate and low-income units is permitted provided the project meets the minimum set-aside test. Over the years, however, the vast majority of California projects have been entirely low income because the state's qualified allocation plans—plans are often slightly modified for each year's funding allocation—have consistently favored such projects.

Maximum Amount of Tax Credits

There is a maximum amount of tax credits that a given project can obtain. This maximum amount is best explained through a discussion of the following concepts from IRC section 42: *eligible basis*, *eligible fraction*, *qualified basis*, and *tax credit rate*.

- A project's "eligible basis" is the portion of the project's total development cost that may be considered when determining the amount of the tax credits. Only depreciable costs may be included in eligible basis; land cost must be excluded. In general, from an appraisal perspective, eligible basis includes all of the components of economic cost typically included in the cost approach, excluding the cost of land.[7]
- A project's "eligible fraction" is the percentage of low-income units in a project. As noted, for California projects, the eligible fraction typically has been 100 percent; that is, all project units have been dedicated to low-income occupancy.
- The "qualified basis," is the eligible basis multiplied by the eligible fraction. Thus, in California, for the vast majority of projects, a project's qualified basis has been the same as its eligible basis.[8]

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[6] Thus, the low-income housing credit does not directly involve HUD or any other federal housing agency, only the IRS. In California, where TCAC administers the program, the lead state housing agency is also bypassed; in most states, the lead state housing agency administers the tax credit program.
[7] See IRC section 42 for a precise definition of eligible basis.
[8] Projects in areas that are federally designated as "high cost areas" or "difficult to develop areas" may qualify for a 30 percent increase in qualified basis, thus providing a higher level of tax credit financing for projects in such areas.

- There are two "tax credit rates," one of approximately 9 percent and another of approximately 4 percent. The tax credit rate is used to determine the maximum annual tax credit amount for a project, based on each type of credit, as described below.

The maximum tax credit amount for a project (i.e., the maximum annual amount of tax credits allocated to a project for each year of the 10-year tax credit period) is the project's qualified basis multiplied by the applicable tax credit rate. There are two tax credit rates—one of approximately 9 percent and another of approximately 4 percent—because there are two variants of federal tax credits, commonly called "9-percent tax credits" and "4-percent tax credits." Since the amount of funds that can be raised for a project depends upon the dollar amount of tax credits available to the project, a much greater proportion of qualified basis (and, hence, total development costs) can be raised with the 9-percent credits than with the 4-percent credits.

The 9-percent tax credits can be used for new construction or major rehabilitation in cases where the project does not receive any other form of federal subsidy. The 4-percent tax credits can be used for new construction or rehabilitation projects that also involve some other form of federal subsidy or for the acquisition costs of improvements that will be rehabilitated.

Projects compete for the 9-percent credits; in general, the 4-percent credits are not subject to competitive allocation. In California, for example, if a project receives an allocation of tax-exempt bonds as part of its financing (considered a federally subsidized form of financing), the project will receive a noncompetitive allocation of 4-percent credits to complement the bond financing. Also, there is no direct cap on the annual amount of 4-percent tax that a state may allocate; the federal tax credit limit of $1.75 per capita applies to the 9-percent credits only.[9]

As an example, if a project's qualified basis were $1,000,000, and the project received the 9-percent tax credits, the project would receive $90,000 in tax credits for each year of the 10-year tax credit period ($1,000,000 x 0.09). If the project received the 4-percent credits, it would receive $40,000 in tax credits for each year ($1,000,000 x 0.04).[10]

[9] There is, however, an indirect cap on the 4-percent credits. Since the 4-percent credits are almost always combined with tax-exempt bond financing, at least in California, and since tax-exempt bond financing is itself subject to an annual cap, there is a de facto limitation on 4-percent credits.

[10] The actual situation is more complex. The two tax credit rates are not fixed at 9 and 4 percent; instead, the rates fluctuate with changes in the federal cost of borrowing, that is, with changes in the general level of interest rates. Revised tax credit rates are published each month by the IRS. When the tax credit program began, the 9-percent rate produced a present value of $.70 per dollar of credit over the 10-year tax credit period at the then-current federal borrowing rate, and the 4-percent credit produced a present value of $.30, which converted to a funding of 70 or 30 percent, respectively, of qualified basis.
As the federal borrowing rate declines, the tax credit rate also declines—at the lower discount rate, a smaller amount of annual tax credits is necessary to meet the 70 and 30 percent targets for funding. Currently (June 2003), with interest rates at record lows, the 9-percent rate is actually 7.89 percent, and 4-percent rate is 3.38 percent. Even though the percentages change, the two types of credits are still widely called the "9-percent" and "4-percent" credits, although they are sometimes called the 70 percent level and 30 percent level credits, reflecting the amount of qualified basis they are designed to fund.

The preceding discussion pertains to the *maximum* amount of tax credits a project may receive. Under IRC section 42, however, each state's allocating agency must ensure that only the minimum amount of tax credits necessary for financial feasibility is in fact allocated to a project. While the maximum amount of tax credit financing is set by the type of credit, the project's qualified basis, and the current tax credit rate, the allocating agency must review all proposed sources of funding for a project—the project's total financing package—in order to ensure that excess tax credits are not allocated. As part of the allocation process, the allocating agency also is responsible for reviewing the "reasonableness" of proposed development costs—that is, the reasonableness of a project's reported qualified basis.[11]

Syndication of Limited Partner/Tax Credit Interests

Debt financing for a tax credit project follows a typical pattern—the developer/sponsor arranges one or more mortgage loans with public or private lenders, subject to their underwriting standards. Equity financing for tax credit projects, which typically involves the creation of limited partner/tax credit interests to raise equity funds, is more complex.

The equity financing of a tax credit project typically uses the process of real estate syndication to convert the future tax credits into funds that can be used to develop the project today. In low-income housing tax credit syndication, a limited partnership is formed with the developer/sponsor of the project as the general partner and one or more outside investors as limited partners. The limited partnership/tax credit interests are sold to the outside investors, and these funds are used to develop the project.

The general partner may be a for-profit or not-for-profit entity (or these two types of entities may act as co-general partners). The general partner typically holds a de minimis equity interest (e.g., 1 percent); the limited partners hold the remainder of the project equity (e.g., 99 percent). The economic return provided to the limited partners/investors is derived almost completely from the tax credits that accompany the limited partner/tax credit interests. [12]

When purchasing the limited partner/tax credit interests, the limited partners/investors pay into a project an agreed-upon percentage of the total tax credit amount (i.e., not the annual tax credit amount but the total amount over the 10-year credit period) into a project. This percentage is called the "tax credit price."[13] The market for limited partnership interests in tax credit properties is competitive, and the tax credit price is thus competitively determined. The tax credit price may reflect the gross equity proceeds raised from the limited partners/investors. The gross proceeds, however, must be reduced

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[11] Title 4, California Code of Regulations, Section 10327 (TCAC regulations), governs TCAC's analysis of project feasibility and determination of tax credit amounts.

[12] A real estate syndication may be "public" or "private." In a public syndication, partnership interests are marketed to the public at large; in a private syndication, the interests are marketed to a much smaller group. Public syndication is subject to more stringent regulatory requirements and, hence, have greater legal and underwriting costs than private syndication. A low-income housing tax credit syndication can be of either type. In fact, most limited partner/tax credit interests are targeted to corporations, who can make the best economic use of the credits, and not to the general investing public.

[13] Not to be confused with the "tax credit rate," described above in the context of credit allocation.

by syndication and other associated costs in order to arrive at the net proceeds, that is, the amount that actually goes to project funding. Typically, these costs consume from 5 to 15 percent of the gross proceeds.[14]

For example, assume that a project generates $90,000 in annual tax credits (assuming a "true" 9 percent tax credit rate with a qualified basis of $1,000,000) and that the gross tax credit price is $0.75. The total amount of tax credits generated over the 10-year credit period would be $900,000 ($90,000/year x 10 years), and the gross proceeds raised from investors would be $675,000 ($900,000 x $0.75/$1 tax credit dollar). Further, if syndication and associated costs consume 5 percent of gross syndication proceeds, the net proceeds to the project would be $641,250 ($675,000 - $33,750).

Although it is commonly stated that the general partner/sponsor of a tax credit project raises funds by "selling the tax credits," this is not exactly what happens. What in fact are sold are equity interests in a limited partnership that also include rights to certain tax credits, not the tax credits per se. Recall that under IRC section 42, low-income housing tax credits may only be claimed by *owners* of low-income housing; the tax credits cannot be claimed without holding a concomitant equity interest.

State Low-Income Housing Tax Credits

Shortly after the federal program was enacted, the California Legislature authorized a state low-income housing tax credit to augment the federal program. The state low-income housing tax credit program is codified in several California statutes and accompanying regulations.[15] State low-income housing tax credits can only be used to offset a California state income tax liability.

The state program does not stand alone; rather, it is designed to supplement the federal tax credit program, with state tax credits used to bridge a project's remaining financing gap. State tax credits are available only to projects that also have received federal tax credits. In its operation, the state program generally mirrors the federal program, but there are a few significant differences:

- As noted, state tax credits are available only to projects that have also received federal tax credits.
- Limited partners/investors take the state tax credits over a 4-year period in contrast to the 10-year federal period. In addition, the total of the 4-year state credit amount allocated to a project is deducted from the state's annual state credit ceiling, whereas only the annual federal credit allocated to a project is deducted from the federal annual credit ceiling.

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[14] Tax credit prices have increased significantly as investors have become more knowledgeable about how the low-income housing tax credit program works and about the risks involved in tax credit projects. Current tax credit prices are $0.70 to $0.80; in the very early years of the program, tax credit prices were $0.40 to $0.50. As the tax credit price increases, the amount of funds raised for a project increases, and the rate of return to limited partners/investors decreases.

[15] See the following California statutes: Health and Safety Code sections 50199.4 through 50199.22; Revenue and Taxation Code sections 12205.5, 12206, 17057.5, 17058, 23610.4, and 23610.5. See also Title 4, California Code of Regulations.

- The applicable percentage applied to qualified basis for determining the annual state credit amount (i.e., the "state tax credit rate") is 30 percent for projects that are not otherwise federally subsidized (i.e., that receive no federal subsidy other than federal tax credits) and 13 percent for projects that are federally subsidized, in contrast to the 9-percent and 4-percent tax credit rates, respectively, for the federal credits.
- State credits are not allowed for acquisition costs, except in the case of existing "at risk" tax credit projects—that is, existing tax credit projects that are at risk of being converted to market-rate projects.

As with federal credits, the state credits generally are syndicated, and the "tax credit price" is competitively determined. State tax credits also are subject to an annual ceiling.

Valuation of Tax Credit Properties

We divide the discussion concerning the valuation of low-income housing tax credit projects into the following subtopics: [16]

- Valuing subsidized housing in general
- Preference for the income approach
- Key considerations for tax credit projects
- Applying the income approach to tax credit projects
- Data sources

Valuing Subsidized Housing in General

The general principle behind the valuation of subsidized housing for property tax purposes, including housing developed with tax credits, is that the market value of such housing should reflect both the benefits and the burdens that result from the regulations to which the housing is subject. A brief analysis of this principle is as follows:

- The defining economic aspect of low-income housing is the public subsidy. If not for the subsidy, such housing would not be built, because low-income households would not be able to pay rents high enough to provide an adequate return to private investors.
- In exchange for the public subsidy and other benefits, an owner of subsidized housing agrees to comply with rent restrictions and other property-related limitations (e.g., rate-of-return limitations). The restrictions and limitations, and the terms under which they are agreed to, are documented in a formal regulatory agreement and/or restrictive covenant that runs with the subject property and generally remains in effect for a

[16] Note that many low-income housing tax credit projects qualify for an exemption from property taxes. Revenue and Taxation Code section 214, subdivision (g), extends the welfare exemption to property owned and operated by qualifying organizations and used exclusively for rental housing that is occupied by lower-income households; qualifying organizations include limited partnerships in which the managing general partner is a qualified nonprofit corporation meeting the requirements of section 214. For more information, see Assessors' Handbook Section 267, pages 68 and following.

prescribed period. [17] Ownership interests in subsidized housing generally are transferable, under specified conditions, with the regulatory provisions "running with" the property.

- Under the statutory definition of market value in Revenue and Taxation Code section 110, property should be valued assuming 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.

- A regulatory agreement involving subsidized housing constitutes an enforceable restriction under section 110, and a property so restricted should be valued in light of the regulatory agreement.
- A typical, informed buyer would consider such an agreement in its entirety—that is, a buyer would review both the economic burdens and benefits contained in the agreement and arrive at their net economic effect on the property. Under the definition of market value for property tax purposes, the value of a subsidized property should likewise be premised on consideration of the regulatory agreement as a whole.

Income Approach Preferred

Property Tax Rules 4, 6, and 8, read together, provide a general order of preference concerning the applicability of the valuation approaches. When reliable comparative sales data are available, the preferred valuation approach is the comparative sales approach. When sales data are not available, and an income for the subject property can be reliably estimated, the income approach is next preferred. Finally, when neither reliable sales nor income data are available, the cost approach is preferred, but with the proviso that "the property is not so regulated as to make such cost irrelevant."

Based on the above, and consistent with our previous guidance regarding the valuation of other types of subsidized housing, the income approach is the preferred approach when valuing properties financed with low-income housing tax credits. Sales data with respect to tax credit projects are scarce because the regulatory agreements that govern such projects effectively limits sales of such properties. [18] The cost approach is problematic because the rent (i.e., income) restrictions to which tax credit projects are subject are unrelated to the cost of the project.

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[17] From Title 4, California Code of Regulations, Section 10337(a):
"All recipients of Credit, whether federal only, or both federal and state, are required to execute a regulatory contract, as a condition to the Committee's making an allocation, which will be recorded against the property for which the Credit is allocated, and, if applicable, will reflect all scoring criteria proposed by the applicant in the competition for federal and/or state housing Credit ceiling."

[18] Also, when a transfer does occur, the indicated sale price may not be a valid indicator of market value. For example, a transfer may occur under a "right of first refusal," in which case the sale price is negotiated well before the transfer date and may not relate to current market value, or under a "qualified offer," in which case the price is based on a statutory formula unrelated to market (see IRC section 42 (H)(6)(F)).

Key Valuation Considerations for Low-Income Housing Tax Credit Projects

The following section describes the specific application of the income approach to low-income housing tax credit properties. First, however, it is helpful to discuss several general considerations:

- Rent restrictions/restricted income
- Term of the regulatory agreement/restrictions
- Treatment of the tax credit equity
- Other sources of financing in tax credit projects
- "Layered" restrictions

Rent restrictions/restricted income. As noted, to qualify for low-income housing tax credits, owners of a tax credit project must agree to restrict the project's gross rents. The maximum gross rent for a particular unit cannot exceed 30 percent of the income limit for a household of a size expected to occupy that unit. The income limit is based on the area median income for households of designated sizes.[19] For most tax credit projects in California, the income limit is based on the 40-60 set aside; that is, the applicable income limit is be 60 percent of area median income, with the maximum gross rent being 30 percent of 60 percent of the area median income for the relevant household size.

Household size is imputed, based on assumptions about how many people will occupy a given type of unit; it is assumed that 1 person will occupy a studio unit and that 1.5 persons per bedroom will occupy units of 1 bedroom or larger.[20] "Gross rent," in this context, includes the cost of certain specified utilities paid by the tenant; that is, certain tenant-paid utilities are an offset to the maximum rent charge (e.g., if the maximum gross rent were $600/month, and specified tenant-paid utilities were $50/month, the maximum rent chargeable to the tenant would be $550/month).

For example, for a 2-bedroom unit, assuming the 60 percent income level (i.e., gross rent at a maximum of 60 percent of area median income), maximum gross rent would be based on 30 percent of 60 percent of area median income for a household of 3 people (1.5 people/bedroom x 2 bedrooms). For 2003, in Sacramento, the estimated annual area median income for a household of 3 is $53,833. Thirty percent of 60 percent of $53,833, or $9,690, is the annual maximum gross rent. The maximum monthly gross rent for this 2-bedroom unit is therefore $807 ($9,690 x 1/12). If the tenant pays certain utilities, these costs may be offset against the maximum gross rent, such that the actual maximum monthly rent would be something less than $807.

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[19] Area median incomes by household size are determined annually for each county by the U. S. Department of Housing and Urban Development (HUD). The 20-50 and 40-60 threshold project set-asides discussed earlier also are based on area median income.

[20] Actually, this applies to projects receiving tax credits in 1990 or later. For projects with tax credit allocations prior to 1990, maximum annual gross rent is determined slightly differently. For these projects, the maximum annual gross rent for a particular unit cannot exceed 30 percent of the annual income limit for the household that occupies the unit—that is, the number of people that actually live in the unit—and not on an imputed household size.

In practice, the appraiser should not be too concerned with actual restricted rent calculations. Rather, the he or she should obtain a current rent roll from the project's general partner/sponsor. This is not only easier but also more reliable; in some cases, the rent charged may be less than the maximum.

Term of the regulatory agreement/restrictions. The appraiser must determine how long the tax credit project will remain subject to the regulatory agreement. Depending on the local real estate market, the option to convert a tax credit project to market rents in the near-to-intermediate term may significantly increase its current market value.

The initial federal tax credit legislation established a restricted period for tax credit properties of 15 years; this is called the "compliance period." Shortly thereafter, in 1990, the law was amended through adoption of an "extended use period," which extended the restricted period for a minimum of 15 additional years, establishing a minimum restricted period under federal regulation of 30 years. The states, however, have been allowed to lengthen the extended use period (and hence the total restricted period), through their qualified allocation plans. Under current California law, the restricted period for tax credit projects is 55 years (the 15-year compliance period plus a 40-year extended use period). Thus, California law has been significantly more restrictive than federal law in regard to the term of restriction.

Under prior rules, California awarded additional points in its allocation process for longer restricted terms, with the maximum number of points awarded for a term of 55 years. In 1996, California's selection criteria were modified such that all California tax credit projects for that year and later must have a minimum restricted period of 55 years. Thus, California projects have not had a consistent term of restriction over the years, although the term generally has exceeded the federal minimum. The appraiser must confirm the remaining restricted period on a case-by-case basis for each project being valued. This information should be available from the project's general partner.

Treatment of tax credit equity. The question here is whether the net proceeds from the sale of a tax credit project's limited partner/tax credit interests should be included in, or excluded from, the taxable value of the project. Or, stated equivalently, the question is, Should the remaining tax credits be considered part of the gross income attributable to the taxable property—that is, as part of "gross return" as defined in Property Tax Rule 8—or excluded from gross income?

We believe that the present value of the remaining tax credits should be considered part of the taxable value of a tax credit project. Arguments in support of this position include the following:

- Holding a corresponding equity interest in the project is a prerequisite to claiming the tax credits. 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.

- Corollary to the above, it is generally accepted that the income tax treatment of real property is part of the market value of real property. In other words, the tax benefits of real property are attributable to real property and not to nontaxable sources. For example, if investment real estate could not be depreciated for income tax purposes, all else being equal, its market value would be lower; in other words, the market value of investment real estate includes the value of any tax benefits it provides.
- In regard to tax treatment, low-income housing tax credits, under Revenue and Taxation Code section 110, subdivision (f), can be interpreted as "intangible attributes of real property" whose value may be reflected in the value of the real property. That is, the tax treatment of real property could be seen as an intangible attribute of real property. Alternatively, in terms of Revenue and Taxation Code section 110, subdivision (e), low-income housing tax credits can be viewed as intangible assets or rights "necessary for the beneficial and productive use of the property." If not for the tax credits, tax credit projects would not exist.
- A final point involves a comparison between tax credits and public grants. In a tax expenditure, government "expends" future tax revenue by granting tax concessions that lower future tax revenue. The low-income housing tax credit is a type of tax expenditure; both federal and state governments use the housing tax credit to raise current funds for housing in exchange for lower tax revenues in the future. From the government's point of view, the housing tax credit is fiscally equivalent to a current budget appropriation for housing (adjusted for borrowing costs).

  In essence, the low-income housing tax credit is a government housing grant in a different guise. In both types of financing, the result is that government provides funds to build housing. With the housing tax credit, public monies are provided indirectly, in the form of future tax expenditures, rather than through direct budgetary appropriation.

  Given the substantive equivalence between housing tax credits and housing grants, it seems that the same reasoning vis-à-vis taxability should apply to both methods of financing. That is, if tax credits used for the construction of housing result in nontaxable property, then public grants used for the construction of housing also must result in nontaxable property. But the use of public grant monies for the construction of housing, does not, per se, result in nontaxable property. In our opinion, the same holds for the use of tax credits.

Other sources of financing with tax credit projects. Proponents of low-income housing tax credits point to their flexibility; tax credits can be combined with other sources of equity or debt financing—public or private, subsidized or market rate—to complete a project's financing.[21]

In a typical project, most, and often all, of the equity financing is raised through the sale of the limited partnership/tax credit interests, but this usually still leaves a significant gap in total project financing. Nine-percent credits provide net proceeds that are from 50 to 60 percent of total development cost; four-percent credits provide 25 to 30 percent of

[21] This contrasts with the financial structure for the previous generation of subsidized housing, which was based largely on federally subsidized, below-market-interest-rate debt with a high loan-to-value ratio and limited equity (e.g., Section 236 and Section 515 housing).

total development cost; state credits, in most cases, compose an even smaller percentage of total project capitalization.

Thus, almost always, tax credits must be combined with other financing sources. Generally, this means that a significant amount of debt financing must be obtained in order to develop the project. In addition to the tax credit equity, financing for a tax credit project often includes, but is not limited to, one or more of the following:

- Conventional, market-rate debt from a private lender.
- State tax-exempt bond financing. The State of California issues tax-exempt, private-activity bonds subject to annual limits on such issuance imposed by the federal government. Private activity bonds are used to fund privately owned projects that also have a significant public purpose. A significant portion of California's annual issuance of private activity bonds is used to fund housing and housing related construction. The bonds carry below-market interest rates because bond interest is exempt from income taxes; hence, they are attractive to developers.[22]
- Soft debt from various sources. Interested third parties, public and private, often make soft loans to a project. The loan is "soft" because repayment is required only if there is available cash flow.
- HOME funds and Community Development Block Grants. HOME is a federal block grant program for housing. Grants are made to state and local jurisdictions; the housing agencies of these jurisdictions then allocate funds at the project level. The grant may be in the form of a soft loan. A community development block grant (CDBG) is another type of federal block grant program but is not limited to housing. Both HOME and CDBG funds can also be as soft loans or outright grants.
- Donations and outright grants or gifts.

Although low-income housing tax credits can be combined with the above sources of financing in myriad ways, the financial structure of most tax credit projects generally follows a few general forms:

- The federal 9-percent credits are combined with a private, market-rate mortgage. The limited partners/investors provide most of the equity through tax credits; the private lender provides most, if not all, of the debt. State tax credits also may be involved. As discussed above, the net proceeds from 9-percent credits typically constitute from 50 to 60 percent of project cost. This financing structure can be used for new construction or substantial rehabilitation.
- Similar to the above, except a public, subsidized loan substitutes for the private, market-rate debt.
- The 4-percent credits are combined with state tax-exempt bonds (i.e., the private activity bonds). The smaller amount of equity financing supplied by 4-percent credits is counterbalanced by a larger amount of debt financing provided by the tax-exempt bond financing. This financing structure can be applied to new construction, major

[22] The state's annual authorization of private-activity bonds is allocated among competing uses by the California Debt Limit Allocation Committee ("CDLAC"), which, like the Tax Credit Allocation Committee ("TCAC"), is a unit of the California Treasurer's Office.

rehabilitation, and for acquisition of existing projects that will be rehabilitated and converted to tax credit projects.

"Layered" regulations and tax credit projects. When tax credits are combined with other sources of subsidized financing (e.g., tax exempt bonds or soft loans), these sources may bring their own sets of regulations or restrictions. In other words, a project may be subject to layers of regulations, with each layer of regulation derived from a separate subsidy program.

The general principle of reconciling multiple regulation is that the most stringent provisions apply in any given area (e.g., restricted rents, term of restriction, etc.). Tax exempt bond financing, for example, may require that a specified number of project units are subject to more stringent rent restrictions than the corresponding tax credit restrictions. When valuing a tax credit project with layered regulations, the appraiser must identify the most stringent regulatory provisions that apply to each of the valuation variables and premise the valuation on these provisions.

Applying the Income Approach to Tax Credit Projects

The fundamental premise of the income approach is that the value of a property is equal to the present value of the future (net) income attributable to it. The approach thus requires estimating the amount, timing, and duration of the estimated future income and discounting this income at a capitalization rate that accounts for both the time value of money and the risk associated with the income stream.

There are two generally recognized variants of the income approach—(1) direct capitalization, which converts a single year's income into an estimate of value, and (2) yield capitalization, or discounted cash flow analysis, which separately discounts multiple years of income over a designated holding period. The method described here for tax credit projects involves yield capitalization.[23]

A tax credit project generates two types of future income: (1) the income represented by the future tax credits and (2) the income from the property's future operation. Although these two sources of income have different characteristics, and should be discounted at different rates, both sources are attributable to the tax credit project, that is, to the taxable real property. In applying the income approach to a tax credit project, the market value of the project is the sum of (1) the present value of the remaining (i.e., as-yet-unclaimed) tax credits and (2) the present value of the project's expected future (net) income.

Estimating the present value of the remaining tax credits

There are two steps in estimating the value of this component. First, determine the annual amount of the subject property's federal (and state, if applicable) tax credits and the remaining years for which the tax credits may be claimed. This information should be obtained from, or confirmed by, the project's general partner/sponsor. Second, discount the future tax credits to their aggregate present value using an appropriate (i.e., risk-

[23] For several reasons not discussed here, the use of direct capitalization to value tax credit properties is problematic.

adjusted) discount rate. As a project's tax credits are claimed (i.e., "used up") the value of this component of total project value declines.

As discussed earlier, limited partners/equity investors discount future tax credits at a risk-adjusted rate to arrive at the amount they will pay for the tax credit equity; this results in a "tax credit price." Conversely, a given tax credit price implies a corresponding discount rate in relation to the annual tax credits. Future tax credits should be discounted using the current discount (i.e., yield) rate for comparable low-income housing limited partner/tax credit interests. In other words, the appraiser should use a discount rate that is based on the sales of comparable limited partnership/tax credit interests on or near the valuation date of the subject property. [24]

The estimated present value of the remaining tax credits should be adjusted, if necessary, for syndication costs; that is, the adjusted present value should reflect the net proceeds to the project from the tax credits, not the gross proceeds to the syndicator. [25]

For example, assume a tax credit project placed in service 5 years ago (i.e., there are 5 years of remaining credits). The project received federal tax credits of $600,000 per year. Assuming that the current annual discount (i.e., yield) rate (based on quoted tax rate prices) for comparable limited partnership interests/tax credits is 7.50 percent, the indicated present value of the remaining tax credits would be $2,427,531 ($600,000/year x 4.045885). Allowing a 5 percent adjustment for syndication costs, the adjusted present value is $2,306,154 ($2,427,531 – $121,377). This would be the estimated value of the remaining tax credits on the valuation date.[26]

Estimating the present value of the income generated by the project

The second component of the market value of a tax credit project is the value produced by the operating project. Estimating the value of this component requires estimations of the standard variables in yield capitalization, or discounted cash flow analysis: (1) the restricted annual net income to be discounted; (2) the remaining restricted period; (3) the residual value of the project at the end of the restricted period; (4) the discount, or yield, rate at which the annual income will be discounted; and (5) the discount rate at which the estimated residual value will be discounted. The estimated value of this component is the present value of the annual restricted income added to the present value of the tax credit project's estimated residual value at the end of the restricted period.

[24] Novogradac & Company LLP publishes two advisory reports about the low-income housing industry, "The Valuation Report" and "LIHC Monthly Report" that often contain current yield information.
[25] When deriving the discount rate for the future tax credits, comparable tax credit prices and corresponding discount rates may be quoted on either a net or gross basis—that is, either before or after syndication or other related transaction costs. If the data is on a gross basis, an adjustment for syndication costs is necessary.
[26] The yield rates quoted in the market for limited partner/tax credit interests are on an after-income taxes basis. The tax credits provide an after-income tax return; they can be used to directly offset income taxes payable. Hence, the yield rates in this market are lower than the before-tax yield rates generally seen by appraisers.

Annual restricted income to be capitalized. As we have discussed, gross rents for a tax credit project are restricted in accordance with IRC section 42 and corresponding state law, and a tax credit project should be valued in light of these income restrictions.

In accordance with Property Tax Rule 8, subsection (c), the income to be capitalized is the "net return," which in the present context is the restricted gross rent (reduced for tenant-paid utilities, if applicable) plus any other income (e.g., vending machines) minus vacancy and collection loss minus operating expenses (excluding tenant-paid utilities, if applicable) minus required replacement reserves.

A tax credit project, however, also may receive income in the form of federal Section 8 rental certificates or vouchers. In some cases, the income received under Section 8 may result in project income that is above the restricted income prescribed under tax credit provisions. In such cases, the appraiser should consider the incremental income provided by Section 8 also to be part of the income to be capitalized, that is, as part of "gross return" as defined in Property Tax Rule 8.

Remaining restricted period. The annual income to be capitalized—that is, the net return—must be estimated for the remaining period of restriction. For most tax credit projects, this period will extend some time into the future, and it will be necessary for the appraiser to forecast changes in both gross rent and operating expenses over this period.[27] A determination regarding a project's remaining restricted period must be made on a project-by-project basis by consulting the project's general partner and/or a review of the project's regulatory agreement

Residual value of project. The valuation method assumes that at the end of the restricted period, the project will no longer be subject to regulation and should be valued as an unrestricted, market-rate project. The future unrestricted value is called the project's residual value. The generally accepted, but not the only, way to estimate residual value is by direct capitalization of the project's estimated net return at the end of the restricted period, with both the overall capitalization rate and the income to be estimated as if at market. As a practical matter, if the residual is far into the future, its effect on present value will be quite limited.

Discount rate for annual restricted income. The band of investment technique should be used to derive the discount rate. Under this technique, the discount (i.e., yield) rate is the weighted average of the cost of equity and debt, with weightings based on the respective proportions of total project capital represented by the equity and debt components. In many tax credit projects, the net proceeds from the tax credits constitute most, if not all, of the tax credit property's equity component. The number of debt components depends on the number of loans; there may be a single debt component or two or more components if there are multiple loans.

[27] Area median income, the basis for gross rents, is estimated by HUD at the county level. When underwriting tax credit projects, TCAC requires budgets to show pro forma increases of 2.5 percent and 3.5 percent for gross income and operating expenses (excluding replacement reserves), respectively.

Consistent with the principle that the market value of a tax credit project should reflect the project's regulatory structure—both burdens and benefits—the estimated rates of return for the equity and debt components also should be based on the project's restricted status. In regard to debt, this means that if there is subsidized debt, the rates of return used for subsidized debt components should reflect the actual subsidized rates.[28] Rates of return used for market-rate debt components should reflect current rates for comparable market-rate debt.

Developing an equity rate of return is more problematic. First, it would be incorrect to use the tax credit discount rate—that is, the rate described above that is used to value the limited partner/tax credit interests—since that rate pertains to an income stream with risk characteristics different from the income stream generated by the operating property. And second, for the same reason, it would be incorrect to use an equity rate derived from an unrestricted, but otherwise comparable, property.

Under IRC section 42, TCAC, as the state's designated allocating agency, is required to analyze the feasibility of all proposed tax credit developments.[29] The focus of the feasibility analysis is to ensure, on the one hand, that a project's restricted income is sufficient to cover operating expenses (including required property reserves) and its proposed hard debt, but, on the other hand, that only the minimum amount of tax credits necessary are allocated to a project.

There is an inherent tradeoff between the amount of tax credits allocated to a project and the project's ability to service (hard) debt. The greater the proportion of tax credit financing, the greater the capacity to service debt from the restricted income (there is no required return to tax credit equity from project operating income). TCAC's underwriting standards, however, require an initial minimum debt service coverage ratio of 1.10, meaning that a project's pro forma net operating income (which is after a deduction for property taxes) must be at least 110 percent of the project's proposed debt service. The project pro forma also must demonstrate a positive cash flow (of an amount unspecified in the regulations) for the first 15 years of project life.

The effect of TCAC's underwriting standards is to (1) effectively limit the equity return from project income by requiring that the minimum amount of tax credits be used per project but (2) allow some equity return by requiring a certain level of debt coverage and an unspecified amount of positive cash flow (from which additional return could be provided to equity). The underwriting standards limit equity return from project income, but the limit is a hazy one.

With state credits, however, the law provides an explicit limit to equity return from project income. Under section 12206 of the California Revenue and Taxation Code,

[28] Typical forms of subsidized debt for tax credit projects include tax exempt bond financing and soft loans from various public or private, not-for-profit entities. Many grants are also forms of soft loans. In general, subsidized financing must remain in place for the term of the loan.

[29] TCAC addresses project feasibility in section 10327 of its regulations (Title 4, California Code of Regulations).

equityholders in a tax credit project may receive a return from project income that does not exceed 8 percent of the lesser of either (1) the owners' equity (which is the amount of capital contributions paid into the project) or (2) twenty percent of the adjusted basis of the building as of the close of the first taxable year of the credit period.

Thus, TCAC's underwriting standards, in regard to federal tax credits, implicitly limit equity return from project income, and in regard to state tax credits, explicitly limit such return in accord with Revenue and Taxation Code section 12206.

Our recommendation is to apply an 8-percent equity return limit to all tax credit equity. This recognizes the intent to limit the return to limited partner/tax credit equity from project income contained in TCAC's underwriting standards and uses one of the two tests provided in the statutory rate-of-return limit pertaining to state tax credit equity (the other test, that based on adjusted basis would be significantly more difficult to apply). An 8-percent equity return limit also mirrors that used in several other federally subsidized housing programs, notably the Section 236 and Section 515 programs.

After calculating the band-of-investment (i.e., weighted average) discount rate, a property tax component should be added to the rate.

Discount rate for residual value. Again, the valuation method assumes that at the end of the restricted period, the project will no longer be subject to regulation and should be valued as an unrestricted, market-rate project. The discount rate should correspond to this unrestricted status and hence should be a market-based rate.

The discount rate for the residual also can be developed using the band of investment, but with changed parameters for the relevant variables. The proportions of debt and equity should be based on the conventional loan-to-value ratio for a market-rate comparable property. The debt rate should be based on conventional financing available to comparable market-rate projects and the equity rate of return should be based on equity rates of return from comparable, market-rate projects. As with the discount rate for operating income, a property tax component should be added to the band-of-investment rate.

Summary

To summarize, the value of a tax credit project is the sum of (1) the present value of the project's remaining tax credits, (2) the present value of the project's operating income over the remaining term of restriction, and (3) the present value of the project's residual value at the end of the period of restriction. The following example illustrates the method.

[Example for inclusion here.]

Article XIII A Considerations

With a newly constructed tax credit property, the base year value for the land, or site, typically is established first, based on its purchase price and/or sales prices of market comparables. This is followed by a second, separate base year value for the completed, newly constructed improvements; this base year value is usually based on the cost of the improvements—either reported cost or an independent cost estimate.

The recommended valuation method above pertains, for the most part, to the lien date valuation of a tax credit property. Upon completion of the improvements, the method would be used to ensure that the combined base year values for land and newly constructed improvements do not exceed the estimated market value of the entire project. On subsequent lien dates, the method also would be used to estimate the lien-date market value of the project. The project's lien date market value would be compared to the combined factored base year values for land and improvements, with the lower of the two values enrolled as the project's taxable value, as required under Revenue and Taxation Code section 51.

Under the method, the estimated market value of a tax credit project will decline on each lien date during the tax credit period as the tax credits are claimed by investors; only the value of the remaining, yet-to-be-claimed tax credits contributes to the project's market value. As this occurs, it is likely that the combined factored base year values for land and improvements will exceed the project's lien-date market value as determined by the method.

When tax credits are obtained for the rehabilitation of existing improvements, there may be a question of whether the rehabilitation constitutes "new construction," as that term is defined in Revenue and Taxation Code sections 70 and following. This raises the related question of how such tax credits should be treated for assessment purposes. In general, it can be said that if the rehabilitation does not constitute new construction, there is no basis for a reassessment of the improvements. In such cases, the net proceeds from the tax credits used to perform the rehabilitation do not create new assessable value.

Data Sources

1) The best source for obtaining information about a specific low-income housing tax credit project is the general partner/sponsor. The general partner, or its designated agent, should be able to provide the appraiser with the following necessary information:

    - A current roll of the restricted rents.
    - Data regarding project vacancy, operating expenses, and reserve requirements.
    - The type and amount of tax credits awarded to the project and the amount of the remaining credits.
    - The project's financial structure—that is, the project's financing in addition to the tax credits.
    - A copy of the regulatory agreement or restrictive covenants to which the project is subject.

- A determination of how long the property will remain subject to restriction.

2) The IRS website is a good source of general information about the federal tax credit program (www.irs.gov). Of particular interest is the “Low-Income Housing Credit Audit Techniques Guide.” The site also provides a means to access IRC section 42.

3) Information about the general operation of the low-income housing tax credit program in California, including the state low-income housing tax credit, is available on the website of the California Tax Credit Allocation Committee (www.treasurer.ca.gov/CTCAC). The website also contains a summary list of all tax credit projects in California and links to CTAC regulations.

   If adequate information about a specific project cannot be obtained directly from the project’s general partner, the appraiser may be able to review the project’s TCAC application file at TCAC’s Sacramento office; a particularly informative document is the TCAC staff report that is prepared for each project. Application files are not available on the website.

4) Many firms, both for-profit and not-for-profit, are involved in the affordable housing industry. In particular, see the following websites: Recapitalization Advisors, Inc., a consulting firm specializing in affordable housing policy and finance (www.recapadvisors.com/); and Novogradac & Company LLP, a CPA firm specializing in affordable housing (www.novoco.com/).

5) Offering circulars and investment prospectuses for limited partnership/tax credit interests provide general information about housing tax credits from an investment perspective.