STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
PROPERTY AND SPECIAL TAXES DEPARTMENT
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April 28, 2005

TO INTERESTED PARTIES:

GUIDELINES FOR THE ASSESSMENT OF PROPERTIES
FINANCED USING LOW-INCOME HOUSING TAX CREDITS

In a letter dated March 11, 2005, we disseminated proposed guidelines for the assessment of properties financed using low-income housing tax credits. Interested parties were invited to provide comments on the proposed guidelines. Enclosed is a matrix summarizing the comments received.

An interested parties meeting will be held on May 11, 2005, to discuss the comments submitted on the proposed guidelines. The meeting will begin at 9:30 a.m. at the Board's headquarters in Sacramento, 450 N Street, Room 122. The guidelines are scheduled for discussion before the Property Tax Committee at the June 30, 2005 meeting.

All documents regarding this project will be posted to the Board's website at www.boe.ca.gov/proptaxes/lowincome05.htm. If you plan to attend the interested parties meeting on May 11, please advise Mr. Paul Lane at paul.lane@boe.ca.gov or 916-324-5828. If you are unable to attend the meeting in Sacramento but would like to participate by telephone, you may contact Mr. Lane to receive the conference call information.

Sincerely,

/s/ Dean R. Kinnee

Dean R. Kinnee, Chief
Assessment Policy and Standards Division

DRK:sk
Enclosure

GUIDELINES FOR THE ASSESSMENT OF PROPERTIES FINANCED USING LOW-INCOME HOUSING TAX CREDITS

COMMENTS AND PROPOSED ALTERNATIVE LANGUAGE

NO.	PAGE/LINE REFERENCE		SOURCE	PROPOSED LANGUAGE	SBE STAFF POSITION/COMMENTS
1	7	18	Sacramento County Assessor's Office	**Revise paragraph:** All three traditional valuation approaches should be applied. The limitations of each should be explored and a reconciliation made to arrive at market value. The valuation ~~method~~ methods outlined below ~~provides~~ provide an estimate of the current market value of a tax credit project given the enforceable restrictions to which the project is subject….	Staff consciously omitted reference to either the cost approach or the comparative sales approach. While there is no prohibition against using one of the other approaches, in staff's view the income approach, performed in the manner described in the guidelines, produces the only valid indicator of value for this type of property. This is because LIHTC properties are subject to enforceable restrictions on use that, for all practical purposes, make the other approaches irrelevant. Hence, the stated preference for the income approach, and the de-emphasis on the other approaches.
2	7	24	Sacramento County Assessor's Office	**Revise heading:** INCOME APPROACH ~~PREFERRED~~	See item 1.

No.	Page/Line Reference		Source	Proposed Language	SBE Staff Position/Comments
3	7	25	Sacramento County Assessor's Office	**Delete paragraph and footnote:** ~~The comparative sales approach is very difficult to apply with respect to tax credit projects. Sales are rare and the terms and conditions of such sales may render the sales data unreliable.[15] The cost approach also is problematic because the rent restrictions to which tax credit projects are subject are unrelated to project cost. Consequently, when valuing tax credit projects, the income approach is preferred.~~ ~~[15] And 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)).~~	We think these statements are valid. See also item 1.
4	11	19	Sacramento County Assessor's Office	**Add sentence:** Thus, CTCAC'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 to 8 percent. <u>These equity returns are inclusive of the tax credits.</u>	The added statement is not accurate. CTCAC's underwriting standards are in regard to the project's operating income only, without reference to any income derived from the tax credits. The capitalization rate we develop in the guidelines also applies only to the project's net operating income. In this context, recently enacted Revenue and Taxation Code section 402.95 again seems relevant. Section 402.95 states that "In valuing property under the income method of appraisal, the assessor shall exclude from income the benefit from federal and state low-income housing tax credits…."

No.	Page/Line Reference		Source	Proposed Language	SBE Staff Position/Comments
5	11	20	Sacramento County Assessor's Office	**Revise paragraph:** ~~We recommend applying an 8 percent equity return limit to all tax credit equity. This recognizes the intent to limit the return to equity from project income contained in CTCAC's general 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 qualified 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.~~ The economic return provided to the limited partners-investors is primarily from the right to claim the future tax credits, not from the expected future operation of the project. Since the equity is provided by the limited partners and the limited partners have no call on any of the rental income, the equity dividend rate is zero. To derive a rate that implies income to equity when the equity component receives all its return elsewhere would result in misapplication of the income approach.	Actually, the general and limited partners do have a claim on the future net operating income of the property. After all expenses are met, and all required reserves are funded, any remaining income may be distributed to the general and limited partners. And there may be remaining income to distribute. Typically, the net income of LIHTC properties grows slowly over time, because HUD's median income amounts (upon which allowed rents are based) tend to grow at a slightly faster rate than operating expenses do. In order to develop a capitalization rate using the band of investment, an equity yield rate is required. Staff arrived at the 8-percent equity yield rate for the reasons stated in the guidelines.

No.	Page/Line Reference		Source	Proposed Language	SBE Staff Position/Comments
6	12	1	San Diego County Assessor's Office	**Comments:** In this example, land was acquired at a "market" or unrestricted value/price. It is my contention that any real (actual) sales of land for these restricted projects will likely reflect "market" or "unrestricted" values because the typical LIHTC project yields a similar return as an unrestricted property. In some cases they may even yield more. Simply stated, there is no reason (at this point in time) for the restricted property land sale to reflect a lower value when transacting on the open market. If we are required to give no consideration to the increment of value contributed by the tax credits, this should probably extend to the establishment of the base value of the land as well. From a purely technical, economic modeling, and appraisal standpoint, the tax credits (particularly in the case of the 9% deals) appear to be the most significant part of the development equation. I think that this consideration could be accomplished in two ways. The first would be simply to enroll a value at the time of transfer of the land only (assuming we know with reasonably certainty that a LIHTC project will be developed) that reflects its proper value as if the tax credits were not included in the project (i.e., a value that is likely less than its actual selling price, or open market value). Without going into the various methods of deriving this value, assume for the moment that this base year value would mesh with the SBE's building residual and not require a subsequent lien date prop 8 adjustment. The second method would be to enroll the sale price/open market value of the land without regard to SB2846. Upon completion of the new construction (when we have obtained all of the requisite information about the project) we compute the value as prescribed by SBE, but we would also re-value the land, reflective of this information we now have. We then reset the base year value of the land prospectively, as of the following lien date, reflecting the correct, restricted value as pertains to the land. This assumes that the land acquisition and subsequent construction pick-up happens in less than four years.	We think our method is actually less involved than the methods suggested. More important, the methods suggested are not in accord with California property tax law, which does not allow either (a) establishing a base year value for land that reflects something other than its market value on the date of change in ownership or (b) a revaluation of land upon completion of new construction.

No.	Page/Line Reference		Source	Proposed Language	SBE Staff Position/Comments
7	12	6	San Diego County Assessor's Office	**Comments:** Regarding the income valuation, I believe that it is impractical to work a yield capitalization approach. While this is technically correct, the author admits that the reversionary rights to be considered are nearly non-existent. To try to estimate the value of the reversion 55 years out is flat out not possible with any level of accuracy. Investors and market participants can reasonably be expected to treat these properties as encumbered into perpetuity. Therefore, unless we are making an assessment on a property that has a significantly reduced term of restricted rents, it makes more sense to work a direct capitalization approach, using a built up rate based upon the actual financing and estimated equity yield as per SBE's proposal.	The yield capitalization model allows an accurate, realistic depiction of the income pattern of LIHTC properties: (1) slow growth in net income during the restricted period and (2) an unrestricted reversionary value at the end of the restricted period. Although it's true that the farther off the reversion the harder it is to estimate its value, it's also true that the farther off, the less significant its value (because of the deep discounting). This situation of course changes when the reversion is nearer, but at that point, the accuracy of the estimated reversionary value would be higher. A direct capitalization model would also require the development of an overall capitalization rate, which would be problematic in this case because of the lack of sales data. Rule 8 states that a capitalization rate can be developed in only two ways: (1) using income and sales data from comparable properties or (2) using the band of investment.
8	12	19	Sacramento County Assessor's Office	**Add new section:** LIMITATIONS OF THE INCOME APPROACH The tax credits received by the limited partners are a form of income. Not including them in the income stream may affect the accuracy of the resulting income analysis. This should be taken into consideration when reconciling the income approach with the cost and market.	The proposed language ignores section 402.95, which expressly states that income derived from the tax credits must be excluded from the income to be capitalized when valuing LIHTC properties.

No.	Page/Line Reference		Source	Proposed Language	SBE Staff Position/Comments
9	12	19	Sacramento County Assessor's Office	**Add new section:** <u>COST APPROACH</u> <u>Property Tax Rule 3 says: (d) If the income from the property is regulated by law and the regulatory agency uses historical cost or historical cost less depreciation as a rate base, the amount invested in the property or the amount invested less depreciation computed by the method employed by the regulatory agency (the historical cost approach).</u> <u>As stated earlier in this guideline, the amount of tax credits received by a property are tied directly to the eligible basis (total development cost). The rates are fixed at approximately 9 percent or 4 percent depending on other financing. Stated another way, the rate of return on the limited partners investment is fixed at 9% or 4% of the cost of the improvements. Therefore, the structure of the contracts fit neatly with Rule 3 (d) and should yield a valid value indicator.</u>	In the case of an LIHTC property, the income is regulated (i.e., allowed rents are linked to HUD's estimates of median income), but this income is in no way connnected to the cost of the property. To put it another way, there is no linkage between the allowed rents and a market rate of return on the project's development cost. For example, with a regulated public utility, if the regulatory body uses historical cost (or something close to it) as the rate base, the utility is allowed to set its rates (income) at a level that provides a market rate of return on historical cost. But this is not how an LIHTC property works. The allowed rents have no connection with the historical or development cost.

No.	Page/Line Reference		Source	Proposed Language	SBE Staff Position/Comments
10	12	19	Sacramento County Assessor's Office	**Add new section:** OTHER CONSIDERATIONS WHEN USING THE COST APPROACH Property Tax Rule 6 (a) says in part "cost approach to value is used when…the income is not so regulated as to make such cost irrelevant." In the case of tax credit apartments, the rents are limited by contract. An argument could be made that rent restrictions agreed to by contract are not "regulated." Assuming that a contract is equivalent to "regulated," does it make the cost irrelevant in the subject example? It should not. The developer and limited partners go into contract knowing full well of the consequences of it. In spite of or because of all the benefits and liabilities contained in the contract, they spend the money to develop the property. They make the decision that the cost is equal to the benefits received.	All LIHTC properties are subject to a regulatory agreement specifying how the property will be operated (essentially, in a manner consistent with IRC Section 42 and any applicable state law). The agreement is between the property owner(s) and the government (i.e., CTCAC). This agreement constitutes an enforceable government restriction that must be recognized when estimating the property's value. In this sense, an LIHTC property is regulated. Further, as discussed above, an LIHTC property is regulated such that the allowed rental income bears no relationship to the property's cost.
11	12	19	Sacramento County Assessor's Office	**Add new section:** MARKET APPROACH No suggested text was provided.	See item 1.
12	12	19	Sacramento County Assessor's Office	**Add new section:** RECONCILIATION All value indicators that have been developed need to be reconciled. Consideration should be given to the reliability and accuracy of each. As stated in the AH 502, "In reconciliation, the appraiser should consider the various factors influencing value that are either not reflected or only partially reflected in the indicators." It goes on to say "…the accuracy of a value indicator depends on the amount of comparable data, the number and type of adjustments, and the dollar amount of adjustments."	See item 1.