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March 11, 2005

TO INTERESTED PARTIES:

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

In Letter To Assessors 2003/037, we announced a project to develop written guidelines for the valuation of properties financed using low-income housing tax credits. At the close of an interested parties meeting on August 19, 2003, all parties acknowledged that additional time was needed to adequately research the valuation issues pertaining to these tax credits. Accordingly, the guidelines were removed from the Property Tax Committee agenda. Further delay in the project resulted from the passage of Assembly Bill 2846 (Chapter 786, Statutes of 2004).

This project has now been resumed. Enclosed is a draft of the proposed *Guidelines for the Assessment of Properties Financed Using Low-Income Housing Tax Credits.* Interested parties may submit proposed changes to the draft guidelines in the form of alternative text. Suggested changes should be submitted by April 11, 2005 to Mr. Paul Lane in the Assessment Policy and Standards Division at paul.lane@boe.ca.gov.

The project is expected to proceed as follows:

- Interested parties have until April 11, 2005 to submit proposed changes to the draft guidelines.
- If necessary, an interested parties meeting will be held on May 11, 2005 at the Board's headquarters in Sacramento, 450 N Street, Room 122, beginning at 9:30 a.m.
- The Board's Property Tax Committee is tentatively scheduled to hear presentations on any unresolved issues regarding the wording of the guidelines at its June 30, 2005 meeting.

This letter and all future documents regarding this project will be posted to the Board's Web site at www.boe.ca.gov/proptaxes/lowincome05.htm. If you have questions or comments about this project, you may contact Mr. Paul Lane at (916) 324-5828, paul.lane@boe.ca.gov, or Mr. Mark Nisson at (916) 324-0295, mark.nisson@boe.ca.gov.

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

Assembly Bill 2846 (Chapter 786, Statutes of 2004) added section 402.95 to the Revenue and Taxation Code (effective January 1, 2005), relating to the valuation by the income approach of rental projects financed using low-income housing tax credits. When using the income approach, section 402.95 requires assessors to exclude from income any benefit a property may receive from federal or state low-income housing tax credits.

This letter provides guidance regarding the valuation of projects financed using low-income housing tax credits. First, we provide an overview of how the low-income housing tax credit program operates. Next, we discuss the valuation of projects financed with low-income housing tax credits within the context of newly-enacted section 402.95.[1]

## OVERVIEW

The institutional and programmatic aspects of the low-income housing tax credit (tax credit) program are complex. The following discussion is designed to provide enough background material to facilitate the valuation discussion that follows.

**Federal program.** The federal low-income housing tax credit program, instituted by the 1986 Tax Reform Act and subsequently codified as section 42 of the Internal Revenue Code (IRC), is now the primary federal program for subsidizing the production of affordable housing, replacing earlier programs that provided mortgage interest subsidies.

Under Section 42, eligible taxpayers may take a credit against federal income taxes due for qualified expenditures involving qualified low-income housing projects.[2] To be eligible for the tax credit, the taxpayer must hold an ownership interest in a low-income housing project for which tax credits have been awarded. In exchange for the tax credits, the project owners agree to operate the project in accordance with the restrictions contained in Section 42 and IRS regulations. Furthermore, as a condition of receiving tax credits, the project owners are required to enter into a recorded regulatory agreement restricting the use of the property to its terms.[3]

[1] Unless noted otherwise, all statutory references refer to the Revenue and Taxation Code.

[2] A tax credit provides a dollar-for-dollar reduction in tax liability, whereas a tax deduction provides only a reduction in taxable income. Hence, a tax credit is significantly more valuable to investors than a tax deduction.

[3] As provided in California Tax Credit Allocation Committee regulations (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

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:

1. Twenty 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

2. Forty 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").

Although there is no federal requirement to dedicate all units of a project to low-income occupancy, the majority of California projects have been rented entirely to lower income households. Project rents cannot exceed 30 percent of an imputed income limit based upon the household size expected to occupy the unit. In general, California tax-credit projects are subject to agreements restricting rents for a period of 55 years.

Each year, the federal government allocates a fixed amount of low-income housing tax credits to each state (California's current annual allocation is about $65 million). The federal credits provide a 10-year stream of credits in the amount of the annual allocation. That is, if a state's annual allocation of federal tax credits were $10 million, that year's allocation would produce 10 years of credits at $10 million per year, or a total of $100 million in credits over the 10-year credit period.[4]

Under IRC section 42, each state must annually adopt a qualified allocation plan describing how its annual share of federal tax credits will be allocated among eligible, competing projects. Although section 42 prescribes certain criteria that must be followed in each state's allocation plan, the statute provides considerable discretion to the states to establish additional criteria and thus to tailor their allocation plans to suit local needs.

The California agency responsible for tax credit allocation, and for developing the state's annual qualified allocation plan, is the California Tax Credit Allocation Committee (CTCAC), a unit of the State Treasurer's Office. CTCAC reviews applications from project developers and allocates the state's federal tax credits on a competitive basis, using the prescribed criteria in IRC section 42 and the additional state criteria contained

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."

[4] However, when a tax credit project is financed using a combination of federal tax credits and California tax-exempt bond financing, these federal credits do not count against the state's annual allocation of federal credits and there is no direct limit on the amount of such credits that may be awarded.

in CTCAC's own regulations. CTCAC currently receives applications for about four times the annual amount of federal tax credits available.[5]

**State program.** The California Legislature has also authorized a state low-income housing tax credit program to augment the federal program that is also administered by CTCAC. The state tax credits, which may be used to offset a California state income tax liability, are only available to projects that have previously received, or are concurrently receiving, an allocation of federal credits. About $70 million in state tax credits is available each year, with the amount indexed annually for inflation.[6]

In general, the state program mirrors the federal program, although there are two significant differences. First, the state credits are granted for a 4-year period in contrast to the 10-year period for federal credits. Second, the full 4-year state credit allocated to a project is deducted from the annual state allocation, whereas only the annual federal credit allocated to a project is deducted from the annual federal allocation.

**Ongoing compliance monitoring.** CTCAC, with assistance from the IRS, also administers a compliance monitoring program involving all operating tax credit projects in California (there are currently about 2,000 such projects). Projects are monitored according to the requirements of IRC section 42, IRS and CTCAC regulations, and the terms of the regulatory agreement entered into between the project owners and CTCAC. Each project receives a site visit from CTCAC staff or its agent at least once every three years. During the visit, tenant files and rent rolls are examined to ensure that tenant income levels are within the required limits and rents are being properly restricted. The physical condition of the development and its level of maintenance are also reviewed. The compliance status of a project holds legal and financial significance. If a project is found to be in material noncompliance, CTCAC notifies the IRS, which by law may take action to disallow previously-claimed tax credits.[7]

## PROJECT FINANCE

To value a tax credit project, it is helpful to have a general understanding of how tax credit projects are financed. In general, the financial structure of a tax credit project is

[5] CTCAC regulations are found in Title 4 of the California Code of Regulations. In regard to allocation criteria in particular, see Title 4, sections 10315, 10325, and 10326.

[6] The statutory provisions related to the state tax credit program are Health and Safety Code sections 50199.4 through 50199.22 and Revenue and Taxation Code sections 12205.5, 12206, 17057.5, 17058, 23610.4, and 23610.5.

[7] An interesting aspect of the tax credit program is that the federal agency responsible for the program is the IRS, not the Department of Housing and Urban Development (HUD) or some other federal housing agency. Further, although the state-level administration of the program typically involves a state housing agency, in California the State Treasurer's Office performs this function.

similar to that of all other projects—total project capital is composed of debt and equity portions. The major difference with a tax credit project involves the mechanism through which the tax credits allocated to the project are converted into the project's equity financing.

**Tax credits allocated to project.** The maximum amount of tax credits that may be allocated to a given project is determined by criteria set forth in IRC section 42. Those criteria are total development cost, eligible basis, eligible fraction, qualified basis, and tax credit rate, each of which is briefly explained below.[8]

- The total development cost of a tax credit project includes all of the components of full economic cost—all hard and soft costs—included in the cost approach. The entrepreneurial profit component is recognized through an allowed developer fee. CTCAC is responsible for reviewing the "reasonableness" of a proposed project's total development costs.
- Eligible basis is total development cost less the cost of land and certain soft costs. Only costs of depreciating assets may be included in eligible basis. Eligible basis is the portion of a project's total development cost that may be considered when determining the maximum amount of the tax credits available to a project.
- Eligible fraction is the percentage of low-income units in a project. As noted above, for California projects, the eligible fraction is typically 100 percent—that is, typically, all project units are dedicated to low-income occupancy.
- Qualified basis is the eligible basis multiplied by the eligible fraction. In California, a project's qualified basis is usually the same as its eligible basis.[9]

IRC section 42 establishes two tax credit rates. For projects that are not financed with a federal subsidy, the tax credit rate is approximately 9 percent. For projects involving a federal subsidy and for projects where tax exempt bonds provide at least 50 percent of total project capital, the rate is approximately 4 percent. The tax credit rate is multiplied by the qualified basis to determine the maximum annual 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).

Since the amount of tax credits allocated to a project ultimately determines the amount of equity funds that can be raised, a significantly greater proportion of the equity to finance a project's total development cost can be raised at the 9 percent tax credit rate than at the

[8] See IRC section 42 for precise definitions of these concepts.
[9] Projects in areas that are federally designated as high cost or difficult to develop may qualify for a 30 percent increase in qualified basis, thus allowing a potentially higher level of tax credit financing.

4 percent rate. For example, if a project's qualified basis were $1,000,000, at the 9 percent tax rate, 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), and at the 4 percent rate, it would receive $40,000 in tax credits for each year ($1,000,000 x 0.04).[10]

**From tax credits to equity financing.** The tax credits allocated to a project form the basis for the project's equity financing ("tax credit equity"). Typically, a public or private real estate syndication is the mechanism for converting tax credits allocated to a project into cash proceeds which, along with the proceeds of debt financing, are used to development the project.

A limited partnership is formed, with the developer of the project as general partner. Equity in the tax credit project is sold to investors in the form of limited partnership interests. The buyers of the tax credits become limited partners and equityholders in the tax credit project, which entitles them to claim the future tax credits. Generally, the general partner of the limited partnership retains only a de minimis equity interest.[11]

The required rate of return of the limited partner investors determines the price they will pay for the limited partnership interests (and the right to claim the future tax credits). The higher the required rate of return the lower the cash proceeds from the sale of the limited partnership interests, and vice versa. The economic return provided to the limited partners-investors is derived primarily from the right to claim the future tax credits, not from the expected future operation of the project. Currently, the 9-percent credits yield net cash proceeds equal to about 60 percent of a project's qualified basis, and the 4 percent credits equal to about 30 percent of qualified basis.[12]

**Debt financing.** The equity financing provided by tax credits may be combined with several types of debt financing, subsidized or unsubsidized, to reach total project capitalization (i.e., to completely finance the project's total development cost). Debt

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[10] Actually, the two tax credit rates vary slightly over time, because they are linked to changes in the federal borrowing rate; the exact rates are announced monthly by the IRS. Currently (March 2005), the "9 percent rate" is 7.97 percent and the "4-percent rate" is 3.42 percent.

[11] Thus, although it is commonly stated that the developer of a tax credit project raises equity funds by "selling the tax credits," this is not exactly what happens. What in fact are sold are limited partnership-equity interests in the project that include rights to certain tax credits, not the tax credits per se. Under IRC section 42, low income housing tax credits may only be claimed by owners of qualifying low-income housing; that is, the tax credits cannot be claimed unless the taxpayer also holds a concomitant equity interest in a low-income housing project.

[12] The tax credit price is a concept that summarizes the required return of investors and provides a quick way to estimate the net cash proceeds. The tax credit price is the present value of $1 in tax credits over the 10-year credit period, divided by $10 (the total credits over 10 years). For example, assume that the tax credit price is $.75. This means that investors will pay $7.50 for $1 in annual tax credits over the next 10 years. The implicit rate of return at this tax credit price is about 5.6 percent.

financing for a project usually involves one or more of the following types of debt (but is certainly not limited to these types):

- 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 imposed by the federal government. A significant portion of California's annual issuance of private- activity bonds is used to fund housing. The tax-exempt bonds carry below-market interest rates because bond interest is exempt from income taxes.[13]
- Other sources of government money. This includes 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. A community development block grant (CDBG) is another type of federal block grant program but is not limited to housing.
- Private, below-market debt.

**Typical financial structures.** Most developers of tax credit projects seek 100 percent project financing (i.e., total development cost), with tax credits providing all of the project equity and the balance of total development cost financed by debt. Although there are many possibilities, most tax credit projects, at least in a general way, follow one of these two patterns:

1. The 9 percent federal credits are combined with a private, market-rate mortgage, and perhaps a small amount of state credits. The tax credits provide all of the equity financing and constitute perhaps 50 percent of total development cost.
2. The 4 percent federal credits are combined with state tax-exempt bonds. The smaller amount of equity financing supplied by 4 percent credits is counterbalanced by a larger proportion of debt financing provided by the bond financing. State tax credits may also be involved.

**Feasibility.** CTCAC is required to analyze the feasibility of all proposed tax credit developments. Given the preceding discussion, it is possible to provide a (very brief) synopsis of CTCAC's underwriting criteria for a tax credit project.

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

In the application for tax credits, the developer provides CTCAC with estimates of total development cost, expected income and expenses, and the amount and terms of proposed debt financing, rendered in a format and subject to assumptions prescribed by CTCAC. The developer also states the amount of tax credits requested.

The underwriting analysis is designed to ensure, on the one hand, that a project's expected gross income (reflecting rent restrictions) is sufficient to cover all expected operating expenses (including prescribed reserve accounts relating to repair and maintenance) and debt service (at a prescribed debt coverage ratio of 1.15:1), while also ensuring, on the other hand, that only the minimum amount of tax credits necessary for financial feasibility are allocated.

In brief, if the gross income is insufficient to cover operating costs and debt service, the project, as structured, is not feasible, and, if possible, more tax credits are allotted and the amount of debt reduced (reducing debt service). If the gross income is more than sufficient, the amount of requested tax credits is in excess, and fewer tax credits are allotted and the amount of debt increased (i.e., the amount of tax credit equity is decreased ).[14]

## VALUATION

The valuation method outlined below provides an estimate of the current market value of a tax credit project given the enforceable restrictions to which the project is subject. The primary restrictions that apply are (1) the provisions contained in the regulatory agreement between the developer and CTCAC (which follow IRC section 42 and applicable IRS and CTCAC regulations) and (2) newly-enacted Revenue and Taxation Code section 402.95.

### INCOME APPROACH PREFERRED

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.

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[14] Section 10327 of CTCAC regulations (Title 4, California Code of Regulations) addresses project feasibility.

[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)).

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. Since the valuation of a tax credit project requires the discounting of multiple years of income over the project's restricted period, including the discounting of the project's reversionary value at the end of the restricted period, the valuation of a tax credit project requires the use of yield capitalization.[16]

Applying yield capitalization, or discounted cash flow analysis, to a tax credit project requires estimating values for the following variables: (1) the annual income to be discounted; (2) the remaining restricted period; (3) the reversionary value of the project at the end of the restricted period; (4) the discount, or yield, rate applied to the annual income; and (5) the discount rate applied to the estimated reversionary value. The indicated value of the project is the sum of the present value of the annual income to be capitalized and the present value of the reversion.

## VALUATION PARAMETERS

**Annual income to be capitalized.** Newly enacted section 402.95 provides that assessors must exclude from income any benefit from federal and state low-income housing tax credits. In other words, any economic return derived from the tax credits must be excluded from a project's gross return. The income to be capitalized must derive solely from the operating project.

In accordance with Property Tax Rule 8(c), the income to be capitalized is the net return, which, with a tax credit project, is the restricted maximum gross rent plus any additional property-derived income (e.g., net income from vending machines) less vacancy and collection loss less allowed operating expenses (including prescribed reserves for project repair and maintenance).

As discussed above, the maximum gross rent for a tax credit unit cannot exceed 30 percent of the income limit for a household of the size expected to occupy the unit. Income limits are based on the area median income for households of designated sizes.[17] For most tax credit projects in California, the applicable income limit is 60 percent of

[16] See Assessors' Handbook Section 502, *Advanced Appraisal*, Chapter 4, or a recognized appraisal text, for additional discussion about yield capitalization.

[17] Area median incomes by household size are determined annually for each county by the U. S. Department of Housing and Urban Development (HUD).

area median income, with the maximum gross rent being 30 percent of 60 percent of the area median income for the relevant household size.[18]

Maximum gross rent includes the cost of certain utilities, and if these utility costs are paid by the tenant, the maximum rent that may be charged is reduced by a specified amount (e.g., if the maximum gross rent were $600/month, and the specified amount for tenant-paid utilities were $50/month, the maximum rent that could be charged would be $550/month). When evaluating income and expenses, the specified amount for tenant-paid utilities should be excluded from the maximum gross rent and from allowed expenses.

The annual restricted net income of a tax credit project should be expected to grow very slowly over the restricted period (in its project evaluations, CTCAC budgets an annual 2.5 percent increase in maximum rents and an annual 3.5 percent increase in operating expenses). Since project income is restricted, only the expected growth in restricted net income can be considered. Expected income growth for nonrestricted projects cannot be applied to the subject restricted property.

In most cases, the appraiser should be able to obtain the restricted rent roll from the project's general partner. In addition, CTCAC publishes the annual maximum gross rents by household size for each county. This information is available at CTCAC's web site.

**Remaining period of restriction.** On each valuation date, the appraiser must determine how long the project will remain subject to the regulatory agreement—that is, the remaining period the project will be restricted. Initial federal legislation established a restricted period for tax credit projects of 15 years; this was called the compliance period. In 1990, the restricted period was extended for a minimum of 15 additional years, called the extended use period, establishing a federal minimum restricted period of 30 years. The states, however, are allowed to lengthen the extended use period, and hence the restricted period. 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).

In the earlier years of the tax credit program, California awarded additional points in its tax credit allocation process for longer restricted periods, with the maximum number of

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[18]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.
However, for projects allocated credits prior to 1990, the maximum gross rent is determined slightly differently. For these projects, the maximum gross rent for a particular unit cannot exceed 30 percent of the annual income limit for the actual household that occupies the unit—that is, the number of people that actually occupy the unit. In other words, the maximum gross rent is based on actual household size, not imputed household size.

points awarded for a term of 55 years. In 1996, CTCAC'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. Since California's minimum restricted period has not been uniform since program inception, the appraiser should confirm the remaining restricted period as of the valuation date on a project-by-project basis, based upon information from the project's general partner, the recorded regulatory agreement, or CTCAC.

**Reversionary value at end of restricted period.** Presumably, at the end of the restricted period, a tax credit project will no longer be subject to regulation and should be valued as a nonrestricted, market-rate project. The future nonrestricted value can be called the project's reversionary value. As a practical matter, if the reversion is far into the future, its present value will be insignificant and have little effect on the estimated value of the project. A generally accepted approach to estimating the reversionary value is by direct capitalization of the project's estimated net income at the end of the restricted period, with both the overall capitalization rate and the net income reflecting a nonrestricted status.

**Discount rate applied to annual restricted net income.** The band of investment technique should be used to derive the discount rate. Under this technique, the discount (yield) rate is the weighted average of the rates of return on equity and debt components, with the weightings based on the respective proportions of total project capital contributed by each component.

In most tax credit projects, the proceeds from the sale of the limited partnership-tax credit interests constitute the entire equity component. The debt component may comprise a single loan or multiple loans. As discussed above, for projects financed with 4 percent credits, the tax credit equity provides about 30 percent of total development cost, with debt about 70 percent. With the 9 percent credits, the tax credit equity is about 55 percent of total development cost, with debt about 45 percent.

The estimated rates of return for the equity and debt components should be based on the project's restricted status. For subsidized debt, the rate of return should be the actual subsidized rate(s). For market-rate debt the rate of return should be the actual rates for the debt actually in place.[19]

As discussed briefly above, there is a tradeoff between the amount of tax credits allocated to a project and the project's ability cover operating expenses and service debt. The greater the proportion of tax credit financing, the greater the capacity to cover expenses

[19] See also *Maples* v. *Kern County Assessment Appeals Bd.* (2002) 96 Cal.App.4th 1007 and *Bontrager* v. *Siskiyou County Assessment Appeals Bd.* (2002) 97 Cal.App.4th 325.

and service debt, given the restricted income, since the return to tax credit equity is residual to all other costs and need not be paid. CTCAC's underwriting standards require an initial minimum debt service coverage ratio of 1.15, meaning that a project's pro forma net income must be at least 115 percent of debt service. The project pro forma also must demonstrate a small positive cash flow (the actual amount is unspecified) for the project's first 15 years.

The effect of CTCAC'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 an additional return could be provided to equity).

With respect to state credits, however, the law provides an explicit limit to the equity return from project income. Under Revenue and Taxation Code section 12206, equity owners of a tax credit project may receive a return from project income that does not exceed 8 percent of the lesser of either (1) owners' equity (i.e., the amount of capital contributions paid into the project) or (2) 20 percent of the project's adjusted qualified basis as of the close of the first year of the tax credit period. 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.

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.

After calculating the band-of-investment discount rate, a property tax component should be added to the rate, since property taxes will be paid out of the income to be capitalized (i.e., property taxes are not an allowed expense).

**Discount rate applied to reversionary value.** 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 a nonrestricted, market-rate project. The discount rate should correspond to a nonrestricted status and hence should be a market-based rate.

The discount rate for the reversion 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 applied to the restricted income, a property tax component should be added to this rate.

**Capitalization of income procedure.** The procedure for capitalizing income for a tax credit project can be summarized in the following steps:

1. Estimate the annual income to be capitalized based upon the restricted gross rental income allowed under program regulations, less allowed operating expenses.
2. Determine the remaining restricted period as of the valuation date.
3. Discount the annual income to be capitalized (the annual restricted net income) to present value over the remaining restricted period, using a restricted discount rate developed using the band of investment as described above.
4. Estimate the project's future reversionary value, as nonrestricted, as of the end of the restricted period.
5. Discount the reversionary value to present value, using a market, or unrestricted, discount rate developed using the band of investment as described above

The estimated value of the tax credit project is the sum of the present values in 3 and 5 above.

## RELATED ISSUES

**Establishment of base year value.** Consider the following circumstances related to a hypothetical tax credit project:

1. The developer acquires the site (land) for the project at a purchase price of $1,000,000. Based upon this change in ownership, the assessor establishes a new base year value for the site of $1,000,000. This value does not reflect any restrictions attendant to the tax credit program.
2. CTCAC underwrites the project at a total development cost of, say, $5,000,000 (this includes the value of the land). Based upon the tax credit reservation and a commitment for permanent debt financing, the developer obtains a construction loan and commences project construction.

3. Some time later, the project is completed and placed in service. At that time, the market value of the entire project (land and improvements), based upon the method described in this letter, is $3,750,000. This amount represents the current market value of the project as subject to the restrictions of the tax credit program. Note that at this point, the land would also be subject to the restrictions of the regulatory agreement, which is a condition of the tax credit program.

A question that arises: How should the base year value of the newly constructed improvements be determined?

We recommend the following approach. Allocate the current market value of the project subject to program restrictions—hypothetically $3,750,000—between land and improvements based upon the typical land-improvement ratio for nonrestricted but otherwise comparable projects. For example, given a ratio of 1:4 (i.e., land represents 20 percent of total project value), the allocation would be (land) $750,000, and (improvements) $3,000,000. The value allocated to improvements, $3,000,000, should be enrolled as the base year value of the newly constructed improvements.

Notice that the project is immediately in a decline-in-value status. The project's combined base year value (ignore factoring) is $4,000,0000 ($1,000,000 plus $3,000,000), but its current market value is only $3,750,000. The value that should be enrolled on the next lien date is $3,750,000, and the decline status of the property should be reviewed on each subsequent lien date.

**Mixed projects.** Some projects may be mixed—that is, only a portion of the total number of units are rented at amounts that are eligible for the tax credit program, with the remainder at market rate rents. When CTCAC underwrites a mixed project, tax credits are allocated based upon the qualified basis of the restricted units only.

In essence, the valuation of a mixed project should be done on a proportional basis. The portion of the project that comes under the tax credit program should be valued in accordance with the method described in this letter, and the remaining portion should be valued as market-rate units are typically valued.

**More than one set of restrictions.** When tax credits are combined with other sources of subsidized financing (e.g., tax exempt bonds or other sources of government funds), 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 sets of regulations 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.

**Acquisition and rehabilitation projects.** As noted above, tax credits may be allocated not only for construction of new projects but also for the acquisition and rehabilitation of existing projects, either market-rate or subsidized.

Although there are many differences involving specific details, the general framework of an acquisition and rehabilitation project closely resembles that of a newly developed project. As determined by CTCAC's underwriting, some portion of the project's total development cost (i.e., the cost of acquisition and rehabilitation) is financed by tax credit equity and the balance by debt (existing debt may either be refinanced or retained, depending upon the circumstances).

Obviously, an acquisition and rehabilitation project becomes subject to the regulatory provisions of the tax credit program. An aspect worth noting is that acquisition and rehabilitation projects in which the acquired project is already in a subsidy program may present the problem of layered restrictions described immediately above. For example, an acquisition and rehabilitation project might involve a Section 236 subsidized housing project that proposed for conversion to market-rate rental housing.

There is also the question of whether the rehabilitation constitutes new construction under Revenue and Taxation Code section 70 and following sections. If not, rehabilitation costs should be excluded from the project's taxable value. This issue must be resolved on a case-by-case basis.

**Section 8 rental vouchers.** A small percentage of tax credit projects may be eligible for Section 8 rental vouchers, another federal low-income housing program. Rental vouchers pay the difference between the actual rent charged for a given unit and the unit's market rent. In essence, for the units to which rental vouchers apply, market rent is obtained. The appraiser should include any incremental income provided by the rental vouchers in project income.[20]

[20] Rental vouchers may be project- or tenant-based. Project-based vouchers attach to a specific project (they may also be called project subsidies), and tenant-based vouchers move with the tenant.

**Exemption status of tax credit projects.** 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 or a co-general partner is a qualified nonprofit corporation meeting the requirements of section 214.[21]

## SOURCES OF ASSESSMENT INFORMATION

1. The best source for obtaining information about a specific low-income housing tax credit project is the general partner. The general partner, or its designated agent, should be able to provide the following 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.
    - 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. 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 CTCAC 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 CTCAC application file at CTCAC's Sacramento office; a particularly informative document is the CTCAC staff report that is prepared for each project. Application files are not available on the web site.

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[21] See also Assessors' Handbook Section 267, *Welfare, Church, and Religious Exemptions*, pages 68 and following.

3. The IRS web site 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.

4. Many firms, both for-profit and not-for-profit, are involved in the affordable housing industry. In particular, see the following web sites: 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 low-income housing tax credits from an investment perspective.