SUBJECT: Taxation of Low-Income Housing Property - G.S. 105-277.16

In 2008 the General Assembly enacted new G.S. 105-277.16 effective for 2009 pertaining to certain low-income housing. Low-income housing development properties to which the North Carolina Housing Finance Agency has allocated a federal tax credit under section 42 of the Code has been designated a special class of property. This e-mail will hopefully give you some guidance in valuing these properties. We have been asking the counties to be pro-active regarding this issue.

Counties do not have a choice regarding how to value these properties. The statutes are clear that the assessor must use the income approach and must take rent restrictions into account when determining the income of the property. The new legislation also states that the tax credits received are not to be considered in determining the income attributable to the property. We are not aware of any county that has been including the tax credits as part of the income stream.

Our office is of the opinion that the value should be based on the year of the last general reappraisal. Therefore, we suggest that you request copies of the audited financial statements for the three years prior to the last general reappraisal. A county with a 2009 reappraisal should ask for audited financial statements for 2006-2008. Likewise, a county with a 2005 reappraisal would ask for audited financial statements for 2002-2004. Income, expenses, and capitalization rates for the property may have changed since the last reappraisal and it would be inconsistent to consider current inputs when all other income-producing properties are valued based on market conditions existing at the last general reappraisal date.

If the property was not in existence or was in the early stages of lease-up at the last general reappraisal date, you may want to consider using data from other similar completed rent-restricted complexes. Alternatively, you can consider using the first couple of years of fully leased-up data from the subject property. However, you must adjust, if necessary, the numbers back to the general reappraisal date to reflect typical conditions at that time, and you should consider that this procedure is most reliable if you are only a year or two past the general reappraisal date.

<u>Income</u>

G.S. 105-277.16 requires that you consider the rent restrictions. Our office interprets that to mean that you must use the restricted rents. Therefore, you should probably use the actual rents with few exceptions. You can usually use the effective gross income from the income statement in the audited financial statements. Note that if you use the actual effective gross income, then vacancy and collection loss have already been taken into account. It might be advisable to review the actual vacancy and collection loss percentage to determine if it falls within an acceptable percentage range. If the property is in a lease-up stage then you should consider another method of determining stabilized income and expenses as discussed above If the property is not in lease-up and the vacancy rate and collection loss seems out of line, you need to consider if it is justified due to conditions present at the property. As way of illustration but not recommendation, we share that a review of several appraisals of rent-restricted properties indicated the use of rates in the 5% to 7% range generally. Remember that this rate reflects collection loss in addition to vacancy. These properties may have slightly higher occupancy rates overall but may also have slightly higher collection loss. If the effective gross income as reported on the income statement appears reasonable for a stabilized occupancy, you should consider using that number since it takes the rent restrictions into consideration.

Of course, the underlying question is whether you should use vacancy and collection rates derived from market complexes or rent-restricted complexes. The statute does not directly address this point. Vacancy and collection loss will likely not be significantly different between similar types of complexes, whether rent-restricted or not. However, the county is directly instructed to consider the rent-restrictions and since the rent-restrictions may directly affect the vacancy and collection loss, it may be advisable to use the rent-restricted vacancy and collection loss rates.

It is possible for multiple housing assistance programs to exist on the same property. As a result, you may occasionally see rental assistance or rental subsidy as an income line item. That amount should be included in income.

Not all units in a Section 42 complex are required to be rent-restricted, but, in practice most are rent-restricted. Using the actual rents should minimize this issue since you will be using the actual market rents (or close to it) for the market units.

Expenses

Expenses are perhaps the most debatable issue. Should you use typical market expense benchmarks, typical rent-restricted expense benchmarks, or actual rent-restricted expenses? Rent-restricted properties may have higher expenses than a conventional complex due to various factors such as stricter compliance requirements and additional administrative duties. Also if you compare the actual expenses to the rent-restricted effective gross income, the income/expense ratio will already be higher than typical because the income is artificially low as a result of the rent restrictions.

We believe that you should consider using the expenses that are provided in the audited financial statements as long as they are justifiable and typical for similar rent-restricted properties.

As way of illustration but not recommendation, we share that our discussion with several industry experts indicates expenses typically fall in the range of $3,400 to $3,600 per unit for newer properties. That number does include property taxes. However, there may be valid reasons why the per unit expense numbers may vary from the typical range.

As we have been taught over the years, some expenses are not applicable when valuing the property for property tax purposes. Proper expenses to allow include management, salaries, utilities, supplies and materials, repairs and maintenance, insurance, miscellaneous, and reserves for replacement. Reserves for replacement may not show up on the income and expense statement but an estimate for this should be allowed. However, you should also remove any actual expenses for items that are included in the reserves for replacement.. You should look at expenses and try to determine if they seem reasonable for the property, as compared to similar rent-restricted properties, by looking at the amount and/or percentage for each particular line item.

Expenses that should be removed are the typical expenses we normally have been taught to remove such as depreciation, mortgage payments including mortgage interest payment, property taxes, capital improvements, and owner's business expenses. Please note that some items on the income and expenses statement titles may vary in name. If you need clarification regarding expenses or the amount stated, please contact the owner.

Capitalization Rate

Finally we come to the capitalization rate. Since these properties rarely sell, it is difficult to develop a rent-restricted capitalization rate. Also, if a property did sell, the capitalization rate would reflect any consideration that a potential investor would give to the tax credits. The county is directly prohibited from considering the effects of the tax credits on income, and indirectly the capitalization rate. Consider that this statutory change requires you to make some assumptions about the property with no way to obtain market data to support those assumptions. For these reasons, we feel that you should use a typical market capitalization rate derived from other similar unrestricted properties.

Some might suggest that the market capitalization rate should be adjusted to reflect the special characteristics of rent-restricted property. However, without going into detail, arguments for a lower rate are often offset by arguments for a higher rate. From discussions with industry experts and a review of several appraisal reports, it appears that fee appraisers make little or no adjustment to the rent-restricted capitalization rate versus the market capitalization rate. It seems that a market capitalization rate derived from similar market properties will closely approximate the rent-restricted capitalization rate.

Schedule of Values

For 2010 general reappraisals and thereafter, you should add language or a copy of the statute on low-income housing (105-277.16) to your schedule of values. Also, if you have questions regarding the income approach, you can refer to any of your International Association of

Assessing Officers (IAAO) reference manuals as they have more detailed information for your review.

Should you have any questions regarding these properties, feel free to contact any of the real property staff with our department at (919) 733-7711.

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