TO: KANSAS COUNTY APPRAISERS

SUBJECT: SUBSIDIZED HOUSING APPRAISAL GUIDE

For some time now there has been concern about the uniform appraisal treatment of subsidized housing projects by Kansas county appraisers. Colleagues, the Board of Tax Appeals, regulators and property managers have been asking the Division of Property Valuation and the County Appraisers Association to adopt a valuation policy regarding low income housing. The Division concurs that there is a need for a valuation guide that all counties may employ in appraising these unique properties and, accordingly, we have prepared a guide that will achieve this task and that the Division will defend.

Today there are two principle government programs offering incentives for investors to develop subsidized housing. These programs are commonly referred to as Section 42 and Section 515 respectively. These programs are the latest of a long line of public housing programs dating back to the 1930's, through which government inducements encouraged developers to provide housing for the nation's needy. This report will function as a guide in appraising all subsidized housing in Kansas.

Based upon information provided by the federal government, currently in Kansas there are over 400 housing projects financed and subsidized under the Farmers Home Administration (FmHA) & Section 515 Subsidized Housing Program, as well as the projects created by Low Income Housing Tax Credits (Section 42) through the Tax Reform Act of 1986. Some of these subsidized projects are exempt from ad valorem taxation because they are owned and operated by not-for-profit entities.. For a number of reasons, these subsidized properties present a situation requiring a valuation methodology tailored to fit the unusual circumstances under which these projects are constructed and operated, as well as the reasons for their existence.

The market for subsidized housing is different from the market for other investment property because of the inherent restrictions on income return to investors and the inability of the property owners to sell the projects without the expressed approval of the federal government, and then only after certain regulatory requirements have been satisfied. As these government subsidized projects present circumstances not normally found in other commercial property, this guide is intended to provide a valuation methodology which should be utilized so that these housing projects are valued uniformly across the state of Kansas.

The following analysis and directive are applicable throughout the state of Kansas. This guide should assist you in your duties and responsibilities related to the ongoing statewide appraisal process.

FmHA SECTION 515 PROGRAM

The FmHA Section 515 Program is designed to provide affordable housing to relatively low to moderate income families and seniors in rural areas with population centers under 20,000 inhabitants. In Kansas, the program is administered through the Rural Economic and Community Development (RECD) of the United States Department of Agriculture, located in Topeka, as well as four RECD district offices located throughout the state.

Financing and Subsidy Features

Housing projects (such as those funded by the FmHA program) are as stated, located in small or rural communities and these projects would/could not exist but for the presence of the federal subsidy. Thus, by its very definition, the fact that subsidized housing exists, establishes that in the market in which the subsidized housing projects are located, there is a shortage of similar multi-family residential housing facilities.

Through the 515 Program, RECD provides specialized financing for the construction and redevelopment of these apartment complexes. As indicated, these projects are generally constructed in small or rural communities which have a limited supply of housing for low-income families or senior citizens.

The financing is provided to these projects in the form of an interest credit subsidy which effectively reduces the finance charge to the owner related to the note and mortgage; in return, the owner agrees to restrict occupancy to qualified families at rental rates which are set and approved by the RECD. In short, the availability of financing for the construction or redevelopment of apartment projects in rural areas is dependent upon and specifically relates to the social goal or commitment of the federal government through the RECD.

These apartment projects would not have been built without FmHA interest credit subsidy. The financing is in the form of non-recourse loans where the FmHA, as the mortgagee, can look only to the assets of the project to satisfy the debt.

Profit Features

One of the features of FmHA 515 housing projects is the RECD restriction which limits the maximum annual profit to an eight percent (8%) return on the five percent (5%) equity investment. This amount of equity results in modest cash flow to the owners of these projects.

It is also noteworthy that the limited amount of profit is often times never achieved by the Projects. Section 515 housing projects differ from other commercial properties in that they have rental income pre-established at levels projected to provide the limited profit (8% return on 5% equity position) after other budgetary items are met. If actual expenses and allocated vacancies exceed budget projections, the limited profit is never realized by the project owners.

Duration of Subsidy

The preponderance of 515 housing projects in Kansas were financed with loans containing amortization schedules exceeding 20 years in duration. Many projects are subject to a 50 year amortization schedule. When the loan is originated under the 515 housing program, the borrower contractually agrees to use such property for low income housing purposes for a period of at least 20 years and, if built after 1987, for the entire 50 year amortization period. The project must remain in this 515 program throughout this 20 or 50 year period and the outstanding mortgage amount cannot be retired during this period unless the federal government determines by legislation that there is no longer a need for subsidized housing in the area which the project services. Allowed sales or transfers are only those involving assumptions of the existing note, mortgage and operation limitations regulated by the RECD.

Historic Income Tax Benefits

As a result of these limitations and restrictions on 515 housing projects, the primary benefit of ownership has been in the form of income deferral. Most of the 515 projects were constructed before 1986. As such, these low income housing projects were entitled to be depreciated over a 15 year period on a 200% declining balance basis. The accelerated depreciation schedule provided increased tax benefits when considering that construction costs for these 515 housing projects were relatively high due to the quality materials involved, the required equity investment (5%) was low and the highest marginal tax bracket was fifty percent (50%).

However, when the Tax Reform Act of 1986 was passed by congress, the above described depreciation benefits for new 515 housing projects were eliminated because all new projects were required to utilize a straight line depreciation methodology over a period of 27 and ½ years. This new depreciation methodology, when combined with a lowering of the maximum income tax bracket to 28% and regulatory limitations on utilization of passive losses, resulted in a dramatic change in the income tax benefits associated with owning low income housing projects such as those regulated under Section 515 of the FmHA program. Thus, the primary incentive for the purchase of equity positions in these housing projects was totally eradicated effective December 31, 1986.

LOW INCOME HOUSING TAX CREDIT (SECTION 42)

As mentioned, subsidized housing projects are not constructed for traditional market reasons. Most subsidized housing projects were constructed (or were in feasibility stages) prior to the Tax Reform Act of 1986 with passive losses generated by allowing double declining depreciation. Subsequent to the Tax Reform Act of 1986, these benefits are no longer accruing to the most recent project owners. To off-set the above described changes in depreciation procedures, in an attempt to preserve the incentive for investing in low income housing projects, the Tax Reform Act of 1986 provided for a procedure for those investing in subsidized housing to receive tax credits. These credits are commonly referred to as Section 42 tax credits as they are established by Section 42 of the Internal Revenue Service (IRS) Code known as the Low-Income Housing Tax Credit (LIHTC) Program. For federal housing programs, the dominant force is no longer HUD or FmHA, but the IRS. The principal benefit of developing or investing in a LIHTC property is "tax credits", a direct deduction from the federal income tax obligation of the investor.

The subsidy to build the project is an indirect transfer of federal funds, that is, uncollected federal taxes, which are used by housing sponsors to write down the cost of the development. Tax credits of approximately four percent (4%) per year for ten (10) years were granted for investment in existing low income housing projects while a credit of approximately nine percent (9%) per year was provided for ten (10) years for new construction and the cost to rehabilitate existing projects. Credits tend to be sold either in private placements to large corporations or through public syndications. Rarely are the credits of direct use to the property developer. Through the syndication process, tax credit investors participate in property ownership as 99% limited partners. Normally the property developer or an affiliate retains 1% partnership interest as the managing general partner. The Kansas Department of Commerce and Housing (KDOC&H) is the designated administrator of the LIHTC for the State of Kansas. It is the responsibility of KDOC&H to allocate tax credits in conformance with regulations set forth in Section 42 of the Internal Revenue Code, in accordance with the allocation plan approved by the Governor.

For purposes of this guide, intangibles, such as Section 42 tax credits offered by the Internal Revenue Service will not meet the definition of property as stated by K.S.A. 79-501. As a rule, low income housing involves more than a normal real estate transaction. Particular inducements are offered to influence an investor to invest in a project the market would probably not support. These benefits are related to the real estate as neither would probably exist without it, but they are distinguishable from it. These are the components of intangible value that come into play in a low-income housing project. *USPAP*, Advisory Opinion AO-14, which is directly applicable to subsidized housing, recognizes that in valuing low income housing, there are likely to be various values that should be considered. Markets for these indirect financial incentives operate correspondingly to the real estate market for subsidized housing, and although there are authorities who value these benefits, they determine that they expedite the development of real estate but are different than the real estate and ordinarily not assessable. The County Appraisers Association assembled a committee to review the valuation of subsidized housing. Committee members while not wholly in consensus, gave their assessment on appraising low income housing. There are members that are convinced that these credits are part of the property and should be valued and assessed with the real estate. The Division respects their opinion and understands that other professionals are in agreement. Still, there is not any learned consensus as to the treatment of tax credits as related to ad valorem value and legal counsel affirms that Kansas statutes will not accommodate their assessment.

VALUATION METHODOLOGY/SUBSIDIZED HOUSING

This methodology is provided to assist the county appraiser in estimating the market value of subsidized housing projects in Kansas. Preparing an appraisal of a subsidized housing project does not differ significantly from the preparation of a conventional appraisal as long as the unique characteristics of the subsidized project are not overlooked and the appraisal accordingly meets the level of competency required by USPAP. The accompanying procedures will avail in appraising subsidized housing.

Market Comparison Approach

There are virtually no open market sales of subsidized housing projects, due to their particular nature as discussed previously. These projects are highly leveraged and subject to particular tax shelter provisions. There have been sales of partnerships or part interests in the partnership that own these projects, however there are few, if any, sales consisting of open market transactions wherein the actual real estate was sold. When the real estate transfers ownership, it is with an assumption of debt (non-recourse financing) with little, or no equity compensation. For this reason, the sales comparison approach was considered and disregarded.

Income Approach

The income approach is very often relied upon in valuing conventional apartments. This is because investors are motivated by the investment potential of the real estate. KSCAMA accommodates an income approach for appraisers with sufficient data to appraise commercial properties. Appraisers with ample income and expense data to appraise the fair market value utilizing the local market derived capitalization rates should, of course, take advantage of this data and value these properties in fee simple. In doing this one must ignore rent subsidies, book interest rates, and tax benefits that are particular to this type of property. The value sought is the value in exchange for cash.
Unfortunately, income information is scarce in many locales throughout the state. Ideally, the appraiser would be able to obtain rental rates in the individual market locations of competing housing and apply these rental rates to the subsidized housing projects. Because many communities have no competing apartment projects for income data, other than single family residences, income/expense data is difficult to obtain. However, if the appraiser is able to utilize single family data in utilizing the income approach, one must be as diligent in collecting the data as in other commercial property projects.

Cost Approach

The cost approach can be devised in a manner comparable to any real estate appraisal assignment in which improvements are located on the property. However, when estimating the depreciation of these properties, the most important item of consideration is external depreciation. It is evident these projects suffer from an inordinate amount of external depreciation in comparison to other apartment projects. This consequence is reflective of the marketplace not having the purchasing power to pay rents that will support the construction cost of the subsidized housing project. It is evident that rental rates in many communities will not support today's construction cost. The Division of Property Valuation has included a short monograph to assist the appraiser in establishing the market value for subsidized housing through the cost approach. This proposal is a hybrid of the cost approach and income approach, which estimates only the external depreciation detected in the property. External or economic obsolescence is the impairment in the desirability arising from factors outside of the property. Inasmuch as many local markets lack the purchasing power to pay rents that justify construction, this approach measures this loss to actual investor requirements. The appraiser measures any external obsolescence, then determines if any other forms of depreciation are apparent and if so, makes the adjustment. This procedure does not require the appraiser to consider income tax circumstances of the investor to appraise the property.

In order to utilize the enclosed model, most of the information needed will be in the appraiser's office. The prerequisites the appraiser will need to provide are:*

1. Building size in square feet.
2. Actual income received from project.
   a. Form 1930-7-Section 515
   b. Request from project manager-Section 42
3. Actual expenses required of the project
   a. Form 1930-7-Section 515
   b. Request from project manager-Section 42
4. Reproduction Cost New less Physical & Functional Depreciation.
5. Land Value.
6. Band of Investment utilizing Mortgage/Equity Capitalization Rate Study.

*See Instructions

A sample worksheet with instructions for each line item corresponding to the analysis of external depreciation present that may be present in subsidized housing projects is attached. (This worksheet is formula driven and is enclosed on the floppy disc.) This worksheet incorporates the above described process and should be utilized by the appraiser in valuing subsidized housing projects. The appraiser should supply the data necessary as stated in the instructions with county and taxpayer figures.

This guide has analyzed and considered what effect utilization of the referenced cost approach model will have on the legal requirement that property be assessed uniformly and equally across the state.