

Draft for Commission Review and Comment

# Valuing Low-Income Housing Tax Credit Properties in Tennessee

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## Valuing Low-Income Housing Tax Credit Properties in Tennessee

The Low-Income Housing Tax Credit (LIHTC) is the largest federal program for providing affordable housing for low-income Americans. From 1987 through 2012, the program helped fund the construction or rehabilitation of more than 900 private low-income housing projects and more than 53,000 housing units in Tennessee. While there is broad support for the program at the local, state, and national levels, there is wide disagreement about the most appropriate approach to valuing these properties for property tax purposes, particularly whether to include the value of the federal tax credits that help fund them.

The LIHTC program promotes investment in low-income housing by allocating federal tax credits through state housing development agencies to developers in return for restrictions on rent and tenant income. Approximately \$15 million in credits was allocated to Tennessee for 2014. The distribution of these credits by the Tennessee Housing Development Agency (THDA) represents only the first year's flow of a ten-year subsidy. As a result, the initial \$15 million in credits allocated to Tennessee in 2014 will ultimately yield \$150 million in tax credits. This means that an initial allocation of \$600,000 in credits for an individual low-income housing property will result in a total of \$6 million in credits taken over ten years. In effect, this is a loan that the federal government repays.

The developers use the tax credits to raise equity to fund construction or rehabilitation by forming partnerships with investors. The investors provide equity in exchange for majority ownership of the property and access to the tax credits. The credits are the primary source of income that investors receive from these projects. They use these credits to pay their federal income taxes. The equity that investors provide in exchange for the credits funds the majority of construction costs. The developer borrows the remaining funds needed, often from commercial banks, which may also invest in the partnerships in order to receive the tax credits, and sometimes from the state or local housing authorities.

Just as with all new commercial buildings, property assessors consider all money spent to build these properties in their initial assessment of their value for property tax purposes. Until the building is occupied, assessors usually use the cost approach. The sales approach to valuing properties cannot be used because these properties are so rarely sold. For properties like LIHTC properties that are rarely sold, the initial value is set based on a cost approach, which includes

- the value of the property if vacant plus
- the current cost of building the structures minus
- the amount of accrued depreciation of the subject property.

Once a commercial property is occupied, local assessors typically apply an income approach to valuing the property on the premise that the income it generates is the key factor in determining the price a buyer would be willing to pay for it. In the case of LIHTC properties, the owners often insist on this approach after receiving a bill based on the cost approach. They argue that the restricted rents on this property should be the sole basis for determining its value for property tax purposes. But, according to an article in the fall 2010 issue of *The Appraisal Journal*, "The market value of the real estate must be based on all of the benefits and liabilities that flow directly from the ownership of the real estate." The main benefit to the limited partner, the majority owner of the low-income housing property, is the tax credits, which, as noted in the article,

are as much a part of the real property as the rent that is paid by the tenants. If the assignment is to appraise the real estate, then a failure to consider the tax credits could constitute a substantial error of omission unless the assignment conditions prominently and clearly exclude the value of that part of the real property from the appraisal.

Following this line of logic, current law in Tennessee requires consideration of

- 1) Location;
- 2) Current use;
- 3) Whether income bearing or non-income bearing;
- 4) Zoning restrictions on use;
- 5) Legal restrictions on use;
- 6) Availability of water, electricity, gas, sewers, street lighting, and other municipal services;
- 7) Inundated wetlands;
- 8) Natural productivity of the soil, except that the value of growing crops shall not be added to the value of the land. As used in this subdivision (b)(8), "crops" includes trees; and
- 9) All other factors and evidence of value generally recognized by appraisers as bearing on the sound, intrinsic and immediate economic value at the time of assessment.<sup>1</sup>

Interpreting this law and the constitutional requirement of uniformity in assessment and tax rates, Tennessee courts recognize the credits as an indicator of property value that is properly included when assessing the value of LIHTC properties (*Spring Hill, L.P., et al. v. Tennessee State Board of Equalization, et al.* (2003)).

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<sup>1</sup> Tennessee Code Annotated, Section 67-5-602(b).

This policy as applied in Tennessee, however, may create a challenge for property owners, especially those that did not anticipate consideration of the tax credits in valuing the property for tax purposes. The current income approach to valuing LIHTC properties in Tennessee adds the present value (the future amount adjusted to what it is worth today, generally less) of all future credits to the assessment valuation produced by the standard income approach based on restricted rents in order to ensure that “all of the benefits and liabilities that flow directly from the ownership of the real estate” are included in its assessed value. The result is an assessment that starts high and drops each year until the tax credits run out, creating a potential cash flow problem for the taxpayer. An option already available to local governments in Tennessee is to enter into agreements with LIHTC partnerships in which the government owns the property and leases it back to the partnerships in exchange for payments in lieu of taxes.

Legislation was introduced in 2001, 2005, and again in 2014 in response to this concern. The bills introduced in the 108<sup>th</sup> General Assembly by Senator Steve Southerland (Senate Bill 1671) and Representative Jeremy Faison (House Bill 1390) would have prohibited assessors from including the tax credits when valuing LIHTC properties and were sent to the Commission by the Senate Finance, Ways, and Means Committee and the House Finance, Ways, and Means Subcommittee. The Commission heard from interested parties at its September 2014 meeting. Developers, investors, and officials from state and local housing agencies argued that this assessment method makes projects less viable in Tennessee than in other states and will shift construction and rehabilitation of low-income housing out of state. But the demand for tax credits generally exceeds supply in every state—less than 1% of tax credits went unused nationwide in 2013—which suggests that investors and developers are unlikely to abandon Tennessee. Property assessor representatives and local officials appearing before the Commission argued that fairness and equity in assessment require consideration of the tax credits.

Alternatives suggested by a review of other states include outright exclusion of any consideration of the tax credits and spreading the effect of tax credits over the life of the rental income restriction. Three states exclude taxation of these properties altogether.

Although most courts in other states where this issue has been litigated agree with the courts in Tennessee, 24 state legislatures, including five in states whose courts agree with Tennessee’s, have chosen to explicitly exclude the tax credits from the valuation process. The legislature in Idaho, a state whose courts also agree with Tennessee’s, has established a special formula for including the tax credits in the assessed value of LIHTC properties, one that helps mitigate the cash flow problem created by including the tax credits directly in the assessed value.

Because there are almost no unused tax credit allocations in other states, it is unlikely that private investment in low-income housing in Tennessee could be shifted to other

states regardless of how or whether it is taxed, but the assessment method currently used could affect the pattern of investment within the state, shifting it from rural areas where the return is already marginal to suburban or urban areas. Idaho spreads the total amount of credits—not their present value—evenly over the life of the restricted rent agreement and adds the result to the income method. This leads to relatively uniform tax payments from year to year but adds very little to the tax bill. An alternative that retains the full value of the tax credits but evens out the annual tax bill to eliminate the cash-flow problem would be to spread their present value evenly over the restricted rent period. This does not change the total amount paid in comparison to the current Tennessee valuation method, but it smooths it out and reduces the annual amount by spreading it over a longer period.

## Promoting Private Investment in Low-Income Housing

Congress created the Low-Income Housing Tax Credit (LIHTC) program as part of the Tax Reform Act of 1986 to encourage private investment in low-income housing.<sup>2</sup> Policymakers have recognized the shortage of safe, affordable housing for working-class Americans since at least the 1930s. The federal government developed the LIHTC program in response to both the perceived failures of public housing projects built in the 1950s and 1960s and cuts to other programs, like Section 8 subsidies, which had been unable to meet the nation's low-income housing needs on their own.<sup>34</sup> The tax credit was established as a public-private partnership to increase the supply of housing for the working poor.<sup>5</sup>

Over the last three decades, the LIHTC program has been a success. It has resulted in almost \$100 billion in private investment in low-income housing nationwide and led to more than 2.4 million rental units being placed in service from 1987 through 2012.<sup>6</sup> During the same period in Tennessee, the \$2.2 billion in tax credits that the program distributed to developers and investors has facilitated the construction of 53,185 new or rehabilitated rental units across 907 properties.<sup>7</sup> Unlike public housing, the LIHTC program has been “virtually scandal free” and has “a default record that any private credit guarantor would die for.”<sup>8</sup> The Low-Income Housing Tax Credit is the largest and

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<sup>2</sup> Title XIV, Part D of TRA 86.

<sup>3</sup> Zigas 2013.

<sup>4</sup> Jolin 2000.

<sup>5</sup> Other major elements of tax reform resulting from TRA 1986 included raising corporate tax rates, providing various tax incentives to for home-ownership, and broadening the alternative minimum tax (AMT).

<sup>6</sup> <http://www.huduser.org/portal/datasets/lihtc.html>; and Cadik 2014.

<sup>7</sup> HUD data available at [lihtc.huduser.org](http://lihtc.huduser.org).

<sup>8</sup> Zigas 2013.

fastest growing federal program for providing affordable housing, and it remains politically popular almost three decades after its inception.<sup>9</sup>

### **State Housing Agencies Allocate Tax Credits to Developers**

The LIHTC program encourages private investment in low-income housing by distributing federal tax credits through state housing agencies to developers. Each year, the Internal Revenue Service allocates credits to states in proportion to their population.<sup>10</sup> These allocations are only the first year of a ten year flow of tax credits. The \$14,940,749 in credits that was allocated to Tennessee in 2014 actually represents a total flow of almost \$150 million in credits to be taken over ten years. This means that the owners of an individual project that receives an allocation of \$600,000 in credits for 2014 will be able to claim \$600,000 in credits against their federal income taxes each year for the next ten years—a total of \$6 million in credits. In effect, the tax credits are a loan that the federal government repays over ten years in exchange for up-front investment in low-income housing.

Since 1987, the demand for credits in each state has exceeded supply in almost every year. In 2013, less than 1% of tax credits—only \$2.6 million out of a total of \$743 million in credits—went unused nationwide. Because each state's supply of credits is capped, the Internal Revenue Service requires state housing agencies to allocate them through a competitive process.

To be eligible to receive tax credits, developers must agree to restrictions both on the income of tenants and on per unit rent. The program requires that either (a) a minimum of 20% of units be rented to households with incomes no greater than 50% of the local median or (b) a minimum of 40% of units be rented to households with incomes no greater than 60% of the local median.<sup>11</sup> The maximum rent charged for a unit can be no greater than 30% of the maximum household income eligible to rent it. Although property owners can raise rents on LIHTC units for any legal reason without prior approval from state housing agencies, they cannot exceed this 30% threshold.<sup>12</sup> In most LIHTC projects nationwide and in Tennessee, 100% of units are rent- and income-restricted both to increase the project's likelihood of being allocated credits and because the amount of credits allocated is based on the number of rent- and income-

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<sup>9</sup> Desai, Dharmapala, and Singhal 2009; Jolin 2000; and Cadik 2014.

<sup>10</sup> The amount distributed to each state in 2014 is the product of \$2.30 multiplied by the state's population; see page 11 of US Department of the Treasury, Internal Revenue Service <http://www.irs.gov/pub/irs-drop/rp-13-35.pdf>.

<sup>11</sup> 26 U.S. Code 42 (g) (1).

<sup>12</sup> 26 U.S. Code 42 (g) (2) (A).



restricted housing units in a project.<sup>13</sup> These restrictions reduce the rental income that property owners can receive from LIHTC projects.<sup>14</sup>

The rent and tenant income restrictions run for a minimum of 15 years, but many developers agree to extend them to 30 or even 40 years to make their projects more competitive in the application process.<sup>15</sup> In Tennessee, most successful applications for tax credits include rent and tenant income restrictions that last for 30 years.<sup>16</sup> If property owners fail to maintain these restrictions—either as a result of negligence or foreclosure—the Internal Revenue Service can cancel any remaining credits and reclaim credits already taken.<sup>17</sup> This is a very real risk for owners of LIHTC projects.

### **Developers Convert Tax Credits Into Equity for Construction**

Developers use the tax credits to raise equity for construction or rehabilitation by forming limited partnerships with investors. While some developers may have tax liabilities large enough to use the credits themselves, neither the credits nor the meager net operating income from managing the rent-restricted property would provide a sufficient payback for their front-end investment in the project.<sup>18</sup> The equity that developers get from investors pays for a significant portion of construction or rehabilitation. The amount of tax credits that projects receive is directly related to estimated development costs excluding land acquisition. Allocations for new construction typically subsidize 70% of total development costs while those for rehabilitation subsidize 30%.<sup>19</sup>

Developers must borrow the remaining money needed for construction or rehabilitation either from banks, which can also be investors in the project, or from state or local housing agencies. Because rent-restrictions on these properties prevent their owners from servicing large debts using operating income, LIHTC projects would not be built were it not for the funds raised from outside investors.

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<sup>13</sup> See examples at Danter Company <http://www.danter.com/taxcredit/rents.htm>.

<sup>14</sup> Other state or federal rent subsidies that tenants might receive do not count against these caps. For example, LIHTC properties can accept Section 8 subsidies above these caps as long as actual rent paid by the tenant is less than the maximum allowed under the restricted rent agreement.

<sup>15</sup> 26 U.S. Code 42 (h) (6) (D).

<sup>16</sup> Email from David Pair, Tennessee Housing Development Agency, November 13, 2014.

<sup>17</sup> 26 U.S. Code 42 (j).

<sup>18</sup> Developers' income from LIHTC properties comes primarily in the form of a development fee which is no greater than 15% of the equity raised from investors for the project.

<sup>19</sup> Keightley 2013.

## **Tax Credits are Investors' Primary Income from LIHTC Properties**

Investors provide equity in exchange for majority ownership of the property and access to tax credits. Investors contribute capital to these projects for the same reasons they invest in any investment vehicle: to make a return commensurate with their financial needs, time-frame, risk aversion, and alternate competitive investments. The prices that investors pay nationwide for access to the credits vary widely by project and location, ranging from highs of over \$1.00 major metropolitan areas to lows of \$0.62 in rural communities.<sup>20</sup> The current national average is \$0.92.<sup>21</sup> As the major source of equity for these properties, investors receive nearly all of the tax credits, and as majority owner in the partnership, they typically have the authority to force the buyout of developers if projects are mismanaged.

Investors' primary source of income from LIHTC properties are the tax credits, which they use to pay their federal income taxes. Any potential investor in a LIHTC project would consider the present value of all remaining tax credits—a value used in finance to show what a future amount is worth today, accounting for expected return on investment and the fact that the credits are paid out over ten years instead of a lump sum—when determining what to pay for the property. Although they do claim depreciation on these projects, they typically do not receive a share of operating income, which is rent-restricted and small relative to comparable market-rent properties. The credits, therefore, are the best indicator of these projects' value to investors. Without them, investors would be unwilling to risk capital on properties where long-term rent restrictions reduce income potential, viability, and resale value.

## **Valuing Tax Credits for Property Tax Purposes**

There are three general approaches to valuing any property for tax purposes: the sales approach, the cost approach, and the income approach. All try to get at the best approximation of a property's value, but only the cost and income approaches are appropriate for LIHTC projects. The sales approach, in which value is determined based on sales data from comparable properties, cannot be used effectively when valuing LIHTC properties because they are rarely sold.

As with any other commercial rental property, assessors most commonly use the cost approach to value an LIHTC property before it is occupied, considering all money spent to build it in the initial assessment of its value for property tax purposes. This approach includes

- the value of the property if vacant plus

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<sup>20</sup> CohnReznick, "Housing Credit Property Performance: A Fresh Look," draft 2014, 34

<sup>21</sup> CohnReznick, "Housing Credit Property Performance: A Fresh Look," draft 2014, 34.

- the current cost of building the structures minus
- the amount of accrued depreciation of the subject property.

Although it provides an approximation of the replacement costs of a property, the cost approach does not incorporate the most important factor to potential investors: income.<sup>22</sup>

As a result, an income approach is typically used to value a commercial rental property once it is occupied. In the case of LIHTC properties, owners often insist on this approach because they argue that the restricted rents on these properties should be the sole basis for determining their value for property tax purposes. However, as an article in the fall 2010 issue of *The Appraisal Journal* states, "the market value of the real estate must be based on all of the benefits and liabilities that flow directly from the ownership of the real estate."<sup>23</sup>

Following this line of logic, current law in Tennessee requires consideration of

- 1) Location;
- 2) Current use;
- 3) Whether income bearing or non-income bearing;
- 4) Zoning restrictions on use;
- 5) Legal restrictions on use;
- 6) Availability of water, electricity, gas, sewers, street lighting, and other municipal services;
- 7) Inundated wetlands;
- 8) Natural productivity of the soil, except that the value of growing crops shall not be added to the value of the land. As used in this subdivision (b)(8), "crops" includes trees; and
- 9) *All other factors and evidence of value generally recognized by appraisers as bearing on the sound, intrinsic and immediate economic value at the time of assessment.*<sup>24</sup> (emphasis added)

According to the same 2010 article from *The Appraisal Journal*, tax credits are the primary economic benefit that investors receive from LIHTC properties. They

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<sup>22</sup> Alford and Wellsandt 2010, 356.

<sup>23</sup> Alford and Wellsandt 2010, 355.

<sup>24</sup> Tennessee Code Annotated 67-5-602.

are as much a part of the real property as the rent that is paid by the tenants. If the assignment is to appraise the real estate, then a failure to consider the tax credits could constitute a substantial error of omission unless the assignment conditions prominently and clearly exclude the value of that part of the real property from the appraisal.<sup>25</sup>

Barring legislation that explicitly prohibits it, the credits should be included in the income approach to valuing LIHTC properties. They are generally recognized by appraisers as the primary source of income for the majority owner of the low-income housing property and would be taken into consideration by any buyers purchasing it.

### **Tennessee's Treatment of Tax Credits in Assessing the Value of Low-Income Housing**

Interpreting Tennessee law and the constitutional requirement of uniformity in assessment and tax rates, Tennessee courts have recognized the credits as an indicator of property value that is properly included when assessing the value of LIHTC properties. In *Spring Hill, L.P., et al. v. Tennessee State Board of Equalization, et al.* (2003), the valuation method authorized by the Court of Appeals represented a variation of the income capitalization approach commonly used to estimate the value of most commercial real estate. The Spring Hill ruling stated that local property assessors should include the value of the LIHTCs as a "value enhancing-factor" when arriving at the taxable value of such properties. The result upheld the Tennessee Board of Equalization's original decision affirming the inclusion of LIHTCs in the valuation process.

In applying the court's decision in *Spring Hill*, the Tennessee Division of Property Assessment instructs assessors to add the present value of all future credits to the valuation that results from using the standard income approach and restricted rents. Table 1 shows how property taxes would be calculated using this approach for a LIHTC property that has ten years of credits remaining. It uses a hypothetical example provided by the Davidson County Assessor's Office that received a total allocation of \$5.5 million in tax credits and had a potential gross income from restricted rents of \$650,000. The example assumes 8% vacancy and collection losses, 3% miscellaneous income, operating expenses of \$300,000, and an 8.29% capitalization rate.

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<sup>25</sup> Alford and Wellsandt 2010, 358.

**Table 1. Property Tax Including Tax Credit Under Current Tennessee Practice for Hypothetical LIHTC Property**

<b>Potential Gross Income (based on restricted rents)</b>	<b>\$ 650,000</b>
Assume 8% Vacancy and Collection Losses	(52,000)
Assume 3% Miscellaneous Income	19,500
<b>Effective Gross Income</b>	<b>\$ 617,500</b>
Operating Expenses	(300,000)
<b>Net Operating Income</b>	<b>\$ 317,500</b>
Total Direct Capitalization Rate	8.29%
<b>Capitalized Value (net operating income divided by capitalization rate)</b>	<b>\$3,829,916</b>
First Year Allocated Tax Credits	550,000
Years of Taxes on Credits Remaining	10
<b>Present Value of Remaining Tax Credits</b>	<b>3,775,245</b>
<b>Taxable Value</b>	<b>\$7,605,161</b>
Tax Rate (per \$100)	\$3.19
Assessment Ratio (Commercial Property)	40%
<b>Property Tax Owed</b>	<b>\$ 97,042</b>
<b>30 Year Total Taxes Owed</b>	<b>\$ 1,759,530</b>

This approach recognizes that the credits are the major source of income for investors in these projects and that any potential investor in a LIHTC property would consider the present value of all remaining credits before purchasing it. This approach results in assessed values that start very large, when there are many tax credits remaining, and drops each year until the tax credits run out. As shown in table 1, the first year's tax bill would be \$97,042, and the 30-year total, assuming no change in potential gross income or tax rates, would be \$1.76 million. Table 2 shows how this approach affects a LIHTC property's tax bill over the life of the restricted rent agreement. It uses the same example from table 1.

Including the credits in property valuations in this way creates cash flow problems for property owners. According to research by the CohnReznick Group, many existing LIHTC properties operate on very thin margins. This is by design. The Tennessee Housing Development Agency allocates individual projects the minimum amount of tax credits that it considers necessary to raise enough equity to make them viable. The rent restrictions on these projects make it difficult to budget for the initially large property tax bills in addition to servicing debt, resulting in an increased risk of foreclosure.

**Table 2. Property Tax Bills, 30-Year Restrict Rent Agreement, Including Tax Credits Under Current Tennessee Practice, Hypothetical LIHTC Property**

Year of Restricted Rent Agreement	Annual Tax Credit Amount	Years of Tax Credits Remaining	Present Value of Remaining Tax Credits (calculated using 7.5% discount rate)	Taxable Value	Tax Rate (per \$100)	Assessment Ratio	Effective Tax Rate	Current Tennessee Practice
1	\$ 550,000	10	\$ 3,775,245	\$ 7,605,160	\$3.19	40%	\$1.276	\$ 97,042
2	550,000	9	3,508,388	\$ 7,338,303	\$3.19	40%	\$1.276	93,637
3	550,000	8	3,221,517	\$ 7,051,433	\$3.19	40%	\$1.276	89,976
4	550,000	7	2,913,131	\$ 6,743,046	\$3.19	40%	\$1.276	86,041
5	550,000	6	2,581,616	\$ 6,411,531	\$3.19	40%	\$1.276	81,811
6	550,000	5	2,225,237	\$ 6,055,152	\$3.19	40%	\$1.276	77,264
7	550,000	4	1,842,129	\$ 5,672,045	\$3.19	40%	\$1.276	72,375
8	550,000	3	1,430,289	\$ 5,260,205	\$3.19	40%	\$1.276	67,120
9	550,000	2	987,561	\$ 4,817,476	\$3.19	40%	\$1.276	61,471
10	550,000	1	511,628	\$ 4,341,543	\$3.19	40%	\$1.276	55,398
<b>11 through 30</b>	-	0	-	\$ 3,829,916	\$3.19	40%	\$1.276	48,870
	<b>\$ 5,500,000</b>		<b>\$ 22,996,740</b>					<b>\$ 1,759,530</b>

## Payments in Lieu of Taxes Agreements: An Alternative for Promoting Low-Income Housing

Tennessee has two statutes that authorize local governments to use payments in lieu of taxes (PILOT) agreements as an incentive for providing low-income housing. One allows local governments except in Davidson County to authorize their housing authorities to establish PILOTs for LIHTC properties.<sup>26</sup> The other allows local governments statewide to establish health, educational, and housing facility corporations and authorize them to establish PILOTs in support of their public purpose, generally to increase the commerce, welfare, and prosperity of the community and improve and maintain health and living conditions.<sup>27</sup> In either of these arrangements, the applicable local government entity takes ownership of the property, removing it from property tax rolls, and leases it back to the LIHTC partnership in exchange for payments in lieu of taxes. Both types of local entities have flexibility to establish PILOTs in any amount. In Memphis, where PILOTs have been widely used for LIHTC projects, they generally result in payments that are considerably less than property taxes would be. Other local governments, including Chattanooga and Knoxville, have used them to a lesser extent, and they are routinely used by industrial development boards throughout Tennessee to promote economic development.

Memphis delegates authority for establishing PILOT agreements to its health, education, and housing facilities board, which uses them extensively for LIHTC projects; 42 of the 47 LIHTC properties in Memphis have PILOTs. To be eligible for a PILOT, the value of the building renovations, site improvements or new construction must be equal to or greater than fifty percent (50%) of the property acquisition cost. The applicant must have the equivalent of fee simple title, 99 year lease, or an option to purchase with no contingencies except financing. They must also have evidence of a commitment for financing for total project costs. The property must have the same tenant income restrictions required for LIHTC eligibility.

PILOT agreements for LIHTC properties have not been widely used by other local governments in Tennessee, in part because some local governments have found the agreements complicated to set up. However, a number of law firms are experienced in assisting local governments in establishing PILOTs. Further, like Tennessee, Michigan also allows local governments to enter into PILOT agreements with LIHTC partnerships, but has developed a model ordinance that local governments can use to establish PILOTs more easily.

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<sup>26</sup> Tennessee Code Annotated Section 13-20-104 et seq.

<sup>27</sup> Tennessee Code Annotated Section 48-101-3-1 et seq.

## **Proposed Legislation: Excluding the Value of Tax credits in Assessing the Value of Low-Income Housing**

In response to concerns about how including the credits in property valuations could affect the viability of low-income housing projects, the 108<sup>th</sup> General Assembly introduced legislation that would have prohibited assessors from including the value of the tax credits when valuing LIHTC properties. The Senate Finance, Ways and Means Committee sent Senate Bill 1671 by Senator Steve Southerland to the Tennessee Advisory Commission on Intergovernmental Relations for further study and analysis. The companion bill, House Bill 1390 by Representative Jeremy Faison, was referred to the Commission by the House Finance, Ways and Means Subcommittee. Similar legislation was introduced in 2000<sup>28</sup> and 2005.<sup>29</sup> The 2000 legislation was amended to provide a credit against franchise and excise taxes instead, and the 2005 legislation did not pass.

At its September 2014 meeting, the Commission heard from interested parties, including developers, investors, and state and local officials and their representatives. The Division of Property Assessment and the Tennessee Board of Equalization spoke about the administrative and court rulings that favor including the credits but took no official position on the bill. Both the Tennessee County Services Association and a representative for the assessors stressed the importance of fairness and equity in property valuation and claimed that excluding the credits would undercut tax bases thereby limiting local governments' ability to fund the public services on which many tenants of low-income housing rely.

The bill's supporters—developers, investors, and the Tennessee Housing Development Agency—argued that including the credits would create a challenge for property owners, especially those that did not anticipate consideration of the tax credits in valuing the property for tax purposes, eliminating a large part of the credits' benefit and reducing the incentive for the private sector to build and maintain affordable rental housing. They claimed that in the long term including the credits would result in developers and investors abandoning Tennessee in favor of other states that exclude the credits from property valuations.

However, there has been no overall shortage of developers seeking to build LIHTC projects, and developers and investors are unlikely to abandon Tennessee for other states because the demand for tax credits in nearly every state exceeds supply. In 2013, less than 1% of all credits nationwide went unused. Moreover, in many states, including Tennessee, housing agencies award points in their competitive application process for credits to developers who have successfully completed and managed projects in that

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<sup>28</sup> Senate Bill 2481 and House Bill 2584.

<sup>29</sup> Senate Bill 387 and House Bill 969.



state. Therefore, it is not easy for developers in particular to transfer their LIHTC operations to new states.

Banks that invest in LIHTC properties in Tennessee are also unlikely to abandon the state because investing in these projects makes it easier for them to get approval for mergers and acquisitions under the Community Reinvestment Act. In 2012, banks accounted for 85% of the investment in LIHTCs projects nationwide.<sup>30</sup>

### **Property Tax Treatment of LIHTCs in Other States**

In fifteen states, neither the courts nor the legislature has provided guidance for the valuation of LIHTC properties developed by for-profit companies. See table 3 and map below. Although an administrative law body in Maine ruled that the credits should be included in property valuations, the legislature has not acted, and the case has not reached the courts. North Dakota law requires all non-profit developers of LIHTC properties to arrange PILOTs with local jurisdictions, and Montana law excludes those LIHTC projects developed by non-profits or public housing authorities entirely from taxation, but neither state provides guidance for properties developed by for-profit companies.

Despite the fact that the tax credits are a direct economic benefit that investors receive from owning LIHTC properties, legislatures in twenty-four states have excluded the credits from use in property valuations. Of these, nineteen acted without guidance from state courts, including two—Hawaii and Nevada—that exempted LIHTC properties from property taxes altogether. In Mississippi and Nebraska, subsequent court rulings have clarified that the legislature’s intent was to exclude the credits. In five states, legislatures overturned court decisions that had included the credits in valuation.

Courts in six states have, absent any action from the legislature, ruled that the credits should be excluded from valuation for property tax purposes. Three of these—Missouri, Oklahoma, and Washington—ruled that the credits were not taxable because they were intangible property and either existing statutes (Missouri and Washington) or the state constitution (Oklahoma) exempts intangible property from property taxes.

The credits are included in valuing LIHTC properties by law or court decision in only four states other than Tennessee. Idaho is the only state where both the courts and the legislature have agreed that the credits should be included in property valuations. The Idaho legislature has established a special formula for including the tax credits that takes the total value of tax credits allocated to a project; divides it by the number of years in the restricted rent agreement; and adds that value to the value obtained using the standard income approach and restricted rents. Kansas and Michigan are the only

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<sup>30</sup> US Department of the Treasury, Office of the Comptroller of the Currency 2014.

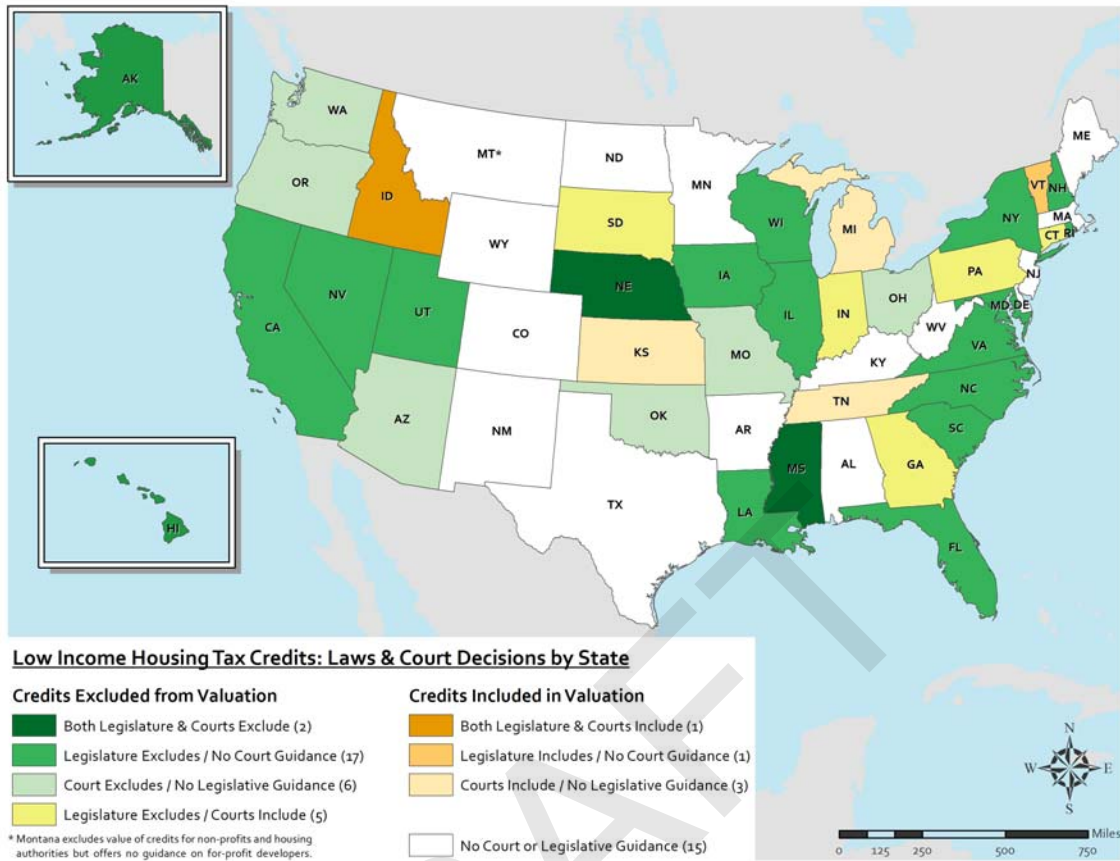
states other than Tennessee that include the credits because of court ruling alone. Vermont is the only state that requires the use of market rents by statute when valuing LIHTC properties under the income approach.

**Table 3. Low Income Housing Tax Credits: Laws and Court Decisions in Other States**

		Courts		
		Include Credits	Exclude Credits	No Guidance
Legislatures	Include Credits	Idaho (smooths actual credits over restricted rent agreement period)		Vermont (tax bill based on market rent)
	Exclude Credits	Connecticut, Georgia, Indiana, Pennsylvania, South Dakota	Mississippi, Nebraska	Alaska, California, Florida, Illinois, Iowa, Louisiana, Maryland, New Hampshire, New York, North Carolina, Rhode Island, South Carolina, Utah, Virginia, Wisconsin, Hawaii (excludes entire property from taxation), Nevada (excludes LIHTC units from taxation) Montana (excludes unless for-profit)
	No Guidance	Kansas, Michigan, Tennessee	Arizona, Missouri**, Ohio, Oklahoma**, Oregon, Washington**	Alabama, Arkansas, Colorado, Delaware, Kentucky, Maine*, Massachusetts, Minnesota, New Jersey, New Mexico, Texas, West Virginia, Wyoming, Montana (no guidance for for-profit developers), North Dakota (requires PILOTs for non-profits)

\* Included per administrative law decision.

\*\* Court ruled credits intangible; either state constitution or state law prohibits taxing intangibles or does not authorize their inclusion.



## Overview of Alternatives

Table 4 compares the example used in table 1 to demonstrate the effect of the current practice for valuing LIHTCs with the estimated effect of the proposed legislation and the approaches used in Vermont and Idaho. Using market rents like Vermont results in property tax bills that are less than current practice in Tennessee in the early years but much larger over time (as shown in table 1 and column D below).<sup>31</sup> Using market rents for a building comprised entirely of two-bedroom units results in a first year payment of \$80,653 but a total 30-year payment of \$2.4 million (see column A), while using them for a building with only one-bedroom units results in a payment of \$66,552 for the first year and a 30-year total payment of almost \$2 million (see column B). Of note, using market rents provides the a close approximation to both the first year and total tax bill owed if the credits are capitalized along with income from restricted rents, demonstrating that the credits are a replacement for income lost to restricted rents (see column C).

<sup>31</sup> This comparison uses market rents for the Nashville MSA for the fourth quarter of 2012—\$741 per month for one-bedroom apartments and \$898 for 2-bedroom apartments; see Colliers International, 2012.

**Table 4. Comparison of Alternative Approaches to Valuing LIHTC Properties**

	(A) Market Rent for Comparable 2 Bedroom [Vermont]	(B) Market Rent for Comparable 1 Bedroom [Vermont]	(C) Tax Credits Smoothed and Capitalized	(D) Current Practice in Tennessee (1)	(E) Without Tax Credits (HB 1390, SB 1671)	(F) Actual Tax Credits Smoothed [Idaho] (2)	(G) Present Value of Tax Credits Smoothed (3)
<b>Potential Gross Income (based on restricted rents)</b>	\$ 867,362	\$ 715,719	\$ 833,333	\$ 650,000	\$ 650,000	\$ 650,000	\$ 650,000
Assume 8% Vacancy and Collection Losses	(69,389)	(57,257)	(52,000)	(52,000)	(52,000)	(52,000)	(52,000)
Assume 3% Miscellaneous Income	26,021	21,472	19,500	19,500	19,500	19,500	19,500
<b>Effective Gross Income</b>	\$ 823,994	\$ 679,933	\$ 800,833	\$ 617,500	\$ 617,500	\$ 617,500	\$ 617,500
Operating Expenses	(300,000)	(247,550)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)
<b>Net Operating Income</b>	\$ 523,994	\$ 432,383	\$ 500,833	\$ 317,500	\$ 317,500	\$ 317,500	\$ 317,500
Total Direct Capitalization Rate	8.29%	8.29%	8.29%	8.29%	8.29%	8.29%	8.29%
<b>Capitalized Value (net operating income divided by capitalization rate)</b>	\$ 6,320,796	\$ 5,215,713	\$ 6,041,415	\$ 3,829,916	\$ 3,829,916	\$ 3,829,916	\$ 3,829,916
Tax Credits (see notes)	0	0	0	550,000	0	5,500,000	22,996,740
Years of Taxes on Credits Remaining				10	-	30	30
<b>Present Value of Remaining Tax Credits</b>	0	0	0	3,775,245	0	183,333	766,558
<b>Taxable Value</b>	\$ 6,320,796	\$ 5,215,713	\$ 6,041,415	\$ 7,605,161	\$ 3,829,916	\$ 4,013,249	\$ 4,596,474
Tax Rate (per \$100)	\$3.19	\$3.19	\$3.19	\$3.19	\$3.19	\$3.19	\$3.19
Assessment Ratio (Commercial Property)	40%	40%	40%	40%	40%	40%	40%
<b>Property Tax Owed</b>	\$ 80,653	\$ 66,552	\$ 77,088	\$ 97,042	\$ 48,870	\$ 51,209	\$ 58,651
<b>30 Year Total Taxes Owed</b>	\$ 2,419,601	\$ 1,996,575	\$ 2,312,654	\$ 1,759,530	\$ 1,466,092	\$ 1,536,272	\$ 1,759,530

(1) The first year of allocated tax credits.

(2) Ten year total of allocated tax credits.

(3) Ten year total of present value of allocated tax credits.

The proposed legislation which excludes the tax credits from valuations would result in a first year property tax bill that was approximately one half of the bill under current Tennessee practice—\$48,870 compared to \$97,042. Over the 30-year restricted rent agreement, the proposed legislation would reduce taxes owed from \$1.76 million to \$1.47 million. See column E.

Dividing the total amount of allocated tax credits by the number of years in the restricted rent agreement and adding that to the value obtained using the standard income approach with restricted rents, as done in Idaho, results in relatively uniform tax payments from year to year and avoids the large early payments that can create cash flow problems under current Tennessee practice. This approach nearly halves a taxpayer's bill for the first year of an LIHTC property—\$51,209 compared to \$97,042. The total tax owed over the 30-year rent restrictions under this method, \$1.54 million, is somewhat less than under current Tennessee practice. See column F.

A similar alternative divides the credits by the number of years in the agreement and adds this to the value obtained using the standard income approach with restricted rents, but uses the cumulative *present value* of the credits rather than their total value. This approach results in the same amount of taxes paid over the 30-year restricted rent period as under current Tennessee practice, \$1.76 million, but would spread the payments out over the life of the restricted rent agreement—\$58,651 per year.

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