

Report of the Tennessee Advisory Commission on Intergovernmental Relations

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 consider 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.

Developers use the tax credits to raise equity to fund construction or rehabilitation by forming partnerships with investors. 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.¹

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 considered when assessing the value of LIHTC properties (*Spring Hill, L.P., et al. v. Tennessee State Board of Equalization, et al.* (2003)).

¹ 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.

Legislation was introduced in 2000, 2005, and again in 2014 in response to this concern. The legislation introduced in the 108th General Assembly by Senator Steve Southerland (Senate Bill 1671) and Representative Jeremy Faison (House Bill 1390) would have prohibited assessors from considering the tax credits when valuing LIHTC properties and was sent to the Commission by the Senate Finance, Ways, and Means Committee and the House Finance, Ways, and Means Subcommittee. See appendix A for copies of the bills.

The Commission heard from interested parties at its September 2014 meeting. Property assessor representatives and local officials appearing before the Commission argued that fairness and equity in assessment require consideration of the tax credits. 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. However, 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 regardless of how or whether the credits are 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.

Local governments concerned that the current assessment method could reduce the availability of low-income housing in their jurisdictions have the option to, under current law, 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. Options that leave the property in private hands suggested by a review of other states include either outright exclusion of any consideration of the tax credits or spreading the effect of tax credits over the life of the rental income restriction. Three states prohibit 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 six in states whose courts agree with Tennessee’s, have chosen explicitly to 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. 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 patterned on Idaho's approach that would similarly even out the annual tax bill to eliminate the cash-flow problem but retain the full value of the tax credits is to spread their cumulative annual present values evenly over the restricted-rent period. This would not change the total amount paid in comparison to the current Tennessee valuation method but would spread it over a much 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.² 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.^{3,4} The tax credit was established as a public-private partnership to increase the supply of housing for the working poor.⁵

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 2012.⁶ 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.⁷ Unlike public housing, the LIHTC program has been "virtually scandal free" and has "a default record that any private credit guarantor would die for."⁸ The Low-Income Housing Tax Credit is the largest and fastest growing federal program for providing affordable housing, and it remains politically popular almost three decades after its inception.⁹

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 (IRS) allocates credits to states in proportion to their

² Title XIV, Part D of TRA 86.

³ Zigas 2013.

⁴ Jolin 2000.

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

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

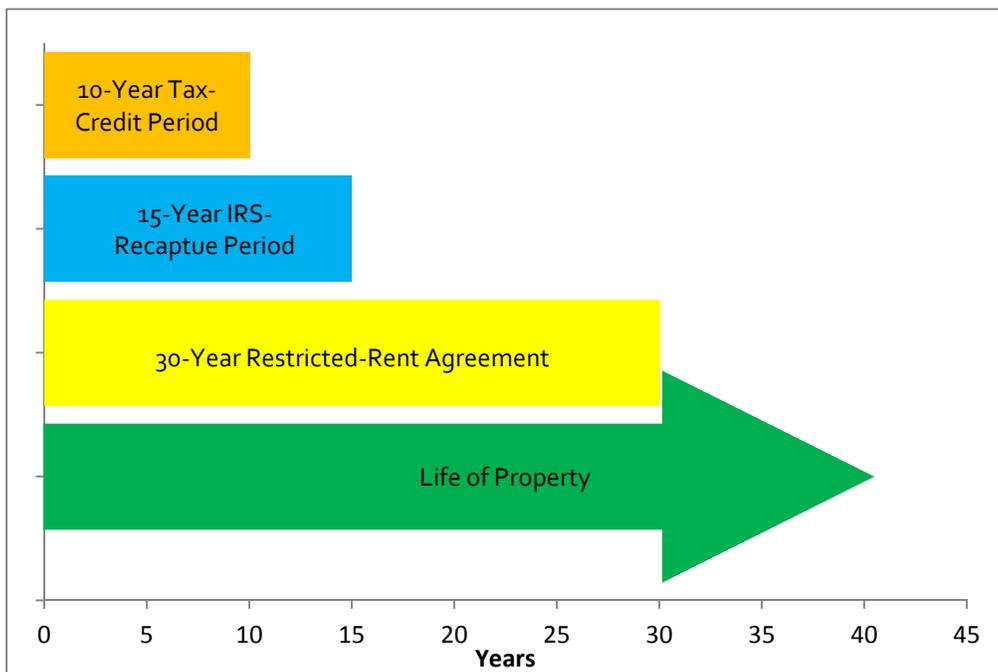
⁷ HUD data available at lihtc.huduser.org.

⁸ Zigas 2013.

⁹ Desai, Dharmapala, and Singhal 2009; Jolin 2000; and Cadik 2014.

population.¹⁰ These allocations are only the first year of a ten year flow of tax credits. See chart below. 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 ten years following construction or rehabilitation—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.

Lifespan of a Low-Income Housing Tax Credit Project



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.¹¹ Because each state’s supply of credits is capped, the IRS requires state housing agencies to allocate them through a competitive process to maximize the number of high-quality low-income housing units constructed or rehabilitated. The Tennessee Housing Development Agency seeks a relatively low debt-coverage ratio—the ratio of estimated net operating income to debt service payments—of 1.2 for each project, low enough to keep rents affordable but high

¹⁰ 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>.

¹¹ Novogradac 2014

enough to ensure that the project qualifies for mortgage loans from most commercial lenders. Consequently, profit margins are much smaller than for other rental properties.

To be eligible to receive tax credits, developers must agree to restrictions on both the rents and the income of tenants. 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.¹² 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.¹³ 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-restricted housing units in a project.¹⁴

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.¹⁵ In Tennessee, most successful applications for tax credits include rent and tenant-income restrictions that last for 30 years.¹⁶ If property owners fail to maintain these restrictions during the first 15 years of the restricted-rent agreement, the IRS can cancel any remaining credits and reclaim credits already taken.¹⁷ This is a very real risk for owners of LIHTC projects.

Funding Low-Income Housing Tax-Credit Properties

Because the rent-restrictions on LIHTC properties prevent their owners from repaying large debts from operating income, the federal government requires substantial equity to reduce the likelihood that they will fail during the tax-credit period. Loans typically fund only 30% of the cost to construct new LIHTC properties and 70% of the cost to rehabilitate existing properties¹⁸ and may come either from banks, which can also be investors in the project, or from state or local housing agencies. Most of the equity needed for the initial cost of the project comes from investors and is repaid by tax

¹² 26 U.S. Code 42 (g) (1).

¹³ 26 U.S. Code 42 (g) (2) (A).

¹⁴ Danter Company 2014.

¹⁵ 26 U.S. Code 42 (h) (6) (D).

¹⁶ Email from David Pair, Tennessee Housing Development Agency, November 13, 2014.

¹⁷ 26 U.S. Code 42 (j).

¹⁸ Keightley 2013.

credits. Because so much equity is required to qualify for tax credits, LIHTC projects would not be built were it not for the funds raised from outside investors. As described in a 2010 article from *The Appraisal Journal*,

An LIHTC property could theoretically be owned by any type of entity—one or more individuals, a partnership, or a corporation. In practice, they are developed almost exclusively by limited partnerships (LP) because this ownership structure is a convenient vehicle for distributing the tax benefit. In a simplified example, the general partner does all of the work and receives a development fee up front, while the limited partners contribute the start-up capital in return for their ownership share and the expectation of receiving the tax credits over a 10-year period. The general partner (which can be a legal entity like a limited liability company) usually plans the project, acquires the necessary permits and approvals, applies for an allocation of tax credits from the state agency, and operates the property.

The startup capital that developers get from investors, typically more than 99% of the equity required by lenders, funds a significant portion of the construction or rehabilitation of these properties. As majority owners of the limited partnerships, investors typically have authority to force general partners out if projects are mismanaged. A 2014 report on the LIHTC program by CohnReznick's Tax Credit Investment Services group explains who the limited partners typically are and how they benefit from investing in LIHTC properties:

Since the mid-1990s, the equity market for housing tax credit investments has been predominantly composed of large, publicly traded companies, most of which are in the banking and financial services sector. As investors and regulators have become increasingly confident in the financial performance of housing tax credit properties as an asset class, the housing tax credit program has become more dependent on the banking sector as a highly reliable source of equity to meet its capital needs. This has been a largely favorable development because banks, for example, filled most of the equity gap created when Fannie Mae and Freddie Mac exited the housing credit market in 2007 and 2008. CohnReznick estimates that approximately \$11 billion of capital was committed to housing tax credit investments in 2013, and that the banking sector was the source for approximately 85% of that amount. There are a number of factors that make housing tax credit investments attractive to banks:

- **Increasing after-tax earnings and lowering effective tax rate:**

Housing credit investors are effectively purchasing a financial asset in the form of a stream of tax benefits (consisting of tax credits and passive

losses associated with depreciation and mortgage interest deductions). Investors do not anticipate receiving cash flow distributions, because housing tax credit properties are generally underwritten to slightly above breakeven and developers or syndicators are generally the recipients of any remaining cash flow. Substantially all of the investors' returns are expected to be derived from tax benefits. Banks typically report fairly stable earnings from year to year and are thus predictable federal taxpayers having sufficient taxable income against which to offset tax credits. The housing tax credit is earned over a 15-year period but is claimed over an accelerated 10-year timeframe, beginning in the year in which the property is placed in service and units are occupied. The ideal housing credit investor is a company with a track record of consistent growth in earnings that is a regular rather than an alternative minimum taxpayer. This has been the profile of the U.S. banking industry for most of the last 28 years, with the exception of rare recession-driven interruptions.

- **Satisfying CRA lending and investment test objectives:** Banks are obligated, under the Community Reinvestment Act (CRA) regulations, to *make loans, provide services, and make investments* in low- to moderate-income neighborhoods in those areas in which they conduct business. As a regulatory matter, banks are obligated to operate in a "safe and sound" manner, which requires them to avoid investments that represent potential loss of capital. The strong financial performance track record of housing tax credit investments has historically been an ideal match for bank investors with a conservative focus. There are a limited number of qualified equity investments under CRA regulations, and many of these have less attractive yield and/or risk profiles. Among the available investment options, housing credit investments appear to be a clear investor favorite.

- **Achieving a reasonable/superior risk adjusted rate of return:** The banks that CohnReznick surveyed have advised us that on a risk-adjusted basis, the yields generated by their housing credit investments are superior to most of their available community development investment alternatives. This is, in part, because banks enjoy a lower cost of funds than other investors, which widens the spread between that cost and the rate of return offered by housing credit investments.

- **Enhancing community relations and searching for cross-selling opportunities:** Notwithstanding their CRA objectives, U.S. banks have become sophisticated housing tax credit investors and have learned to leverage their equity investments to sell other products and services to the development community. Thus, we increasingly see banks cross-

selling other services such as construction financing, letters of credit, permanent loans, and other products to the properties in which they invest.

Developers Convert Tax Credits Into Equity to Fund LIHTC Projects

Developers form limited partnerships with investors eligible to take the tax credits against other forms of income. The developers become minority owners in these partnerships—typically providing less than 1% of the overall equity in them—but retain the role of general partner and responsibility for managing the property to ensure that it meets all of the requirements of the restricted-rent agreement and the IRS. Because both the tax credits and any positive cash flows from operating these properties—including rent and other fees from tenants—are allocated first to investors, developers' income from individual LIHTC projects comes mostly from a development fee equal to a maximum of 15% of project costs. This fee is not intended to be paid from a property's annual rental revenue but rather from the mortgage loan and from the up-front equity provided by investors. The fee is paid to the general partner over time based on how well the property is performing as an investment.

Tax Credits are Investors' Primary Income from LIHTC Properties

The equity investors provide in exchange for majority ownership of the property and access to tax credits varies widely by project, location, and year. The current national average is \$0.94 invested for each tax-credit dollar received.¹⁹ The median amount of equity invested in Tennessee LIHTC projects per tax-credit dollar received was \$0.68 before 2000, \$0.80 in the period 2000 through 2005, and \$0.91 in the period 2006 through 2011. Current medians in Tennessee's metropolitan statistical areas range from \$0.83 in the Jackson and Kingsport-Bristol areas to \$0.95 in the Clarksville area.²⁰ As the major source of equity for these properties, limited partners receive nearly all of the tax credits, which are worth not only the difference between the amount invested and the amount received as a credit but, relative to tax deductions, may be worth significantly more depending on the tax bracket. For example, for an investor in the 20% tax bracket, a \$1 credit is the equivalent of a \$5 deduction against income so that a limited partner who invested \$0.95 per tax-credit dollar in an LIHTC property is able to reduce his taxable income by a net of \$4.05.

Tax Credits as an Indicator of Fair Market Value

The 2010 article from *The Appraisal Journal* describing how to appraise LIHTC properties describes the tax credits as

¹⁹ CohnReznick, "The Low Income Housing Tax Credit Program: A Performance Update Analysis," November 2014, 34.

²⁰ Email from Matt Barcello, CohnReznick, January 5, 2015.

a cash substitute; just as a Target gift card can be received as payment in lieu of cash at a Target store, in the same fashion a tax credit is received as payment by the IRS at tax time. Although it would be annoying to be paid a large sum of money in Target gift cards, it is clear that the gift cards—and the tax credits—are monetary consideration.

LIHTC properties receive the contracted amount of tax credits annually during the first 10 years of the agreement. The appraiser must understand the timing of the tax credit receipts in order to appropriately analyze their future benefits. The tax credits are not transferrable; they flow exclusively to the property owner on the basis of the ownership of the eligible LIHTC real property. Section 42 of the U.S. Internal Revenue Code, Subsection (f)(4), titled “Dispositions of Property,” states,

If a building (or an interest therein) is disposed of during any year for which credit is allowable under subsection (a), such credit shall be allocated between the parties on the basis of the number of days during such year the building (or interest) was held by each.

The point bears repeating: the tax credits flow to the property owner solely by virtue of its ownership of an eligible LIHTC property. The credits are monetary consideration paid to the property owner in exchange for the owner giving up some rights of use: the right to rent to anyone and the right to charge any rental rate. As Ronnie J. Hawkins states in “Misconceptions Associated with LIHTC Valuations,” the “tax credits cannot individually be separated from the real property rights and sold separately—tax credits always coincide with the real property ownership.” Although market participants often talk casually about “selling” the tax credits, they are actually referring to selling a partial ownership interest in the entity that owns the real estate. The tax credits themselves cannot be severed from the ownership of the real estate. . . .

It is legally permissible for a property owner to sell an LIHTC property during the restriction period. However, there are some special issues that apply to this scenario and differ from conventional property sales. These issues include approval of the sale, seller liability, and right of first refusal. . . .

Also, if the property is sold during the restriction period, the seller may be forced to retain liability for any possible future noncompliance of the LIHTC property. If the buyer fails to fully comply with the terms of the LURA [land use restriction agreement], the seller may face recapture of tax credits received prior to the sale.

The article concludes by saying that

The tax credits flow to the property owner solely by virtue of its ownership of an eligible LIHTC property, and they cannot be separated from the real estate. They are monetary consideration paid to the property owner in exchange for giving up real property rights that are inherent in the ownership of the real estate. **The tax credits 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.

Valuing Low-Income Housing Tax Credit Properties 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. 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
- the current cost of building the structures minus
- the amount of accrued depreciation of the subject property.

The income approach is typically used to value a commercial rental property once it is occupied. The 2010 article from *The Appraisal Journal* quoted above describes the differences and issues thus:

In the cost approach to value, a replacement cost estimate does not reflect value associated with the future tax credits. A replacement cost estimate also does not reflect any impairment of value that may result from the LURA's restrictions unless a specific deduction is applied. This deduction is measured by the consideration of the loss in income caused by the restrictions, so the cost approach may be inbred with the income capitalization approach and cease to be an independent indicator of value. In cases where the LURA's restrictions have significantly impaired value, it may be difficult to perform a credible cost approach.

The sales comparison approach would be very compelling if there were any truly comparable sales. The characteristics of an LIHTC property

potentially include future tax credits, lower operating income, and prolonged illiquidity. Adjusting for these differences from a conventional property sales comparison is extremely difficult and may produce unreliable results. Comparison to LIHTC sales is difficult because LIHTC properties rarely sell, especially during the first 10 years of the project. Partners do sometimes sell their interest in the ownership entity, but those are not sales of the real estate. If an LIHTC sale is found, it is incumbent on the appraiser to carefully consider all of the differences between the subject property's LURA and future tax credits and the comparable property's LURA and future tax credits, adjusting for all those differences that affect value.

Because of the steep challenges encountered in the cost approach and sales comparison approach, the income capitalization approach is generally considered the best indicator of an LIHTC property's value. It contains the mechanisms needed to reflect differences in future tax credits as well as differences in rents, occupancy, and expenses according to the restrictions.²¹

According to the Appraisal Standards Board of the Appraisal Foundation, the non-profit organization authorized by Congress to set appraisal standards for the United States,

When an income approach is necessary for credible assignment results, an appraiser must

1. analyze such comparable rental data as are available and/or the potential earnings capacity of the property to estimate the gross income potential of the property,
2. analyze such comparable operating expense data as are available to estimate the operating expenses of the property,
3. analyze such comparable data as are available to estimate rates of capitalization and/or rates of discount, and
4. base projections of future rent and/or income potential and expense on reasonably clear and appropriate evidence.

In developing income and expense statements and cash flow projections, an appraiser must weigh historical information and trends, current supply and demand factors affecting such trends, and anticipated events such as competition from developments under construction.

The 2010 article from *The Appraisal Journal* mentions a number of issues to consider when applying the income approach to valuing LIHTC properties, including

²¹ Alford and Wellsandt 2010, 356.

- the rent ceilings set by the LURA may or may not be below normal market levels;
- the income limits set by the LURA may influence occupancy, administrative costs, and achievable rents;
- LIHTC properties require additional management expertise and as a result may experience higher management fees; and
- the tax credit income has a duration (only 10 years) that is different from the income from operations, and if direct capitalization is used the credits must be capitalized separately at their own appropriate rate.²²

In the case of LIHTC properties, owners often insist on the income 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."²³ Moreover, the guidelines established by the Appraisal Foundation suggest that tax credits may be properly considered as evidence of a property's value. According to the Foundation, one of the most important factors in valuing subsidized housing such as LIHTC properties is

whether or not the various subsidies, incentives, and restrictions remain with the real property following a sale or foreclosure and thus are marketable property rights to be included in 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;

²² Alford and Wellsandt 2010, 356.

²³ Alford and Wellsandt 2010, 355.

- 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.*²⁴ [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

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.²⁵

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 tax rates, Tennessee courts have recognized the credits as an indicator of property value that is properly considered when assessing the value of LIHTC properties. In *Spring Hill, L.P., et al. v. Tennessee State Board of Equalization, et al.* (2003), the court of appeals noted that "the tax credits are not being taxed as intangible property . . . [and their] inclusion does not constitute a tax on those intangibles." The court further noted that "the tax credits are irrevocably attached to the real property" and concluded that they "relate directly to the real property and are not a tangible benefit severable and sold to third parties and that they were properly included in the valuation" of the Spring Hill property and two others.

In applying the court's decision in *Spring Hill*, the Tennessee Division of Property Assessments 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.

²⁴ Tennessee Code Annotated 67-5-602.

²⁵ Alford and Wellsandt 2010, 358.

**Table 1. Income Method Assessment Comparison Using Alton Place Apartments
Example from Hamilton County**

	Market Rent Property (A)	LIHTC Property— credits remaining	
		8 years, 11 months (B)	3 years, 11 months (C)
Potential Gross Income²⁶	\$ 813,000	\$ 611,040	\$ 611,040
Assume 7% Vacancy and Collection Losses	(56,910)	(42,773)	(42,773)
Assume 3% (A) or 2% (B & C) Miscellaneous Income*	24,390	12,221	12,221
Effective Gross Income	\$ 780,480	\$ 580,488	\$ 580,488
Operating Expenses [^]	(240,000)	(240,000)	(240,000)
Replacement Reserves	(26,400)	(26,400)	(26,400)
Net Operating Income	\$ 514,080	\$ 314,088	\$ 314,088
Total Direct Capitalization Rate**	8.53%	9.03%	9.03%
Capitalized Value (net operating income divided by capitalization rate)	\$ 6,026,729	\$ 3,478,272	\$ 3,478,272
Ten-Year Total Tax Credits	n/a	10,300,000	10,300,000
Present Value of Remaining Tax Credits	n/a	\$ 7,000,567	\$ 3,678,817
Taxable Value (rounded to thousand)	\$ 6,027,000	\$ 10,479,000	\$ 7,157,000
Tax Rate (per \$100)	\$5.07	\$5.07	\$5.07
Assessment Ratio (Commercial Property)	40%	40%	40%
2014 Property Tax Owed	\$ 122,329	\$ 212,690	\$ 145,264
30 Year Total Taxes Owed***	\$ 3,669,864	\$ 3,047,950	\$ 3,047,950

*Miscellaneous income includes such items as vending, laundry, parking, etc.

[^]Operating expenses exclude depreciation and property taxes. Property taxes are reflected in overall total direct capitalization rate.

**CAP Rate chosen based on available data on comparable returns.

***Assumes no changes in net operating income or tax rate.

Table 1 shows the effect of applying the standard income approach to Alton Place Apartments, a LIHTC property in Hamilton County, presented first as a market rent property (column A) and then as a LIHTC property (columns B and C). The example is based on information provided by the developer of Alton Place and by the Hamilton County Assessor's Office. The income figures in column A are higher because there are no restrictions on rental rates or tenant income. The capitalization rate for the property

²⁶ The Hamilton County assessor calculated a lower a market potential gross income without rent restrictions, of \$753,600.

as low-income housing (columns B and C) is higher because, as noted in an article on controlling LIHTC property taxes, “While restricted projects tend to be perceived as carrying lower risk due to assured income streams, appreciation is nonexistent, and major value upgrading potential such as condo conversion is usually impossible. Therefore, non-restricted properties as a group tend to sell at lower cap rates,”²⁷ The vacancy and collection losses, operating expenses, and replacement reserves are assumed to be the same for both examples.

The standard income 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. While the last line for column A is simply the 2014 amount owed multiplied by 30, the number of years in the restricted-rent agreement, the 30-year totals for columns B and C, which are the same, reflect the declining value of the credits over time. Table 2 shows those calculations.

²⁷ <http://www.housingfinance.com/affordable-housing/controlling-lihtc-property-taxes.aspx>

Table 2. Property Tax Bills Under Current Tennessee Practice over 30-Year Restricted Rent Agreement for Alton Place Apartments in Hamilton County

Year of Restricted Rent Agreement	Annual Tax Credit Amount	Years of Tax Credits Remaining	Present Value of Remaining Tax Credits (calculated using 6% discount rate)	Net Operating Income (uses restricted rents)	Capitalized Value of Net Operating Income (uses 9.03% capitalization rate)	Taxable Value	Tax Rate (per \$100)	Assessment Ratio	Tax Bill Under Current Tennessee Practice
1	\$ 1,030,000	9 Years, 11 Months	\$ 7,479,517	\$314,088	\$ 3,478,272	\$10,958,000	\$5.07	40%	\$ 222,412
2	1,030,000	8 Years, 11 Months	\$ 7,000,567	\$314,088	\$ 3,478,272	\$10,479,000	\$5.07	40%	212,690
3	1,030,000	7 Years, 11 Months	\$ 6,459,817	\$314,088	\$ 3,478,272	\$ 9,938,000	\$5.07	40%	201,710
4	1,030,000	6 Years, 11 Months	\$ 5,857,267	\$314,088	\$ 3,478,272	\$ 9,336,000	\$5.07	40%	189,491
5	1,030,000	5 Years, 11 Months	\$ 5,192,917	\$314,088	\$ 3,478,272	\$ 8,671,000	\$5.07	40%	175,994
6	1,030,000	4 Years, 11 Months	\$ 4,466,767	\$314,088	\$ 3,478,272	\$ 7,945,000	\$5.07	40%	161,258
7	1,030,000	3 Years, 11 Months	\$ 3,678,817	\$314,088	\$ 3,478,272	\$ 7,157,000	\$5.07	40%	145,264
8	1,030,000	2 Years, 11 Months	\$ 2,829,067	\$314,088	\$ 3,478,272	\$ 6,307,000	\$5.07	40%	128,012
9	1,030,000	1 Year, 11 Months	\$ 1,917,517	\$314,088	\$ 3,478,272	\$ 5,396,000	\$5.07	40%	109,522
10	944,167	11 Months	\$ 944,167	\$314,088	\$ 3,478,272	\$ 4,422,000	\$5.07	40%	89,752
Years 11 through 30	-	-	-	\$314,088	\$ 3,478,272	\$ 3,478,000	\$5.07	40%	70,592
	\$ 10,300,000*								\$ 3,047,950

* Includes \$85,833 in tax credits from December 2012 not shown in table

Considering the credits in property valuations in this way creates cash flow problems for property owners. According to research by CohnReznick, a financial advisory firm, many existing LIHTC properties operate on very thin margins. This is by design.

State housing credit agencies are statutorily obligated to award only enough housing tax credits to make potential developments financially feasible, and the allocators have been effective at ensuring that projects to which they award housing credits have not been overfinanced. With statutory rent restrictions constraining the income potential of housing credit projects, one consequence of this statutory obligation is that housing tax credit properties are underwritten with very little margin for error in generating sufficient net operating income.²⁸

The rent restrictions on these projects make it difficult to budget for the initially large property tax bills in addition to servicing debt.

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

In response to concerns about how considering the credits in property valuations could affect the viability of low-income housing projects, legislation was introduced by members of the 108th General Assembly to prohibit considering the value of low-income housing tax credits when assessing LIHTC properties. The Senate Finance, Ways and Means Committee sent Senate Bill 1671 by Senator Southerland to the Commission for further study and analysis; the companion bill, House Bill 1390 by Representative Faison, was referred by the House Finance, Ways and Means Subcommittee. Similar legislation was introduced in 2000²⁹ and 2005.³⁰ The 2000 legislation was amended to provide a temporary credit against franchise and excise taxes following some of the initial decisions by the State Board of Equalization that tax credits are properly considered in valuing LIHTC properties. 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 Assessments and the Tennessee Board of Equalization explained the administrative and court rulings that require consideration of the credits but took no official position on the bill. Both the Tennessee County Services Association and the Tennessee Association of Property Assessors stressed the

²⁸ CohnReznick 2012.

²⁹ Senate Bill 2481 and House Bill 2584.

³⁰ Senate Bill 387 and House Bill 969.

importance of fairness and equity in property valuation and, noting that counties have little room to maneuver financially, that reducing property taxes on one sector shifts the burden to others and can limit 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' present value 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 said that in the long term considering 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 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 (CRA). Banks often compete to invest in LIHTC properties to receive CRA credit. According to CohnReznick, bank investors pay as much as 35 cents more per credit in highly competitive CRA areas.³¹ In 2012, banks accounted for 85% of the investment in LIHTCs projects nationwide.³²

It is possible that considering the credits in property valuations could change the pattern of development within Tennessee. Developers of future LIHTC properties are likely to focus on communities—usually in suburban and urban rather than rural areas—where greater median household incomes and greater rent limits along with larger applicant pools can help make projects more viable. This could reduce the supply of affordable housing in certain areas of the state. However, there is no evidence that development has shifted away from the cities and counties that already consider the tax credits in property valuations.

³¹ CohnReznick 2012.

³² US Department of the Treasury, Office of the Comptroller of the Currency 2014.

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 the map below. Although an administrative law body in Maine ruled that the credits should be considered 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, eighteen 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 six states, legislatures overturned court decisions that ruled credits should be considered 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 considered 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 considered 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 states other than Tennessee that consider 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

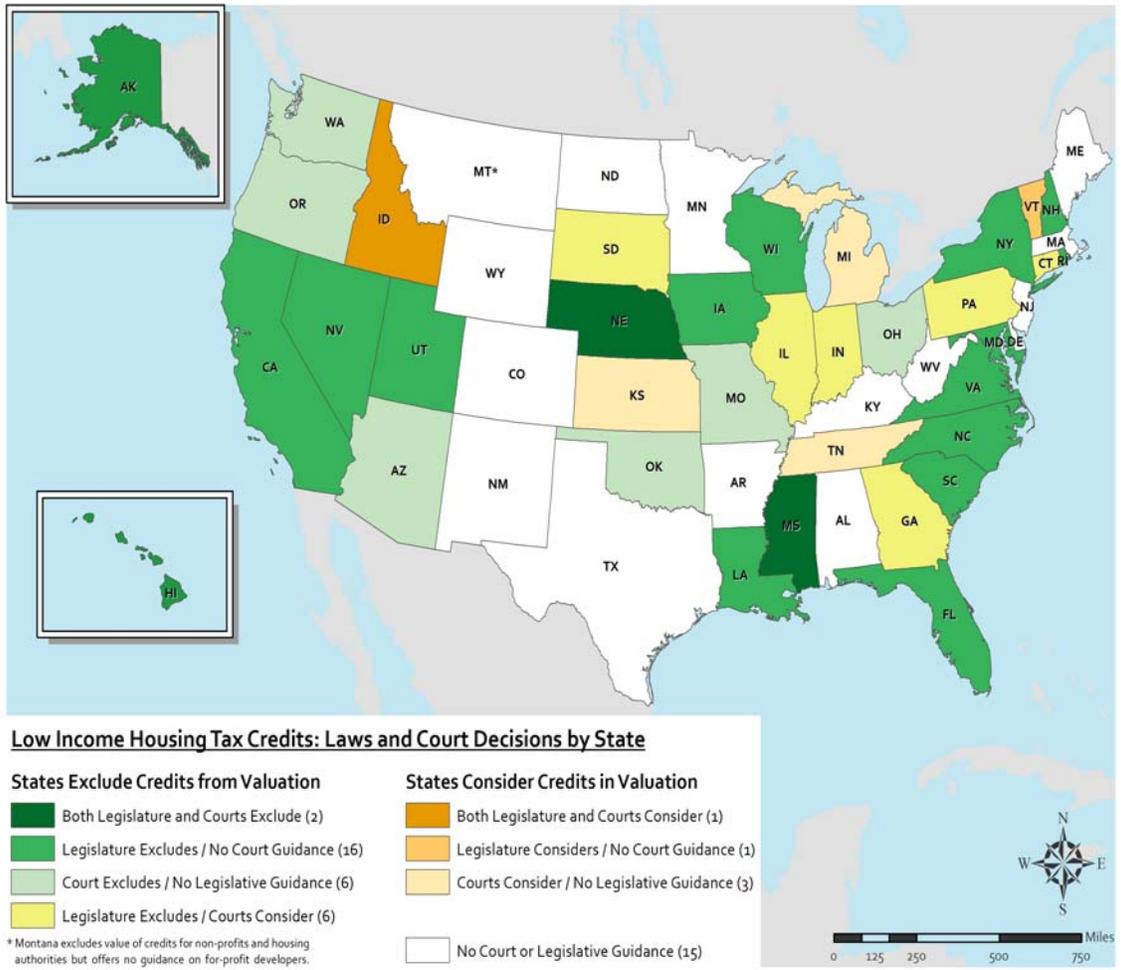
		Courts		
		Consider Credits	Exclude Credits	No Guidance
Legislatures	Consider Credits	Idaho (smooths actual credits over restricted rent agreement period)		Vermont (tax bill based on market rent)
	Exclude Credits	Connecticut, Georgia, Illinois, Indiana, Pennsylvania, South Dakota	Mississippi, Nebraska	Alaska, California, Florida, 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)

* Considered per administrative law decision.

** State of Kansas Department of Revenue appraisal guide says to exclude credits.

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

Laws and Court Decisions by State



Comparison of Assessment Methods

Table 4 uses the same Chattanooga LIHTC property presented in table 1 to compare alternative methods for valuing tax credit properties for property tax purposes. Column A shows the effect of applying the market rate assessment method used in Vermont, column B shows current practice in Tennessee, column C shows the effect of the proposed legislation, and column D shows the effect of spreading the actual tax credits over 30 years as done in Idaho. Column E modifies current practice in Tennessee to even out the annual tax bill and eliminate the cash-flow problem it creates by spreading their cumulative annual present values evenly over the 30-year restricted-rent period. It retains the full value of the tax credits but reduces the annual tax bill. It would not change the total amount paid in comparison to the current Tennessee valuation method but would spread it over a much longer period.

Table 4. Comparison of Alternative Approaches to Valuing LIHTC Properties

	Market Rent [Vermont] (A)	Current Practice in Tennessee (1) (B)	Without Tax Credits (HB 1390, SB 1671) (C)	Actual Tax Credits Smoothed over 30 years [Idaho] (2) (D)	Present Value of Tax Credits Smoothed over 30 years (3) (E)
Potential Gross Income (either market rent or restricted rent)	\$ 813,000	\$ 611,040	\$ 611,040	\$ 611,040	\$ 611,040
Assume 7% Vacancy and Collection Losses	(56,910)	(42,773)	(42,773)	(42,773)	(42,773)
Assume 2% Miscellaneous Income	24,390	12,221	12,221	12,221	12,221
Effective Gross Income	\$ 780,480	\$ 580,488	\$ 580,488	\$ 580,488	\$ 580,488
Operating Expenses	(240,000)	(240,000)	(240,000)	(240,000)	(240,000)
Replacement Reserves	(26,400)	(26,400)	(26,400)	(26,400)	(26,400)
Net Operating Income	\$ 514,080	\$ 314,088	\$ 314,088	\$ 314,088	\$ 314,088
Total Direct Capitalization Rate	8.53%	9.03%	9.03%	9.03%	9.03%
Capitalized Value (net operating income divided by capitalization rate)	\$ 6,026,729	\$ 3,478,272	\$ 3,478,272	\$ 3,478,272	\$ 3,478,272
Ten-Year Total Allocated Tax Credits	n/a	10,300,000	10,300,000	10,300,000	10,300,000
Years of Credits Remaining	n/a	8 years, 11 months	8 years, 11 months	8 years, 11 months	8 years, 11 months
Taxable Value of Credits	n/a	\$ 7,000,567	\$ -	\$ 343,333	\$ 1,548,433
Taxable Value of Property	\$ 6,027,000	\$ 10,479,000	\$ 3,478,000	\$ 3,822,000	\$ 5,027,000
Tax Rate (per \$100)	\$5.07	\$5.07	\$5.07	\$5.07	\$5.07
Assessment Ratio (Commercial Property)	40%	40%	40%	40%	40%
Property Tax Owed	\$ 122,329	\$ 212,690	\$ 70,592	\$ 77,574	\$ 102,032
30 Year Total Taxes Owed	\$ 3,669,864	\$ 3,047,950	\$ 2,117,768	\$ 2,327,231	\$ 3,060,960

(1) Includes the present value of remaining tax credits.

(2) Spreads the actual amount of allocated credits over 30 years.

(3) Spreads the cumulative present value of the credits over 30 years.

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

Tennessee has three statutes that authorize local governments to use payments in lieu of taxes (PILOT) agreements as an incentive for providing low-income housing. The first 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.³³ The second allows local governments statewide to establish industrial development corporations and authorize them to establish PILOTs for LIHTC properties in support of their public purpose, which includes increasing the supply of housing.³⁴ The third allows local governments except in Davidson County to authorize their housing authorities to establish PILOTs for LIHTC properties; however, if a property would be subject to both municipal and county taxes, this option requires both jurisdictions to authorize the housing authority to issue the PILOT. It may also require the housing authority to be a member of the limited partnership for the property, though no court has ruled on this issue.³⁵

In each 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. Each type of local entity has 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 for LIHTC properties to a lesser extent. Throughout Tennessee, industrial development corporations routinely issue PILOTs for other types of businesses 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.

³³ Tennessee Code Annotated Section 48-101-3-1 et seq.

³⁴ Tennessee Code Annotated Section 7-53-102(a) and 7-53-305(b) (1).

³⁵ Tennessee Code Annotated Section 13-20-104 et seq.

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.

Michigan requires PILOTs for LIHTC properties owned by limited dividend corporations—a designation that allows the state housing authority to regulate the profits of property owners. State law sets the payments for these PILOTs: for new construction, the greater of the tax on the property before construction or 10% of annual revenue from rent and tenant fees minus any charges for utilities; and for rehabilitation, the lesser of the tax on the property before rehabilitation or 10% of annual revenue from rent and tenant fees minus any charges for utilities. However, Michigan allows local governments to modify these PILOT amounts by local ordinance as long as the new payments are no more than what the project would owe in the absence of a PILOT.

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