

Issue Paper Number 01-029



- Board Meeting
- Business Taxes Committee
- Customer Services and Administrative Efficiency Committee
- Legislative Committee
- Property Tax Committee
- Other

VALUATION OF SECTION 515 LOW-INCOME HOUSING PROPERTIES

I. Issue

Should staff revise its guidance in Letter To Assessors 98/51 as to the calculation of the capitalization rate in valuing "Section 515" low-income housing properties?

In making this decision, staff is requesting the Board to provide direction on the following:

1. Should the Board postpone action on this matter pending the outcome of current litigation?
2. Is staff's existing guidance in conflict with the intent of Revenue and Taxation Code section 402.9?
3. Is staff's existing guidance in conflict with Property Tax Rule 8, subsections (g)(1) and (g)(2)?
4. Is staff's existing guidance in conflict with certain appellate court holdings?
5. Does staff's existing guidance lead to assessed values that are consistent with the meaning of "fair market value" as defined in Revenue and Taxation Code section 110?

II. Staff Recommendation

Staff recommends that the Board uphold staff's position on the valuation of Section 515 property and conclude that (1) action on this matter be postponed until pending litigation is resolved; (2) staff's guidance is *not* in conflict with the intent of Revenue and Taxation Code section 402.9; (3) staff's guidance is *not* in conflict with Property Tax Rule 8; (4) staff's guidance is *not* in conflict with certain appellate court holdings; and (5) staff's guidance leads to assessed values consistent with the meaning of "fair market value" as provided in Revenue and Taxation Code section 110.

III. Alternatives Considered

The Board could conclude that (1) action on this matter should *not* be postponed until the resolution of pending litigation; (2) staff's guidance *is* in conflict with the intent of Revenue and Taxation Code section 402.9; (3) staff's guidance *is* in conflict with Property Tax Rule 8; (4) staff's guidance *is* in conflict with certain appellate court holdings; and (5) staff's guidance leads to assessed values that are *not* consistent with the meaning of "fair market value" as provided in Revenue and Taxation Code section 110.

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IV. Background

The United States Department of Agriculture's (USDA's) "Section 515" multi-family housing program is designed to boost the availability of low-income rental housing in rural areas. The government finances up to 97 percent of a project's cost at an effective interest rate of as little as 1 percent, amortized over 50 years. In return, developers under the program agree to restrictions both on the rents that they may charge and on the profits they may earn. Additionally, the properties may not be sold until the loan is paid off, and projects generally must remain in the program for the entire 50-year period.

Staff, county assessors, and industry (i.e., Section 515 property owners, property managers, and agents) all agree that the income approach is preferred to other approaches in valuing Section 515 properties. Moreover, all parties agree that the income to be capitalized into an indicator of present value is the income obtained considering the restrictions imposed by the contracts between project owners and the USDA. As discussed below, however, staff and county assessors disagree with industry over the rate at which the restricted income should be capitalized.

Under the income approach a seemingly small adjustment in the capitalization rate can translate into a large difference in value. Staff's method produces capitalization rates that are markedly lower than those calculated under industry's method. Since both methods use the same income stream, staff's method—with its lower capitalization rates—results in values significantly greater than does industry's.

The Section 515 program is similar in most respects to its urban-area counterpart, HUD's Section 236 program. Staff's existing guidance on the valuation of Section 515 projects follows longstanding Board policy with respect to Section 236 projects. That policy was most recently expressed in Letter To Assessors (LTA) 98/51 (Attachment 1), issued October 1, 1998, which advised that Section 515 projects should be valued by capitalizing the restricted income at a rate that reflects the below-market rate for debt provided under the contract with the USDA. In this way, staff's guidance seeks to recognize all of the contractual provisions inherent in the ownership of a Section 515 property. County assessors generally agree with, and have adhered to, staff's guidance.

Industry urges a contrasting position. Industry's view, essentially, is that a Section 515 property should be valued by capitalizing the restricted income at a rate that reflects financing that would be expected by purchasers of conventional properties.

In support of its position, industry cites a Board regulation (Property Tax Rule 8) that directs the use of "market" capitalization rates. Industry further supports its position by citing Revenue and Taxation Code section 402.9, which, with respect to the valuation of both Section 236 projects and Section 515 projects, expressly prohibits the inclusion of the interest subsidy in the income to be capitalized. Here, industry's view is that the intent of section 402.9 is to preclude recognition of the interest subsidy not only as income, but also in the estimated capitalization rate.

Industry argues also that staff's guidance conflicts with several appellate court holdings and other property tax rules. More specifically, industry argues that staff's guidance conflicts with an appellate court holding that, under Property Tax Rule 4, the adjustment of a property's sale price to its "cash equivalent" is not left to an assessor's discretion, but is instead required in all cases. Industry argues additionally that staff's guidance is at odds with an appellate court holding that, in the construction of

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statutes, a duly adopted Board rule is entitled to great weight by the courts despite a subsequent argument by the Board that the rule was contrary to the statute in which the rule found its basis.

Finally, industry argues that staff's guidance results in assessments that violate the requirement, under Revenue and Taxation Code section 110, that all property be assessed based on its fair market value.

The disagreement over the proper method of calculating the capitalization rate has led to many assessment appeals in recent years. In these appeals county assessors were at first without any recent guidance from the Board; the issuance of LTA 98/51 was intended to clarify for assessors that staff's longstanding position with respect to Section 236 properties is equally applicable to Section 515 properties. The LTA influenced the outcomes of some appeals. Two appeals in separate counties, decided prior to the issuance of LTA 98/51, are currently in litigation at the appellate court level.

At industry's request, staff agreed in August, 2000, to undertake a review of its longstanding policy as reiterated in LTA 98/51. Many appeals were postponed pending some resolution by the Board. After a review of the applicable law and numerous discussions with industry, staff concluded that the advice contained in LTA 98/51 was both legally and theoretically sound.

On August 10, 2001, staff met with interested parties to discuss the valuation methodology and issues involved. Although the meeting did not result in any substantive change in the respective positions of either staff or industry, the discussion did serve to more sharply identify the issues of disagreement.

The central focus is on whether staff's guidance for valuing Section 515 low-income housing properties, as expressed in LTA 98/51 and as related to the derivation of the capitalization rate, is correct. To assist staff in making this determination, staff requests direction from the Board on five issues, which are presented in this issue paper:

1. Should the Board postpone action on this matter pending the outcome of current litigation?
2. Is staff's guidance in conflict with the intent of section 402.9?
3. Is staff's guidance in conflict with Property Tax Rule 8?
4. Is staff's guidance in conflict with certain appellate court holdings?
5. Does staff's guidance lead to assessed values that are consistent with the meaning of fair market value?

V. Staff Recommendation on Issue 1: Whether to Delay Action

Postpone action on this matter due to pending litigation.

A. Description of the Staff Recommendation

Staff recommends that action on this matter be postponed until current litigation involving Siskiyou and Kern counties is decided.

B. Pros of the Staff Recommendation on Issue No. 1

- Postponement would eliminate the possibility of the Board's decision having an undue influence on the court decision. Oral arguments are already scheduled for January 11, 2002 in one of the two pending court cases—*James Maples, Assessor/Recorder County of Kern v. Kern County Assessment Appeals Board, Lake Isabella Enterprises II, LP*.
- Postponement would provide all litigants in the pending cases, the courts, and other interested parties the time and opportunity to consider the meaning and effects of existing law and the current interpretation of that law, without last minute changes that may prejudice one party in contrast to the other.
- Postponement would enable the Board to consider decisions in the pending court cases. Issues before the courts directly relate to the proper methodology and whether staff's guidance is correct.

Specific issues before the courts that may necessitate future revisions to LTA 98/51 are: (a) In *Carl Bontrager, Assessor of Siskiyou County v. Assessment Appeals Board of Siskiyou County, Yreka Investment Group*, the court will decide whether Rule 8(g)(2) requires for Section 515 properties that the band-of-investment method of deriving a capitalization rate make use of the market rate for debt rather than the investors' actual rate; (b) in *James Maples, Assessor/Recorder County of Kern v. Kern County Assessment Appeals Board, Lake Isabella Enterprises II, LP*, the court will determine whether the income approach under Rule 8 may be used in valuing new construction of Section 515 property and, if so, whether Rule 8 requires—as in the Siskiyou case—that, for Section 515 properties, the band-of-investment method of deriving a capitalization rate make use of the market rate for debt rather than the investors' actual rate.

- Postponement would eliminate the need for the Board to issue further guidance if the court's decision is contrary to the Board's.

C. Cons of the Staff Recommendation on Issue No. 1

- Industry believes that the Board should not wait before making a determination. In this regard, industry asserts that (1) any further delay by the Board could worsen the "cash flow crisis" that, according to industry, threatens the Section 515 program; (2) the appellate court cases involve a number of property-specific issues, and the overall issue may not be resolved; and (3) many of the actions of Board staff are not before the appellate courts, as they were either unknown by the Section 515 industry or occurred subsequent to the time that the initial appeal hearing took place.
- Decisions in the pending litigation might not be issued if the parties were to settle their differences or dismiss their actions.

D. Statutory or Regulatory Change

None

E. Administrative Impact

None

F. Fiscal Impact

1. Cost Impact

No additional costs.

2. Revenue Impact

None

G. Taxpayer/Customer Impact

None

H. Critical Time Frames

None

VI. Alternative to Staff Recommendation on Issue No. 1

A. Description of the Alternative

The Board could provide direction on this matter despite pending litigation involving Siskiyou and Kern counties.

B. Pros of the Alternative

- Industry would like the matter addressed by the Board at the November 28, 2001, meeting. Industry asserts that:
 - (a) Actions and opinions of Board staff have contributed to a cash flow crisis that threatens the Section 515 program and negatively impacts the tenants with higher rents. Any further delay, industry believes, would only exacerbate this problem.
 - (b) Actions pending in appellate court involve a number of property-specific issues that may or may not resolve the overall issue facing the Section 515 program.
 - (c) Many of the actions of Board staff are not before the appellate court as they were either unknown by the Section 515 industry or occurred subsequent to the time that the initial appeal hearing took place.

C. Cons of the Alternative

- If the courts decide contrary to the Board, the Board would have to issue further guidance after the court decision.

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- As to industry's assertions that opinions of Board staff have contributed to a cash flow crisis that threatens the Section 515 program, several points are in order:

First, property taxes are but one expense item among many that owners are allowed to recapture before they start to earn a return on their initial investment. If the financial viability of any particular Section 515 property is at peril, it is implausible that property taxes, which make up a small proportion of a project's total operating expenses, is the cause.

Second, industry's assertion that the viability of the Section 515 program itself is threatened by excessive property taxes is unsupported by facts. In truth, funding for the Section 515 program has diminished in recent years, not because of over-assessments for property tax purposes, but instead because the Low Income Housing Tax Credit program has become the federal government's vehicle of choice for funding low-income housing projects.

Finally, even acknowledging that higher property taxes may translate into marginally higher rents, this is irrelevant to the proper valuation method. By law, Section 515 projects are taxable under the same fair market value standard that applies to most other real property. Thus, it would be not only illogical to have the level of tax determine the valuation method (taxes are a consequence of value, not the other way around) but also unlawful.

- Industry's implication that property-specific issues may obviate the need for the appellate courts to resolve the relevant legal issues is without merit. There are purely legal issues before the courts; the property-specific facts do not detract from those issues.

D. Statutory or Regulatory Change

None

E. Administrative Impact

None

F. Fiscal Impact**1. Cost Impact**

If the Board decides that staff's guidance is incorrect, no additional costs will be incurred for issuing new guidance, since this is considered part of the routine workload for the BOE.

2. Revenue Impact

See attached Revenue Estimate.

G. Taxpayer/Customer Impact

If the Board decides that staff's guidance regarding the use of the subsidized rate in developing the capitalization rate is incorrect, then it may potentially reduce the assessed value of Section 515 low income housing properties and consequently the taxes paid by owners of the property. The assessed values would be reduced as long as the resulting value is below the factored base year value.

H. Critical Time Frames

None

V. Staff Recommendation on Issue No. 2: Legislative Intent of Section 402.9

The Board should conclude that staff's guidance is not in conflict with the intent of Revenue and Taxation Code section 402.9.

A. Description of the Staff Recommendation

Staff's guidance is consistent with the legislative intent of section 402.9.

B. Pros of the Staff Recommendation on Issue No. 2

As originally enacted in 1979, section 402.9 provided that an assessor valuing Section 236 properties should "not consider as income any interest subsidy payments." Effective January 1, 2000, the section was amended to clarify that the prohibition against including interest subsidy payments as income applies also to Section 515 properties.

- Staff's guidance is consistent with the legislative intent of section 402.9 as evidenced by both the analyses of SB 1760, the original bill that enacted section 402.9 in 1979, and the analyses of SB 1231, which amended code section 402.9 in 1999.

Although there is no doubt that the broad purpose of the author and supporters of the 1978 bill (SB 1706, Sieroty) was to reduce property taxes on Section 236 properties, the legislative history suggests that the Legislature might not have been of the same mind as the bill's supporters. Specifically, several analyses before the Legislature in 1978 show that lawmakers were advised that the bill would not affect the calculation of the capitalization rate, and, by inference, did not accomplish the author's apparent purpose.

For example, the staff analysis of the Senate Revenue and Taxation Committee contains the following statement on page 3:

3. The State Board of Equalization indicates that if interest subsidy payments are excluded from income, good appraisal procedure dictates that the capitalization rate reflect the low interest paid by the owner.

Similarly, the staff analysis of the Assembly Revenue and Taxation Committee states on page 3:

Further, staff feels that if the interest subsidy payments are excluded from income, good appraisal procedure dictates that the capitalization rate reflect the low interest paid by the owner.

As further evidence that the Legislature was advised that the bill would not affect the capitalization rate, the staff analysis of the Department of Finance dated June 19, 1978, states under "Summary of Opposition":

1. Without placing any restrictions on the method of calculating the rate of capitalization, simply excluding subsidy payments from income would not significantly reduce values (if at all) of low income property....

Despite this clear advice, the author and the Legislature did not include specific language in the bill to deal with the issue of how to treat the interest subsidy in calculating the capitalization rate.

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- After the bill was passed, the author was advised of the Board's position on how Section 402.9 would be implemented. As required by Government Code section 11017.7, on July 2, 1979, the Board submitted to the author a report of the action taken to implement the legislation. The report included a copy of LTA 79/37, dated February 22, 1979, which advised assessors that when the interest subsidy is not considered income in the valuation of Section 236 properties (as was now required by section 402.9), then the capitalization rate must reflect the effective rate for debt of 1 percent.

The July 1979 report provides further evidence that the Legislature was aware that SB 1706 would not affect the calculation of the capitalization rate; if the author had been of the opinion that the Board's implementation action was inconsistent with his intent, he could have so advised the Board at the time or introduced corrective legislation. He did neither.

- The 1999 amendment to Section 402.9 affirmed the Board's interpretation and supports the staff's recommendation. Senate Bill 1231 was sponsored by the Board. The bill included the amendment that made Section 515 properties subject to the same provisions that govern the valuation of Section 236 properties. The specific purpose of the bill was to codify the guidance contained in LTA 98/51. An analysis by the staff of the Assembly Revenue and Taxation Committee shows that the Legislature was aware of the bill's purpose. On page two, the analysis stated:

The Board of Equalization has recently issued Letter to Assessors' 98/51 that, in part, instructs assessors to exclude the interest subsidy payments when determining the income stream on Section 515 projects. This bill would codify the Board of Equalization's Letter.

The law presumes that the Legislature, when it amends a statute, has knowledge of existing laws and judicial interpretations and acquiesces in or approves of them. The same acquiescence and approval is implied with respect to preexisting and longstanding administrative interpretation and practice, particularly where, as here, this interpretation and practice was brought to the Legislature's attention. As stated in 58 Cal.Jur.3d, Statutes, §111:

In other words, the reenactment of a provision, the meaning of which is well established by administrative construction, is persuasive of a legislative intention to continue the same construction. Similarly, if in amending a statute the legislature makes no substantial modification of a preexisting and long-standing administrative practice, there is a strong indication that the administrative practice was consistent with the legislative intent, since the legislature presumably would have enacted contrary legislation at the time of the amendment had it disagreed with such practice.

C. Cons of the Staff Recommendation on Issue No. 2

Industry asserts that the Board's guidance regarding the development of the capitalization rate when using the band-of-investment method conflicts with the legislative intent of section 402.9. According to industry:

- The legislative history from SB 1706 reveals the legislative intent based on the Assembly Third Reading: "the purpose of this bill is to reduce the tax burden that may be passed on to low income tenants of such subsidized housing and to clarify for county assessors the intent of the Legislature with respect to valuation of subsidized housing."

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- The legislative history from SB 1706 reveals the legislative intent based on an Enrolled Bill Report from the Department of Housing and Community Development (HCD):

...even with Proposition 13 in effect, eliminating the capitalized value of the subsidy payments lowers the taxes, and hence the rents in these projects.

- After section 402.9 was enacted in 1978, staff issued additional guidance, this time advising assessors to exclude the interest subsidy by recapturing its effect in the final capitalized value via the capitalization rate. Industry asserts that staff issued this guidance for the express purpose of defeating the intent of SB 1706.
- The staff's guidance produces essentially the same value before and after the enactment of section 402.9, thereby attributing no real meaning to the legislation. Including the interest credit subsidy in the value through the income (numerator) or capitalization rate (denominator) defeats the entire purpose and intent of the legislation to reduce the assessed value, the property taxes and thereby the rent for the disabled, low-income, handicapped and elderly tenants.

D. Statutory or Regulatory Change

None

E. Administrative Impact

None

F. Fiscal Impact**1. Cost Impact**

No additional costs.

2. Revenue Impact

See attached Revenue Estimate.

G. Taxpayer/Customer Impact

None

H. Critical Time Frames

None

VI. Alternative to Staff Recommendation on Issue No. 2**A. Description of the Alternative (Industry proposal)**

The Board could conclude that staff's guidance, in LTA 98/51, regarding the development of the capitalization rate is in conflict with the intent of Revenue and Taxation Code section 402.9.

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Industry asserts that:

"The interest credit subsidy should be excluded from the final taxable value by excluding its effects from the income (numerator) and the capitalization rate (denominator). This will produce a value that is in accordance with section 110(a) and all other R&T Code property tax rules; it will also be in accord with the intent of Section 402.9. Most importantly, it will accomplish the goal of the Legislature to reduce the rent to the ones who need it the most, the disabled, handicapped, elderly and low-income tenants who reside in Section 515 federally subsidized housing."

B. Pros of the Alternative

Industry states its position on the legislative intent of section 402.9, as follows:

- It is the opinion of the Section 515 industry that the legislative intent of Section 402.9 must be understood before a determination can be made as to whether ANY guidance from the SBE staff actually conflicts with this legislative intent. The legislative history from Senate Bill 1706 reveals the legislative intent as follows:

ITEM ONE: Assembly Third Reading

Comments: The purpose of this bill is to reduce the tax burden that may be passed on to low income tenants of such subsidized housing and to clarify for county assessors the intent of the Legislature with respect to valuation of subsidized housing.

*ITEM TWO: Enrolled Bill Report for Senate Bill 1706*REASON FOR RECOMMENDATION:

First, because even with Proposition 13 in effect, eliminating the capitalized value of the subsidy payments lowers the taxes, and hence the rents in these projects.

Most assessors, despite logic to the contrary, are including the amount of the subsidy to write-down the mortgage rate as either part of the net operating income of the project or, at least, in calculating the capitalization rate. Both of these techniques are incorrect, in that the owner receives no benefit from the write-down. It simply is a tenant subsidy designed to keep rental rates lower.

- In 1976, SBE staff issued LTA 76/157 instructing assessors to include the interest credit subsidy in the final taxable value by including it as part of the income. The wording of Section 402.9 was therefore constructed by the legislature to overturn the instructions in SBE LTA 76/157 and to remove the interest credit subsidy from the income and thereby from the capitalized value as follows:

LTA 76/157 - The gross income...should include...the interest subsidy payments made by the government to a lending institution on behalf of the landlord.

Section 402.9 - The assessor shall not consider as income any interest subsidy payments made to a lender on that property by the federal government.

- After Section 402.9 was enacted in 1978, the Board staff issued additional guidance for the express purpose of defeating the intent of the legislature. Their instructions were to include the interest subsidy by recapturing its effect in the final capitalized value....

C. Cons of the Alternative

Industry's position is inconsistent with the legislative intent of Revenue and Taxation Code section 402.9 as evidenced by the analyses of SB 1706, which enacted section 402.9 in 1979, and SB 1231, which amended section 402.9 in 1999.

- The legislative history shows that the Legislature was advised that the provisions of section 402.9, by eliminating subsidy payments from income and not placing any restrictions on the method of calculating the capitalization rate, would not significantly reduce assessed value of low-income rental property, but the Legislature did not specifically address the issue.
- The Board's longstanding interpretation was affirmed by the Legislature when section 402.9 was amended in 1999.
- Industry's documentation of legislative intent is misguided.

First, the quote from the "Assembly Third Reading" about the purpose of the bill is of no significance. The courts have held that

statements of individual legislator, including bill's author, are generally not considered in construing a statute, as the court's task is to ascertain the intent of the Legislature as a whole *Heavenly Valley v. El Dorado County Bd. of Equalization* (2000), 84 Cal.App.4th 1323, citing *Quintano v. Mercury Casualty Co.* (1995) 11 Cal.4th 1049.

Similarly, industry's quotation from HCD's Enrolled Bill Report, urging the Governor's signature on SB 1706, is unpersuasive. The courts have held that

letters urging Governor to sign bill are not cognizable legislative history unless they indicate their statements were presented to legislators *Heavenly Valley v. El Dorado County Bd. of Equalization* (2000), 84 Cal.App.4th 1323 citing *California Teachers Assn. v. San Diego Community College Dist.* (1981) 28 Cal.3d 692.

Industry's assertion that staff's post-SB 1706 guidance (LTA 79/37) was issued "for the express purpose of defeating the intent of the legislature" is not only inaccurate, but also conveys an unjustly unfavorable impression of staff. The fact is that in 1977 (LTA 77/173) staff had already expressed its position to assessors that if the restricted income is used, then so must the subsidized rate for debt be used. Since staff espoused this position in 1977, prior to SB 1706, it cannot be said that the advice in LTA 79/37 was promulgated only in response to the bill's passage in 1978.

D. Statutory or Regulatory Change

None

E. Administrative Impact

None

F. Fiscal Impact

1. Cost Impact

If the Board decides that staff's guidance is incorrect, no additional costs will be incurred for issuing new guidance, since this is considered part of the routine workload for the BOE.

2. Revenue Impact

See attached Revenue Estimate.

G. Taxpayer/Customer Impact

If the Board decides that staff's guidance regarding the use of the subsidized rate in developing the capitalization rate is incorrect, then it may potentially reduce the assessed value of Section 515 low-income housing properties and, consequently, the taxes paid by owners of the property. The assessed values would be reduced as long as the resulting value is below the factored base year value.

H. Critical Time Frames

None

V. Staff Recommendation on Issue No. 3: Conflict with Rule 8

The Board should conclude that staff's guidance is not in conflict with Property Tax Rule 8.

A. Description of the Staff Recommendation

Staff recommends that the Board conclude that staff's guidance regarding (1) use of the subsidized rate in developing the capitalization rate by the band-of-investment method and (2) the theoretical need for cash equivalency adjustments in deriving a capitalization rate by reference to comparable sales, is not in conflict with the Property Tax Rule 8.

B. Pros of the Staff Recommendation on Issue No. 3

Staff's guidance advises assessors to consider in their valuations of Section 515 properties not only the legally enforceable restrictions on income, but also the accompanying contractual provisions relating to debt financing.

- Staff's guidance regarding cash equivalency adjustments in deriving a capitalization rate by reference to comparable sales of Section 515 properties is consistent with subsection (g)(1) of Rule 8.

Rule 8(g)(1) discusses the derivation of a capitalization rate from data developed from recently sold comparable properties. The rule makes clear that, when an appraiser uses this method of deriving a capitalization rate, the sales prices of the comparable properties must be adjusted, "if necessary," to cash equivalents.

LTA 98/51 advises that no cash equivalent adjustment is necessary where the recently sold comparable properties are under the Section 515 program. The LTA reasoned that adjustments for the subsidized debt would result in misrepresentations of the overall investments in Section 515 properties. The entire issue is of little practical import, however, since sales of Section 515 properties almost never occur. Thus, in practice, there will be few, if any, "market-derived" capitalization rates for appraisals of Section 515 properties.

- Staff's guidance regarding the use of the subsidized rate for the debt component in deriving a capitalization rate for such properties by the band-of-investment method is consistent with subsection (g)(2) of Rule 8.

Rule 8(g)(2) discusses the derivation of a capitalization rate by the so-called band-of-investment method. Specifically, this provision of Rule 8 provides for the derivation of a capitalization rate from a weighted average of the rates for debt and for equity capital "appropriate to the California money markets." In LTA 98/51, staff advised that this instruction in the rule should not be construed so narrowly that it would require the use of a debt component that bears little or no relationship to the net income forecast for the overall investment. Here, it is important to note that subsection (c) of Rule 8 requires that the net income to be capitalized is that which reasonably well informed persons may anticipate the property will yield subject to legally enforceable restrictions as such persons may foresee.

C. Cons of the Staff Recommendation on Issue No. 3

Industry asserts that the Board's guidance regarding cash equivalency adjustments and use of the subsidized rate in developing the capitalization rate is in conflict with Property Tax Rule 8 in that it

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violates Property Tax Rule 8, subsections (g)(1) and (g)(2). Industry further asserts that it is these violations specifically that recapture the subsidy in the final capitalized value, thereby violating the "intent" of Section 402.9.

According to industry, staff created specific modifications to and interpretations of subsections (g)(1) and (g)(2) as follows:

- Assessors' Handbook Section 503, Cash Equivalency, adopted in 1985, put forth the opinion that the mandate of Rule 8(g)(1) requiring cash equivalency adjustments was not required for the Section 236 program. Industry holds that any exception to the mandatory rule of cash equivalency violates the expressed mandate of Rule 8 (g)(1).
- Instructions, in LTA 98/51, which advise the use of the 1 percent subsidized loan rate for the debt component when using the band-of-investment method to develop the capitalization rate ignores the mandate of Rule 8 (g)(2). Industry holds that Rule 8 (g)(2) requires the use of the "California money market" rate when determining the interest rate for the debt component.

D. Statutory or Regulatory Change

None

E. Administrative Impact

None

F. Fiscal Impact**1. Cost Impact**

No additional costs.

2. Revenue Impact

See attached Revenue Estimate.

G. Taxpayer/Customer Impact

None

H. Critical Time Frames

None

VI. Alternative to Staff Recommendation on Issue No. 3**A. Description of the Alternative (Industry proposal)**

The Board could conclude that staff's guidance regarding (1) cash equivalency adjustments in deriving a capitalization rate by reference to comparable sales and (2) the use of the subsidized rate

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for the debt component in deriving the capitalization rate by the band-of-investment method is in conflict with Rule 8, subsections (g)(1) and (g)(2).

B. Pros of the Alternative

Industry asserts that staff instructions violate the stated mandates in Rule 8, subsections (g)(1) and (g)(2). It is these violations specifically, industry asserts, that recapture the subsidy in the final capitalized value, thereby violating the intent of section 402.9.

Industry further asserts that in order to successfully recapture the interest credit subsidy through the capitalization rate, staff created specific modifications to and interpretations of subsections (g)(1) and (g)(2) well after the enactment of section 402.9.

Industry states its position as follows:

- SBE creates an 'EXCEPTION' to Rule 8 (g) (1) –

In 1985, the SBE staff introduced and the SBE adopted an amendment to Assessors' Handbook Section 503, Cash Equivalency 'An exception: 236 Housing'. This exception put forth the opinion that the mandate of Rule 8(g)(1) requiring cash equivalency adjustments was not required for the Section 236 Program. This exception was created by the staff due to the many successful appeal applications that were being filed by the owners of Section 236 properties in the early 1980's using Rule 8(g)(1) and adjusting sales to their cash equivalents. Any exception to the mandatory rule of cash equivalency violates the expressed mandate of Rule 8(g)(1). Just a few short months after this exception is introduced the Appellate Court issued an opinion in Prudential that cash equivalency adjustments are mandatory in all instances.

- SBE staff advises assessors to 'IGNORE THE MANDATE' of Rule 8 (g)(2)

In 1998, the SBE staff introduced LTA 98/51, which instructed assessors to ignore the mandate of Rule 8(g)(2) requiring the use of the 'California money markets' when determining the interest rate for the debt component using the band-of-investment method to calculate a capitalization rate. Instead, the SBE staff instructed assessors to use the 1% subsidized loan rate that the owners are required to pay despite the fact that the entire amount of the subsidy is not realized by the owners, but is instead returned to the tenants in the form of reduced rents.

This instruction is in direct conflict with the stated mandate of the Rule 8(g)(2) as evidenced by the following quotation from LTA 98/51:

Specifically, the issue is whether the appraiser should use (1) a rate that is, as stated in rule 8, 'appropriate to the California money markets,' or (2) a rate that reflects the investor's actual cost as to the financed portion of the overall investment.

The assertion in favor of the first approach relies on the **apparent mandate** of rule 8. However, the phrase 'appropriate to the California money markets' should not be construed so narrowly that it would require the use of a debt component that bears little or no relationship to the net income that is forecast for the overall investment. (emphasis added)

C. Cons of the Alternative

- In discussing the derivation of a capitalization rate from data developed from recently sold comparable properties, Rule 8, subsection (g)(1), makes clear that when an appraiser uses this

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method of deriving a capitalization rate, the sales prices of the comparable properties must be adjusted, "if necessary," to cash equivalents.

LTA 98/51 advises that no cash equivalent adjustment is necessary where the recently sold comparable properties are under the Section 515 program. The LTA reasoned that adjustments for the subsidized debt would result in misrepresentations of the overall investments in Section 515 properties. The entire issue is of little practical import, however, since sales of Section 515 properties almost never occur. Thus, in practice, there will be few, if any, "market-derived" capitalization rates for appraisals of Section 515 properties.

- In discussing the derivation of the capitalization rate by the band-of-investment method, Rule 8(g)(2) instructs that the rate be derived from a weighted average of the rates for debt and for equity capital "appropriate to the California money markets." In LTA 98/51, staff advised that this instruction in the rule should not be construed so narrowly that it would require the use of a debt component that bears little or no relationship to the net income forecast for the overall investment.
- Here, it is important to note that Rule 8, subsection (c) requires that the net income to be capitalized is that which reasonably well informed persons may anticipate the property will yield subject to legally enforceable restrictions as such persons may foresee. Under industry's alternative, Rule 8 would have to be interpreted as requiring an appraiser to recognize enforceable restrictions on net income (subsection (c)), only to have that same appraiser turn around and ignore concomitant governmental restrictions relating to the rate for debt.

D. Statutory or Regulatory Change

None

E. Administrative Impact

None

F. Fiscal Impact**1. Cost Impact**

If the Board decides that staff's guidance is incorrect, no additional costs will be incurred for issuing new guidance, since this is considered part of the routine workload for the BOE.

2. Revenue Impact

See attached Revenue Estimate.

G. Taxpayer/Customer Impact

If the Board decides that staff's guidance regarding the use of the subsidized rate in developing the capitalization rate is incorrect, then it may potentially reduce the assessed value of Section 515 low-income housing properties and consequently the taxes paid by owners of the property. The assessed values would be reduced as long as the resulting value is below the factored base year value.

H. Critical Time Frames

None

V. Staff Recommendation on Issue No. 4: Court Case Holdings

Staff's guidance is not in conflict with certain appellate court holdings.

A. Description of the Staff Recommendation

Staff recommends that the Board conclude that staff's guidance as to (1) cash equivalency adjustments in deriving a capitalization rate by reference to comparable sales and (2) the use of the subsidized rate for the debt component in developing the capitalization rate by the band-of-investment method is not in conflict with the appellate court holdings in *Prudential Insurance Co. v. City and County of San Francisco* (1987) 191 Cal.App.3d 1142 and *Coca-Cola v. State Board of Equalization* (1945) 25 Cal.2d 918, respectively.

B. Pros of the Staff Recommendation on Issue No. 4

The appellate court holdings support staff's position as follows:

- The *Prudential Insurance Co. v. City and County of San Francisco* (1987) 191 Cal.App.3d 1142 decision clarified that Property Tax Rule 4 is mandatory in its instruction to convert a sale price to its cash equivalent. The Court also noted, however, that "[s]uch conversion will not significantly affect the determination of market value where, for instance,...the financing of the subject property is typical of that available in the market at the time of the sale."

LTA 98/51 advises that the subsidized financing for Section 515 properties is typical of that available in the market for such properties. Under these circumstances a cash equivalent adjustment is not required, and, in fact, such an adjustment would distort the market value of the property. The entire issue is of little practical import, however, since there is rarely a true sale of a Section 515 property.

- *Coca-Cola v. State Board of Equalization* (1945) 25 Cal.2d 918 supports staff's position in two ways. First, the Court reaffirmed the established rule that the contemporaneous administrative construction of an enactment by those charged with its enforcement and interpretation is entitled to great weight, and courts generally will not depart from such construction unless it is clearly erroneous or unauthorized. Under this rule, staff's longstanding interpretation of section 402.9, without any legislative enactment contrary to that interpretation, would be upheld by a court.

Similarly, with respect to certain amendments to the Retail Sales Act, the *Coca-Cola* Court noted that:

It may be presumed that these amendments were made with full knowledge of the construction which had been placed upon the statute by the Board of Equalization, yet there was no modification of the legislation which would require a contrary interpretation. This is a factor that may be considered in determining the meaning of the terms intended by the Legislature. [Citations omitted.] And particularly because of the amendment made at the last session of the Legislature, the board's construction of the act should be decisive of the present litigation.

This holding underpins staff's argument that the 1999 amendments to section 402.9 affirmed staff's longstanding guidance.

C. Cons of the Staff Recommendation on Issue No. 4

Industry asserts that staff's guidance conflicts with the holdings in *Prudential Insurance Co. v. City and County of San Francisco* and *Coca-Cola v. State Board of Equalization*:

- Rule 8(g)(1) (market derived rate) is similar to Rule 4(a) (the market approach) in that both rules rely on market sales, and both contain expressed mandates requiring cash equivalent adjustments.
- In addition, the SBE staff created exceptions to each of these rules in the Cash Equivalent Handbook (AH 503). For Section 236 (&515) the SBE adopted a "special exception" expressing their "opinion" that cash equivalency adjustments are not required for these properties only.
- Therefore, the Board staff's guidance for valuing Section 515 housing is in direct conflict with the court's holding in *Prudential Insurance* as the mandate of any rule, including Rule 4(a) or Rule 8(g)(1), requiring cash equivalency adjustments is mandatory.
- Clearly, the SBE staff "opinion" and the "actual wording" of Rule 8 (g)(2) conflict with each other. The *Coca-Cola* decision states that in any conflict between a "rule" and an "opinion" of the SBE regarding the interpretation of that rule, the actual rule must govern.
- The stated mandate of Rule 8(g)(2) requiring the use of the "California money markets" must take precedence over the "opinion" of the SBE staff to use the 1% subsidized loan rate.
- Therefore, the Board staff's guidance for valuing Section 515 housing is in direct conflict with the court's holding in *Coca-Cola v. SBE* (1945) 25 Cal. 2d 918.

D. Statutory or Regulatory Change

None

E. Administrative Impact

None

F. Fiscal Impact

1. Cost Impact

No additional costs.

2. Revenue Impact

None. (See attached Revenue Estimate.)

G. Taxpayer/Customer Impact

None

H. Critical Time Frames

None

VI. Alternative to Staff Recommendation on Issue No. 4

A. Description of the Alternative (Industry proposal)

The Board could conclude that staff's guidance regarding cash equivalency adjustments and the use of the subsidized rate for the debt component of the capitalization rate *is* in conflict with appellate court holdings in *Prudential Insurance Co. v. City and County of San Francisco* and *Coca-Cola v. State Board of Equalization*.

B. Pros of the Alternative

Industry asserts that staff's guidance for valuing Section 515 housing is in direct conflict with the court's holding in (1) *Prudential Insurance* and (2) *Coca-Cola v. SBE*.

Industry provides the following in support of its assertion:

- "In the Prudential case, the assessor relied on an SBE staff created exception to AH 503 requiring cash equivalency adjustments stating that cash equivalency adjustments were not mandatory in all cases and that the mandate of Rule 4 (a) requiring these adjustments was in some cases discretionary. The Court ruled that cash equivalency adjustments are mandatory in all cases. A similar exception was created by the SBE for Section 236 (515) properties and this decision is directly relevant as Rule 8(g)(1) contains the same mandate for cash equivalency adjustments that is in Rule 4 (a)."
- "The Coca Cola case clearly demonstrates that when SBE 'opinions and/or interpretations' are in conflict with the rules or regulations being interpreted, the 'rules' must govern. For Section 515 properties, the SBE 'opinion' is in direct opposition to the stated mandate of Rule 8 (g)(2) to use the 'California money markets' when developing a capitalization rate, and therefore the SBE 'opinion', to use the 1% subsidized loan rate, must be disregarded in favor of the 'rule'."

C. Cons of the Alternative

In response to industry's assertions, staff provides the following comments:

- The subsidized financing is typical of Section 515 properties, and so no cash equivalent adjustment is necessary. In *Prudential* the court acknowledged that a conversion of a sale price to its cash equivalent "will not significantly affect the determination of market value where, for instance, ...the financing of the subject property is typical of that available in the market at the time of the sale."
- Industry misapplies the *Coca-Cola* case. Where, as here, the Board has consistently followed a longstanding policy, has consistently interpreted its own rules to be in harmony with that policy, and has successfully sponsored legislation to clarify that policy, it cannot be said that the Board's "opinion" conflicts with its rules.

D. Statutory or Regulatory Change

None

E. Administrative Impact

None

F. Fiscal Impact

1. Cost Impact

If the Board decides that staff's guidance is incorrect, no additional costs will be incurred for issuing new guidance, since this is considered part of the routine workload for the BOE.

2. Revenue Impact

See attached Revenue Estimate.

G. Taxpayer/Customer Impact

If the Board decides that staff's guidance regarding the use of the subsidized rate in developing the capitalization rate is incorrect, then it may potentially reduce the assessed value of Section 515 low-income housing properties and consequently the taxes paid by owners of the property. The assessed values would be reduced as long as the resulting value is below the factored base year value.

H. Critical Time Frames

None

V. Staff Recommendation on Issue No. 5: Fair Market Value

The Board should conclude that staff's guidance is consistent with the provisions of Revenue and Taxation Code section 110.

A. Description of the Staff Recommendation

Staff's guidance is consistent with the fair market value provisions of Revenue and Taxation Code section 110. Specifically, staff's guidance recognizes not only the legally enforceable restrictions of the Section 515 program relating to income, but also the contractual provisions relating to rates of return for both debt and equity.

B. Pros of the Staff Recommendation on Issue No. 5

- Staff's guidance leads to assessments consistent with the legal requirement that all property be assessed based on its fair market value. "Fair market value" is defined in section 110 as "the amount of cash or its equivalent that property would bring if exposed for sale in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other, and both the buyer and the seller have knowledge of all of the uses and purposes to which the property is adapted and for which it is capable of being used, *and of the enforceable restrictions upon those uses and purposes.*" [Emphasis added.]

The contractual arrangement between the federal government and an owner of a Section 515 project constitutes a set of enforceable restrictions that would be recognized by knowledgeable buyers and sellers. These "restrictions" of the Section 515 program extend not only to property income but also to the rates of return (or costs) of both debt and equity. For as long as a property is subject to Section 515 provisions, both its income and its financing (debt and equity) will be prescribed (its income based on the restricted rents, and its financing at debt and equity rates of 1 percent and 8 percent, respectively). This is the only income and financing that a knowledgeable, prospective owner of a Section 515 property would expect.

C. Cons of the Staff Recommendation on Issue No. 5

Industry asserts that:

- Board staff's guidance clearly violates R&T Code section 110(a) as this method predetermines an assessed value years in advance of the market. Section 110 of the R&T Code requires all property to be assessed at its "Full Cash value." "Full Cash value" is determined by market sales predicated on the combined actions of a willing buyer and seller. Any method that determines the assessed value of a property before the market has even materialized is in direct violation of section 110(a). By separating itself from the actual market the current SBE method is illegal and violates the primary mandate of Section 110(a) to determine "full cash value."

D. Statutory or Regulatory Change

None

E. Administrative Impact

None

F. Fiscal Impact

1. Cost Impact

No additional costs.

2. Revenue Impact

See attached Revenue Estimate.

G. Taxpayer/Customer Impact

None

H. Critical Time Frames

None

VI. Alternative to Staff Recommendation on Issue No. 5

A. Description of the Alternative (Industry proposal)

The Board could conclude that staff's guidance, as expressed in LTA 98/51, for valuing Section 515 housing properties violates the provisions of Revenue and Taxation Code section 110.

B. Pros of the Alternative

Industry asserts that the current SBE staff method of valuing Section 515 properties violates Section 110 and provides the following in support of its position:

- SBE staff method produces a value that is directly correlated to the amortized loan amount plus down payment thereby assessing the loan instead of the real property. The SBE method uses the loan amount and down payment in a staff created method (circular equation) that is directly correlated to and the approximate equivalent of the very same amortized loan amount and down payment (plus reversion) in every instance. As no amortization has taken place at the beginning of the loan, this method establishes the actual cost as the base year value...[T]he cost approach is prohibited by Rule 6(a) and 8(a). In subsequent years the assessed value is reduced based on the amortization of the loan so this method pre-determines that Proposition 8 reductions will be required in every year after the base year value has been established. Therefore, the current SBE method appraises the loan and not the real property.
- SBE method uses data from the subject property only. The SBE staff method relies solely on loan information from the subject property and uses no market data. The restricted income is correctly used due to the mandate of Section 402.9. Therefore, the only remaining area where market data can be utilized is from interest rates when developing the capitalization rate. Market interest rates are accurately reflected by the 'California money markets', as stated in Rule 8(g)(2), however this method ignores the mandate to use these money markets and uses the 1% subsidized loan rate instead. However, there are no 1% market rates anywhere in the State of California, and ALL Section 515 and 236 loans are based upon current 'California money market' rates. Therefore, no market information is employed by this methodology.

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- SBE method pre-determines the assessed value for most of the 50 years associated with the government contract prior to the "full cash value" being established by actual market forces. As a result, the assessed valuations for these properties are pre-determined at the beginning of the loan for almost the entire 50-year life of the government contract. The SBE method produces a predetermined value independent of any market forces including but not limited to interest rates. It makes no difference if the prime interest rate is at 2% or 22%, this method will produce a pre-determined value based on data from the original loan. Using the SBE method, one can accurately forecast at the beginning of the loan what the assessed value will be for any year in the future.

C. Cons of the Alternative

Industry's alternative is inconsistent with the provisions of Section 110 defining "fair market value." To appraise Section 515 properties in the way that industry has suggested would be to unfairly treat them under a value standard different from that which is applied to other properties.

- Section 110 defines "fair market value" as "the amount of cash or its equivalent that property would bring if exposed for sale in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other, and both the buyer and the seller have knowledge of all of the uses and purposes to which the property is adapted and for which it is capable of being used, *and of the enforceable restrictions upon those uses and purposes.*" [Emphasis added.]

Knowledgeable buyers and sellers would recognize that the contractual arrangement between the federal government and an owner of a Section 515 project constitutes a set of enforceable restrictions. These "restrictions" of the Section 515 property extend to property income, as well as to the rates of return (or costs) of both debt and equity. To ignore the contractual arrangements would be to dismiss the provisions of section 110 pertaining to enforceable restrictions.

- Industry's assertion that staff's guidance violates Rule 6, subsection (a), is based on language in that subsection stating that the cost approach is preferred when neither reliable sales data nor income data is available, and when "the income from the property is not so regulated as to make such cost irrelevant." Industry's argument fails for the simple reason that, in the case of Section 515 properties, the income is regulated in a way that is *directly* relevant to the costs as calculated under the program. Thus, while staff's guidance has consistently espoused the use of the income approach, it is neither surprising nor illegal that the resulting value under staff's method may approximate the original cost under the program. To the contrary, that staff's method produces such results provides further evidence that staff's method is consistent with proper appraisal practice.

D. Statutory or Regulatory Change

None

E. Administrative Impact

None

F. Fiscal Impact

1. Cost Impact

If the Board decides that staff's guidance is incorrect, no additional costs will be incurred for issuing new guidance, since this is considered part of the routine workload for the BOE.

2. Revenue Impact

See attached Revenue Estimate.

G. Taxpayer/Customer Impact

If the Board decides that staff's guidance regarding the use of the subsidized rate in developing the capitalization rate is incorrect, then it may potentially reduce the assessed value of Section 515 low-income housing properties and consequently the taxes paid by owners of the property. The assessed values would be reduced as long as the resulting value is below the factored base year value.

H. Critical Time Frames

None

Prepared by: Property Taxes Department; Policy, Planning, and Standards Division
Legal Division; Property Taxes Section

Current as of: October 26, 2001



VALUATION OF SECTION 515 LOW-INCOME HOUSING PROJECTS

Staff Recommendation

Staff recommends that the Board uphold staff's position on the valuation of Section 515 property and conclude that (1) action on this matter be postponed until pending litigation is resolved; (2) staff's guidance is *not* in conflict with the intent of Revenue and Taxation Code section 402.9; (3) staff's guidance is *not* in conflict with Property Tax Rule 8; (4) staff's guidance is *not* in conflict with certain appellate court holdings; and (5) staff's guidance leads to assessed values consistent with the meaning of "fair market value" as provided in Revenue and Taxation Code section 110.

Alternative 1:

The Board could conclude that (1) action on this matter should *not* be postponed until the resolution of pending litigation; (2) staff's guidance *is* in conflict with the intent of Revenue and Taxation Code section 402.9; (3) staff's guidance *is* in conflict with Property Tax Rule 8; (4) staff's guidance *is* in conflict with certain appellate court holdings; and (5) staff's guidance leads to assessed values that are *not* consistent with the meaning of "fair market value" as provided in Revenue and Taxation Code section 110.

Background, Methodology, and Assumptions

Staff Recommendation:

The staff recommendation would continue in force the guidance currently given by the Board to county assessors regarding the valuation of Section 515 low-income housing projects. The staff recommendation has no revenue effect.

Alternative 1:

Alternative 1 would overturn the staff's guidance on the valuation of Section 515 low-income housing. The issue here concerns what debt rate on debt to use in the calculation of the capitalization rate used in the income approach. Under the staff recommendation, the debt rate would be 1% as that is the rate at which the government finances the projects. Alternative 1 would use a market debt rate that is currently at about 9%.

The calculation of the capitalization rates under the band of investment method would be as follows:

	<u>Staff</u>	<u>Alternative</u>
Percent Equity	5%	5%
Equity Rate	8%	8%
Percent Debt	95%	95%
Debt Rate	1%	9%
Capitalization Rate	1.35%	8.95%

The capitalization rate is calculated using the formula - $Capitalization Rate = (Percent Equity \times Equity Rate) + (Percent Debt \times Debt Rate)$. Calculating the present value factor for the property using the above capitalization rates and assuming 30 years as the average remaining term under the contract, yields a factor of \$24.53 for the staff method and \$10.32 for the alternative method. The alternative factor is 42% of the staff factor. Since the income does not change, the difference between the staff method and the alternative method is based only on this difference in the capitalization rate.

According to the United States Department of Agriculture, there are 426 Section 515 low-income housing projects in California. Of these, it is estimated that about 25 are non-profit projects that are exempt from property tax. Using the staff methodology, the average value of these projects is estimated to be \$1.5 million. The estimated total assessed value for the 401 taxable Section 515 projects under the staff method would be \$601.5 million. The alternative method would be 42% lower than this amount or \$252.6 million. The difference would be \$348.9 million. The estimated annual decrease in revenues at the basic one percent property tax rate is \$348.9 million x 1%, \$3.5 million.

Revenue Summary

Staff Recommendation:

The staff recommendation has no revenue effect.

Alternative 1:

The estimated annual decrease in revenues at the basic one percent property tax rate under the alternative is \$3.5 million.

Preparation

This revenue estimate was prepared by David E. Hayes, Research and Statistics Section, Agency Planning and Research Division. This revenue estimate was reviewed by Ms. Laurie Frost, Chief, Agency Planning and Research Division and Mr. Richard Johnson, Deputy Director, Property Tax Department. For additional information, please contact Mr. Hayes at (916) 445-0840.

Current as of August 28, 2001