Low-Income Housing Valuation Guide

Property Tax Assessment
of Multifamily Low-Income Housing Properties

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Purpose

This guide, which is to be used in conjunction with the Property Tax Advisory 15.0.2008 (PTA), provides some background and suggests the appropriate approaches for assessing multifamily housing subject to rental use restrictions in federal or state programs that are available for low-income tenants.

Assessors will encounter four broad classes of low-income multifamily housing that are distinguished by their capital financing structure: (1) low-income housing tax credit (LIHTC) projects; (2) subsidized mortgage projects (for example, U.S. Department of Agriculture Rural Development [USDA-RD] Section 515 or U.S. Department of Housing and Urban Development [HUD] Section 236); (3) those which proportionately encompass both LIHTC and USDA-RD/HUD projects; and (4) restricted-use projects that also have market-rate rental units.

The reason for this advisory is to provide assistance and guidance to county assessors on the valuation of properties enrolled in these very complicated programs. Properties involved in these programs typically have required rent limits tied to local area median family incomes and also have management, maintenance, and physical requirements that may be different than properties conventionally built, managed, and maintained by conventional owners and renters. Due to the long-term deed restrictions placed on properties participating in these programs and the restrictions placed on resale, they are not typically available on the open market, nor are they attractive to conventional multifamily willing sellers or willing buyers. Those buyers and sellers who venture into this market segment often are specialists because of the many technical rules governing a property's qualification and operation.

Willing Sellers/Willing Buyers

The open and available real estate market is highly dependent on supply, demand, and competition. Key components to a healthy and typical real estate market are the availability of real estate inventory and competition made up of a pool of "willing sellers" and "willing buyers" not unduly influenced by outside pressures or economic forces. The terms "willing seller" and "willing buyer" are familiar to real estate professionals, and the concept is normally associated with conventional multifamily housing transactions. Unlike conventional properties not enrolled in any program that restricts rents, the properties that are the subject of this Guide are in a situation where, due to the difficulty of transferring these properties because of the program requirements, the conventional "willing seller/willing buyer" concept is altered. There are periods of time in the program when transferring ownership of a multifamily low-income property in a federal or state program is easier than at other times. Therefore, the "willingness" or ability for an owner to sell is greater at the close of the program than it is in the beginning of the program. This is due to the restrictions or penalties for early removal of a property enrolled in a program. However, as the property enrolled in one of these programs matures into the program, the restrictions or penalties for early exit soften, and the property owner **may** be more convinced to sell. Therefore, as the property progresses into the program, a seller's potential willingness to sell grows each year. Since the concept of property assessments is based on the market valuation concept of having adequate motivation between sellers and buyers, it is important to understand how the motivation of owners and buyers changes each year while enrolled in one of these programs and how that affects the market value of the property from year to year.

Background and Legal Developments

This Low-Income Housing Valuation Guide incorporates generally accepted appraisal practices with Washington statutory and appellate court case law. Appraisal theory and practice and Washington case law have long held that the basis for determining the value of real property is all the factors that enter into a sale of property between a knowledgeable willing seller and a knowledgeable willing buyer who are not compelled to sell or buy. Furthermore, Washington case law is clear that "where private land is leased, the entire estate including the fee, the leasehold and any improvements thereon, is assessed and taxed as a unit . . . ." (*Duwamish Warehouse Co. v. Hoppe*, 102 W. 2d 249, 253; 684 P. 2d 703 (1984).) (See also, *Folsom v. County of Spokane*, 106 W. 2d 760, 725 P. 2d 987 (1986) ["*Folsom I*"] and *Folsom v. County of Spokane*, 111 W. 2d 256, 759 P. 2d 1196 (1988) ["*Folsom II*"].) (See also, *Twin Lakes Golf Club v. King County,* 87 W. 2d 1, 548 P. 2d 538 (1976).)

Assessment of real property as a unit applies to all taxable real property that is leased, regardless of any restrictions on the amount of rent charged or the use of the property. Yet, when such restrictions affect what a willing buyer will pay for the property, then those restrictions must be taken into consideration. This is merely good appraisal practice and is helpful for determining the true and fair value of the property as statutorily required. Rent-restricted housing is not a different "class" of real property from any other real property. However, because such housing has certain characteristics that differ from other real property, including other rental housing properties, the proper appraisal of rent-restricted housing requires consideration of those different characteristics and their affect on the marketability of those properties.

One of the differing characteristics that is relevant for the proper appraisal of rent-restricted housing is the treatment of the difference between "contract rent" and "market rent" and the concept of an owner's positive leasehold reversion or "leasehold bonus." (See *Folsom II.*) Generally speaking, particularly in the early years of the low-income housing program, there will be little or no owner's positive leasehold reversion influence on value. This is because the lessees, the tenants in these housing projects, do not have the ability to sublease or transfer their rental spaces. Any positive leasehold value belongs to the tenants and ends with lease or rent restriction termination. Since their leasehold position cannot be transferred and may exist for up to 40 years, it has no value to a prospective willing buyer. (See *The Appraisal of Real Estate,* 12th ed., page 84.) Therefore, there is little or no owner's positive leasehold reversion value to be added to the leased fee interest to determine the overall value of the property. The value of the leased fee interest is, at least at the beginning of the program, the total value of the restricted-use property.

In the context of valuing restricted rent and restricted-use housing, there is currently only one Washington appellate court decision, *Cascade Court Limited Partnership v. Noble*, 105

Wash.App. 563, 20 P.3d 997, (2001). That decision affirms the importance of the willing buyer and willing seller concept, and it goes on to conclude that the restricted rents of property in a low-income housing program, as opposed to the market rents of conventional housing, are to be taken into account by the assessor when valuing the rent-restricted property. The court stated that "a willing buyer would not buy the property based on rents that the buyer could not charge." The court went on to say, "[f]or example, an assessor using the income method should capitalize the maximum rents allowed under the covenants." Nevertheless, even though the court did not explicitly state it, the decision, taken as a whole, implies the fact that the maximum rents under the *covenants* must also be considered in light of the *market*. If the restricted-rent housing, under prudent management, has maximum rents that are less than what the covenants allow, then those are the maximum rents that should be capitalized. In other words, "a willing buyer would not buy the property based on rents that the buyer could not charge," whether that rent maximum is established by covenant or by the market.

Low-Income Housing Tax Credit, Section 42 Properties (LIHTC § 42)

The LIHTC program laws, rules, and guidelines are intricate. This section is designed to provide enough background material to facilitate the valuation discussion that follows.

Background

The LIHTC program, instituted by the 1986 Tax Reform Act and subsequently codified as section 42 of the Internal Revenue Code (IRC), is now the primary federal program to subsidize affordable housing production. The central and core feature of this program is that it provides a dollar-for-dollar federal income tax credit over a 10-year period. The credits are typically sold to investors. The sale of the credits is commonly through a syndication process, and the revenue generated through the sale contributes equity to a project. The investors use the credit to reduce their federal tax liabilities, and the developer uses the investors' equity to help rehabilitate or construct the project. Since the developer is able to complete the project with less debt-service financing, the project's rents are reduced to serve low-income households. Because only a limited number of credits are available each year, the housing tax credits are allocated through a competitive application process administered by the Washington State Housing Finance Commission (WSHFC), a state government agency. Federal law requires that the allocation plan give priority to projects that (a) serve the lowest-income families and (b) are structured to remain affordable for the longest period of time. Qualifying projects must comply with the requirements of the IRC and the WSHFC. There are two credit rates, or applicable percentages, a "9% Credit" and a "4% Credit," depending on the type of project. The "9% Credit" is available for new construction and substantial rehabilitation projects without other federal subsidies. The "4% Credit" is available for projects that involve acquisition of an existing building, or for federally subsidized projects. The credit amount for a project is calculated based on the costs of development and the number of qualified low-income units, and it cannot exceed the amount needed to make the project feasible.

How the Program Works

In exchange for the tax credits, the project owners agree to operate the project in accordance with the restrictions contained in 26 CFR, Section 42, of the Code of Federal Regulations and IRS regulations. Furthermore, as a condition of receiving tax credits, the project owners are required to enter into a recorded regulatory agreement restricting the use of the property to its terms. The WSHFC, the designated tax credit allocating agency for the state of Washington, must, by law, give preference to projects that serve the lowest income tenants for the longest period of time. Projects must be maintained as low-income housing for a minimum of 30 years, including both the 15-year compliance period and an additional 15-year period (the 30-year extended low-income housing use period).

The relationship between debt and equity for a new LIHTC development is generally 70 to 80 percent equity and 30 to 20 percent debt. The equity financing provided by tax credits may be combined with several types of debt financing, subsidized or unsubsidized, to reach total project capitalization (to completely finance the project's total development cost). Since the developer is able to complete the project with less debt-service financing, the project's rents can be reduced to serve households with qualifying low incomes.

Governmental regulations require that a minimum percentage of rental units be set aside as low-income housing. To qualify, one of the following two minimum conditions must be met:

- At least 20 percent of the units are rent restricted and inhabited by renters whose income is a maximum of 50 percent of the area median gross income.
- At least 40 percent of the units are rent restricted and inhabited by renters whose income is a maximum of 60 percent of the area median gross income.

When the tax credits are awarded, a regulatory agreement between the WSHFC and the project owner is recorded with the county auditor where the project is located. Exhibit "B" to the regulatory agreement (Extended Use Agreement) summarizes several important use restrictions, including:

- Project compliance period.
- Total units.
- Total common area units.
- Total housing units in low-income housing commitment.
- Percent of area median gross income for qualified low-income housing units.
- Any additional low-income housing commitments.

Tax credits can be claimed on the portion of units matching one of the above conditions; this could be up to 100 percent of the units if all the units meet the criteria. Rent values will then depend on a level correlated to the county's median income.

The two most fundamental LIHTC occupancy requirements relate to household income and maximum rent. Each LIHTC-assisted household's income must be at or below the minimum income (by household size) permitted for that LIHTC unit (depending on the income level targeted for that unit). Each LIHTC-assisted resident must pay a rent that does not exceed the maximum LIHTC rent (including tenant-paid utilities) established for that unit.

To determine the maximum gross rent, the appraiser must verify the number of units set aside for tenants in the targeted income groups (30, 35, 40, 45, 50, and 60 percent of area median income

(AMI)). Use Exhibit “B,” the regulatory agreement (Extended Use Agreement) recorded at the county auditor’s office between the developer and WSHFC, to determine the number of set-aside units, or alternatively, the WSHFC web site has a search for commission finance properties to find LIHTC properties by county, city, or zip code. Maximum gross rents by AMI, unit size, county, and year are published by the WSHFC and updated annually.

Compliance
The WSHFC, with assistance from the IRS, also administers a compliance-monitoring program involving all operating tax credit projects in Washington. If a project is found to be in material noncompliance, WSHFC notifies the IRS, which by law may take action to disallow previously claimed tax credits.

Section 515 Properties

Background
Section 515 is a major program used to finance affordable rental housing in rural areas, but it is not the only one. USDA’s Section 514 loan and 516 grant programs fund the development of housing for farm workers, and HUD programs can be used in rural areas as well. Created in 1962, Section 515 enables the USDA to make deeply subsidized loans directly to the developers of rural rental and cooperative housing. USDA-RD staff in field offices around the country administer the Rural Housing Service (RHS) programs, including Section 515.

How the Program Works
Rental units funded under Section 515 must be occupied by very low-, low-, and moderate-income families; elderly persons; and persons with handicaps and disabilities. Very low-income is defined as below 50 percent of the AMI, low income is between 50 and 80 percent of AMI, and moderate income is capped at $5,500 above the low-income limit. (This is different from HUD’s definition of moderate income.) People living in substandard housing are given first priority for tenancy. When Section 521 Rental Assistance is used, top priority is given to very low-income households.

Section 515 provides loans directly to developers of rural rental housing. Almost all types of development entities are eligible: for-profit and nonprofit corporations, partnerships, public agencies, individuals, and others. Typically, for-profit Section 515 projects are highly leveraged: 5 percent equity and 95 percent debt. The owner’s profit is limited to an 8 percent dividend on their equity investment, which is not guaranteed. USDA-RD restricts income to generate only enough to cover operating expenses, mortgage payments, reserve payments, and equity dividend.

Interest credit subsidy is provided on loans to nonprofit entities and to those for-profit entities that agree to operate on a limited-profit basis. The subsidy lowers the effective interest rate to only 1 percent. Currently, the loans have 30-year terms and are amortized over 50 years.

Loan prepayment allows owners to exit the Section 515 program and operate the project as a conventional apartment complex. The ability to prepay a Section 515 mortgage, and the process for doing so, are governed by statutes and RHS regulations. Mortgages made after December 15, 1989, cannot be prepaid during their terms. Mortgages financed before December 21, 1979, can be prepaid only if the owners decline RHS incentives to stay in the program and RHS determines that the prepayment has no adverse impact on minority housing opportunities. (See *Franconia Associates v. U.S.*, 536 U.S. 129, 122 S.Ct. 1993 (2002).) Projects with interest credit subsidy or rental assistance approved between December 21, 1979, and December 15, 1989, are subject to 20-year use restrictions, and those without either subsidy are subject to 15-year restrictions. Legislation in 1992 imposed the pre-1979 requirements on mortgages initiated between 1979 and 1989. The date of the mortgage documents determines whether a loan was made on or after December 15, 1989. USDA-RD and the property owner have this information; it is not provided in the public record. The applicable restrictions change on a loan approved before December 21, 1979, if a loan consolidation or reamortization occurs, or if the loan is transferred to and assumed by a new borrower. The date of that action, rather than of the original commitment or mortgage, determines what restrictions apply to the property.

Summary of Section 515 Properties and Loan Prepayment Restrictions

Project Type	Prepayment restriction
Pre-1979	May prepay at any time but subject to Emergency Low Income Housing Preservation Act (ELIHPA) process
Post-1979 projects (1979-1989)	May prepay at any time subject to ELIHPA process but must maintain housing for low-income residents for first 20 years
Post-1989 projects	Cannot prepay

Holding Periods

LIHTCs

The 15-year compliance period for LIHTCs requires that most investments be held for at least that long. The principal risk of LIHTC investing is the loss of the tax credit itself and its recapture by the IRS, which means the investor would forfeit all or a portion of the previously claimed credits, plus interest, and might also have to pay a penalty. To avoid recapture of tax credits for investments sold before the end of the compliance period, the seller must post a bond with the U.S. Treasury Department or provide U.S. Treasury bills in an amount equal to the tax credits subject to potential recapture.

Section 515s

For Section 515 projects with loans initiated on or prior to December 15, 1989, the low-income housing use period expects that most initial investments will be held for at least 20 years. For Section 515 projects developed after that date, the holding period is likely to be through the entire low-income housing use term.

In comparison to an unrestricted apartment complex, investors typically forecast a 7- to 10-year holding period in their decision-making analysis.

Appraisal Methodology

Sales Comparison

The sales comparison approach is applicable when there are sufficient recent, reliable transactions to indicate value patterns or trends in the market. Although appraisers cannot always properly identify and quantify how the factors affecting property value are different, they can still use the sales comparison approach to determine a probable range of values and support a value indication derived using one of the other approaches. Furthermore, the comparison process often provides data needed to apply the other approaches—i.e., overall capitalization rates for the income capitalization approach, or depreciation estimates for the cost approach. To ensure the reliability of the value conclusions derived by applying the sales comparison approach, the appraiser must verify the market data obtained and fully understand the behavior characteristics of the buyers and sellers involved in property transactions of these types.

The normal and typical ***comparison units*** for multifamily housing of all types are:

Units of Comparison

1. Price per apartment unit.
2. Price per room.
3. Price per square foot of gross building area.

Basic ***comparison elements***, applicable to all properties conventional or unconventional, that should be considered include:

Elements of Comparison

1. Real property rights conveyed.
2. Conditions of sale.
3. Financing terms.
4. Expenditures made immediately after purchase.
5. Market conditions (time).
6. Location.
7. Physical characteristics.
8. Economic characteristics.
9. Use (zoning or other government or private restriction).
10. Non-realty value components.

Both the units and elements of comparison are more fully discussed in most real estate appraisal textbooks, such as *Property Assessment Valuation*, published by the International Association of Assessing Officers, or *The Appraisal of Real Estate*, published by The Appraisal Institute.

Units of comparison for low-income housing properties are identical to units of comparison for conventional multifamily housing. Buyers typically buy multifamily housing in comparison with other properties based on a price per foot, price per room, or price per unit, and this nomenclature and measurement standard would apply to both conventional and restricted multifamily properties.

Elements of comparison, however, may be slightly different for restricted properties than they are for conventional properties. For instance, key to comparing different low-income multifamily properties, in addition to the typical elements of comparison, are the following:

a. Geographic area
b. Area median income
c. Expense ratios
d. Tenant mix
e. Rent change rate

The assessor using sales comparison should develop two values for the subject property: a value "as if" unrestricted use and a value "as" restricted use. The unrestricted-use value is developed by comparing the subject property to conventional unrestricted multifamily housing and provides valuable information because it indicates the probable upper value limit "as if" conventional unrestricted use is the property's highest and best use. It also shows compliance with RCW 84.40.030(1) that other highest and best uses, such as conventional apartments, were considered and ***not*** used as the valuation basis. The restricted-use value is developed following the advice contained in this Guide.

When reconciling in the sales comparison approach, the appraiser should ask: Is each comparable property a valid and reliable indicator of the subject property's value? Is the comparable similar in physical characteristics and location? Was it developed, rented, or sold in the same market as the subject? Are the transaction characteristics similar to those expected for the subject property? Would a potential buyer of the subject property consider the comparable as a reasonable alternative?

Income Approach

Potential Gross Income

Section 42s

Many LIHTC projects have multiple rent levels, which include the LIHTC rents as well as market rents. The goal when reconstructing an operating income statement is to estimate the rents, expenses, and net operating income an owner will anticipate from operating the property prudently. The assessor should use the lower rent, chosen from either restricted rent or market rent. The rent that should be used in the valuation of the LIHTC property is the highest rent that meets the tax credit program requirements, satisfies the project based agreements affecting the property, and can be supported by the restricted market.

The *Cascade Court* decision (*Cascade Court v. Noble*, 105 Wn. App. 563 (2001)) emphasized the fact that "A willing buyer would not buy the property based on rents that the buyer could not charge." Therefore, if the **actual** rents were less than the rents allowed under the covenants, and were the maximum that could be charged without losing tenants, then the actual rents are, in fact, the maximum for purposes of a willing buyer and are the rents that should be capitalized under the income approach to value. To merely assume that the maximum rents under the covenants is the rent to be capitalized is to misconstrue *Cascade Court*. Therefore, the assessor should estimate the achievable restricted rents. Achievable restricted rent is never more than maximum gross rent or maximum allowable rent.

Example 1A
ABC LIHTC § 42 Apartments
Restricted Potential Gross Income Calculation

Program Description	Unit Count	Type	Monthly Rent	Annual Potential Gross Income
§ 42 Maximum at 45% AMI less utility allowance	10	1 Bedroom	$657 - 39 $618	$74,160
§ 42 Maximum at 60% AMI less utility allowance	10	1 Bedroom	$876 - 39 $837	$100,440
§ 42 Maximum at 45% AMI less utility allowance	20	2 Bedroom	$911 - 54 $857	$205,680
§ 42 Maximum at 60% AMI less utility allowance	20	2 Bedroom	$1,051 - 54 $ 997	$239,280
Market Rate	10	1 Bedroom	$950	$114,000
Market Rate	10	2 Bedroom	$1,100	$132,000
Totals	80			$865,560

Example 1B
ABC LIHTC § 42 Apartments
As If Unrestricted Potential Gross Income Calculation

Program Description	Unit Count	Type	Monthly Rent	Annual Potential Gross Income
Market Rate	40	1 Bedroom	$950	$456,000
Market Rate	40	2 Bedroom	$1,100	$528,000
Totals	80			$984,000

Section 515s

Section 515 rents are negotiated between the owner and USDA-RD yearly, based on the projected operating budget. Tenants pay a maximum 30 percent of their income for rent. If that rental income is not enough to pay operating expenses and debt service and provide the owner's dividend, USDA-RD contributes enough rental assistance to allow the property to meet those obligations. Cooperation and collaboration between the assessor and the property owner is key to an accurate valuation. Therefore, because the potential gross income is project specific, the assessor should request and the taxpayer should provide the required income information, in order to obtain the most accurate appraisal.

Section 42s and 515s

Miscellaneous Income
All other income attributable to the real estate—e.g., income from services provided to tenants, storage, garage space, and coin-operated equipment.

Vacancy and Collection Loss
Vacancy rates tend to be lower for both LIHTC and Section 515 projects than for market-rate properties in the same markets because rents are set below those of competitive properties. Market studies should determine the correct vacancy and collection loss rate.

Operating Expenses
Operating expenses are mainly market determined. The assessor should review expenses on a line-by-line basis and make an overall expense-per-unit-per-year comparison. Some expense items that tend to be more for restricted-use properties than for conventional apartments are audits, tenant income verification, additional regulatory reports, and required replacement reserves. The assessor should review the subject (if available) and comparable properties' expense histories and/or nationally published data to take into account those items unique to subsidized projects to determine appropriate expense estimates.

Capitalization Methodology
Either direct capitalization or yield capitalization may correctly produce a supportable value indication, when based on relevant market information derived from comparable properties. The comparable properties should have similar income/expense ratios, risk characteristics, and expectations of future income and value changes over a typical holding period. Generally, when speaking about direct capitalization, the term capitalization rate is used, and when speaking about yield capitalization, the term yield rate or discount rate is used. The symbol for direct cap is R_o, and the symbol for yield or discount rate is Y_o.

Direct Capitalization
Comparable income-producing property transactions that would appeal to the same category of prospective purchaser provide the most compelling value indication. When selecting comparable sales for direct capitalization, the assessor should consider the same factors as discussed earlier in the Sales Comparison discussion.

Appropriate Rates
The general formula linking direct and yield capitalization is $Y_o = R_o + CR$, where Y_o is the yield rate, R_o is the capitalization rate, and CR is the change rate (growth in income and value). The formula can be restated in many forms, offering the appraiser the tools to make appropriate adjustments to capitalization rates when yield and change rates are known, or calculate the appropriate capitalization rate when yield and change rates are known.

For example, Property A sells for $360,000 with an expected net operating income (NOI) of $36,000 during the first ownership year. R_o = 10% ($36,000 ÷ $360,000). CR is 3 percent because the buyer expects 3 percent growth in income and value annually during the 15-year holding period. The implied Y_o is 13% = (10% + 3%).

The formula to determine the capitalization rate used in direct capitalization for a property is $R_o = Y_o - (CR)$. The knowledgeable appraiser now knows from Property A's sale that a 13 percent yield rate is required in the marketplace in order to attract buyers. Property B expects annual growth rate of +3 percent. Property B's capitalization rate is 10 % = (13% - 3%). Competing properties C and D are expecting annual growth rates of 0 percent and -1 percent, respectively. For C, the R_o is 13 % = (13% - 0%), and for D, the R_o is 14 % = (13% - (-1%)). From this example, it is clear that investments with the same relative risk, even in the same marketplace, will have various direct capitalization rates.

The practical application of this formula is fourfold.

1. Generally accepted appraisal principles provide a basis to adjust R_o (direct cap) from quantitatively based, derived, and adjusted empirical market evidence.
2. Generally accepted appraisal principles provide a basis to compute Y_o (yield rate) from quantitatively based and derived empirical market evidence. Y_o is required to discount future value calculations appropriately.
3. R_o (direct cap) will be relatively lower when CR (change rate) is greater than average market rates. This is likely when low-income housing use covenants are near termination and the project is eligible for conventional market use.
4. R_o (direct cap) will be relatively higher when CR (change rate) is lower than average market rates. This is likely where low-income housing use covenants tie rent to AMI that grow slower than market-driven rents and expenses. Section 515 projects restrict NOI to zero growth.

Direct Capitalization Procedure When Comparable Sales Are Not Available

An understanding of the legal and appraisal principles is required to provide the methodology foundation. Leases divide fee simple interest into partial interests. The owner's portion is the leased fee interest, and the tenant's is the leasehold interest.

A leased property, even one with market rents, is appraised as a leased fee interest, not as a fee simple interest. Often the appraiser must appraise the fee simple interest when valuing leased fee interest. The value of a leased fee interest encumbered with a fixed rent that is below market rates may be worth less than the leased fee interest with rent at market level.

(The following charts are included here to illustrate general principles and do not represent any particular properties.)

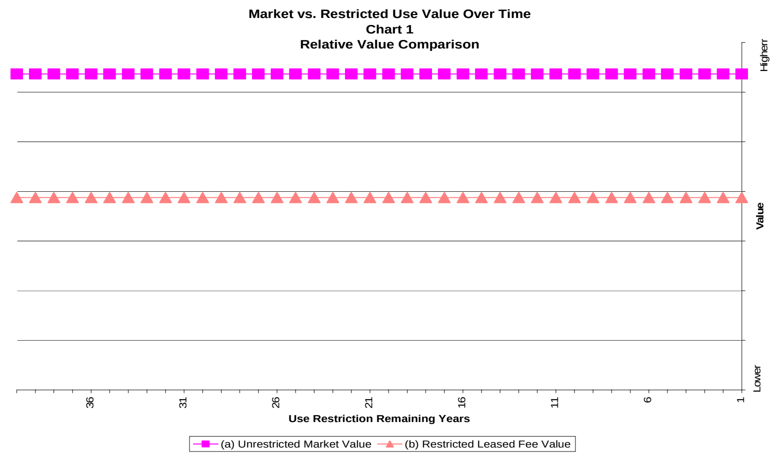

Chart 1 graphically shows this generally accepted premise that an unrestricted apartment project is more valuable than the same project with income restrictions.

If the rent and/or terms of the lease are favorable to the tenant (or lessee), the value of the leased fee interest will usually be less than the value of the fee simple interest, resulting in a positive leasehold interest.

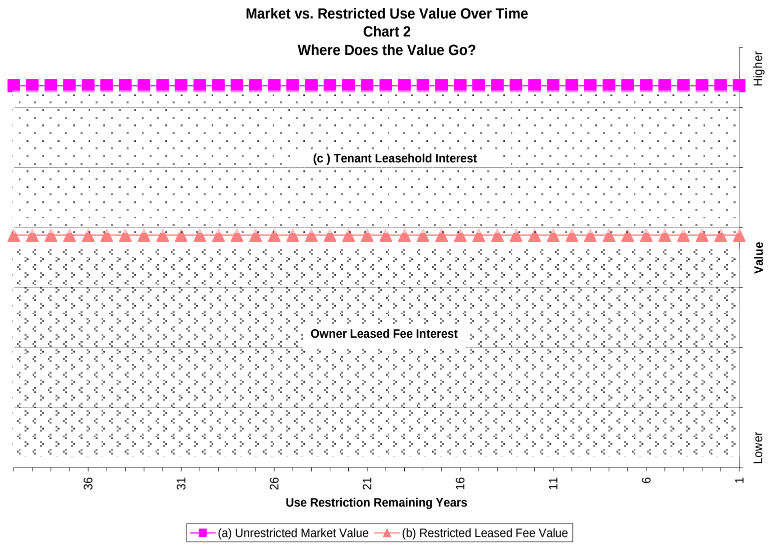

Chart 2 demonstrates the fee simple interest division into two distinct but related interests—the owner's leased fee interest and the tenant's positive leasehold interest. It is important to note that value isn't lost or destroyed. Value is merely shifted between the various economic interests.

If a tenant's positive leasehold interest has market value, it is typically valued using the income capitalization approach. The capitalization or discount rates usually depend on the relationship between contract and market rent. This excerpt from *Folsom I* explains the tenant's positive leasehold interest in a situation when market rent is greater than contract rent, and the lessee's interest is readily transferable.

> On the other hand, property valuation based solely on capitalization of contract rent does not account properly for the value enjoyed by the lessee when market rent rises above contract rent. This value, often referred to as "bonus value", "leasehold bonus" or the "surrender value" of the lease, is readily transferable by assignment or sublease assuming no contractual restrictions, and therefore has a

> market value capable of assessment. *See* W. Kinnard, Jr., at 421-22. In fact, commentators have suggested an approach to valuation that recognizes the present value of the leasehold bonus to the lessee. Koeppel & Kramer, *Property Tax Assessments: Contract Rent Is Fair Market Rent, Or Is It?* 2 Real Estate L.J. 561 (1973). *See generally* Youngman, *Defining and Valuing the Base of the Property Tax*, 58 Wash.L.Rev. 713, 714-46 (1983).

Over time, as the below-market contract rents near termination, the present value of the tenant's positive leasehold interest bonus wanes, and conversely, the owner's positive leasehold reversion interest grows.

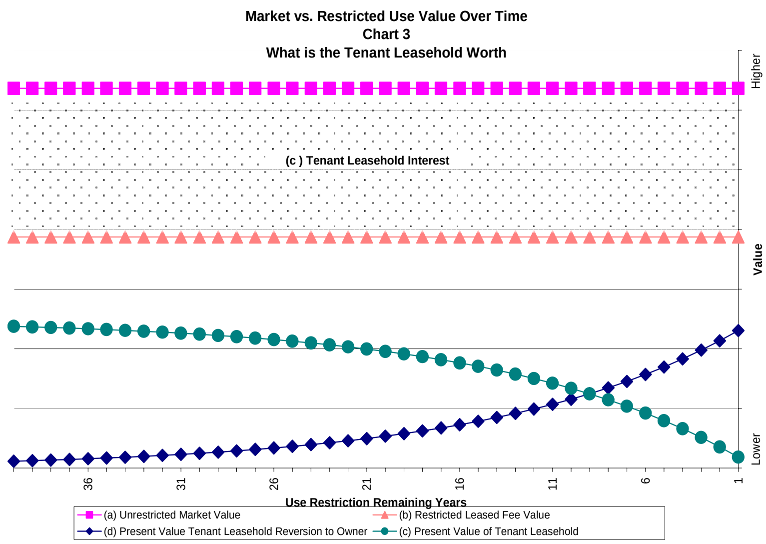

Chart 3 shows the ever-changing relationship between tenant's positive leasehold interest and owner's positive leasehold interest reversion lines. Present value of tenant leasehold is the dark green line (c) and present value of owner reversion value is the dark blue line (d).

Buyers are unwilling to pay unrestricted market prices for property encumbered by a long-term use restriction at below-market rents. However, when the restricted-use provisions and below-market rents end, any positive leasehold interest reverts to the owner. Willing sellers and buyers anticipate rents, expenses, and net operating income reverting to market-based levels when the use restrictions end, which creates a reversionary value.

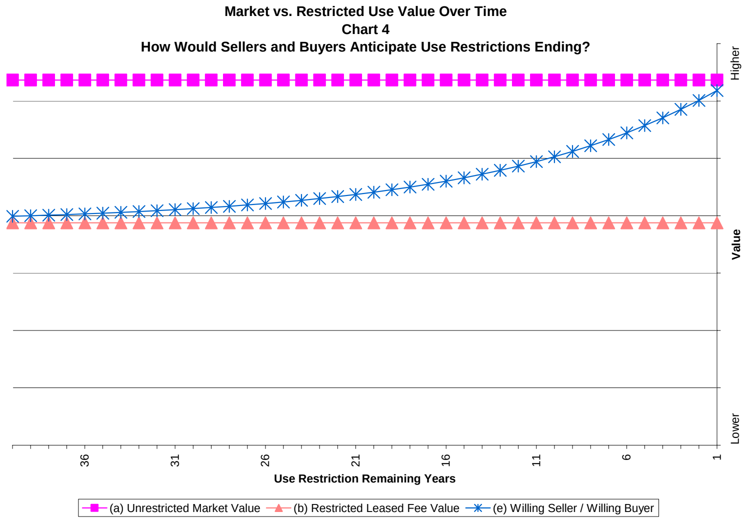

Chart 4 graphically shows how restricted market value changes over time (light blue line) because the owner's positive leasehold reversionary interest grows as the rent restriction nears termination. Both sellers and buyers anticipate future income and factor that information into their value opinion.

Direct Capitalization Basic Steps

This methodology is applicable to any property with long-term, below-market rents. An assessor using this method effectively demonstrates compliance with RCW 84.40.030(1) as amended in 2007. It shows that other highest and best uses, such as conventional apartments, were considered and ***not*** used as the valuation basis. It also demonstrates compliance with RCW 84.40.030(2) "Consideration should be given to any agreement, between an owner of rental housing and any government agency, that restricts rental income, appreciation, and liquidity; and to the impact of government restrictions on operating expenses and on ownership rights in general of such housing."

1. Determine the unrestricted market value.
    a. Capitalize market NOI @ market direct capitalization rate.
2. Determine the owner's restricted leased fee value.
    a. Capitalize restricted NOI @ appropriate direct capitalization rate.
        i. If market NOI change rates are +3 percent annually and the restricted-use NOI is expected to grow +1 percent annually, it would be appropriate to adjust the direct capitalization rate +2% = (3% - 1%). This adjustment is consistent with the general formula $R_o = Y_o – (CR)$.
3. Compute the owner's positive leasehold reversion value.
    a. Unrestricted market value – Owner's leased fee value.
    b. A positive leasehold interest in the property that benefits the tenants is created by the below-market rents. When the restricted-use provisions and below-market rents end, any positive leasehold interest reverts to the owner. Willing sellers and buyers anticipate rents, expenses, and net operating income reverting to market-based levels when the use restrictions end, which creates the reversionary value.
4. Compute the present value of the owner's positive leasehold reversion.
    a. The owner's positive leasehold reversion is an anticipated future payment of an amount determined now. Therefore, it must be discounted back to the present—because of the time value of money, a dollar received in the future is worth less

than a dollar received today. Using a market-derived R_o in the capitalization process also implies market-derived Y_o's and CR's. Because direct capitalization anticipates future income and reversion, then implicitly discounts it back to the present value, no further consideration of value change is necessary.

b. Determine market yield rates by using the general formula $Y_o = R_o + CR$.
   i. Alternatively, in the absence of market-derived data, investor surveys may be used to estimate Y_o. A survey with an incorrect link in the CR relationship to R_o and Y_o can cause a value distortion.

c. Determine the discount period.
   i. If restrictions end in 5 years, then 5 years is the appropriate period. If restrictions end in 15 years, then 15 years is the appropriate period.

d. Compute the present value using the factors determined in steps 3, 4b, and 4c.

5. Compute the restricted-use value.
   a. Add the present value of the owner's positive leasehold reversion (determined in Step 4) to the owner's restricted leased fee value (determined in Step 2).

The value concluded is the leased fee value plus any value created by sellers and buyers anticipating rents, expenses, and net operating income changing to market-based levels when use restrictions end. This method results in three values for the assessor to reconcile: unrestricted market value, restricted leased fee value, and restricted use value. When an assessor follows this methodology step by step, the value conclusion will be fully developed.

An assessor using this method effectively demonstrates compliance with RCW 84.40.030(1). The method shows that other highest and best uses, such as conventional apartments, were considered and ***not used*** as the valuation basis. It also demonstrates compliance with RCW 84.40.030(2): "Consideration should be given to any agreement, between an owner of rental housing and any government agency, that restricts rental income, appreciation, and liquidity; and to the impact of government restrictions on operating expenses and on ownership rights in general of such housing."

Example:
This low-income housing is a 60-unit LIHTC project. Restrictive use covenants expire in 10 years. Market rates for yield, capitalization, and change are 10, 7, and 3 percent, respectively. The restricted rates for yield, capitalization, and change are 10, 9, and 1 percent, because AMI-restricted rents are expected to grow slower than unrestricted market rents.

Step 1. Determine the unrestricted value.

Determining Gross Monthly Income

Number of Units	Type of Unit	Description	Market Rent	Rent Per Month
20	1 Br	Market Rent	$ 950	$19,000
40	1 Br	Market Rent	$ 1,100	$44,000
60	**Total Units**		**Gross Monthly Income**	**$63,000**

Capitalization Process

Capitalization Process - Overall Rate			
Gross Potential Income			$756,000
Vacancy/Collection Loss	7.0%		(52,920)
Other Income:			12,200
Effective Gross Income			715,280
Total Annual Expense	-33.6%	$4,000/Unit	(240,000)
Net Operating Income			475,280
Overall Rate	7%		
Indicated Property Value, Rounded			**$6,790,000**

Step 2. The restricted leased fee value is:

Determining Gross Monthly Income

Number of Units	Type of Unit	Description	Rent	Rent Per Month
10	1 Br	§ 42 Maximum at 45% AMI less utility allowance	$618	$6,180
10	1 Br	§ 42 Maximum at 60% AMI less utility allowance	$837	$8,370
20	2 Br	§ 42 Maximum at 45% AMI less utility allowance	$736	$14,720
20	2 Br	§ 42 Maximum at 60% AMI less utility allowance	$997	$19,940
60	**Total Units**	**Gross Monthly Income**		**$49,210**

Capitalization Process

Capitalization Process - Overall Rate			
Gross Potential Income			$590,520
Vacancy/Collection Loss	4.0%		(23,621)
Other Income:			12,200
Effective Gross Income			579,099
Total Annual Expense	-42.6%	$4110/Unit	(246,600)
Net Operating Income			332,499
Overall Rate	0.090		
Indicated Property Value, Rounded			**$3,694,000**

Step 3. Compute the owner's positive leasehold reversion value.
$3,096,000 = $6,790,000 - $3,694,000

Step 4. Compute the present value of the owner's positive leasehold reversion.
Restrictions end 10 years from the valuation date. Present value factor @ 10% yield = 0.38554
Present value owner's positive leasehold reversion $1,193,642 = $3,096,000 * 0.38554

Step 5. Compute restricted value
$4,887,642 = $3,694,000 + $1,193,642

Value Summary:

Unrestricted Market Value:	$6,790,000
Restricted Leased Fee Value:	$3,694,000
Restricted Use Market Value:	$4,887,642

Yield Capitalization

Yield capitalization or discounted cash flow (DCF) analysis is useful when a project has changing income or when use restrictions will end during the expected holding period. In DCF analysis, a yield rate is applied to a set of projected income streams and a reversion to estimate the value of a property. Using a rate of return to discount available income, a DCF analysis reflects the present value of the property, factoring future events into a present value. The reliability of DCF analysis is dependent on the care and reasonableness of the assumptions. Changes in the assumptions have a significant impact on the value of the estimate. Yield capitalization is not discussed in this Guide nor generally recommended unless the inherent assumptions can be substantiated.

GLOSSARY

Term	Definition
Area Median Income (AMI)	Median family income for a particular county or metropolitan statistical area (MSA), as estimated by HUD. HUD, each year for each area, also publishes a revised estimate of the income limit for a very low-income (VLI) household, defined as 50 percent of the estimated AMI. LIHTC tenant income and rent limits are based on this VLI amount, which may or may not exactly equal 50 percent of the estimated AMI for the area.
Basic Rent	The minimum monthly rent that tenants who do not have rental assistance pay to lease units developed through the USDA-RD Section 515 Program, the HUD Section 236 Program, and the HUD Section 223(d)(3) Below Market Interest Rate Program. The basic rent is calculated as the amount of rent required to operate the property, maintain debt service on a subsidized mortgage with a below-market interest rate, and provide a return on equity to the developer in accordance with the regulatory documents governing the property.
Below Market Interest Rate (BMIR) Program	Program targeted to renters with income not exceeding 80 percent of AMI by limiting rents based on HUD's BMIR Program requirements and through the provision of an interest-reduction contract to subsidize the market interest rate to a below-market rate. Interest rates are typically subsidized to effective rates of 1 or 3 percent.
Capitalization Rate	Any rate used to convert income into value.
Capture Rate	The percentage of age, size, and income-qualified renter households in the primary market area that the property must capture to fill the units. Funding agencies may require restrictions to the qualified households used in the calculation including age, income, living in substandard housing, movership, and other comparable factors. The capture rate is calculated by dividing the total number of units at the property by the total number of age, size, and income-qualified renter households in the primary market area. See also Penetration Rate.
Change Rate (CR)	The rate of stabilized change in property value and/or income.

Comparable Property	A property that is representative of the rental housing choices of the subject's primary market area and that is similar in construction, size, amenities, location, and/or age. Comparable and competitive properties are generally used to derive market rent and to evaluate the subject's position in the market. See the National Council of Affordable Housing Market Analysts' white paper "Selecting Comparable Properties."
Competitive Property	A property that is comparable to the subject and that competes at nearly the same rent levels and tenant profile, such as age, family, or income.
Contract Rent	1. The actual monthly rent payable by the tenant, including any rent subsidy paid on behalf of the tenant, to the owner, inclusive of all terms of the lease. (HUD and RD) 2. The monthly rent agreed to between a tenant and a landlord. (U.S. Census Bureau)
Demand	The total number of households in a defined market area that would potentially move into the proposed new or renovated housing units. These households must be of the appropriate age, income, tenure, and size for a specific proposed development. Components of demand vary and can include household growth, turnover, those living in substandard conditions, rent over-burdened households, and demolished housing units. Demand is project specific.
Direct Capitalization	1. A method used to convert an estimate of a single year's income expectancy into an indication of value in one direct step, either by dividing the income estimate by an appropriate rate or by multiplying the income estimate by an appropriate factor. 2. A capitalization technique that employs capitalization rates and multipliers extracted from sales. Only the first year's income is considered. Yield and value change are implied but not identified.
Elderly or Senior Housing	Housing where (1) all the units in the property are restricted for occupancy by persons 62 years of age or older or (2) at least 80 percent of the units in each building are restricted for occupancy by households where at least one household member is 55 years of age or older and the housing is designed with amenities and facilities designed to meet the needs of senior citizens.
Extremely Low Income	Person or household with income below 30 percent of AMI adjusted for household size.

Fair Market Rent (FMR)	The estimates established by HUD of the gross rents (contact rent plus tenant-paid utilities) needed to obtain modest rental units in acceptable condition in a specific county or metropolitan statistical area. HUD generally sets FMR so that 40 percent of the rental units have rents below the FMR. In rental markets with a shortage of lower priced rental units, HUD may approve the use of FMRs that are as high as the 50th percentile of rents.
Gross Rent	The monthly housing cost to a tenant which equals the contract rent provided for in the lease plus the estimated cost of all tenant-paid utilities.
Housing Choice Voucher (Section 8 Program)	Federal rent subsidy program under Section 8 of the U.S. Housing Act, which issues rent vouchers to eligible households to use for the housing of their choice. The voucher payment subsidizes the difference between the gross rent and the tenant's contribution of 30 percent of adjusted income or 10 percent of gross income, whichever is greater. In cases where 30 percent of the tenant's income is less than the utility allowance, the tenant will receive an assistance payment. In other cases, the tenant is responsible for paying his share of the rent each month.
HUD Section 202 Program	Federal program that provides direct capital assistance (i.e., grant) and operating or rental assistance to finance housing designed for occupancy by elderly households who have income not exceeding 50 percent of AMI. The program is limited to housing owned by 501(c)(3) nonprofit organizations or by limited partnerships where the sole general partner is a 501(c)(3) nonprofit organization. Units receive HUD project-based rental assistance that enables tenants to occupy units at rents based on 30 percent of tenant income.
HUD Section 236 Program	Federal program that provides interest reduction payments for loans which finance housing targeted to households with income not exceeding 80 percent of AMI who pay rent equal to the greater of basic rent or 30 percent of their adjusted income. All rents are capped at a HUD-approved market rent.
HUD Section 8 Program	Federal program that provides project-based rental assistance. Under this program, HUD contracts directly with the owner for the payment of the difference between the contract rent and a specified percentage of the tenant's adjusted income.

HUD Section 811 Program	Federal program that provides direct capital assistance and operating or rental assistance to finance housing designed for occupancy by persons with disabilities who have income not exceeding 50 percent of AMI. The program is limited to housing owned by 501(c)(3) nonprofit organizations or by limited partnerships where the sole general partner is a 501(c)(3) nonprofit organization.
Income Limits	Maximum household income by county or metropolitan statistical area, adjusted for household size and expressed as a percentage of the AMI for the purpose of establishing an upper limit for eligibility for a specific housing program. Income limits for federal, state, and local rental housing programs typically are established at 30, 50, 60, or 80 percent of AMI. HUD publishes income limits each year for 30 percent median, very low income (50 percent), and low income (80 percent), for households with 1 through 8 people.
Leased Fee Interest	An ownership interest held by a landlord with the rights of use and occupancy conveyed by lease to others. The rights of the lessor (the leased fee owner) and the lessee are specified by contract terms contained within the lease.
Leasehold Interest	The interest held by the lessee (the tenant or renter) through a lease transferring the rights of use and occupancy for a stated term under certain conditions. See also Negative Leasehold and Positive Leasehold.
Low Income Housing Tax Credit (LIHTC)	The 1986 Tax Reform Act created the LIHTC Program under Section 42 of the Internal Revenue Code (IRC) to assist the development of low-income rental housing by providing qualified owners with credit to reduce their federal tax obligations. The LIHTC is a dollar-for-dollar reduction of federal income tax liability for owners of or investors in low-income rental housing. LIHTC is available for a 10-year period subject to compliance with the requirements of the IRC and the Washington State Housing Finance Commission.
Market Rent	The most probable rent that a property should bring in a competitive and open market reflecting all conditions and restrictions of the specified lease agreement including term, rental adjustment and revaluation, permitted uses, use restrictions, and expense obligations; the lessee and lessor each acting prudently and knowledgeably, and assuming consummation of a lease contract as of a specified date.
Marketability	The manner in which the subject fits into the market; the relative desirability of a property (for sale or lease) in comparison with similar or competing properties in the area.

Maximum Allowable Rent	See Maximum Gross Rent. Maximum allowable rent is a term originated by the Washington State Board of Tax Appeals and derived from the Cascade Court v. Noble decision phrase "maximum rents allowed under the covenants."
Maximum Gross Rent	The maximum rent for a low-income housing unit, including utility allowances. The utility allowance is the amount that is credited against the maximum in gross rent for resident-paid utilities. The Washington State Housing Finance Commission publishes maximum gross rents annually for each county.
Mixed Income Property	An apartment property containing either (1) both income restricted and unrestricted units or (2) units restricted at two or more income limits (i.e., low-income tax credit property with income limits of 30, 50, and 60 percent).
Negative Leasehold	A lease situation in which the market rent is less than the contract rent.
Overall Capitalization Rate (R_o)	An income rate for a total real property interest that reflects the relationship between a single year's net operating income expectancy and the total property price or value; used to convert net operating income into an indication of overall property value.
Positive Leasehold	A lease situation in which the market rent is greater than the contract rent.
Project Based Rent Assistance	Rental assistance from any source that is allocated to the property or a specific number of units in the property and is available to each income-eligible tenant of the property or an assisted unit.
Restricted Rent	The most probable rent that a property should bring in a restricted-use market, reflecting all conditions and restrictions of the specified use agreement including special set-asides for senior, handicapped, homeless, farm workers, or other tenant classifications.
Restricted Rent, Achievable	The rents that the project can attain taking into account both market conditions and rent in the primary market area and income restrictions.
Reversion	A lump-sum benefit that an investor receives or expects to receive at the termination of an investment; also called reversionary benefit.
Reversion Date	The date when use restrictions end and a restricted-use project may be converted to conventional multifamily use.

Rural Development (RD) Market Rent	A monthly rent that can be charged for an apartment under a specific USDA-RD housing program, that reflects the agency's estimate of the rent required to operate the property, maintain debt service on an un-subsidized mortgage, and provide an adequate return to the property owner. This rent is the maximum rent that a tenant can pay at an RD Property.
Rural Development (RD) Program (Formerly The Farmers Home Administration Section 515 Rural Rental Housing Program)	Federal program that provides low interest loans to finance housing which serves low- and moderate-income persons in rural areas who pay 30 percent of their adjusted income on rent or the basic rent, whichever is the higher (but not exceeding the market rent). This program may include property-based rental assistance and interest-reduction contracts to write down the interest on the loan to as low as 1 percent.
Section 515 Program	The Section 515 Rural Rental Housing Program provides mortgage loans to develop rental housing for very low-, low- and moderate-income tenants. Housing financed by Section 515 is affordable because the loans are for long terms (30 years, amortized for 50 years), carry a basic interest rate of only 1 percent, and can be combined with deep subsidy rental assistance. Section 515 is used to provide rental or cooperative housing for elderly people and for families, congregate facilities, and group homes. It is often used in conjunction with low-income housing tax credits.
Section 521 Program	To make Section 515 housing available to tenants who cannot afford market rents, USDA provides assistance through the separately appropriated Section 521 Rental Assistance Program, which brings tenants' rent down to 30 percent of their adjusted incomes and makes up the difference to the landlords.
Subsidized Housing	Housing developed by private or public sponsors for low-income earners. Subsidies may take the form of below-market financing or direct payment of a portion of the rent. In recent years, some subsidized multifamily housing has undergone co-op conversion (the National Co-op Bank, created by Congress in 1978, finances co-op conversions of subsidized multifamily housing). See also Public Housing.
Subsidy	Monthly income received by a tenant or by an owner on behalf of a tenant to pay the difference between the apartment's contract rent and the amount paid by the tenant toward rent.
Tenant Paid Utilities	The cost of utilities (not including cable, telephone, or internet) necessary for the habitation of a dwelling unit, which are paid by the tenant.
Unrestricted Rents	Rents that are not subject to restriction.

Unrestricted Units	Units that are not subject to any income or rent restrictions.
Utility Allowance	The amount that is credited against the maximum allowable rent for resident-paid utilities. Most properties use published public housing authority utility allowances. Alternatively, as of January 2007, owners may submit utility estimates based on actual usage data for approval. HUD has developed a utility schedule model that enables the user to calculate utility schedules by housing type after inputting utility rate information http://www.huduser.org/resources/utilmodel.html. The IRS has proposed using this model to determine utilities for its LIHTC Program.
Washington State Housing Finance Commission	The designated tax credit allocating agency for the state of Washington.
Yield And Change Formula	Method of deriving a capitalization rate by deducting the rate of stabilized change in property value and/or income from the yield rate (R = Y - CR)
Yield Capitalization	The capitalization method used to convert future benefits into present value by discounting each future benefit at an appropriate yield rate or by developing an overall rate that explicitly reflects the investment's income pattern, value change, and yield rate.
Yield Rate (Y)	A rate of return on capital, usually expressed as a compound annual percentage rate. A yield rate considers all expected property benefits, including the proceeds from sale at the termination of the investment.

Source: *The Dictionary of Real Estate Appraisal*, 4th ed. Appraisal Institute, Chicago, 2002.

Source: National Council of Affordable Housing Market Analysts, http://www.housingonline.com/Portals/0/12122007MarketStudyTerminology(UpdatedClean).pdf