

**The Valuation of Federally Subsidized Housing:
Ten Questions for the Property Tax**

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Abstract

The complex federal incentives for private investment in low- and moderate-income housing have produced decades of judicial decisions on the appropriate local tax treatment of these properties. This enormous volume of thoughtful legal analysis offers insights relevant to issues beyond the valuation of subsidized housing, and illuminates many fundamental assessment questions. Many subsidized developments are not in any simple sense public housing. The federal government has long offered incentives for private parties to own and operate low- and moderate-income rental apartments as a financial investment. These structures are generally not tax-exempt, and courts have struggled to characterize them for property tax purposes, in the process confronting with a wide range of fundamental issues with implications far beyond the specific issue of rent-restricted property.

Table of Contents

| | |
|--|-----------|
| A. Introduction. | 1 |
| B. General Valuation Questions. | 3 |
| 1. When should standard valuation approaches be adjusted? | 3 |
| 2. What is the significance of construction costs? | 7 |
| 3. Is the price paid for underlying partnership interests evidence of real property value? | 9 |
| 4. How should business value be distinguished from property value? | 9 |
| C. Appropriate Treatment of Legal Restrictions. | 10 |
| 5. Should the income approach utilize restricted rents or market rents? | 10 |
| 6. Should voluntary governmental restrictions control valuation? | 12 |
| D. Appropriate Treatment of Tax Benefits. | 14 |
| 7. What is the relevance of the tax benefits of ownership? | 14 |
| 8. Are tax attributes “personal to the owner”? | 16 |
| 9. Are time-limited tax benefits a wasting asset? | 17 |
| 10. Are tax benefits a nontaxable intangible asset? | 18 |
| E. Conclusions. | 19 |

The Valuation of Federally Subsidized Housing: Ten Questions for the Property Tax

A. Introduction.

The complex federal incentives for private investment in low- and moderate-income housing have produced decades of judicial decisions on the appropriate local tax treatment of these properties. This enormous volume of thoughtful legal analysis offers insights relevant to issues beyond the valuation of subsidized housing, and illuminates many fundamental assessment questions.

To those who have not previously encountered the maze of court rulings and legislative enactments on the topic, the property tax treatment of federally subsidized low-income rental housing might seem a straightforward matter. Housing constructed under government programs to assist a needy population would appear to be a natural target for reduced taxation, if not an outright exemption. Moreover, familiar images of poorly maintained public housing projects hardly suggest that their value might greatly augment the local property tax base. However, many subsidized developments are not in any simple sense public housing. For many decades the federal government has offered incentives for private parties to own and operate low- and moderate-income rental apartments as a financial investment. These structures are generally not tax-exempt, and courts have struggled to characterize them for property tax purposes.

Federal incentives have taken many forms, including long-term, low-interest mortgages, payments to mortgage lenders to reduce the effective interest rate for construction loans, cash payments to supplement rent paid by qualified tenants, and, most recently, federal income tax credits.¹ State courts have dealt with property tax cases involving all of these types of subsidies and their associated regulatory restrictions, particularly limitations on allowable rents. Subsidies provide the incentive for acceptance of the restricted return, but courts must determine whether these two elements are to be considered in tandem, separately, or not at all. Courts have considered unprofitable developments and profitable investments, situations in which government supplements raised rents above market levels and the more typical situations in which subsidies were granted in exchange for below-market rent. They have analyzed many valuation techniques and adopted a variety of interpretive principles.

As in the fable of the blind men and the elephant, this endeavor has given rise to sharply contrasting opinions. Is such housing a social good that deserves a reduced assessment? Is it the property of a private syndication whose wealthy investors take their profits in the form of tax benefits rather than cash income, with no claim to property tax relief on that account? Is it an investment gone bad, and if so, should the owners receive the benefit of a tax reduction? Is it an investment expected to go bad even before construction, with capital knowingly placed into buildings not worth their cost because other subsidies made this investment profitable? This

¹ Sections 221(d)(3) and 236 of the National Housing Act provided mortgage subsidies. Section 8 of the Housing Act provides cash supplements for rent payments. As described in more detail below, the current Low Income Housing Tax Credit is contained in Section 42 of the Internal Revenue Code.

wide range of fundamental issues has implications far beyond the specific issue of rent-restricted property.

A Simplified “Standard Case.” Early federal programs that offered reduced-interest mortgages, accelerated depreciation, or rental supplements contained many convoluted technical provisions, but these pale in comparison to the complexity of their successor, the Section 42 tax credit. The 1986 Tax Reform Act eliminated or restricted many Internal Revenue Code provisions that had supported earlier subsidies, such as accelerated depreciation and tax benefits from “passive losses,” but also added Section 42, the Low-Income Housing Tax Credit (LIHTC) program.² This section establishes an annual distribution of income tax credits to the states (calculated as a dollar amount per capita), which in turn allocate these credits among investors willing to provide funds for limited-income housing. Section 42 is now the primary form of federal assistance for subsidized rental housing. It is extremely complex, and sometimes described as the longest provision of the Internal Revenue Code. As summarized by the Michigan Court of Appeals:

In the section 42 program, the low-income housing developer is allocated tax credits for ten tax years, the developer generally uses the tax credits to recruit private investors, and the investors are assigned the tax credits in exchange for the investors’ contribution of capital to build or rehabilitate the housing project.

Generally, as here, the sale of the tax credits is structured as a limited partnership between the developer and the investors. The limited partner investors purchase the limited partner interests in the ownership of the development in return for the tax credit benefits expected to be realized in the ten-year period.³

The Tennessee Court of Appeals gave voice to the perplexity with which many tribunals first encounter Section 42 when it wrote, “Little is known about the LIHTC program outside of the circle of affordable housing developers, syndicators, and some investors who have waded through its sometimes oblique rules to take advantage of this rather unique incentive for the creation of affordable rental housing for lower income people.... [L]imited partner investors (many individuals or a single or several corporations) buy up to 99% of limited partner interests in the ownership of the development in return for an allocation of up to 90% of the tax credit benefits expected to be realized in the 10-year period...”⁴

Because subsidized housing cases present a unified core set of issues, a simplified abstract case drawing on their common elements can identify the larger implications of these inherently fact-specific decisions. A standard case would consider the property tax valuation of low- and moderate-income rental housing whose owners receive a federal subsidy, whether in the form of cash assistance, mortgage reduction payments, income tax credits, or other transfers, in return for

² Cases, statutes, and commentators use the terms “Section 42” and “LIHTC” interchangeably.

³ *Huron Ridge L.P. v. Ypsilanti Township*, 275 Mich. App. 23, at 25 n. 1, 737 N.W.2d 187, at 188 n.1 (2007).

⁴ *Spring Hill, L.P. v. Tennessee State Board of Equalization*, No. M2001-02683-COA-R3-CV, 2003 Tenn. App. LEXIS 952, n. 7 (Tenn. Ct. App. 2003).

rent limitations and other restrictions on the property. Both the subsidies and the limitations would run for a set period of time, such as ten to twenty years.⁵

This simplified set of facts allows consideration of an equally simplified tax dispute in which the owners challenge their assessment as not adequately reflecting the special burdens of ownership, primarily the restrictions on rent. They may also charge that the assessment overstates or incorrectly includes financial benefits, such as the Section 42 tax credits. Of course, in cases where government supplements have raised rents above market levels, the roles are often reversed, with taxing districts taking the position that government regulations enhance value and taxpayers arguing that this effect should be ignored.

Determining the appropriate assessment has required courts to address a myriad of other issues, such as the taxability of the property, whether and how the income restrictions should affect its assessment, and the nature of the rent restrictions as a matter of property law. The resulting body of case law is significant in itself, but its greatest impact may lie in its contribution to understanding larger problems of property assessment. This article examines ten questions of this type, falling within three broad categories: general valuation questions, the appropriate treatment of legal restrictions, and characterization of the investment for property tax purposes.

B. General Valuation Questions.

1. When should standard valuation approaches be adjusted? The most basic valuation issue raised by these cases questions whether subsidized properties should be valued in the same manner as any other taxable real estate. Although these structures are rarely exempt from property tax under state law,⁶ a sense that they serve the public good has plainly influenced courts and legislatures dealing with tax valuation. In some cases this had led to what might be called a “quasi-exemption,” with the valuation process influenced by a desire to support housing policy goals. For example, the Massachusetts Supreme Judicial Court distinguished the assessment of rent-restricted subsidized housing from that of property whose rent is restricted by a private lease. It referred to the “unique status of a federally regulated low income housing project,” finding that “federally funded projects are particularly vulnerable to changes in property taxes.” Although the court had adopted the general rule that fair market rent, and not rent as limited by contract, sets the basis for assessment, it found subsidized housing to be an exception, noting that “there was evidence that the company would be forced to default on the mortgage” if its development were taxed in the same manner as private rental property.⁷ This is a

⁵ Note that many state and local programs support affordable owner-occupied housing and publicly owned housing, neither of which raises the specific tax issues considered here.

⁶ See *Supervisor of Assessments v. Har Sinai West Corp.*, 95 Md. App. 631, at 642 n. 4, 622 A.2d 786, at 792 n. 4 (1993), for a discussion of cases on this point. For an argument in favor of exemption, see Jonathan Penna, “Fairness in Valuation of Low-Income Housing Tax Credit Properties: An Argument for Tax Exemption,” 11 *Journal of Affordable Housing and Community Development Law* 53, at 54 (2001) (the author “discusses the confusing and conflicting methods utilized by courts and government assessors to value LIHTC properties for taxation purposes and proposes a fairer alternative, i.e., tax exemption.”). For an example of a specific exemption for such property, see “District of Columbia Final Act 18-281 Exempts Property Used for Low-Income Housing,” *State Tax Today*, May 3, 2010, 2010 STT 84-22.

⁷ *Community Development Co. of Gardner v. Board of Assessors*, 377 Mass. 351, at 354-355, n. 10, 385 N.E.2d 1376, at 1378, n. 10 (1979).

dramatic example of the way in which technical determinations concerning assessment methods can remove property value from the tax base even as the property itself remains on the tax rolls.

Other courts have taken the opposite position and refused special treatment for subsidized property. Some argue that the federal subsidies afforded these developments do not necessarily imply that they should receive favorable property tax treatment as well. The Michigan Supreme Court wrote, “To the extent that federal income tax receipts are utilized to subsidize the owners and tenants of Petitioner’s property, the citizens of the City . . . are already contributing to the support of subject property, albeit indirectly.”⁸ Still other opinions have focused on the private and profit-motivated aspects of these projects, finding the rent restrictions simply a quid pro quo for other benefits: “This is nothing more than a financial arrangement voluntarily chosen by taxpayers, whereby taxpayers have substituted one income stream (higher rents) for another (lower rents and tax credits), because taxpayers believe that will maximize the return on their investment.”⁹

There are thoughtful arguments on both sides of this debate, although they are not often fully developed in a judicial context that does not explicitly recognize extra-legislative exemptions. The political and social concerns behind arguments for and against quasi-exemptions are also particularly complex. The public responsibility to house the needy has always coexisted uneasily with the use of housing assistance funds to reduce wealthy investors’ tax payments. An often-quoted statement by the late Professor Stanley Surrey found “something terribly amiss when to provide low-income housing for the shelter of the poor, we at the same time shelter tax millionaires.”¹⁰ It can seem even more strange that the major federal program for subsidizing low-income rental housing is primarily overseen by the Internal Revenue Service rather than the Department of Housing and Urban Development. Yet the inefficiencies and scandals that mark the history of publicly built and publicly operated developments, often constructed on a massive scale, support efforts to enlist private investment and market discipline in the cause of housing assistance. The iconic images of the Pruitt-Igoe towers being demolished in St. Louis, or the infamous Cabrini-Green apartments in Chicago, mirror the failure of similar enormous projects to the present day.¹¹ Even those who would prefer an entirely public commitment to low-income

⁸ *Meadowlanes Limited Dividend Housing Associates v. City of Holland*, 437 Mich. 473, at 501 n. 51, 473 N.W.2d 636, at 650 n. 51 (1991) (quoting the Michigan Tax Tribunal in *Kentwood Apartments v Kentwood*, 1 MTTR 295, 301 (1977)). Cf. *Bayridge Associates Limited Partnership v. Department of Revenue*, 321 Ore. 21, at 40, 892 P.2d 1002, at 1012 (1995) (Van Hoomissen, J., dissenting) (“Had the legislature intended owners of property that qualified under IRC § 42 to be entitled to property tax relief on that basis, it surely would have provided for an explicit exemption or reduction. It did not.”).

⁹ *Bayridge Associates Limited Partnership v. Department of Revenue*, 321 Ore. 21, at 40, 892 P.2d 1002, at 1012 (1995) (Van Hoomissen, J., dissenting).

¹⁰ “There is something terribly amiss when to provide low-income housing for the shelter of the poor, we at the same time shelter tax millionaires.... If it is low-income rental housing we are considering, we must ask if we would pay out funds to well-off professional people or executives so that they will turn over some of the dollars to the developers as their compensation but will keep as middlemen enough to provide a 15-20% rate of return on the after-tax profits....” Stanley S. Surrey, Committee on Ways and Means, Panel Discussion on Tax Reform, 93rd Congress, 1st Session (February 5, 1973), pp. 71, at 100-101.

¹¹ “Since the 1990s, public housing high-rise buildings have come tumbling down by the dozens across the country....now, for the first time in its 75-year history, the New York City Housing Authority wants to knock down an entire high-rise complex, Prospect Plaza in Brooklyn” Manny Fernandez, “New York City Plans to Topple Public Housing Towers,” *The New York Times*, February 6, 2010.

housing sometimes argue that private sector incentives can increase political support for these programs.

Another complexity to these arguments concerns the incidence of the tax. Property owners have stressed that governmental limitations on rent cannot be changed during the life of the restrictions. That would also mean, however, that unsuccessful property tax appeals would not place a burden on the parties who are the object of the charitable endeavor, but rather would reduce the net income of the investors.¹²

A few states permit local governments to determine whether specific subsidized rental developments are to be assessed according to standard approaches or afforded some measure of exemption.¹³ For example, under certain circumstances Texas permits local taxing units to “deny the exemption if the governing body determines that: (A) the taxing unit cannot afford the loss of ad valorem tax revenue that would result from approving the exemption; or (B) additional housing for individuals or families meeting the income eligibility requirements of this section is not needed in the territory of the taxing unit.”¹⁴

For their part, developers often feel that governments at all levels look to them to provide affordable housing with insufficient subsidies.¹⁵ An architect writing in the *Washington Post* complained that the government “presumes that developers enjoy large profit margins, have access to unlimited capital and should willingly use some of that profit and capital to subsidize affordable units,” while in fact “weak market demand, rental and pricing constraints, tight financing and cost overruns can result in slim, nonexistent, or negative profit margins.”¹⁶

The details of specific subsidy programs also complicate these arguments. For example, Section 42 is not designed to assist the neediest population, since its rents attempt to fit the budget of those earning approximately half the area median income.¹⁷ Although project sponsors may be

¹² “Owners of low-income housing units cannot raise rents to account for cost increases because the rental rate is restricted....” Jonathan Penna, “Fairness in Valuation of Low-Income Housing Tax Credit Properties: An Argument for Tax Exemption,” 11 *Journal of Affordable Housing and Community Development Law* 53, at 66 (2001).

¹³ E.g., Alaska Stat. § 29.45.110(d); Tex. Tax Code § 11.1825 (x)(3).

¹⁴ Tex. Tax Code § 11.1825 (x)(3).

¹⁵ The expense of housing subsidies provides continuing pressure for government to reduce costs. In discussing the Section 8 rental subsidy, two analysts remarked, “[T]he Section 8 program had positive results in rebuilding substantial areas of the nation’s cities....The program has several major problems, however, that ultimately limited its expansion and are now likely to cause its phaseout over the coming years. First and most important, subsidizing the gap between a fair market rent and a low-income family’s share of housing costs is very expensive. When an open-ended commitment is made for a twenty-year contract, the costs add up tremendously.” Jean L. Cummings and Denise DiPasquale, “The Low-Income Housing Tax Credit: An Analysis of the First Ten Years,” Fannie Mae Foundation, *Housing Policy Debate* 10(2) 251-307 (1999), reprinted in Thomas A. Jaconetty, ed., *The Valuation of Subsidized Housing* (International Association of Assessing Officers 2003) 63-105, at 53.

¹⁶ An accompanying cartoon shows public officials saying to developers, “Quit whining – you developers have plenty of money,” while the developers respond, “Most of it borrowed!” Roger K. Lewis, “Affordable Housing Needs Public Funding,” *The Washington Post*, March 13, 2010, p. E4

¹⁷ “LIHTC is a capital subsidy designed for properties serving residents at 40-60% of area median income (AMI).” A. Smith and Ethan Handelman, “Recap Update,” in “Real Estate Analyst Group Responds to Low-Income Tax Credit Crisis,” *State Tax Today*, 2009 STT 1-1 (January 5, 2009). See, e.g., *In re Ottawa Housing Assoc., L.P.*, 27 Kan. App. 2d 1008, at 1009, 10 P. 3d 777, at 778 (2000) (“The contract provides Ottawa Housing with tax credits, and, in return, Ottawa Housing is required to rent the apartments at a reduced rate to persons who earn less than

mission-driven nonprofit entities, these buildings are almost always owned by partnerships or limited liability companies in which more than 99 percent of the interests are held by investors seeking tax shelter, or banks seeking credit under the Community Reinvestment Act. Even official documents often refer to the investors as “buying tax credits,” when in fact they are acquiring ownership interests in entities holding real estate.¹⁸ Investors themselves are sometimes actually surprised to learn that they have essentially bought an apartment complex. Analysts have noted that “[i]nvestors that previously treated LIHTC like a yield-based bond investment are recognizing that it is indeed a real estate equity investment, with all of the attendant risks.”¹⁹

Developers, syndicators, and sponsors of subsidized housing have recognized the advantages of cutting this Gordian knot of legal analysis with special legislation. Over twenty states have addressed the taxation of subsidized housing by statute, often with very specific provisions favorable to taxpayers—for example, by prohibiting consideration of the Section 42 tax credits in the assessment process while requiring that value be set by reference to regulated rent limits. Other legislation deals with more technical details, such as income capitalization rates.

As would be expected when both financial interests and social advocates support highly technical legislation that the great majority of taxpayers would find incomprehensible, these measures have generally passed easily.²⁰ This follows a long history in which court-mandated

60% of the median income for Franklin County.”) The income base for these calculations can include all households, and not just renters, increasing the median figure. A study of several thousand LIHTC projects found average rents there to be 9% lower than average rents for the nation as a whole. Jean L. Cummings and Denise DiPasquale, “The Low-Income Housing Tax Credit: An Analysis of the First Ten Years,” Fannie Mae Foundation, *Housing Policy Debate* 10(2) 251-307 (1999), reprinted in Thomas A. Jaconetty, ed., *The Valuation of Subsidized Housing* (International Association of Assessing Officers 2003) 63-105, at 77, 82.

¹⁸ “[A]lthough it is commonly stated that the developer of a tax credit project raises equity funds by ‘selling the tax credits’ what is in fact sold are limited partnership equity interests in the project that include rights to certain tax credits.” “Factors to be Considered in Determining the Just Value of Property Acquired, Rehabilitated or Constructed Pursuant to Federal Laws Related to Affordable Housing,” Report Prepared for the Joint Standing Committee on Taxation by the Department of Administrative and Financial Services, Maine Revenue Services, Property Tax Division (January 2007). Cf. Missouri Department of Revenue, Letter Ruling 5948 (October 30, 2009), *State Tax Today*, 2009 STT 236-12 (referring to “purchase” of low-income housing tax credits). The Illinois Appellate Court wrote, “A limited partnership does not ‘sell’ the tax credits to investors; they remain in the limited partnership. Limited partners buy securities giving them an interest in the limited partnership. The benefit of a tax credit to a limited partner is entirely incidental to that investment.” *Rainbow Apartments v. Illinois Property Tax Appeal Board*, 326 Ill. App. 3d 1105, at 1108, 762 N.E.2d 534, at 537, 260 Ill. Dec. 875 (2001) (citation omitted).

¹⁹ David A. Smith and Ethan Handelman, “Recap Update,” in “Real Estate Analyst Group Responds to Low-Income Tax Credit Crisis,” *State Tax Today*, 2009 STT 1-1 (January 5, 2009). Compare *In re Application of CLASS Homes I, L.L.C.*, 234 P.3d 35, at 38 (Kan. Ct. App. 2010) (finding that the equity fund holding a 99.99% interest in the limited liability company receiving low income housing tax credits was “essentially an owner.”).

²⁰ See Joseph Rosenblum, “Assessing the Value of Affordability: Ad Valorem Taxation of Properties Participating in the Low Income Housing Tax Credit Program,” *2 John Marshall Law School Fair and Affordable Housing Commentary*, 32, at 53 (“In almost all cases these statutes passed unanimously.”). On the other hand, *Spring Hill, L.P. v. Tennessee State Board of Equalization*, No. M2001-02683-COA-R3-CV, 2003 Tenn. App. LEXIS 952, n. 28 (Tenn. Ct. App. 2003), considered evidence as to “why the proposed legislation, which would have prohibited tax assessors from considering the value of LIHTC’s when valuing real property, failed,” and *Stone Brook Limited Partnership v. Sisinni*, Supreme Court of Appeals of West Virginia, No. 34423, No. 34424, No. 34863, 2009 W. Va. LEXIS 85 (2009), explained that “the Legislature passed Senate Bill 696 that would have required LIHTC property to be valued under the income method; however, Governor Joe Manchin, III, vetoed this Bill due to its difficult

uniformity in assessment has been followed by legislative exceptions for property such as farmland or single-family residences. Moreover, state legislatures are always more receptive to appeals for quasi-exemptions that reduce budgets of local governments than to those that affect the revenue of the states themselves. As would also be expected, such legislation often gives rise to new litigation, with sometimes surprising results.²¹

2. *What is the significance of construction costs?* The standard income, market, and cost approaches base property valuation on rental income, the market value of comparable realty, and depreciated construction cost. Of these, the cost approach is often the least relevant. The price of income-producing properties will clearly be affected by expected future net earnings, and an investor bidding on a structure will be extremely interested in recent sales of similar properties. But even recent construction cost may have limited influence on buyers not considering building a new structure themselves.²² Cost estimates for older buildings require adjustments for physical, economic, and functional depreciation that can rarely be estimated with precision in the absence of income or sales data. The cost approach is therefore generally used with special care. It is often recommended that all three approaches be employed wherever possible.²³

Despite its limitations, construction cost can serve as a check on the results of the income and comparable sales approaches.²⁴ For example, a cost-based valuation of a successful and newly constructed building can challenge owners' claims that the property value is far below that figure. If owners argue that new property is not worth its cost, it is reasonable to require an explanation for their investment decision. In the *Seagram* cases,²⁵ New York courts found that

application, and the Legislature did not reintroduce legislation in 2009 to correct these problems.” (citations omitted).

²¹ For example, 2005 Nebraska legislation required that assessors perform an income-based calculation of value for rent-restricted property, and provided that “low-income housing tax credits authorized under section 42 of the Internal Revenue Code that were granted to owners of the project shall not be considered income for purposes of the calculation.” Neb. Rev. Stat. § 77-1333(1). However, the statute permitted the credits to be considered in determining the capitalization rate, and did not preclude consideration of other valuation approaches in addition to the income approach. In *Schuyler Apartment Partners LLC v. Colfax County Board of Equalization*, 279 Neb. 989, 783 N.W.2d 587 (2010), the Supreme Court of Nebraska upheld a cost-based valuation of subsidized rental housing. It affirmed a decision of the Nebraska Tax Equalization and Review Commission, *Schuyler Apartment Partners LLC v. Colfax County Board of Equalization*, No. 06C-254 (June 2, 2009), which held that “[e]stimates of value based on use of the income approach with restricted rents and expenses unique to LIHTC projects are incomplete without consideration of the contribution to actual value of LIHTC credits.”

²² In discussing actual historic cost, James Bonbright went so far as to say that a “hard-headed businessman....would hardly turn his finger” to make this calculation, just as a purely rational investor should take no account of the original price paid for a security in determining whether to hold or sell it at a later time. James Bonbright, *The Valuation of Property*, Vol. 1, at 146 (1937). Bonbright made allowance for human nature, however, in recognizing that “[e]ven businessmen are reluctant to act on the assumption that the property which they have bought is worth less than what they have paid for it.” *Id.* at 147 (footnote omitted). Current replacement cost would be more relevant to purchasers than historic cost.

²³ E.g., *Meadowlanes Limited Dividend Housing Association, v. City of Holland*, 437 Mich. 473, at 485, 473 N.W.2d 636, at 642 (1991) (citing the Michigan assessor’s training manual and the American Institute of Real Estate Appraisers, *The Appraisal of Real Estate* (9th ed. 1987), at 61-75).

²⁴ E.g., *Stone Brook Limited Partnership v. Sisinni*, Supreme Court of Appeals of West Virginia, No. 34423, No. 34424, No. 34863, 2009 W. Va. LEXIS 85 (2009) (upholding valuations based on the cost approach in the case of newly constructed buildings, where the cost approach was checked against income data).

²⁵ *Joseph E. Seagram & Sons, Inc., Appellant, v. Tax Commission of the City of New York*, 18 A.D.2d 109, 238 N.Y.S.2d 228 (1963), *aff’d*, 14 N.Y.2d 314, 251 N.Y.S.2d 460, 200 N.E.2d 447 (1964).

Joseph E. Seagram & Sons had not met its burden in arguing for a reduced assessment of the renowned Seagram Building on Park Avenue. “Nowhere in the record is it explained how just two years before the period under review an experienced owner employing a reliable contractor and having the services of outstanding architects put \$36,000,000 into a structure that was only worth \$17,800,000. Such a startling result requires more than speculation before it can be accepted as fact.”²⁶

The cost approach can play a particularly important role in the valuation of subsidized housing, because there are few arm’s-length sales and the parties often disagree as to the measure of income to be capitalized. At the same time, taxpayers have argued that special regulatory and prevailing-wage requirements raise the cost of subsidized housing above that of comparable market-rental structures.²⁷ Analysts have also noted that “the basis for the tax credits in an LIHTC project is correlated to the reported construction costs, creating an incentive to show the highest cost possible” for the taxpayer’s records.²⁸ Both considerations touch on a fundamental valuation challenge: whether special value to the owner, here in the form of tax credits and other financial benefits that made the initial investment worthwhile, should be considered in setting the taxable value. This issue arises in many cases dealing with special-purpose property. For example, the prestige value of name recognition and association with an architectural landmark such as the Seagram Building might or might not be transferable to another purchaser.²⁹

The question as to whether construction costs are evidence of value leads to a topic of intense dispute: whether the financial burdens of ownership can be taken into account without considering the corresponding tax benefits. Some analysts have argued that “[c]onstruction costs are known; but these overstate the market value of a project, since in the absence of subsidy the rental stream produced by the property would not justify the actual expenditure on construction.”³⁰ But “in the absence of subsidy” begs the question as to basis for valuation. If both benefits and burdens are taken into account, as they were presumably taken into account by the investor, the actual expenditure could be justified by the combined return, including the subsidy. If only the burdens are taken into account, the cost of a new and successful building could indeed be seen as overstating value. Ironically, the fear that tax incentives could distort investment decisions and lead to uneconomic construction was one of the concerns that led to the Tax Reform Act of 1986, and thus to the Section 42 credit.³¹

²⁶ 18 A.D.2d at 112, 238 N.Y.S.2d at 232-233.

²⁷ “Construction costs for an LIHTC project are typically higher than those for a comparable unsubsidized project.” Jonathan Penna, “Fairness in Valuation of Low-Income Housing Tax Credit Properties: An Argument for Tax Exemption,” 11 *Journal of Affordable Housing and Community Development Law* 53, at 56 (2001).

²⁸ Jonathan Penna, “Fairness in Valuation of Low-Income Housing Tax Credit Properties: An Argument for Tax Exemption,” 11 *Journal of Affordable Housing and Community Development Law* 53, at 56 (2001) (references omitted).

²⁹ Even before the demise of the Seagram company, the Seagram Building had been sold to other owners, including the Teachers Insurance & Annuity Association of America (TIAA). *Teachers Insurance & Annuity Association of America v. City of New York*, 185 A.D. 2d 207, 586 N.Y.S.2d 262 (1992).

³⁰ G. Peterson, A. Solomon, H. Madjid, W. Apgar, Jr., *Property Taxes, Housing and the Cities*, at 73 (1973), quoted in *Community Development Co. of Gardner v. Board of Assessors*, 377 Mass. 351, at 355, 385 N.E.2d 1376, at 1378 (1979).

³¹ In discussing the Section 8 rental subsidy program, two analysts observed, “When a federal agency can guarantee a cash flow for twenty years and offer tax-exempt bond financing, accelerated depreciation, and other benefits, a marginal project can become feasible. Poor real estate decisions, based on misguided priorities, resulted in the

3. *Is the price paid for underlying partnership interests evidence of real property value?* In appropriate circumstances, the sale of an entity holding real estate can be treated as a sale of the real estate itself for tax purposes. For example, real property transfer taxes are sometimes imposed on sales of controlling interests in corporations or partnerships that own real estate.³² Could the recent sale price of partnership interests in syndicated subsidized housing be considered evidence of the value of the property itself? The details of the partnership's legal arrangements would complicate such an analysis, and the ownership interests may represent only a part of the project financing.³³ However, these considerations bear on the computation of the price and the weight to be afforded it, not on the relevance of the sale itself. Such an investment is influenced by the purchaser's own tax situation and other individual considerations, but this can be the case with any sale, particularly one involving tax-favored property. This extension of the comparable sales approach has not been raised in property tax cases dealing with subsidized housing, and limited partnerships or limited liability companies could consider the price paid for their interests to be proprietary.³⁴ But to the extent that limited partners or shareholders in limited liability companies are investing in real estate rather than simply "buying tax credits," this amount could shed light on the value of the underlying property.

4. *How should business value be distinguished from property value?* Determining the relevance of the sale value of partnership interests is one facet of a larger challenge: distinguishing the value of property ownership from the value of a business conducted on that property. It would be erroneous, for example, to equate hotel occupancy revenue with property rent, for hotel charges

construction of some poorly designed projects." Jean L. Cummings and Denise DiPasquale, "The Low-Income Housing Tax Credit: An Analysis of the First Ten Years," Fannie Mae Foundation, *Housing Policy Debate* 10(2) 251-307 (1999), reprinted in Thomas A. Jaconetty, ed., *The Valuation of Subsidized Housing* (International Association of Assessing Officers 2003) 63-105, at 53.

³² For example, the New York City real estate transfer tax defines a "transfer" to include "the transfer or transfers or issuance of shares of stock in a corporation, interest or interests in a partnership, association or other unincorporated entity, or beneficial interests in a trust, whether made by one or several persons, or in one or several related transactions, which shares of stock or interest or interests constitute a controlling interest in such corporation, partnership, association, trust or other entity." New York City Administrative Code § 11-2101(7). In 2010 Hawaiian legislators sought to introduce a similar measure, noting "that the conveyance tax is imposed each time real property changes title or ownership. But when the controlling interest in a corporation or a partnership that has large holdings of real property is sold, the transfer of the stock in the entity is not subject to the conveyance tax." Lowell L. Kalapa, "Hawaii House Passes Tax on Transfers of Controlling Interest in Real Estate," *State Tax Today*, March 16, 2010, 2010 STT 50-10. In 2008 Florida passed legislation to notify appraisers of transfers of interests in entities holding real estate. The Palm Beach County appraiser told the *Daily Business Review*, "It's been a big issue for us because when these entities transfer properties, we have no idea what the actual prices were. This will give us something to hang our hat on for market value." "Florida Governor Signs Bill to End Masking of Property Transfers," *State Tax Today*, July 11, 2008, 2008 STT 134-3.

³³ "Proceeds from the sale of an interest in the owner entity are used to fund development of the project. Proceeds from the sale may represent 50 to 60 percent of the cost of development....Other estimates are higher with proceeds being over 70% of the cost of development." *Schuyler Apartment Partners LLC v. Colfax County Board of Equalization*, Nebraska Tax Equalization and Review Commission, No. 06C-254 (June 2, 2009).

³⁴ "Virtually no information is publicly available on risks and returns to equity investors in LIHTC projects or to investors in other rental housing developments....[T]here are no published data on LIHTC IRRs [internal rates of return] to compare with our results, and actual IRR calculations are closely guarded by syndicators and investors." Jean L. Cummings and Denise DiPasquale, "The Low-Income Housing Tax Credit: An Analysis of the First Ten Years," Fannie Mae Foundation, *Housing Policy Debate* 10(2) 251-307 (1999), reprinted in Thomas A. Jaconetty, ed., *The Valuation of Subsidized Housing* (International Association of Assessing Officers 2003) 63-105, at 91.

constitute payment for many amenities and services, and reflect the hotel’s investment in such nontaxable assets as a trained workforce, a reservation system, and name recognition. Hotel valuation cases have long struggled to distinguish real property value from the value of the hotel enterprise—such as that reflected in the extra income attributable to the prestige of a premium hotel chain.³⁵

At the same time, hotel owners have sometimes sought to enhance their valuations for mortgage appraisal purposes by attributing business value to the real property, only to find this used against them in tax cases.³⁶ In a similar effort to strengthen mortgage financing of subsidized housing, a 1995 joint policy statement by the Office of Thrift Supervision, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve Board held that “lenders should ensure that appraisals of affordable housing projects identify, consider and discuss the effect of certain types of financial assistance, such as low-income housing tax credits, subsidies and grants, sometimes referred to as intangible items, on the estimate of market value for such projects.”³⁷ This is especially significant for tax assessment disputes because mortgage lenders rely on the value of the real estate itself to secure their loans. The foreclosure value of the property would not be enhanced by an enterprise formerly operated there. The security for the mortgage loan lies in the real estate value that is the subject of the property tax.

C. Appropriate Treatment of Legal Restrictions.

5. Should the income approach utilize restricted rents or market rents? The problem of distinguishing property income from business income arises whenever rents set under a long-term lease diverge from current market levels. In most subsidized housing assessment disputes, the rents permitted to be charged to limited-income tenants are below the market rates that could be obtained for physically similar unregulated units. This can be considered analogous to the valuation of property burdened by below-market private leases, an area of lively differences of opinion among state courts.

Many courts have concluded that a long-term private lease calling for rent that later falls below market levels does not provide the landlord with grounds for a reduction in the property’s assessment.³⁸ It is true that a prospective purchaser seeking to buy the owner’s interest will not pay as much for the right to collect below-market rents as he or she would bid for identical unencumbered property that could be leased at current market rates. But such a purchase would not convey all interests in the property—only the landlord’s interest, the right to collect rents due under current leases. A true purchase of all rights in the property would also bid for the tenants’ interests. This would mean acquiring the value of their right to pay below-market rent for the remainder of the lease term. Purchasing both sets of interests would transfer all rights in the property and place the new owner in a position to obtain full market rent. A rational buyer could

³⁵ E.g., *Chesapeake Hotel LP v. Saddle Brook Township*, 22 N.J. Tax 525 (2005).

³⁶ John Garippa, “The Other Side of the *Marriott v. Saddle Brook* Decision,” *Fair & Equitable*, April, 2006, pp. 26-27.

³⁷ Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board Office of Thrift Supervision, “Appraised Market Value Clarified for Affordable Housing Loans,” (March 10, 1995), <http://www.occ.treas.gov/ftp/bulletin/95-16a.htm>.

³⁸ A partial review of such cases may be found in *Omaha Country Club v. Douglas County Board of Equalization*, 11 Neb. App. 171, at 180-182, 645 N.W.2d 821, at 829-831 (2002).

choose instead to pay less, acquire only the owner's interest, and continue to collect below-market rents, but payment of that lower price for a partial interest does not establish that the property itself is worth less than an identical unencumbered parcel. These cases raise a truly fundamental issue. They demonstrate that the sale price of property can only be estimated after identifying the interests that constitute the property.

Courts that equate the value of the property with the value of the landlord's interest find it obvious that the landlord's property would be diminished by the burden of an unfavorable lease. These courts consider it "incongruous, indeed violative of the rule of uniformity, to assess two properties the same despite the fact that their usual selling prices are different."³⁹ On the other hand, courts that disagree find that the value of all interests in the property, the landlord's and tenant's together, is unchanged by the relative division between the two. The New York Court of Appeals wrote, "Otherwise, the landlord who fails to realize the fair potential of his property would, in effect, shift part of his tax burden to the shoulders of his fellow taxpayers."⁴⁰ Any other result, the court felt, would leave the tax authority a "coentrepreneur" required to depend on "the uncertain results of managerial banes or boons."⁴¹ But the New York court was also clear that the same logic did not allow above-market leases to increase assessments, since only the property value, and not this "managerial boon," was subject to tax.⁴² By definition, the market rent is the return to the property, and earnings above that are a fortunate bonus to the leasing enterprise.

These arguments are mirrored in the subsidized housing cases. Courts basing assessments on actual rent point out that this is the amount that the landlord in fact receives. The opposite result obtains when courts focus instead on the private, voluntary, and profit-oriented motives for accepting below-market rent.

Subsidized housing cases have also considered the appropriate treatment of above-market rent. Section 8 of the 1937 Housing Act and its successor provisions, like some state subsidies for low-income housing, provide rental supplements that can guarantee building owners "substantially higher rent than that received by comparable, nonparticipating apartments."⁴³ This has been especially true during the current housing downturn, when "overbuilding during the housing boom has left so many homes available that landlords, desperate for renters, are wooing Section 8 recipients, whose government subsidies, delivered electronically, guarantee the landlord gets paid."⁴⁴

³⁹ *CAF Investment Co. v. Saginaw Township*, 410 Mich. 428, at 464, 302 N.W.2d 164, at 173 (1981).

⁴⁰ *Merrick Holding Corp. Board of Assessors*, 45 N.Y.2d 538, at 544, 382 N.E.2d 1341, at 1344, 410 N.Y.S.2d 565, at 568 (1978).

⁴¹ *Merrick Holding Corp. v. Board of Assessors*, 45 N.Y.2d 538, at 545, 382 N.E.2d 1341, at 1344, 410 N.Y.S.2d 565, at 569 (1978).

⁴² "Of course, in arriving at the value of the entire property, if Merrick's [the taxpayer's] leases with its lesser tenants were at above market rents these should be offset against the below market rentals received from the three flagship tenants." *Merrick Holding Corp. v. Board of Assessors*, 45 N.Y.2d 538, at 545, 382 N.E.2d 1341, at 1344, 410 N.Y.S.2d 565, at 569 (1978).

⁴³ *Alta Pacific Associated, Ltd. v. Utah State Tax Commission*, 931 P.2d 103, at 104 (Utah Sup. Ct. 1997). That case considered participating apartments with average monthly rent of \$565 and \$335 when market rent for nonparticipating apartments was \$275.

⁴⁴ Dawn Wotapka, "Housing Bust Opens New Doors for Subsidized Tenants," *The Wall Street Journal*, August 2, 2010, p. 1.

Not surprisingly, in cases where subsidized rent exceeds market rent, owners have urged courts to value the property without regard to these special provisions, “and to instead consider the rental income that the property would command in the open market of unsubsidized housing.”⁴⁵ Here, taxpayers rely on cases that disregard above-market rent,⁴⁶ although that position could increase taxes when subsidized rent is below market levels. Courts that disagree have found it “obvious”⁴⁷ that “[a] willing buyer would most certainly consider the guaranteed income rate set by the Federal government when determining the fair cash value of the property.”⁴⁸

Courts that reach inconsistent results in lease cases and subsidized housing disputes often fail to offer a convincing analytic basis for this distinction, whether it proves to be favorable or unfavorable to the taxpayer in any individual decision. As noted, the Massachusetts Supreme Judicial Court held as early as 1923 that a long-term lease did not control assessed value,⁴⁹ but it distinguished subsidized housing valuation on grounds that those rent restrictions were “a condition of financing the project on favorable terms, and without the Federal assistance the project would be impossible.”⁵⁰ Similarly, although it has long held that a long-term lease does not necessarily govern property assessment,⁵¹ the Illinois Supreme Court considered above-market subsidized rents to reflect “earning capacity”: “Where actual income truly reflects the income-earning capacity of the property, however, it may not be ignored simply because it does not coincide with rents obtainable on the open market.”⁵²

6. Should voluntarily assumed restrictions control valuation? These disputes present a question as to whether below-market leases are sufficiently similar to subsidized housing rent limitations for the tax treatment of one to provide guidance with regard to the other. In both instances a property owner has entered an agreement to accept less than a market rate of return. In many cases, courts have allowed voluntary restraints on income to reduce property value only if the

⁴⁵ *Kankakee County Board of Review v. Property Tax Appeal Board*, 131 Ill. 2d 1, at 19, 544 N.E.2d 762, at 770, 136 Ill. Dec. 76 (1989).

⁴⁶ *Canton Towers, Ltd. v. Board of Revision*, 3 Ohio St. 3d 4, 444 N.E.2d 1027 (1983), required use of the lower market-level rents in assessment, finding these subsidies similar to unfavorable long-term leases, which were held not to control valuation in *Wynwood Apartments, Inc. v. Board of Revision*, 59 Ohio St. 2d 34, 391 N.E.2d 346, 13 Ohio Op. 3d 19 (1979): “Moreover, this court has previously recognized ... economic rental value of commercial real property as an indicium of valuation for ad valorem real property taxation purposes. Although *Wynwood* involved a commercial property which had been rented for less-than-market rate, the principle applies with equal force to a residential unit in which artificially inflated rents are set. As in *Wynwood*, ‘economic rent is a proper consideration in a situation in which contract rent is not truly reflective of true value in money.’” 3 Ohio St. 3d at 7, N.E.2d at 1030 (citations omitted).

⁴⁷ *Alta Pacific Associated, Ltd. v. Utah State Tax Commission*, 931 P.2d 103, at 119 (Utah Sup. Ct. 1997) (concurring opinion).

⁴⁸ *Kankakee County Board of Review v. Property Tax Appeal Board*, 131 Ill. 2d 1, at 16, 544 N.E.2d 762, at 769, 136 Ill. Dec. 76 (1989). Other opinions taking this position include *Executive Square Limited Partnership v. Board of Tax Review*, 11 Conn. App. 566, 528 A.2d 409 (1987), and *Steele v. Town of Allenstown*, 124 N.H. 487, 471 A.2d 1179 (1984).

⁴⁹ *Donovan v. Haverhill*, 247 Mass. 69, 141 N.E. 564 (1923).

⁵⁰ *Community Development Co. of Gardner v. Board of Assessors*, 377 Mass. 351, at 355, 385 N.E.2d 1376, at 1379 (1979).

⁵¹ *Springfield Marine Bank v. Property Tax Appeal Board*, 44 Ill. 2d 428, 256 N.E.2d 334 (1970).

⁵² *Kankakee County Board of Review v. Property Tax Appeal Board*, 131 Ill. 2d 1, at 15-16, 544 N.E.2d 762, at 764, 136 Ill. Dec. 76 (1989).

financial benefits that provide the incentive for accepting those restraints are taken into account as well.

In supporting consideration of both the benefits and burdens of subsidized status in assessment, the Indiana Tax Court commented, “Although a property owner can reduce a property’s value by imprudently agreeing to deed restrictions and cause himself economic loss, a property owner should not be allowed to reduce the tax base in such a manner,”⁵³ finding nothing “inherently wrong with the property itself.”⁵⁴ The court held it reasonable to assume that the regulatory burdens were at least balanced by their benefits, for the taxpayer “would not have entered into the deed restrictions if the federal tax benefits did not adequately compensate [it] for the decreased rental income.”⁵⁵

Most publicly imposed governmental restrictions that limit the use of property must be considered in its assessment. A tax valuation cannot contemplate a hypothetical highest and best use for property that ignores legal limitations on development. The rental restrictions on subsidized property are similar in that they are publicly enforced and their breach would lead to heavy penalties. At the same time, these restrictions differ from zoning restrictions, wetlands protection, or public safety ordinances, because they have been voluntarily assumed by the owners. In fact, they may have been eagerly sought by syndicators in a competitive bidding process. As one expert wrote, “The important point about the rent restriction in LIHTC projects is that it is voluntarily imposed in return for special benefits. Restrictions are not imposed by the government, as with a zoning ordinance. The restrictions do not take something of value from the property owner for the benefit of the public at large or protect the public at large.”⁵⁶

The Oregon Supreme Court took an opposing view when it interpreted the state’s requirement that assessments take into account any “governmental restriction as to use” as being applicable to LIHTC rent limits. “[L]imits on what taxpayers may do with their properties, resulting from taxpayers’ participation in the section 42 program, constitute ‘governmental restrictions as to use.’ ... The most probable price depends on what the buyer will receive in exchange for that price; the buyer will pay only for what it will receive. Thus, the most probable price to be received for the properties at issue would not include the tax credits, because the record shows that the credits would be recaptured if the property were not maintained as low-income housing.”⁵⁷ The import of the last sentence is uncertain if a purchaser stepping into the shoes of

⁵³ *Pedcor Investments-1990-XII, L.P. v. State Board of Tax Commissioners*, 715 N.E.2d 432, at 437 (Indiana Tax Court 1999).

⁵⁴ *Lake County Trust Company No. 1163 v. State Board of Tax Commissioners*, 694 N.E.2d 1253, at 1258 (1998).

⁵⁵ *Pedcor Investments-1990-XII, L.P. v. State Board of Tax Commissioners*, 715 N.E.2d 432, at 439 (Indiana Tax Court 1999).

⁵⁶ Michael W. Collins, “Another Ad Valorem View of Low-Income Housing Tax Credit Properties,” *The Appraisal Journal*, July, 1999, 306-308. The Supreme Court of North Carolina took a similar position in finding that Section 42 limitations on rental income did not necessarily govern the property tax assessment: “Unlike a governmental restriction such as zoning, section 42 restrictions do not diminish the property’s value, but instead balance tax credits allowed to the developer against rent restrictions imposed on the developer. Because section 42 restrictions are freely entered contractual covenants, not governmental regulations, the Commission did not err in concluding that taxpayer may not artificially alter the value of its property below fair market value.” *In the Matter of Appeal of the Greens of Pine Glen Ltd. Partnership*, 356 N.C. 642, at 651, 576 S.E.2d 316, at 322 (2003).

⁵⁷ *Bayridge Associates Limited Partnership v. Department of Revenue*, 321 Or. 21, at 30-32, 892 P.2d 1002, at 1006-1007 (1995).

the original owner could succeed to the tax credits. The penalties for withdrawal from the subsidized-housing program help insure that the property will be maintained a low-income housing. Note also how quickly additional issues become entwined in such analysis: whether the restrictions are considered publicly imposed; whether the benefits and burdens would carry over to a new purchaser; and whether the benefits and burdens can be separated for purposes of valuation.

In the Oregon case, a dissenting justice wrote, “This is nothing more than a financial arrangement voluntarily chosen by taxpayers, whereby taxpayers have substituted one income stream (higher rents) for another (lower rents and tax credits), because taxpayers believe that will maximize the return on their investment. The below-market rents charged by taxpayers are not the result of a ‘governmental restriction’; rather, they are the result of a quid pro quo – federal income tax credits (a financial benefit) in return for charging the favored class below-market rents (a financial detriment).”⁵⁸

The relevance of the tax benefits to valuation raises related questions concerning their characterization: whether they are an attribute personal to the owner rather than part of the taxable property, whether they are a “wasting asset,” and whether they constitute intangible property that should not be included in the base of a real property tax.

D. Appropriate Treatment of Tax Benefits.

7. *What is the relevance of the tax benefits of ownership?* A central issue raised by these cases questions whether the tax benefits to the individual investor are relevant to property valuation. If the recent construction cost or the price in an arm’s-length sale were the basis for assessment, there would be no need to account for the tax considerations behind the decision to pay that specified amount, any more than the purchase price of a residence needs to be adjusted to account for the federal mortgage interest deduction. The existence of a market price obviates the need to construct an independent measure of value by reference to all the elements a potential purchaser might consider.

If, however, property is to be valued by reference to regulated rental income, or if those income limits are used as a basis for an obsolescence deduction from construction cost, it is not clear whether the limited rents permitted in exchange for tax benefits provide an accurate basis for valuation without consideration of the tax benefits themselves. As the Georgia Court of Appeals wrote, “[T]he tax credits go hand in hand with restrictive covenants that require the property to charge below-market rent....If viewed in isolation, the rental restrictions would artificially depress the value of the property for tax valuation purposes.”⁵⁹ The Illinois Supreme Court took a similar position: “A valuation approach which considers the subsidy income, but does not consider the negative aspects of a subsidy agreement upon the earning capacity of the subsidized

⁵⁸ *Bayridge Associates Limited Partnership v. Department of Revenue*, 321 Ore. 21, at 40, 892 P.2d 1002, at 1012 (1995) (Van Hoomissen, J., dissenting) (citations and footnotes omitted).

⁵⁹ *Pine Pointe Housing, L.P. v. Lowndes County Board of Tax Assessors*, 254 Ga. App. 197, at 199, 561 S.E.2d 860, at 863 (2002).

property, would be inappropriate.”⁶⁰ This question has a long history in debate over the assessment of subsidized rental property. As the court wrote in a 1974 Rhode Island case concerning Section 221(d)(3) property, “The depreciation benefits were described as ‘excellent’ and the 6% return as the frosting on the cake.”⁶¹ In other words, the tax benefits were the true return, and the nominal rental income a welcome addition.

In response, taxpayer advocates have argued that “[b]asing market value on the income tax benefits of ownership destroys uniformity because the tax consequences of ownership vary from person to person.”⁶² Courts taking an opposite view consider that “there would be no market for private investment in low-income housing development were it not for these federal tax incentives.... [T]he appraised value of the property for property tax purposes would be artificially depressed if the value of the tax credits is not included.”⁶³

Recall that some earlier programs, such as Section 236, offered subsidies that reduced the effective mortgage interest rate to 1 percent. Many courts found that the reduced mortgage interest clearly affected the return to property ownership and so was relevant to an income-based valuation. “Certainly, the fact of lower mortgage payments decreases expenses and thereby increases the owner’s potential income from the investment.”⁶⁴ If the introduction of Section 42 were to change the mortgage subsidy to an economically equivalent tax credit, should that affect the valuation of the subsidized real property? Some courts have distinguished credits that affect the owner’s individual after-tax income from items that affect property revenue,⁶⁵ but others have found “no legally cognizable distinction between low-income housing tax credits and these programs.”⁶⁶

⁶⁰ *Kankakee County Board of Review v. Property Tax Appeal Board*, 131 Ill. 2d 1, at 16-17, 544 N.E.2d 769, at 764, 136 Ill. Dec. 76 (1989).

⁶¹ *Kargman v. Jacobs*, 113 R.I. 696, at 702, 325 A. 2d 543, at 546 (1974).

⁶² Jonathan Penna, “Fairness in Valuation of Low-Income Housing Tax Credit Properties: An Argument for Tax Exemption,” 11 *Journal of Affordable Housing and Community Development Law* 53, at 62 (2001) (references omitted).

⁶³ *Huron Ridge, L.P. v. Township of Ypsilanti*, 275 Mich. App. 23, at 34, 737 N.W.2d 187, at 199 (2007).

⁶⁴ *New Walnut Square Limited Partnership v. Louisiana Tax Commission*, 626 So.2d 430, at 432 (La. Ct. App. 1993). The court noted that the subsidized mortgage was transferable to a new owner, a factor that also influenced the Maryland Court of Special Appeals in *Supervisor of Assessments v. Har Sinai West Corp.*, 95 Md. App. 631, at 650, 622 A.2d 786, at 796 (1993) (“Value is not only what a willing buyer will pay for a piece of property but also includes the mortgages or other indebtedness that a buyer is willing to assume for the seller in exchange for the property.”) (emphasis in the original).

⁶⁵ “Below market leases and tax abatements have direct effects on the income of a property. LIHTCs do not.” *Maryville Properties, L.P., v. Nelson*, 83 S.W.3d 608, at 616 (2002). The Arizona Tax Court later followed *Maryville* in finding that “LIHTCs do not have a direct effect on the income of the property. The value of the tax credits is to the owner of the property and not to the property itself.” *Cottonwood Affordable Housing v. Yavapai County*, 205 Az. 427, at 429, 72 P.2d 357, at 359 (Ariz. 2003) (citing *Maryville* at 83 S.W. 3d 616). The Michigan Court of Appeals found *Maryville* and *Cottonwood* both to “err in overlooking or underestimating the value of the credits during the ten-year payout period.” *Huron Ridge, L.P. v. Ypsilanti*, 275 Mich. App. 23, at 41, 737 N.W.2d 187, at 197 (2007). “The Missouri court essentially denied the existence of a willing seller for low-income housing tax credit property during the relevant period and, therefore, subjectively concluded that the tax credits were no factor in the fair market value. Similarly, the Arizona court overlooked the possibility of an appraisal method, like the one at issue here, that would include the value of the remaining tax credits in the property’s assessed value, during the ten-year payout period, in a manner that reflects their diminishing value.” 275 Mich. App. 23, at 42, 737 N.W.2d 187, at 197.

⁶⁶ *Huron Ridge, L.P. v. Ypsilanti Township*, 275 Mich. App. 23, at 33, 737 N.W.2d 187, at 192 (2007).

8. *Are tax attributes “personal to the owner?”* Property law distinguishes covenants personal to the owner from those that “run with the land” and bind future purchasers.⁶⁷ Although courts have sometimes referred to these categories in dealing with federally subsidized property, they do not necessarily apply with precision to the rent restrictions and tax benefits contained in a specific statute. However, in practical terms both “run with the land” if the legislative design includes incentives and penalties intended to insure that they will survive any change in ownership. The Michigan Court of Appeals used this terminology in describing the potential recapture of tax credits if any current or future owner failed to abide by the low-income housing regulatory agreements:

Under the federal tax code, the regulatory agreement creates a restrictive covenant that runs with the land. IRC § 42(h)(6). If the original owner or its successor ceases to operate the development as low-income housing under the terms of the regulatory agreement, the value of the tax credits is reduced or entirely recaptured. IRC § 42(j). On the other hand, as long as the subsequent owner continues to operate under the regulatory agreement, it is entitled to receive the remaining tax credits. IRC § 42(d)(7)(A).⁶⁸

Although the Internal Revenue Code does not provide that these restrictions “run with the land” in so many words, it requires that owners seeking the low-income housing tax credit enter an agreement with the housing credit agency “which is binding on all successors of the taxpayer.”⁶⁹ Section 42 provides a quid pro quo: financial penalties, including cancellation or recapture of tax credits, will be imposed if the taxpayers sell to future owners who do not abide by the restrictions, but purchasers who do abide by the restrictions can succeed to the credits as well as to the property ownership. As the Maine Supreme Judicial Court stated with regard to Section 236 property, it “could have been sold to an open market participant with the permission of HUD; the purchaser would have been subject to the regulatory agreement.”⁷⁰ In discussing Section 42 property, the Michigan Court of Appeals wrote, “Though the low-income tax credits may not interest a ‘typical’ buyer of residential rental property, there is a specialized market for

⁶⁷ “The essentials of a real covenant are (1) observance of certain formalities; (2) an intention of the parties that the covenant ‘run with the land’; (3) a promise of such kind that it may be said to ‘touch or concern the land’; and (4) ‘privity of estate.’” A. James Casner and W. Barton Leach, *Cases and Text on Property* 988 (3rd ed. 1984), citing Clark, *Real Covenants and Other Interests Which Run with the Land* (2nd ed. 1947).

⁶⁸ *Huron Ridge, L.P. v. Ypsilanti Township*, 275 Mich. App. 23, at 25, 737 N.W.2d 187, at 189 (2007). See also *In re Ottawa Housing Assoc., L.P.*, 27 Kan. App. 2d 1008, at 1009, 10 P. 3d 777, at 778 (2000) (“Although the property could be withdrawn from the government program, it would require the recapture of the tax credits.”); *Brandon Bay Ltd. Partnership v. Payette County*, 142 Idaho 681, at 684, 132 P.3d 438, at 441 (2006) (“[I]f the developer originally qualifying for the tax credits sells the property, the purchaser assumes the tax position of the seller: ‘a purchaser of creditworthy property steps into the seller’s shoes with respect to the unused credits.’ 26 U.S.C. § 42(d)(7). Moreover, the tax credits are only received if the owner continues to comply with the requirements for the low-income housing project as set forth in the agreement with the IHFA [Idaho Housing and Finance Association] and governed by 26 U.S.C. § 42.”). The Oregon Tax Court and the Oregon Supreme Court held that tax benefits that could only be enjoyed by the first owner could not affect assessment: “If tax benefits are limited to the first owner or are recaptured when a property is transferred, such benefits will not enter into market considerations.” *Bayridge Associates L.P. v. Department of Revenue*, 321 Or. 21, at 31, 892 P. 2d 1002, at 1007 (1995), citing the Oregon Tax Court decision in the same case, 13 Or. Tax 24, at 29 (1994).

⁶⁹ I.R.C. Sec. 42 (h)(6)(B)(5).

⁷⁰ *Glenridge Development Co. v. City of Augusta*, 662 A.2d 928, at 930 (Me. 1995).

properties subject to § 42,” because their foremost value “is found in the tax benefits they generate to the owner.”⁷¹ The Supreme Court of Idaho found that “a purchaser of creditworthy property steps into the seller’s shoes with respect to the unused credits.”⁷² The benefits and burdens of ownership are intended to follow ownership of the property. This has strengthened the case for recognizing both in the assessment process.

9. Are time-limited tax benefits a wasting asset? Both the restrictions and tax benefits that accompany ownership of subsidized housing have limited lives. Section 42 credits generally extend over a ten year period, while the rent limitations and other restrictions accompanying them often expire after fifteen years. It is sometimes said that credits are earned over fifteen years but paid out over ten years. This raises a question as to how these time periods, and particularly the mismatch in their lengths, affect tax valuation. For some commentators, the final five year period would be one in which prospective purchasers could only assume the burdens of subsidized housing, while the tax benefits, as a type of wasting asset, would have expired.⁷³ But the example of leased property suggests several complications in translating this situation into a nominal or even negative assessed value.

In states that do not equate taxable value with the sale price of the landlord’s interest, a low sale value for the landlord’s encumbered share does not set the taxable value of the real estate as a whole. Courts taking the opposite position and accepting low rents as evidence of property value still limit this approach in order to minimize the problem of identical properties bearing different property tax burdens. For example, no court would consider fraudulent or non-arm’s-length agreements in the assessment—such as below-market rental terms accompanied by side payments not mentioned in the lease. Some courts have similarly attempted to distinguish prudent leases from those that were “improvident when made.”⁷⁴

A similar issue could arise if for valid business reasons a bona-fide lease called for most of the rent to be paid early in the lease term. At the extreme, a completely legitimate lease might require an initial lump-sum payment equal to the discounted present value of a series of standard monthly payments for the duration of the tenancy, perhaps with provision for a bond or other means of securing the landlord’s future performance. Could the landlord demand a nominal tax assessment after receipt of such a lump-sum payment, since no rent remains to be paid for the term of the lease? It is highly unlikely that an unusual rent schedule would eliminate the owner’s

⁷¹ *Huron Ridge L.P. v. Ypsilanti Township*, 275 Mich. App. 23, at 34, 737 N.W.2d 187, at 193 (2007) (quoting *Antisdale v. Galesburg*, 420 Mich. 265, 362 N.W.2d 632 (1984)).

⁷² *Brandon Bay Ltd. Partnership v. Payette County*, 142 Idaho 681, at 684, 132 P.3d 438, at 441 (2006), citing Section 42(d)(7).

⁷³ “Since the credits run out after ten years, but the restrictions may last for another twenty years beyond that time, a purchaser would, in effect, be buying only the restrictions without getting the benefit of the credits.” Wayne A. Tenenbaum, “Fitting a Square Peg Into a Round Hole: The Difficulty in Valuing Section 42 Low Income Housing Tax Credit Properties for Ad Valorem Tax Purposes” in Thomas A. Jaconetty, ed., *The Valuation of Subsidized Housing* (International Association of Assessing Officers 2003) 169-172, at 170.

⁷⁴ E.g., *Merrick Holding Corp. v. Board of Assessors*, 58 A.D.2d 605, at 606, 395 N.Y.S.2d 233, at 234 (1977), *rev’d*, 45 N.Y.2d 538, 382 N.E.2d 1341, 410 N.Y.S.2d 565 (1978) (“We deem it improper to apply the leasehold bonus principle to a selected portion of leases in a shopping center in the absence of proof of special circumstances or proof that the questioned leases were improvident when made.” [citations omitted]).

tax liability. Similar questions might arise if a sale of subsidized housing were characterized as “buying only the restrictions without getting the benefit of the credits”⁷⁵ for tax purposes.

10. Are tax benefits a nontaxable intangible asset? Taxpayers have sometimes taken the position that credits constitute intangible property not subject to a real estate tax.⁷⁶ A few of the states that have enacted special legislation addressing the assessment of subsidized housing have eliminated the value of the credits from the tax base by declaring them to be intangibles.⁷⁷

Of course, a tax benefit is intangible property, as are all types of financial interests and even currency itself—the paper and ink being tangible, but the claim on value that they represent being intangible. But this overlooks the distinction between imposing a tax on an intangible asset⁷⁸ and imposing a tax on tangible property at a market value that reflects its intangible features. Many homes command a premium because buyers value intangible attributes such as historic significance, neighborhood reputation, or school quality. This periodically raises debate, as in the case of New Hampshire homeowners who protested that taking scenic settings into account in valuation amounted to a “view tax.” The state explained that it had no “view tax,” but that tax assessments reflect tangible and intangible elements affecting market value.⁷⁹

The better reasoned cases have similarly distinguished a tax on intangible elements from a tax on real estate that recognizes the influence of intangible factors on property value. As the Michigan Court of Appeals wrote in considering this issue as a case of first impression in the state, “[I]ntangibles are not taxable in and of themselves, but they may be taken into account for purposes of assessing the value of tangible property....”⁸⁰ Similarly, the Tennessee Court of

⁷⁵ Wayne A. Tenenbaum, “Fitting a Square Peg Into a Round Hole: The Difficulty in Valuing Section 42 Low Income Housing Tax Credit Properties for Ad Valorem Tax Purposes” in Thomas A. Jaconetty, ed., *The Valuation of Subsidized Housing* (International Association of Assessing Officers 2003) 169-172, at 170.

⁷⁶ E.g., *Woda Ivy Glen Limited Partnership v. Fayette County Board of Revision*, 121 Ohio St. 3d 175, at 183 n. 4, 902 N.E.2d 984, at 992 n. 4 (“[T]he proportionate interest in the tax credits themselves is transferred apart from any transfer of the entire legal fee interest in the property, and...the value that the purchaser places on the credit is driven primarily by the purchaser’s particular tax considerations rather than any future value anticipated from the real property itself. As a result, the tax credits qualify as intangible interests separable from the real property.”); *Rainbow Apartments v. Illinois Property Tax Appeal Board*, 326 Ill. App. 3d 1105, at 1108; 762 N.E.2d 534, at 537; 260 Ill. Dec. 875 (2001) (“We disagree with the characterization of the tax credits as intangible property sold and existing apart from the real estate. Section 42 tax credits are not intangible property because they do not constitute a right to a payment of money, have no independent value, and are not freely transferable upon receipt.”) (citations omitted); *Cascade Court Ltd. Partnership v. Noble*, 105 Wash. App. 563, at 571, 20 P.3d 997, at 1002 (2001) (“Tax credits are intangible personal property and thus are not subject to real property taxation.... The Assessor should not take the tax credits into account in the assessment of the property.”) (citations omitted).

⁷⁷ N. H. Rev. Stat. Ann. § 75:1-a (“The assessed valuation of residential rental property subject to a housing covenant under the low-income housing tax credit program shall not take into consideration the value of intangible assets including, but not limited to, government subsidies or grants, below market rate mortgage financing, and tax credits...”); Utah Code Ann. § 59-2-102(2)(b) (“‘Intangible property’ means... a low-income housing tax credit.”).

⁷⁸ For example, Florida formerly had a tax on intangible property, repealed in 2006. Deborah Bernstein, “The Repeal of Florida’s Intangibles Tax,” *State Tax Notes*, May 15, 2006, p. 537. Then-Governor Jeb Bush had called the tax “insidious,” “evil,” and “stupid.” Joe Follick, “Prospects Bright for Final Repeal of Intangibles Tax,” *State Tax Notes*, Apr. 3, 2006, p. 13.

⁷⁹ See Daphne A. Kenyon, “Seeing Through the ‘View Tax’ Myth,” *State Tax Notes*, Sept. 3, 2007, p. 641.

⁸⁰ *Huron Ridge LP v. Ypsilanti*, 275 Mich. App. 23, at 37, 737 N.W.2d 187, at 195 (2007) (citations omitted). Similarly, the Connecticut Superior Court wrote, “We conclude that LIHTCs, although intangibles, do have an

Appeals stated, “The legislature clearly envisioned that intangible aspects of the property would be included in valuation. The potential to produce income in the future is itself an intangible.”⁸¹

E. Conclusions.

Although the legal and financial issues raised by the taxation of subsidized housing are extremely complex and sometimes arcane, these cases touch on controversies that arise in many tax disputes, and their lessons have wide application. Their attention to conceptual valuation problems has illuminated questions as diverse as the impact of voluntarily assumed restrictions and the intangible nature of tax benefits. In every instance, a determination as to the interests that constitute the taxable property must precede a computation of value. This issue affects property tax valuation cases of every type.

The subsidized housing decisions provide dramatic evidence of the importance of consistency in identifying the taxable interests to be valued. This concern has clearly motivated many courts that have required that both the benefits and burdens of regulation be considered in the assessment process. From this perspective, the fact that taxpayers seek the right to assume regulatory burdens in exchange for tax benefits means that both elements play a role in establishing the value of ownership. Consistency could also be achieved by disregarding both the benefits and burdens, on the assumption that they are roughly equivalent, as in the case of a cost-based approach to value. However, considering both the benefits and burdens has the advantage of recognizing the regulated status that is a central fact of these properties’ economic reality. Even where statutory formulas or individual court decisions prescribe special treatment for the valuation of subsidized housing, the underlying importance of consistency in judicial interpretation remains a central lesson for other cases.

No set of decisions proceeding from such a wide array of factual situations, legislative enactments, and judicial precedent could be expected to provide a single conclusive resolution. However, a varied range of opinions allows stronger reasoning to emerge over time, in the best tradition of the common law. The wealth of careful analysis, attention to tax policy concerns, and close statutory interpretation found in these cases offers great benefit to future courts and lawmakers.

effect on the valuation of real estate for assessment purposes, and should be a factor in determining the fair market value....” *Deerfield 95 Investor Assoc., LLC v. Town of East Lyme*, CV96-0538357 (Conn. Super. Ct. 1999).

⁸¹ *Spring Hill, L.P. v. Tennessee State Board of Equalization*, M2001-02683-COA-R3-CV, 2003 Tenn. App. LEXIS 952, 30 (Tenn. Ct. App. 2003).