

Sec. 42 Owners Can Reduce Property Taxes

By J. Kieran Jennings, As published by *Affordable Housing Finance* , April 2005

"Real estate taxes are one of the few expenses that can be reduced when all other costs are rising. The devil, however, is in the details."

While owners of low-income housing are already facing increased expenses across the board, local governments are trying to raise property taxes to combat budget shortfalls. But owners of projects with tax credits or other subsidy can take steps to ward off increased taxes and reduce excessive taxes.

In many ways, Sec. 42 housing isn't very different from other multifamily housing. Owners have seen utility costs continue to rise, insurance costs almost double, and property taxes go up persistently. Furthermore, these increased expenses fail to add to the life of the property or to its desirability.

Real estate taxes are one of the few expenses that can be reduced when all other costs are rising. The devil, however, is in the details. Sec. 42 housing, by its very nature, differs from project to project. Income is calculated differently based on area demographics, expenses vary based on turnover, and the disparities in size, style and tenancy all contribute to a project's unique characteristics.

These are some reasons why several schools of thought exist about how to assess these properties. In some states, specific laws dictate whether assessors can consider the value of the tax credit when establishing assessments. Most states don't have such statutory laws. Where the state hasn't established rules, the courts will decide the issues.

Methods of Assessment

The cost of construction for low-income housing is often greater than its fair market value. It is the low-income housing tax credits (LIHTCs) that make the project economically feasible. Unfortunately, it is not uncommon for assessors to use cost of construction to establish assessments on newly renovated or constructed buildings, leaving a great number of LIHTC projects overassessed. And reducing the assessments on these properties can be a challenge.

Ideally, the assessor should look to the income potential of the property, given its restricted rents and often higher expenses. This means the assessor should develop fair market value by using the operating cash flow before taxes, debt service and depreciation and dividing it by a suitable capitalization rate. Some assessors actually do this.

However, some states require that property be assessed as an unencumbered fee simple estate. In other words, the property must be assessed as if there were no Sec. 42 restrictions, producing values based solely on market conditions. As a result, market rents are used rather than restricted rents, and market expenses and vacancy rates also apply. In these states, market rents would likely be higher than the restricted rents and the vacancy loss would also be higher, given that the property would not be financially feasible for certain tenants. Here, sales of comparable conventional apartments can be used to help persuade the assessor to establish a reasonable fair market value.

Tools to use when law unclear

In other instances, the law may not be entirely clear when it comes to LIHTC properties. In a jurisdiction that has not established clear law, the best advice is to argue that the credit is separate from the real estate, and therefore not taxable as real property. After all, the federal government passed a law establishing the credit as an incentive to encourage construction of affordable housing. Thus, the credit isn't real estate. As an alternative approach, taxpayers can try to prove that the credits are intangible personal property.

One way to establish the credit as personal property is to show that it can be removed from the real estate. Because the credits regularly sell without the real estate, this stands as proof that the credits are separate from the real property. Although the fact that a tax credit is not real estate appears to be self evident, in at least one Pennsylvania court, it was

decided that all items that could affect the purchase of the property must be taken into consideration. In that instance, the remaining tax credits along with the restrictions were used to establish the assessed value.

A number of issues come into play if the assessment is to be established with the added value of the credits. Are the credits actually sold? Once sold they can no longer add value. The value of the credits has been separated, which is no different than selling off excess acreage. Once the asset is sold, it's gone.

Taxpayers can use another argument: Long after the credits expire the restriction continues. Therefore, the additional value becomes part of a discounted cash flow analysis aimed at finding the overall effect of the restriction and the credit. This argument faces the problem that the speculative nature of the future restrictions subjects the methodology to manipulation and error.

Finally, the fact remains that by increasing the tax burden on restricted properties, the assessor is working counter to the state and federal government in their attempts to encourage affordable housing. This argument may be used either as common sense persuasion or as part of a legal theory.

The issues relating to Sec. 42 housing assessment are varied. Some steps to challenge a tax assessment can be taken informally and may result in a decrease in taxes. Others present more of a legal challenge, requiring strong local representation. In any case, always review assessments when they arrive in order to ensure that a property is paying only its fair share of taxes.

J. Kieran Jennings is a partner in the law firm of Siegel Siegel Johnson & Jennings, the Ohio and Western Pennsylvania member of American Property Tax Counsel, the national affiliation of property tax attorneys. he can be reached at kjennings@siegeltax.com.