Chicago Rehab Network

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Assessing Government Assisted Multi-Family Housing

Commissioned by the Chicago Rehab Network, a citywide coalition of neighborhood-based nonprofit housing organizations working to create affordable housing and promote community empowerment and development without displacement.

Vision Statement
Property Tax Task Force
Adopted November 18, 1996

The Chicago Rehab Network and allied organizations advocate public taxation policy which serves to raise revenue for the operation of government in a manner which ensures low- and very low-income households are able to continue to access affordable housing and that: Provides immediate relief for affordable housing developments which have been publicly and charitably subsidized to keep them affordable to low and very low income households; Provides for displacement protection from rising property taxes for residents; Ensures an affordability provision in all property tax initiatives for school funding, regional revenue sharing and other tax reform; Ensures the appeal process is accessible through marketing and education. Task Force allies are the Leadership Council for Metropolitan Open Communities and Center for Economic Policy Analysis.

Preface

The **Chicago Rehab Network** has been promoting "tax fairness" in the context of affordable housing since 1996. Working with public interest groups such as the Leadership Council for Metropolitan Open Communities and the Center for Economic Policy Analysis, we were able to convince the City of Chicago in 1998 to adopt the Chicago Homeowners Assistance Program, which provides limited relief to long-time residents who face rising property tax bills as a result of gentrification. In 1999, we published *Solving the Right Problems: Making the Property Tax Fair For Everyone*. This year, as a result of our collaborative efforts under the banner of "Public-Private Finance Initiative," we took a new look at the property tax system in Illinois, and particularly in Cook County.

The document before you is one of the outcomes of this effort. While we understand that the current property tax system is far from perfect, we have advanced some specific reforms to improve it. We also believe that the existing system can be made friendlier to affordable housing. In particular, we are concerned about the long-term sustainability of rental property that receives some form of government assistance in order to maintain affordable rents. This report provides the foundation for a tax assessment that will not cause undue hardship on the operations of these properties.

Of course, we cannot simply stop with a theoretical document, however well informed. The Chicago Rehab Network has built its reputation on the practical hands-on training that puts theory into practice. Therefore, a key challenge before us is the incorporation of this learning into workshops and other training venues that will benefit the owners and managers of government assisted housing.
In looking beyond the current property tax system, there are a number of proposals that Chicago Rehab Network has advanced. First, with regard to the Cook County classification system, we have advocated reducing or eliminating the differential between rental and ownership housing. For this reason we support the proposal put forward by Cook County Assessor James Houlihan to significantly reduce the classification rate on rental housing (known as Class 3). Secondly, we want to expand an existing tool, the Class 9 incentive program, so that it can be used in all areas of the county. Right now it is limited to "low/mod" census tracts. We believe that these two reforms would significantly increase the production and retention of rental housing in the county.

Further, we believe that the over reliance on local property taxes for school funding leads to troublesome real estate practices. As long as education funding remains a "win-lose" game between those who have a growing tax-base and those who do not, we will not have a tax system that allows for both adequate funding for education and the development of affordable housing.

Finally, we want to see statewide property tax relief that does not leave senior citizens, poor homeowners and renters out in the cold. For this reason, we support a proposal to expand the current Senior Citizens Circuit Breaker to include all families in Illinois. This will allow both renters and owners to have some degree of relief, and will assure that the relief goes to those who need it the most.

The report authored by Reilly, Lyons, Burke and Oliver is provided here in a synopsis form. The authors contend that government-assisted housing cannot be valued in the same manner as market-rate rental property. Accurate valuation of assisted housing by the methods outlined in the report will allow for fair property taxes and thus contribute to the long-term sustainability of affordable housing.

The proper application of existing assessment principles is an important component to ensure comprehensive property tax support for the public investment in assisted housing. This approach, combined with a reduction in Cook County's property tax classification rate for multi-family rental housing, will provide a needed market incentive for the development of more affordable rental housing as well as ensure the stability of existing housing. Increasing the availability of affordable housing is vital for families and communities access to jobs and to maintain stable neighborhoods.

About the authors

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Daniel J. Burke, JD is Vice President of Chicago Community Development Corporation, a private firm that specializes in the development and management of affordable rental housing, and he is recognized as an expert in the field of government assisted housing.

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Introduction

Across the country and particularly in cities like Chicago, the recent decade of prosperity has also been a decade of rising property values. Rising property values can be a sign of health and resurgence in many neighborhoods and can be a great advantage to those Americans who own or invest in real estate; but they can be a great disadvantage to families whose incomes have not kept pace with the surging housing market especially as property taxes rise with them.

For 50 years, the federal government has invented programs to assist the development of safe, affordable housing for those the regular market does not reach either because they cannot afford market rate housing, or because market driven development has abandoned their neighborhoods. Government assisted housing units are critical for the stability and economic growth of the communities where they are located whether in inner-city neighborhoods or in suburbs, towns and small cities. But as property values in surrounding areas rise, property taxes threaten to unbalance the budgets of assisted apartment buildings and prevent the development of new ones.

In Illinois and many other states, property taxes are the single greatest operating expense in an apartment building's budget, and over the years many have argued that assisted housing should be shielded from property taxes in gentrifying neighborhoods with special classifications or other protections. In fact, the principles of tax valuation already guarantee that property taxes will never be so high as to turn an otherwise sustainable building into an unsustainable one provided those principles are applied. This paper draws on principles already used in the assessment of factories, office buildings and retail stores to recommend methods to assure tax fairness in the special case of assisted housing.

The underlying principle of property tax assessments in most states (including Illinois) is that real estate should be taxed according to its fair cash value. In the terminology of appraisers and assessors, the fair cash value of a property is "the amount for which a property can be sold in the due course of business and trade, not under duress, between a willing buyer and a willing seller." Assessors recognize that a buyer's willingness to buy a property is usually determined by the income he or she anticipates earning from it; they also recognize that the tax itself is an expense affecting net income. Therefore, the fair cash value of income producing properties is determined by the income producing potential of that property. For owners of assisted housing, correct application of the income approach will seek a balance between the market return to investors on the one hand, and a fair contribution to government revenues on the other. Therefore, a properly administered property tax should never undermine an otherwise economically sustainable property.

> *"Property taxes are the single greatest operating expense in an apartment building's budget."*

A Case Study

In practice, it is impossible for an assessor to analyze the value of all property on a case-by-case basis. Typically, he or she does it by comparing a property with others like it, on the assumption that physically similar properties generate similar net incomes, and therefore similar purchase prices. For the most part this method works, and assessors can simplify their assessments by analyzing sales among buildings with similar characteristics, using values such as dollars per square foot, per apartment unit, or per bedroom.

Such physical comparisons are inadequate for valuing assisted housing, however, because government financing carries a variety of restrictions that have a dramatic impact on the building's income characteristics and restrict its sale. In order for an income-based assessment of such properties to be fair, it must take account of how these restrictions affect the property's value to a willing investor.

Consider as an example a hypothetical 100-unit assisted multifamily housing project in the Chicago area that would cost approximately $125,000 per unit, or $12.5 million, to construct in the year 2000. Construction costs may be increased by the desire to achieve certain social goals, such as appropriate design features for the building. In addition though, development costs of assisted housing are higher from the start simply because the process of coordinating applications for the available forms of assistance is extremely time consuming. It is not uncommon for an assisted housing project to use 5-10 different sources of financing, and for the process of putting them together to take two years or more. This expensive predevelopment activity must be recouped in the development costs. (side bar examples-an assisted property and restrictions)

For the sake of clarity, the financing for our sample project will be kept relatively simple. However, because rental income will be restricted in various ways that will be explained below, the projected cash flow will support only $5 million in construction financing from conventional, or market rate, sources. Since the project cost is $12.5 million, the developer must fill in the $7.5 million gap with special financing from one or more of several government programs. In this case, the developer is able to raise $5 million in equity through the federal Low Income Housing Tax Credit Program, and fill in the remaining $2.5 million with a deferred-payment loan from the local housing department, whose source of funds is the federal HOME program. The developer now has the financing commitments necessary to proceed with the project. However, each of these commitments brings a burden that reduces rent levels, increases operating expenses, or imposes long-term use and resale restrictions.

The most obvious of these burdens is the fact that rent levels are no longer free to fluctuate with the marketplace, but are capped by a formula that is based on a fixed percentage of median income. For tax credit properties, the formula for rents is based on the county or metropolitan median income. Specifically, for tax credit properties, the rent cannot exceed 30% of gross monthly income for a household that earns 60% of the area median income, minus utility costs. However, since the developer is also using HOME funds, there is a further requirement that at least 20% of the units be affordable to households earning 50% of area median income. In reality, the lowest required rent becomes the baseline rent for all units because the owner does not want to accidentally fall into non-compliance through vacancy, or other factors that are out of his or her control. In the Chicago metropolitan area, where the year 2000 median household income is $67,900 a year, the federal affordable housing formula would limit monthly housing costs rent plus utilities to $882 per month for the three bedroom unit.

"The Illinois Supreme Court recognizes that factors restricting properties built with government assistance change the property's value—a value approach that considers subsidy income but does not consider the negative aspects of a subsidy agreement upon the earning capacity of a subsidized property would be inappropriate."

Under normal circumstances, the assessor would compare this project with a similar non-assisted project in the general area, in this case, a non-assisted 100-unit building costing the same $12.5 million. We know through market studies that the rent for such apartments is typically much higher than the rent for their tax credit counterparts. If this project were to be done using only market financing, the rents need to underwrite the property would be $1611 monthly per unit. Under this scenario, the difference between market rent and federally restricted rent is $729 per unit, and thus our assisted property would have significantly less rental income than a similar market rate property.

Not all markets, however, would support the development of new rental construction. But even in less optimal markets, the federal restrictions usually result in a rent level significantly below that of non-assisted housing in the area. The annual survey by the U.S. Department of Housing and Urban Development, which tends to be lower than other surveys, shows a typical market rent (plus utilities) of $1,060 for a three-bedroom unit.
For our hypothetical building, the maximum rent is $178 per month less than the market rent. Thus for a 100-unit building, the result is an annual loss of $213,600 in potential income as a result of government imposed restrictions.

An Assisted Development	
Number of units	100
Cost per unit	$125,000
Total cost of development	$12,500,000
Projected rental income gap financing:	$5,000,000
Low Income Housing Tax Credit	$5,000,000
HOME	$2,500,000

Restrictions

- Limits on rents charged
- Restrictions on resale
- Deferred debt
- Compliance and social services are additional costs associated with government assistance

At the same time, operating expenses are increased because the landlord must annually certify each tenant's income by examining their tax returns and other financial records. The owner must also prepare detailed reports, often with significantly different information requirements, to each of the government agencies that provided assistance. For our hypothetical building, the added cost amounts to 50% of a full-time staff person, or about $30,000 annually.

Another expense that many, but not all, assisted housing projects assume is the cost of social services that are required for certain types of government programs. This is particularly true of buildings designed to house persons with special needs, such as those formerly homeless. The cost of operating social services will be reflected in higher maintenance and administrative expenses, even if the actual cost of the social services themselves is paid for separately from the building's operating budget.

In addition, long-term use and re-sale restrictions imposed by the government as a requirement of the assistance inhibit the owner's ability to sell the property. The owner may be forced to hold on to the building even if the economic potential of the project changes and the building loses money. Because it is a tax credit property, the owner cannot sell in the first 15 years without serious tax liability. After this first 15 years, tax credit benefits expire, but the owner must continue to use the building for low-income housing for an additional 15 years. There is special risk in this requirement because the government makes no commitment to provide additional subsidies during this period.

In our hypothetical building, one of the layers of finance (the HOME financing) was a deferred loan due after 30 years. At the end of the 30-year period, the $2.5 million loan will be payable. Further, the deferred loan has been accruing and compounding interest though at a low rate. Usually at this point of a building's life-cycle, the building is fully depreciated and requires extensive capital investment. Owners typically anticipate that reduced property debt will offset the lost value due to a building's age. In this case the deferred debt will probably be refinanced and linger on to reduce the property's investment value.

All, of these restrictions substantially reduce the owner's ability to react to future changes in the economy, and thus increase the risk of his or her investment. In fact, over the 15-year history of the tax credit program, a large number of these buildings have experienced serious financial difficulties due to changing social and economic circumstances of their tenants and the neighborhoods around them.

In a 1989 case, the Illinois Supreme Court recognized that the factors restricting properties built with government assistance change the property's value. The court ruled that subsidies are something a prospective buyer would consider when determining fair cash value of a property, and that the assessor should be free to do the same. At the same time, the court recognized that "a value approach that considers subsidy income but does not consider the negative aspects of a subsidy agreement upon the earning capacity of a subsidized property would be inappropriate." The taxing authority must weigh both positive and negative impacts of a subsidy to make an income-based assessment.

100 unit rental apartment	Market Housing	Assisted Housing
Total development Cost	$ 12.5 mil	$ 12.5 mil
Operating Expenses	$ 420,000	$ 450,000
Gross Potential Rents	$ 1,933,200	$ 1,101,600
NOI before debt/deprec.	$ 1,513,200	$ 551,600
Assessed Value	$ 8,767,092	$ 3,195,828
Taxes	$ 636,490	$ 232,017

Appraising Assisted Housing

The appraisal industry has also recognized the positive and negative impacts of government assistance on property value. The Appraisal Standards Board advises that appraisers understand and adjust for all specific features that can make an assisted project unique. No two assisted housing projects are alike because of the great variety of assistance programs and the many different ways in which programs can be combined. Even the same program may impose different terms on different projects. For this reason, an appraiser should look to the actual income and expense statements in making his or her appraisal of an individual property.

In fact, a competing principle holds that for tax purposes, property should be valued on the basis of typical market income as opposed to the income actually produced. Yet the particular set of restrictions brought to bear on each assisted housing project means there is no typical market for assisted housing. Government assistance creates a market for each that is genuinely unique, and an assessor's estimate of fair cash value should be derived from an analysis of the net income for each separate building.

This is not as daunting a proposition as it may seem because assisted housing makes up a very small part of the total assessment base. Individualized assessments could be greatly facilitated if assessors can compile a list of assisted buildings in their jurisdiction and mail information requests to the owners. In this way, assessors can obtain income and expense data before the initial assessment is prepared. In fact, owners already file detailed information with regulating agencies as a condition for receiving assistance. Adapting existing forms for the assessor's use would help make reporting simpler and more uniform.

In making income valuations for these properties, assessing officials should use information about particular government programs. In addition, assessors should recognize that assisted housing projects will show gross income and expense items not found in non-assisted housing, and should adjust their procedures and appeal forms to allow for the diversity of income and expenses that individual building owners will provide.

Once initial assessments have been made, in most cases assessors can simply project the current net income of each building as if it will continue indefinitely. If a building's income stream changes because of changes in the economics of the building's neighborhood, changes in law by Congress or other providers of assistance, or the expiration of subsidy agreements, assessments can be reviewed.

When determining the capitalization rate, care should be taken to include all relevant income and expense items in calculating net income. Some types of assistance add to the stability of income, while others reduce stability. These opposite tendencies may or may not balance out in any given project.

> *"Government assistance creates a market for each that is genuinely unique… fair cash value should be derived from an analysis of the net income."*

It should be noted that the Illinois Revenue Code contains special legal provisions for properties financed with federal low-income housing tax credits. One of these requires emphasis on the income approach, recognizing the fact that for assisted housing, construction costs do not determine value. The other excludes tax credits from the definition of property rights. Tax credits are essentially a vehicle to raise acquisition and construction capital, and do not contribute to the operating income of a building. The effect of this exclusion is also to point away from construction cost and towards operating income as a more accurate basis of valuation.

The authors believe these recommendations will work to encourage fair valuations. In many cases, this will mean assessments that are low by comparison with the per-unit or per-square-foot assessments of other buildings. Constructing and operating assisted housing, especially in troubled neighborhoods, is inherently risky. Even deep subsidies may sometimes fail to provide the income a building owner legitimately needs to break even. Under such circumstances, a low assessment is neither favoritism nor unwarranted implementation of social policy, but simply recognition of market realities. Yet it will also have the effect of insuring that the property appreciation that benefits so many Americans does not jeopardize our public investment in safe, sustainable housing for low or moderate income families.

> *"Increasing the availability of affordable housing is vital for families and communities access to jobs and to maintain stable neighborhoods."*

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