BEFORE THE BOARD OF TAX APPEALS OF THE STATE OF KANSAS

IN THE MATTER OF THE EQUALIZATION
APPEAL OF PAOLA-SUNDANCE APARTMENTS
FOR THE YEAR 2004 FROM
MIAMI COUNTY, KANSAS

Docket No. 2004-8772-EQ

AND

IN THE MATTER OF THE EQUALIZATION
APPEALS OF MIAMI COUNTY APPRAISER/
PAOLA-SUNDANCE APARTMENTS
FOR THE YEAR 2005 FROM
MIAMI COUNTY, KANSAS

Docket Nos. 2005-9276-EQ
& 2005-9277-EQ

O R D E R

Now the above-captioned matters come on for consideration and decision by the Board of Tax Appeals of the State of Kansas.

This Board conducted a hearing in these matters on August 10, 2006. By Order of the Board certified January 25, 2006, the Board consolidated these three appeals for purposes of hearing and adjudication. After considering all of the evidence presented, the Board finds and concludes as follows:

The Board has jurisdiction of the subject matter and the parties as equalization appeals have been filed pursuant to K.S.A. 79-1609. The subject matter of these tax equalization appeals is described as follows:

Docket Nos. 2004-8772-EQ & 2005-9276-EQ
Real estate and improvements commonly known as
202 E. Sundance Drive, Paola, Miami County, Kansas, also
known as Parcel ID# 061-132-09-0-40-06-003.43-0
(hereinafter “Sundance I”); and

Docket No. 2005-9277-EQ
Real estate and improvements commonly known as
1010 Industrial Park, Paola, Miami County, Kansas, also
known as Parcel ID# 061-132-09-0-40-06-001.01-0
(hereinafter “Sundance II”).

The Taxpayer, Paola-Sundance Apartments, appeared by Carol B. Bonebrake, Attorney; Tom Savage, Property Tax Consultant; and Bernie Shaner, Appraiser. The County appeared by David R. Heger, County Counselor; Peggy Stroup, Deputy County Appraiser; and Russ Dillon, Appraiser. The Board admitted County Exhibits #3, part of #5, and #6 through #9 and Taxpayer Exhibits # 1 and #2. The Board did not admit County Exhibits #1, #2, #4 and pages 1-13 of #5.

Sundance I is a 40-unit, frame construction, two story apartment complex built in 1999 and located in Paola, Kansas. Twenty-four (24) units have two bedrooms and sixteen (16) units have three bedrooms. As of 2004, the complex was in average condition.

Sundance I was developed as a Section 42 low-income tax credit housing project. It is subject to a Declaration of Land Use Restrictive Covenants for Low-Income Housing Credits (“Declaration”) dated November 24, 1999 between the owner and the Kansas Department of Commerce and Housing (“KDCOH”) which is filed of record, runs with the land, and binds future owners. Pursuant to the Declaration, the Taxpayer agreed to lease 100% of its units to persons whose income is 60% or less than the area’s median gross income in accordance with Section 42 of the Internal Revenue Code. The Declaration restricts rents for a period of 30 years; the rent structure is $430 per month for the two bedroom units and $483 per month for the three bedroom units. An amendment of the KDCOH agreement to increase the rental rate, if permitted, would result in the imposition of a penalty upon the owner.

The County originally valued Sundance I at $2,103,890 for tax year 2003. The County lowered the value to $1,543,800 following the informal meeting. The Taxpayer appealed to the Small Claims Division of the Board. The Small Claims Hearing Officer reduced the value to $924,960 based upon the actual income and expenses of Sundance I. The County received a copy of the 2003 decision on July 13, 2004. Neither party appealed the decision.

The County valued Sundance I at $1,543,800 for tax year 2004 and $1,554,500 for tax year 2005. The Taxpayer appealed the 2004 value to the Regular Division of the Board. The Taxpayer appealed the 2005 value to the Small Claims Division. The Small Claims Hearing Officer found that the market for subsidized properties is impacted by restrictions on investors’ income return and saleability of the property and reduced the 2005 value to $871,200. The County appealed the Small Claims decision to the Regular Division of the Board of Tax Appeals.

Sundance II is a 40-unit apartment complex constructed in 2003. It is Class D frame, average quality construction consisting of two buildings in a two-story walk-up design. It has thirty-two (32) two bedroom, two bath units and eight (8) three bedroom, two bath units. Sundance II's amenities include a clubhouse, small playground area, laundry room and a manager's office.

Sundance II is a Section 42 project developed for the purpose of providing affordable housing to individuals with low incomes. Sundance II is subject to a Declaration of Land Use Restrictive Covenants for Low-Income Housing Credits ("Declaration") with KDCOH dated June 7, 2001. Pursuant to the Declaration, the Taxpayer and all future owners and operators are subject to restrictions on use, occupancy and transfer of the land and project. KDCOH may void any sale, transfer or exchange if the buyer fails to assume in writing the requirements of the Declaration and Section 42 of the Internal Revenue Code. The owner must comply with the requirements of Section 42 for a 30 year period; all 40 units shall be leased to individuals who qualify as low-income tenants; and the units are rent restricted. The restricted rents are $450 per month for the two bedroom units and $485 per month for the three bedroom units.

The County valued Sundance II at $1,450,000 for tax year 2005. The Taxpayer appealed the 2005 value to the Small Claims Division. The Small Claims Hearing Officer found that the market for subsidized properties is impacted by restrictions on investors' income return and saleability of the property and reduced the 2005 value to $923,600. The County appealed the Small Claims decision to the Regular Division of the Board of Tax Appeals.

Peggy Stroup, Deputy County Appraiser, testified that the County valued the subject properties at fee simple at fair market value. Stroup asserted that fee simple requires that the appraisal be made as unencumbered property including the full bundle of rights. The County's position is that the tax credits or financing should not be considered and that subsidized apartments should be considered no different than any other apartment buildings out there.

The County also called Russell Dillon, a Kansas certified real estate appraiser. Pursuant to the letter of authorization from the County, Dillon was asked to determine the fair market value in fee simple estate of the subject properties without regard to any encumbrances for the years in question. Dillon appraised the properties in fee simple estate utilizing the cost, sales comparison and income approaches. Dillon's opinions of value for Sundance I as of January 1, 2004 was $1,773,300 and as of January 1, 2005 was $1,876,000. His opinion of value for Sundance II as of January 1, 2005 was $2,115,300. (County Exhibits #6, #7 and #8.)

Dillon's cost approaches were based upon the Marshall Valuation Cost Service Manual without any external obsolescence and the Sundance II land sale from May 2002. Dillon considered four sales of similar wood frame, two story, walk-up projects and adjusted the sale prices for differences in time/market conditions, quality/condition and average unit size. Further, Dillon's estimate of market rent used in his income approach was based upon rental rates at properties not rent restricted or encumbered. Dillon asserted that the cost approach was a good indicator of value based upon the age of the properties and the income approach was particularly appropriate based upon the volume of market data.

For Sundance I, Dillon's income approach indicated a value of $1,800,000 for 2004 and 2005. Upon review of three market comparables in Paola and one in Louisburg, Dillon opined that market rent for the two bedroom, two bath units is $575 and the market rent for the three bedroom, two bath units is $675. Dillon asserted that the market suggests that 100% occupancy is being achieved citywide. He utilized a stabilized 95% occupancy level. For tax year 2005, the sales comparison approach indicated a value of $2,000,000 and the cost approach indicated a value of $1,910,000. With a range in value of $1,800,000 to $2,000,000, Dillon concluded a market value opinion of $1,900,000 in fee simple estate as of January 1, 2005. The property includes items of personal property with a depreciated contributory value estimated at $24,000 for a real property value of $1,876,000 for 2005. (County Exhibit #8) Dillon prepared a supplement to his January 1, 2005 appraisal for January 1, 2004. (County Exhibit #6) Dillon again completed the cost approach, sales comparison approach and income approach. These methodologies suggested values of $1,800,000, $1,900,000 and $1,800,000, respectively. Dillon concluded a market value opinion of $1,800,000 for 2004. With depreciated contributory value of personal property estimated at $26,700, Dillon's opinion of value for the Sundance I real property was $1,773,300 for 2004.

For Sundance II, Dillon similarly performed the cost approach, sales comparison approach and income approach. These methodologies suggested values of $2,150,000, $2,100,000 and $1,950,000, respectively. Based upon the cost approach due to the age of the property, Dillon concluded a market value opinion in the fee simple estate of $2,150,000 as of January 1, 2005. With depreciated contributory value of personal property estimated at $34,700, Dillon's opinion of the real property value was $2,115,300 for 2005. (County Exhibit #7)

The County requests that the Board recognize Dillon's appraisals as being in conformance with state law and recognized appraisal practices and find that the appraisals for Sundance I be established at $1,773,300 for 2004 and $1,876,000 for 2005, and for Sundance II be established at $2,115,300 for 2005.

The Taxpayer called Tom Savage, a property tax consultant with Savage & Browning who represents approximately 150 Section 42 properties in various states, to describe the restrictions upon Section 42 properties. Under the Declarations, Sundance I and Sundance II must provide housing for a 30 year period of time at a pre-established rent to tenants who earn 60% or less than the median income. Savage explained that while the Taxpayer could seek to amend the rental amounts, they may do so only if KDCOH, HUD and the IRS approve. Further, any change not so approved would subject the Taxpayer to substantial penalties and allow the IRS to recapture the tax credits. Savage stated that if a property is removed from the Section 42 program before the expiration of the restriction period, the owners have to refund all of the tax credits received plus 12% interest and a penalty. He was aware of only one 26-unit project which sold for $500,000 subject to tax credits and the project stayed in the Section 42 program rented at the restricted rents.

Savage also testified that he was aware of one particular situation where an owner in Montgomery County owned a 100-unit complex in the Section 42 program. The owner found it to be a bad investment because a pool of qualified tenants was not available to occupy the property. There were plenty of people wanting to rent the units, but they made more than 60% of median income. As a result, the owner removed 40 units from the Section 42 program with approval, refunded back to the IRS the income tax credits that had been paid out to that point plus interest, and paid a penalty.

Bernie Shaner, MAI, SRA, appraised the subject properties on behalf of the Taxpayer. Shaner explained that Section 42 properties are unique as they are developed for the purpose of providing housing in areas where there is a shortage of good affordable housing. He further explained the process of project application, approval and tax credit allocation. He has appraised numerous Section 42 properties and typically there are two values, one for the real estate and one for the tax credits which are not part of the real estate.

Shaner was engaged to appraise the subject properties at fair market value for *ad valorem* taxation purposes. He utilized two of the three traditional approaches to value – the cost approach and the income approach. He did not perform a sales comparison approach due to lack of comparable sales with land use restrictions. Shaner considered both the actual costs of construction of Sundance II and the Marshall Valuation Service Manual costs. He used the higher actual cost of $71.90 per square foot. Sundance II had no physical depreciation because it was essentially new at the time of valuation. Shaner testified that both Sundance I and Sundance II suffered from external obsolescence due to the restrictions placed upon their income production capabilities. He asserted that external obsolescence is measured by the amount of income the property can produce versus its cost. He determined that there was a 63% external obsolescence factor due to the below market rents. Shaner's cost approach conclusions of value were $900,000 for Sundance I for 2004 and $1,100,000 for Sundance II for 2005. (Taxpayer Exhibit #2.)

Shaner also performed income approaches utilizing the contract rents to which the properties are restricted. He allowed 6% vacancy and collection loss and added $81.00 per unit for miscellaneous income. To determine operating expenses, Shaner reviewed the three-year income and expenses history of the properties, considered the operating numbers of competing properties, and consulted the Institute of Real Estate Management survey for industry average costs of operation. He analyzed each expense item and determined what the stabilized expenses should be for each category. Shaner determined his capitalization rate by analyzing ten sales of apartments, mostly in Johnson County. He asserted that the capitalization rate needed to be above the normal market because the restrictions make it harder to sell Section 42 properties. For 2004, Shaner utilized an 8.5% capitalization rate or overall capitalization rate of 10.07% including the effective tax rate. For 2005, Shaner utilized an 8.0% capitalization rate or overall capitalization rate of 9.57%. Shaner's income approaches indicated values of $855,000 for Sundance I for 2004; $885,000 for Sundance I for 2005; and $905,000 for Sundance II for 2005. Shaner relied upon the income approach to support his opinions of value. The Taxpayer requests that the Board find that the fair market values of Sundance I are $855,000 for 2004 and $885,000 for 2005 and the fair market value of Sundance II is $905,000 for 2005. (Taxpayer Exhibit #2.)

In Kansas, each parcel of non-agricultural real property is appraised at its fair market value. See K.S.A. 79-501 and K.S.A. 79-1439(a). Pursuant to K.S.A. 79-503a, the term "fair market value" is defined as "the amount in terms of money that a well informed buyer is justified in paying and a well informed seller is justified in accepting for property in an open and competitive market, assuming that the parties are acting without undue compulsion."

K.S.A. 79-503a further provides:

> Sales in and of themselves shall not be the sole criteria of fair market value but shall be used in connection with cost, income and other factors including but not by way of exclusion:
>
> (a) The proper classification of lands and improvements;
> (b) the size thereof;
> (c) the effect of location on value;
> (d) depreciation, including physical deterioration or functional, economic or social obsolescence;
> (e) cost of reproduction of improvements;
> (f) productivity;
> (g) earning capacity as indicated by lease price, by capitalization of net income or by absorption or sell-out period;
> (h) rental or reasonable rental values;
> (i) sale value on open market with due allowance to abnormal inflationary factors influencing such values;
> (j) restrictions imposed upon the use of real estate by local governing bodies, including zoning and planning boards or commissions; and
> (k) comparison with values of other property of known or recognized value. The assessment-sales ratio study shall not be used as an appraisal for appraisal purposes.

> The appraisal process utilized in the valuation of all real and tangible personal property for ad valorem tax purposes shall conform to generally accepted appraisal procedures which are adaptable to mass appraisal and consistent with the definition of fair market value unless otherwise specified by law.

K.S.A. 79-505(a)(1) also requires that all appraisals in connection with *ad valorem* taxation be performed in accordance with generally accepted appraisal standards. The Division of Property Valuation adopted Directive #92-006 incorporating by reference the Uniform Standards of Professional Appraisal Practice, commonly referred to as USPAP. In 1998, the Division of Property Valuation promulgated a Subsidized Housing Appraisal Guide noting concern about the uniform appraisal treatment of subsidized housing projects by Kansas county appraisers. The guide stated that intangibles such as Section 42 tax credits offered by the Internal Revenue Service will not meet the definition of property as stated in K.S.A. 79-501. Further, with respect to the cost approach, the Guide notes these projects suffer from an inordinate amount of external depreciation in comparison to other apartment complexes reflecting a marketplace not having the purchasing power to pay rents that will support the construction cost. However, with respect to the income approach, the Guide instructs appraisers with ample income and expense data to appraise the fair market value utilizing local market derived capitalization rates, rental rates and expenses. The Guide explains that the value sought is the value in exchange for cash and one must ignore rent subsidies, book interest rates and tax benefits.

The Kansas Court of Appeals addressed the issue of the effects of low-income housing contracts when valuing property for *ad valorem* taxation purposes in *In re the Equalization Appeal of Ottawa Housing Assoc., L.P.*, 27 Kan.App.2d 1008, 10 P.3d 777 (2000). The district court had sustained the Board's decision sustaining Franklin County's appraisal and finding that Ottawa Housing's value failed to consider both the benefits and burdens of the low-income housing contract. Franklin County admitted that it did not consider the rental restrictions in its appraisal. Ottawa Housing argued that this admission established that the appraisal was not in conformance with K.S.A. 79-503a(d) and (j). The Court noted that Kansas had not yet addressed the issue, but that several other states had addressed the issue. The Court cited several cases and stated that "[w]ith the exception of cases from Ohio, all of the cases support the proposition that the taxing authority should consider the effects of the low-income housing contract when valuing the property for *ad valorem* taxes." *Id.* at 1011. The Court found that:

> These cases apply the general theory that a low-income housing contract is an investment tool for maximizing an investment in real estate. (Citations omitted) Buyers and sellers of real estate consider these tools in determining the market value of real estate. (Citations omitted) This principle corresponds with the Kansas definition of "fair market value" as "the amount in terms of money

> that a well informed buyer is justified in paying and a well informed seller is justified in accepting for property in an open and competitive market, assuming that the parties are acting without undue compulsion." K.S.A. 79-503a. *Id.* at 1013.

Pursuant to K.S.A. 79-1609, with regard to any matter properly submitted to the Board relating to the determination of valuation of residential property, it shall be the duty of the county appraiser to initiate the production of evidence to demonstrate, by a preponderance of the evidence, the validity and correctness of such determination. No presumption shall exist in favor of the county appraiser with respect to the validity and correctness of such determination. Pursuant to Kan. Const. art. XI, § 1, the subject properties are classified as residential property. Therefore, the above duty is placed upon the County.

Pursuant to *Ottawa Housing*, the effects of low-income housing contracts must be considered when valuing property for *ad valorem* taxation purposes. The Board finds that the effects of the low-income housing contracts should be analyzed on a case by case basis in light of the specific property at issue and the relevant marketplace. Contrary to the references in *Ottawa Housing* to K.S.A. 79-503a(j), the Board finds that the rent restrictions in this case are not "restrictions imposed upon the use of real estate by local governing bodies, including zoning and planning boards or commissions." The owner of the subject properties voluntarily entered into a contract in which it agreed to rent the property to low income tenants in exchange for tax credits. First, there are no restrictions placed on the use of the real estate at all. It is a voluntary obligation only. If the property is not leased to low income tenants as required by contract, the owners will not qualify for the tax credits. Nevertheless, there is no restriction on use. Second, the "restrictions" are not imposed by anyone. They are awarded after the owner applies for them and enters into a contractual agreement. There are more applicants than there are tax credits available. Third, the "restrictions" are awarded, not by a local governing body, but by federal and/or state agencies. Thus, these low-income housing contract obligations should not be considered a part of K.S.A. 79-503a(j).

The fair market value of real property should be based upon the highest and best use of the property. See PVD Directive #99-038. "Highest and best use" is the reasonably probable and legal use of vacant land or an improved property which is physically possible, appropriately supported, financially feasible, and that results in the highest value. The highest and best use must meet four criteria: legal permissibility, physical possibility, financial feasibility, and maximum productivity. *The Dictionary of Real Estate Appraisal*, Appraisal Institute, p.135 (4th ed. 2002); *Yellow Freight System, Inc, et al. v. Johnson County Board of County Comm'rs*, 36 Kan.App.2d 210, 217, 137 P.3d 1051, *rev. denied* (2006). As shown by a comparison of the Shaner and Dillon appraisals, the Board finds that the highest and best use of the subject properties is to operate the apartment complexes at market rental rates. In this case, the owner does not even own the tax credits, having sold them previously, but the issue is not one of maximizing the value of the intangibles, it is the value of the real property. The maximum productivity in this case is achieved through offering the units at reasonable market rental rates. This is not a case where there is inadequate market demand for the units, such as may be the case in a depressed or low-income area. The evidence in this matter shows that the market occupancy exceeds 95% in non-subsidized housing.

The Board further notes that the *Ottawa Housing* decision highlights K.S.A. 79-503a(f) and (h) relating to the productivity and rental or reasonable rental values, respectively. Both considerations lead to the same issue – is the productivity or reasonable rental value of the property limited by the housing contract or is it market-based? The County provided clear and convincing evidence that the subject units would reasonably rent for more each month and produce much more income if the owner chose to offer them at market rates, rather than voluntarily restrict the rent. Unlike zoning and planning board restrictions, which place legal restrictions on the use of the property, offering and renting these units at achievable market rates is not illegal. As stated previously, the Board finds that the highest and best use in terms of return to the real estate in this case is to offer the units at market rent. Further, the evidence presented in this matter is that market rents even justify the cost of construction. However, the Board recognizes that once the owner has been granted tax credits, the owner can achieve even greater returns in the form of intangible tax benefits. These intangibles are not taxed because they are not real or tangible personal property. K.S.A. 79-501.

Even though the Taxpayer has sold its tax credits, the Board agrees that the credits are still inextricably intertwined with the real estate due to the contractual obligations. If the owner decides to maximize the return to the real estate, the tax credits must be repaid with penalties, but they are intangible assets. Furthermore, the issue is fee simple value, which is premised on the value of the entire bundle of rights. Sale of the tax credits is no different than the sale of any other portion of the bundle of rights, such as a transfer of the right to use and enjoy the property through a lease. Neither a below-market or above-market lease is a factor in the fair market value determination for *ad valorem* tax purposes, nor is any incremental value of a high-credit tenant. The typical market lease terms are utilized. If the owner had chosen to keep the benefit of the tax credits, its decision would be whether the market rent at any time would justify fee simple market value use or whether the value to the particular investor is greater because of the combination of the real estate and the intangible tax credits. The Board finds that the owner could sell the properties for the amounts asserted by the County based upon the market evidence, but the owner would net less on the transaction because of its tax credit financing decision. The Board is required to appraise the fair market value of the real property, not the investment value or the value to a particular investor.

The Board finds that the use of market-derived evidence in this case is supported by the ample local market rental data and the high occupancy rates of non-subsidized housing in the local market. Further, the Board finds that the subject properties do not suffer from an inordinate amount of external depreciation in comparison to other apartment projects because the local market in this case does include the purchasing power to pay rents that justify construction. These findings are consistent with guidance provided for the income approach and cost approach by the PVD Guide. After fully considering the effects of the low income housing contract in this case, the Board concludes that substantial competent evidence in light of the record as a whole supports the County's recommended values based upon the Dillon appraisals as reflecting the fair market values of the real estate.

However, the Board notes that the valuation of Sundance I for tax year 2003 was reduced pursuant to a final determination made pursuant to the valuation appeals process. The County did not present documented substantial and compelling reasons to increase the valuation for 2004. As a result, the Board concludes that the valuation of Sundance I shall not be increased for tax year 2004 pursuant to K.S.A. 79-1460(a)(2). The appraised value of Sundance I shall remain $924,960 for tax year 2004.

For the foregoing reasons, the Board concludes that the appraised values of Sundance I are $924,960 for 2004 and $1,876,000 for 2005 and the appraised value of Sundance II is $2,115,300 for 2005.

IT IS THEREFORE ORDERED BY THE BOARD OF TAX APPEALS OF THE STATE OF KANSAS that the appraised values of Sundance I are $924,960 for 2004 and $1,876,000 for 2005 and the appraised value of Sundance II is $2,115,300 for 2005. IT IS FURTHER ORDERED that the appropriate officials are directed to correct the County's records accordingly, re-compute the taxes owed by the Taxpayer and issue a refund for any overpayment.

Any party to these appeals who is aggrieved by this decision may file a written petition for reconsideration with this Board as provided in K.S.A. 77-529, and amendments thereto. The written petition for reconsideration shall set forth specifically and in adequate detail the particular and specific respects in which it is alleged that the Board's order is unlawful, unreasonable, capricious, improper or unfair. Any petition for reconsideration shall be mailed to: Secretary, Board of Tax Appeals, DSOB Suite 451, 915 SW Harrison St., Topeka, KS 66612-1505. *A copy of the petition, together with all accompanying documents submitted, shall be mailed to all parties at the same time the petition is mailed to the Board. Failure to notify the opposing party shall render any subsequent order voidable.* The written petition must be received by the Board within fifteen (15) days of the certification date of this order (allowing an additional three days for mailing pursuant to statute if the Board serves the order by mail). If at 5:00 pm on the last day of the specified period the Board has not received a written petition for reconsideration, this order will become a final order from which no further appeal is available.

IT IS SO ORDERED THE BOARD OF TAX APPEALS