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

ORDER ON RECONSIDERATION

Now the above-captioned matters come on for consideration and decision by the Board of Tax Appeals of the State of Kansas. 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 and a timely petition for reconsideration has been filed pursuant to K.S.A. 74-2426 and K.S.A. 77-529. 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 Board certified its Order in these matters on December 29, 2006. The Taxpayer filed a Petition for Reconsideration on January 16, 2007. The Board certified an Order Granting Limited Reconsideration on February 2, 2007 and conducted a limited rehearing in these matters on May 14, 2007. The Taxpayer, Paola-Sundance Apartments, appeared by Carol B. Bonebrake, Attorney. The County appeared by David R. Heger, County Counselor. At the limited rehearing, Ryan Huffman, Vice-President and COO of Cohen Esrey Real Estate Services, Inc., the management company for the subject property, testified on behalf of the Taxpayers. Cohen Esrey Housing Partners is a tax credit development company, and CEHP II, LLC is the developer and general partner with 1% ownership in Paola-Sundance I. The Board admitted Taxpayer Exhibit #3.

Additional Findings of Fact

The low-income housing tax credit (LIHTC) was created by the Tax Reform Act of 1986 as Section 42 of the Internal Revenue Code to provide an incentive for the acquisition, rehabilitation and construction of affordable rental housing. 26 U.S.C.A. § 42. The tax credits can be used by property owners to reduce federal income taxes, but are generally utilized by outside investors who contribute to the initial development funds for a project. The developer/owner enters into an agreement to restrict the use of the property for a certain period ("compliance period") in exchange for tax credits for a ten-year period ("credit period"). Each state has an annual housing credit ceiling which limits the dollar amount of credits the state can allocate. State housing agencies play an important role in the program and are authorized to allocate credits. The Kansas Department of Commerce and Housing ("KDCH") monitors and administers the Section 42 program for the Internal Revenue Service in the State of Kansas.

The developer seeking to acquire tax credits to finance a project must first establish need and support for an affordable rental housing project through a market study and letter from the applicable city administrator with city council support. Next, the developer makes an application to the KDCH. The application process is competitive as there are more applications than available credits. Points are awarded on the application, and at this time, a project must agree to a compliance period of 30 years to be awarded credits.

In this case, after the tax credits were awarded to the developer/general partner, CEHP II, it looked for an investor/limited partner to purchase partnership interests. The limited partner became entitled to a 99% partnership interest and 99% of the tax credits. Under the program, the tax credits can be used by the partners or can be resold. If the owner retains the credits and decides to sell the property, the buyer "steps into the shoes" of the original owner and is entitled to assume the unused tax credits. 26 U.S.C.A. § 42(d)(7) Huffman testified that he believed that the tax credits for Sundance I were sold to General Electric Capital Corporation.

The Section 42 program is a subsidy of the construction costs through the sale of the tax credits. Unlike Section 8 projects, there is no direct rental subsidy. Renters pay the restricted rent set by the KDCH. The developers in this case agreed to rent 100% of the units to persons whose income is 60% or less of the areas gross median as calculated by the KDCH. (See Taxpayer Exhibit #1.) Miami County is in the Kansas City MSA with a median income of $68,400. (See County Exhibit #3). The income limit is dependent on the number of persons in a family. For example, the income limit for a family of four is $41,040. Rent increases must be approved by the KDCH based upon an application with evidence of need, and a request for rent increase can be denied. The subject projects agreed to restrict rent for an initial period of 15 years with an extended period of 15 years for a total compliance period of 30 years.

A Section 42 project can be withdrawn from the program. If an owner wishes to withdraw a project during the compliance period or if the project fails to remain a part of the program due to non-compliance with requirements such as rent restrictions, the entire accelerated portion of the tax credits with interest for all prior years must be repaid, commonly described as a "recapture of credits." I.R.S. Rev. Rul. 91-38. If the owner wishes to sell a project during the compliance period and the property is reasonably expected to continue to be operated as a qualified low-income project, Section 42 does allow the owner to post a performance bond equal to the tax credit allocation. Huffman described a withdrawal as highly onerous since the developer in this case would have to post cash or a $5.2 million surety bond in order to withdraw both Sundance I and Sundance II from the program. He explained that typically these properties do not sell because the owner would realize a cash loss on a sale of the property at an amount such as the County's appraisal value because the net amount is insufficient to repay the tax credits to get out of the program.

In this case, upon the occurrence of a hypothetical recapture event, the I.R.S. would send a letter to GE telling them that they need to repay the tax credits they have taken on the project. The investor would tap its limited partner who would tap the general partner or developer, all of whom usually have contractual guarantees in place. The KDCH monitors the property for compliance with the program. If the KDCH finds that an owner rented to someone who exceeds the income limit, the KDCH will issue an I.R.S. Form 8823 on the building and the tax credit flow will stop.

Tax credits may be used by the owner or investors may purchase the tax credits up front, but the credits are taken against federal income taxes for 10 years after the property is placed in service ($1/10^{th}$ of the allocated credits are taken each year for 10 years). Huffman explained that the tax credit market determines the price received for the credits as the need by large investors drives the price paid.

The Section 42 tax credit allocation for Sundance I was $2,213,290, and the total construction cost, including fees, was $1,908,679. The construction cost was paid from four sources: (1) tax credit equity of $ 497,834 (from the "sale" of the tax credits); (2) Cohen Esrey Housing Partners deferred developer fee of $140,845; (3) a soft loan of $220,000 from East Central Kansas Economic Corp.; and (4) an amortized loan of $1,050,000. The soft loan is not required to be repaid so long as the project remains in the Section 42 program, but the $1,050,000 amortized loan must be repaid. The Board notes that the witness disclosed the deferred portion of the developer fee, but did not disclose the total developer fee received. The Section 42 tax credit allocation for Sundance II was $3,030,000, and the total construction cost, including fees, was $3,688,117. The construction cost was paid from four sources: (1) tax credit equity of $2,336,983; (2) Cohen Esrey Housing Partners deferred developer fee of $276,134; (3) soft financing of $225,000 from Housing Resources of the Midwest; and (4) a permanent loan of $850,000.

Conclusions of Law

The Kansas Constitution, Art. 11, § 1 provides that "the legislature shall provide for a uniform and equal basis of valuation and rate of taxation of all property subject to taxation." The legislature addresses matters of taxation in Chapter 79 of the Kansas Statutes. K.S.A. 79-102 defines "real property" and "real estate" to "include not only the land itself, but all buildings, fixtures, improvements, mines, minerals, quarries, mineral springs and wells, *rights and privileges appertaining thereto*." (Emphasis added.) Because real property is defined to include all rights and privileges appertaining thereto, it is the "fee simple interest" that is valued for purposes of *ad valorem* taxation purposes in the State of Kansas. The "fee simple interest" denotes "absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by governmental powers of taxation, eminent domain, police power, and escheat." *The Appraisal of Real Estate*, Appraisal Institute, at 69 (12th ed. 2001). Both parties' appraisers, Shaner and Dillon, agree that it is the fee simple interest that is to be appraised for purposes of *ad valorem* taxation.

Each parcel of non-agricultural real property is appraised at its fair market value. 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."

The director of property valuation is required to adopt rules and regulations prescribing the appropriate standards for performing appraisals that are in accordance with generally accepted appraisal standards as evidenced by the standards promulgated by the appraisal standards board. K.S.A. 79-505. The Appraisal Standards Board publishes the Uniform Standards of Professional Appraisal Practice (USPAP). In

November 1992, the director of property valuation adopted Directive #92-006 requiring county appraisers to perform all appraisal functions in conformity with Standards 2 and 6 of the 1992 USPAP. USPAP provides a "jurisdictional exception" stating that if any part of the standards is contrary to the law of any jurisdiction, then that part shall be void and of no force or effect in that jurisdiction. The Division of Property Valuation also promulgated a Subsidized Housing Appraisal Guide in October 1998 addressing mortgage interest subsidies and Section 42 projects. The Board notes that the Guide was promulgated prior to the Kansas Court of Appeals decision in *In re the Equalization Appeal of Ottawa Housing Assoc., L.P.*, 27 Kan.App.2d 1008, 10 P.3d 777 (2000).

In Kansas, the fair market value of real property for *ad valorem* taxation purposes is based upon the highest and best use of the property. 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 Appraisal of Real Estate*, Appraisal Institute, at 305 (12th ed. 2001); *Yellow Freight System, Inc., et al. v. Johnson County Board of Co. Comm'rs*, 36 Kan.App.2d 210, 217, 137 P.3d 1051, *rev. denied* (2006).

There are three generally accepted valuation methodologies: the cost approach, the sales comparison approach, and the income capitalization approach. In this matter, both Shaner and Dillon substantially rely upon the income capitalization approach because the subject properties are income-generating property. The most significant difference between the two income approaches is that Dillon, the County's witness, examined the market and utilized market rents while Shaner, the Taxpayer's witness, utilized the actual income associated with the subject property as encumbered by the Section 42 agreement. With respect to the cost approach, Shaner asserted a 63% external obsolescence attributed to the income loss associated with the rent restrictions while Dillon estimated no external obsolescence.

The underlying principles of valuing the unencumbered *fee simple estate* of real property at its *highest and best use* are fundamental for purposes of *ad valorem* taxation in the State of Kansas. The valuation of the subject property's fee simple estate must take into account all rights and interests associated with the property as if merged into a single estate. The "bundle of rights" concept compares real property ownership to a "bundle of sticks" with each stick representing a separate right or interest inherent in the ownership. The fee simple estate is the entire bundle of sticks or absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by governmental powers of taxation, eminent domain, police power, and escheat. See *The Appraisal of Real Estate*, Appraisal Institute, at 68-69 (12th ed. 2001). Regardless of how the rights and interests in the property were negotiated and separated by contract or by deed, the Board is charged with determining the properties' fair market value in a hypothetical transaction where the buyer is purchasing all rights and interests in the property free of encumbrance or restriction.

Upon further review of this matter, the Board continues to believe, as explained in its original Order, that the highest and best use of the subject properties is to operate the apartment complexes at market rental rates. This use is obviously physically possible. Unlike zoning and planning board restrictions, which impose legal restrictions on the use of property as a governmental exercise of police power, the owners would not violate any laws by charging market rent for the subject property. The contractual restrictions on use (land use covenants) are designed to protect the original developer from having to repay tax credits to the IRS from its own pocket in a situation where a future owner decides to rent the units at market rates. The Taxpayer is not prevented *by any law* from selling the subject property for rental at market rates or even charging market rates on its own. In such an event, Section 42 requires the owner repay the tax credits plus interest. After concluding that a use is physically possible and legally permissible, the test of financial feasibility is considered. The question is not whether a specific owner possesses the financial ability to use the property at the potential use in light of existing leases and contracts affecting the landlord's use. The test of financial feasibility is whether the net revenue capable of being generated from a potential use of the fee simple estate of the property is sufficient to satisfy the required market rate of return on the investment. See *The Appraisal of Real Estate*, Appraisal Institute, at 313-314, 318 (12th ed. 2001). In this case, the County's income approaches in a non-subsidized rental housing market with occupancy exceeding 95% support the finding that a non-subsidized housing use is financially feasible. Further, the maximum productivity of the real property is achieved through offering the units at reasonable market rental rates.

The Taxpayer's argument that the rent restrictions are "restrictions imposed upon the use of real estate by local governing bodies, including zoning and planning boards or commissions" under K.S.A. 79-503a(j) is not persuasive and fails to address the underlying principles of valuation for *ad valorem* taxation which are in place to ensure uniform and equal taxation. As the Board stated in its original Order, the owner of the subject properties freely entered into a contract in which it agreed to rent the property to low income tenants in exchange for tax credits used to finance construction. The owner transferred one of its rights from its bundle (specifically, the right to charge market rent) in exchange for substantial consideration in the form of tax credits. This contractual agreement was not *imposed* by a governing body and does not constitute a governmental exercise of police power. The Section 42 obligations were freely accepted by the owners after a competitive application process in exchange for consideration. No governmental body unilaterally imposed this contract on this property owner. "Restrictive covenants are a matter of private contract, whereas zoning regulations constitute a governmental exercise of the police power." *McDonald v. Emporia-Lyon County Joint Board of Zoning Appeals*, 10 Kan.App.2d 235, 697 P.2d 69, *rev. denied* (1985).

K.S.A. 79-503a expresses that sales are not the sole criteria of fair market value but shall be used in connection with cost, income and other factors including "(f) productivity," "(g) earning capacity as indicated by lease price, by capitalization of net income or by absorption or sell-out period," and "(h) rental or reasonable rental values." K.S.A. 79-503a must be interpreted to give effect to the entire act, including the concepts of the fee simple estate and highest and best use, so that *ad valorem* taxation statutes are interpreted in a consistent and sensible manner. Actual rents, vacancy, collection loss and expenses are relevant under K.S.A. 79-503a(f), (g) and (h). In a fair market value analysis, actual data should be reviewed, if available, and compared to market rents, vacancy, collection loss, and expenses which are also relevant under K.S.A. 79-503a(f), (g) and (h). If the actual income and expenses differ from the market, the analysis must continue to examine why they differ. Are there factors inherent in the fee simple interest of the property which would lead an appraiser to conclude that the market data representing typical, proper and efficient use of similar property is not reflective of the fair market value of the property at issue, such as location, deferred maintenance, or adverse external influences? Or, alternatively, has the owner made business decisions which affect the actual net income of the property?

As stated previously, the "fee simple interest" denotes "absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by governmental powers of taxation, eminent domain, police power, and escheat." In contrast, the "leased fee interest" is the lessor's or landlord's interest. Contract terms, often found in a lease, divide the fee simple estate into separate interests: the interests or rights of the lessor ("leased fee interest") and the interests or rights of lessee ("leasehold interest"). See *The Appraisal of Real Estate*, Appraisal Institute, at 81-83 (12th ed. 2001).

The use of actual rents, vacancy, collection loss and expenses experienced by a particular property in an income capitalization approach results in an appraisal of the "leased fee interest," or the landlord's interest, when the actual rents, vacancy, collection loss or expenses differ from the market. An appraisal of this leased fee interest does not achieve uniform and equal valuation pursuant to the Kansas Constitution because it values in part the business acumen of the owners. For example, assume an owner entered into a lease agreement in which the lessee paid a much lower rent than typical in the market for nearly identical property. In that case, the owner is not receiving full value for the property. Utilizing actual rent in the income capitalization approach would estimate a lower than fair market value for the property. An owner with inferior business acumen or an owner who intentionally receives less than market rent for some other business reason should not be allowed to reduce the "potential gross income" utilized in the income capitalization approach for purposes of *ad valorem* taxation. To allow a reduction in "potential gross income" based upon these business decisions would lower the valuations for such properties and would ultimately shift the tax burden to those owners who operate similar property at its highest and best use under proper and efficient management. Admittedly, this "leased fee" analysis may be very useful to owners for management purposes, but it does not achieve uniform and equal appraisal for purposes of *ad valorem* taxation in the State of Kansas and exemplifies the importance of appraising the unencumbered fee simple interest at highest and best use, not the owner's interest in existing leases or contracts.

The Board recognizes that upon the sale or use of the subject property at its highest and best use, the owner would be required to repay the tax credits with interest. Due to the owner's contractual obligations and receipt of tax credits, the ownership would take a loss, or net less, on the sale. This financing situation is similar to a hypothetical owner who mortgages a property for more than its fair market value. Upon the sale of such a property at market value, the hypothetical owner would also take a net loss on the sale because it must repay the lender more than received from the sale. Nevertheless, the appraised valuation of such a property is not reduced below fair market value due to the amount of the mortgage. The potential loss in this case is a result of the ownership's method of development and financing. The business acumen of the owners resulted in developer's fees for CEHP, II and the construction of the properties with an outstanding mortgage debt at a fraction of the properties' actual cost. These business transactions of the ownership resulting in encumbrances which divide the fee simple interest of real property are not properly included in a fee simple interest valuation.

When appraising real property, USPAP Standards 2 and 6 require that the appraiser identify the real property interest being appraised. Advisory Opinion 14 (AO-14 Rev. 1998) from the Appraisal Standard Board addressing "Appraisals for Subsidized Housing" notes that "the value definition selected or required by the client and the reporting techniques used should be discussed with the client prior to the acceptance of the assignment because the analysis may be based on general market terms, subsidized housing submarket financing with unusual conditions or incentives, both, or some other defined purpose." Although the Taxpayer's appraiser asserts in his written appraisal that he is valuing the fee simple estate, the Board finds that the Taxpayer's valuation methodologies value the subject property without all of its rights and privileges, specifically lacking the right to charge market rent. Since this restriction was not imposed by a governmental body as an exercise of police power, governmental power of taxation, eminent domain, or escheat, the right to charge market rent inherent in the subject property must be included in the fee simple interest valued for purposes of *ad valorem* taxation. The Board recognizes that there may exist a submarket of buyers that would be willing to purchase the subject property subject to the Section 42 restrictions, but the price paid would be a reflection of the sale of the leased fee interest, not the fee simple interest. The methodologies presented by the Taxpayer ignore the highest and best use of the property and value the leased fee interest which is in direct contravention to the uniform and equal provision of our state Constitution.

The Kansas Court of Appeals briefly 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 Court cited several cases from other states and found 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 opined:

> 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.

In reviewing the case law cited by the *Ottawa Housing* Court, one must be mindful that other states often have constitutional and statutory provisions differing from the State of Kansas. To better understand the distinctions observed by the Board with respect to the authorities cited in *Ottawa Housing*, the case citations and comments by the Court of Appeals are set forth in the same order as in the Court's opinion with additional comment by the Board as follows:

- "*Greenfield Village Apts. v. Ada County*, 130 Idaho 207, 210-11, 938 P.2d 1245 (1997) (holding that the property valuation should consider the restricted use of the land as low-income and rent restricted; a concurring opinion notes that the valuation should consider the benefits of the tax credits as well)." *Id.* at 1011. The property at issue was a Section 42 project. The applicable Idaho code section stated "that the actual and functional use shall be a major consideration when determining market value for assessment purposes." The court found that the county's use of market rents ignored the "actual and functional use" of the property and remanded the valuation case with instructions as the tax credit issue was not fully developed in the appeal. This actual use standard is distinguishable from the highest and best use standard in Kansas.

- "*Kankakee Co. Board of Review v. PTAB*, 131 Ill. 2d 1, 17, 544 N.E.2d 762 (1989) (holding that the taxing authority must weigh both the positive and negative aspects of a subsidy agreement and adjust the income figure to accurately reflect the true earning capacity of the property)." *Id.* at 1011. The question was whether the rental subsidies for low income elderly housing received under the government contract (not a Section 42 project) should be included in the income approach. The rent received from tenants plus the subsidy was higher than rent received on the open market. The court described the property's rental subsidy as a substantial benefit to the owner and not as an "encumbrance" like the below-market lease in a prior court decision *Springfield Marine Bank v. PTAB,* 44 Ill.2d 428, 256 N.E.2d 334 (1970). The court noted that *Springfield Marine* held that "when a property is subject to an unfavorable lease, the contract rent or actual income must be disregarded in determining the property's fair market value when the actual income does not reflect the property's capacity for earning income. Thus, under *Springfield Marine,* a property's income-earning capacity is the most significant element in arriving at 'fair cash value.'(citation omitted)" "When actual rental income does not reflect the income-earning capacity of a property, it may be disregarded, and the taxing authority may look to rents obtainable for comparable property in the open market. 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." 131 Ill. at 15-16. The court held that it is the capacity for earning income, rather than the income actually derived, which reflects "fair cash value" for taxation purposes in Illinois.

- "*Pedcor Investments v. State Bd.*, 715 N.E.2d 432, 437 (Ind. Tax 1999) (concluding that deed restrictions may constitute economic obsolescence depending on the effect of the tax incentives)." *Id.* at 1011. Indiana uses a "true tax value" for taxation of commercial property defined as its reproduction cost (calculated under state regulations) minus physical depreciation and obsolescence depreciation. The court held that the federal tax incentives of the Section 42 project must be taken into consideration when evaluating whether the deed restrictions do, in fact cause the property to experience economic obsolescence. Note, however, that a property tax assessment in Indiana is not based on a property's fair market value.

- "*Glenridge Development v. City of Augusta*, 662 A.2d 928, 931 (Me. 1995) (concluding that the taxing authority should consider the effect of the regulations governing the housing complex but refusing to find error because the valuation was based on the cost approach rather than the income approach)." *Id.* at 1011-1012. The Section 236 property received a mortgage interest subsidy in exchange for rent restrictions. Specifically HUD paid 7.5% interest on the mortgage while the owner paid 1%. The owner benefited by approximately $162,000 per year. The owner argued that this interest subsidy should not be included in net income in the income approach. Maine Code required that all relevant factors be considered and defined "restrictions" to include recorded contractual provisions limiting the use of land. The court found consideration of the interest subsidy payments proper in the income approach.

- "*Meadowlanes v. Holland*, 437 Mich. 473, 495, 473 N.W.2d 636 (1991) (holding that the interest subsidy payments made by the government in return for the rent restrictions affect the selling price of the property and should be considered in the property's valuation)." *Id.* at 1012. The Section 236 property received a mortgage interest subsidy and a Section 8 rental subsidy. In this highly fact specific case, the court discussed a hybrid valuation approach. The court cited its prior decision finding that its statute lists a number of value-influencing factors such as zoning and location that should be considered when determining the "usual selling price" or "True Cash Value." Although these factors are intangibles, and not taxable in and of themselves, they can increase or decrease the value of property. Tax shelter benefits, although intangibles, should be reflected in the assessment process to the extent that they increase or decrease the value of the subject real property.

- "*Rebelwood, Ltd. v. Hinds County*, 544 So. 2d 1356, 1364 (Miss. 1989) (holding that because the benefits of participating in a federal low-income housing program affect the value of the property in the open market, they must sensibly be considered in assessing the value)." *Id.* at 1012. The property received a mortgage interest subsidy and Section 8 rental subsidy. In Mississippi, "true value" for purposes of *ad valorem* taxation is based on current use; the concept of highest and best use is inapplicable.

- "*Steele v. Town of Allenstown*, 124 N.H. 487, 491-92, 471 A.2d 1179 (1984) (holding that federally subsidized housing should be valued as such and not as non-subsidized housing)." *Id.* at 1012. The appraisers disagreed with respect to the highest and best use of the property receiving Section 8 rental subsidies: present use as subsidized housing or use as a non-subsidized apartment complex. The government assisted rent was $325 while market rent was $225. The court found that the property's use as a federally subsidized housing complex was the use that produced the highest market value and greatest economic return.

- "*Penns Grove Gardens v. Penns Grove*, 18 N. J. Tax 253, 264-65 (1999) (holding that the governmental contract rent and the actual management fee should be used in determining valuation)." *Id*. at 1012. Both experts agreed that the highest and best use of the property was its existing use as Section 8 subsidized housing. The taxpayer's appraiser valued the property as a conventional apartment complex without regard to its subsidized nature while the municipalities' appraiser valued the property as a government-subsidized apartment complex. Since, the contract rent paid by the tenants was the same as the economic or market rent in the area, the court found that it was not valuing a leasehold interest because the leased fee and fee simple were synonymous. The primary difference between the two appraisers' conclusions was due to their differing capitalization rates derived based upon their differing opinions of the risk involved in the investment.

- "*Bayridge Assoc. Ltd. Partnership v. Dept. of Rev.*, 321 Or. 21, 31, 36, 892 P.2d 1002 (1995) (holding that participation in a § 42 housing program is a governmental restriction as to use and must be considered in valuing property, but a dissenting judge found the contract to be "nothing more than a financial arrangement, voluntarily chosen by the owner, for its own financial benefit").” *Id.* at 1012. An Oregon statute provided that when a property is “subject to government restriction as to use,” the true cash value must be adjusted to reflect or take into account that restriction. The court found the Section 42 restrictions to be a “governmental restriction as to use.” The court noted that the ordinary words of the statute do not require that the “governmental restriction” be involuntary or non-beneficial. The Oregon statute is different from K.S.A. 79-503a(j) which lists as a factor to be considered “restrictions *imposed* upon the use of real estate *by local governing bodies*, including zoning and planning boards or commissions.” (Emphasis added.)

- “*Parkside Townhomes v. Board of Assess.*, 711 A.2d 607, 611 (Pa. Commw. 1998) (holding that the fair market value of property is a function of the economic reality which includes the effects of tax credits for low-income housing).” *Id.* at 1012. The taxpayer’s expert did not consider the value of the tax credits arguing that the credits constituted intangibles. The court disagreed with the expert’s argument and found that it was not constrained to determine fair market value of a Section 42 project as though the property lacked tax shelter features because tax related benefits associated with investment property ownership inherently affect value. The court did not render an opinion of value, but remanded the case for further proceedings on the merits.

- “*Alta Pacific v. Utah State Tax Com'n*, 931 P.2d 103, 115-16 (1997) (concluding that the commission should have considered the effects of the low-income housing contract but refusing to reverse because the taxpayer failed to show substantial prejudice).” *Id.* at 1012. Under the Section 8 and the Rural-Rental Housing Programs, the owners were guaranteed substantially higher rent than that received by comparable, nonparticipating apartments. The court found that the benefits and the burdens of the federal programs should be accounted for in the valuation approach. The court found the owners’ position contradictory: the owners’ experts stated that the contract rents should not be used (the benefit), but argued that larger deductions need to be made for the costs associated with the federal constraints (the burdens). The commission’s valuation standards provided that properties are generally appraised as if all ownership rights and interests are attached, i.e., the fee simple estate. The court found that the commission’s “fee simple rule” should be viewed as a guideline for appraisal in Utah and should not be presumed to apply to every case. In Kansas, the fee simple estate must be utilized in every case.

- “*Metro. Holding v. Milwaukee Review Bd.*, 173 Wis. 2d 626, 634, 495 N.W.2d 314 (1993) (holding that the property assessment for low-income housing should be based on actual rents and expenses).” *Id.* at 1012. The opinion did not state with specificity the federal program at issue and did not address the concepts of fee simple interest or highest and best use.

- "But *cf.*: *Alliance Towers v. Bd. of Revision*, 37 Ohio St. 3d 16, 24, 523 N.E.2d 826 (1988) (holding that market rental rates should be used in valuing low-income housing and stating that the artificial effects of government housing assistance programs are not indicative of the valuation of real estate)." *Id.* at 1013. The properties received a mortgage subsidy. The taxpayer's appraiser used market rents and mortgage rates which estimated a lower value than if actual rent and actual mortgage rates were used. The market rents did not support the cost of construction of the projects (as evidenced by the lower value indicated when using market rates). The appraisers were at odds because the taxpayer's appraiser valued the property free and clear of any encumbrance while the taxing authorities valued the properties as encumbered by mortgages and restrictions. The court held that the federal loan guarantees, favorable mortgage terms, rent subsidies, and income tax advantages allowed the project to be built in an area which would not support market rents high enough to make the construction of the apartments feasible. The court found that in Ohio, for real property tax purposes, the fee simple estate is to be valued as if it were unencumbered. "An apartment property built and operated under the auspices of HUD is to be valued, for real property tax purposes, with due regard for market rent and current returns of mortgages and equities." 37 Ohio St. 3d at 24.

- "*Canton Towers, Ltd. v. Bd. of Revision*, 3 Ohio St. 3d 4, 7, 9, 444 N.E.2d 1027 (1983) (holding that it was proper to use market rental rates in determining the value of a low-income housing complex, but two dissenting justices found that the effects of the low-income housing contract should have been considered)." *Id.* at 1013. The market rents were lower than the contract rents received under a Section 8 rental subsidy.

In summary, the legal and factual distinctions are important and relevant to the complex appraisal problem presented in these matters. The Board notes that only four of the cases specifically addressed property where rent was restricted by Section 42. The remaining cases involved property receiving rental and/or mortgage interest subsidies. Notably, many of these courts determined that the actual use as subsidized housing was the highest and best use of the property because it produced the greatest economic return. In these cases, the taxpayers were arguing in favor of the use of market or economic rent because the taxing authorities' use of actual subsidized rent, or inclusion of the mortgage interest subsidy as income, indicated higher values in the income approach. An analysis of the type of subsidies received and the applicable market in each case is critical. Further, the Board notes that none of the courts found in favor of the particular income approach methodology utilized by the Taxpayer's appraiser in these matters.

On reconsideration, the Board also reviewed more recent cases in the developing body of law found in other states addressing *ad valorem* taxation of Section 42 projects. In *Spring Hill v. Tennessee State Bd. of Equalization*, 2003 WL 23099679 (Tenn.Ct.App. 2003), the county assessor included a value-enhancing factor, the present value of the tax credits, and a value-decreasing factor, the lower restricted rents, in the income capitalization approach valuations. The assessor argued that to properly appraise the fee simple interest, or full bundle of rights, the present value of the tax credits must be added to the income value for it is payment for relinquishing the right to lease the property to whoever he pleases and for the amount he wishes, the right to sell without restraint and the right to use the property without restraint. The Court of Appeals of Tennessee noted that although the tax credits are intangible personal property that cannot be taxed under the laws of the state, they are a value-enhancing factor properly considered in the assessment. The court pointed out that the potential to produce income in the future is itself an intangible, but is considered in the determination of value. The Tennessee Court concluded that both the value-increasing benefits (investment or tax benefits) and the value-decreasing burdens (rent restrictions) of the Section 42 housing arrangement should be considered. The court also interpreted *Ottawa Housing* to support the proposition that both the benefits and the burdens of the Section 42 housing arrangement should be considered.

In *Town Square L.P. v. Clay County Bd. of Equalization*, 704 N.W. 2d 896 (2005), the Supreme Court of South Dakota concluded that both the restricted rents and the tax credits must be considered when assessing property at "true and full value." The taxpayer's appraiser used only reduced rents in the income approach and gave no consideration to the tax credits. The county's appraiser performed two income approaches, one using market rents and one using reduced rents. The court noted that South Dakota makes no distinction between tangible and intangible property, so the argument for the omission of tax credits as intangible property is not applicable. The court found that "[t]o ignore these credits, which enhance value, would be to ignore the realities of the marketplace. Buyers and sellers most certainly consider the benefits and restrictions that come with LIHTCs in determining the market value of real estate." *Id.* at 902-903. The court remanded the case because neither appraiser used both the reduced rents and the tax credits in their computations and the court did not know to what degree the reduced rents and the tax credits offset each other.

The Supreme Court of North Carolina in *In re Appeal of the Greens of Pine Glen Ltd*, 356 N.C. 642, 576 S.E.2d 316 (2003) noted that it has consistently held that where the income approach is used, the valuation must be based on market rents, not contractually restricted rents. The "income" referred to in the North Carolina statute to be considered in valuation is not necessarily the actual income, but the statutory language is sufficient to include the income which could be obtained by the proper and efficient use of the property. "[T]axpayers cannot adjust the value of their property by engaging in contractual agreements that reduce the income potential of the property below the fair market value." *Id.* at 649. The court found that the participation in the Section 42 program created another way to finance the project and represented a business and economic decision, not unlike a long-term lease. In addition, the court stated that "[u]nlike 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 the taxpayer may not artificially alter the value of its property below fair market value." *Id.* at 651.

The Board was particularly interested in the appraisal methodology and reasoning set forth by the Tennessee court in *Spring Hill* because it contemplated the principle of valuing of the fee simple interest, or full bundle of rights. The court found in favor of an appraisal methodology that considered both the value-enhancing benefits and value-decreasing restrictions. Although the tax credits are non-taxable intangibles, their affect on value is a factor to be considered, not unlike the potential to produce income in the future is an intangible, but commonly utilized in the income approach. However, the Tennessee court operated under the presumption of valuing the property in its current actual use, as evidenced by the utilization of restricted rent in the income approach and adding a present value of the tax credits. Upon further consideration, the Board believes that if this methodology were applied in this particular case, it would likely result in a "leased fee interest" valuation because it would value the property subject to the current contract, which is not the highest and best use of the real property. The Board recognizes that this methodology arguably could provide evidence of fair market value in a case without sufficient market evidence or where the current use was the highest and best use, but that is not the case presented here and neither party utilized such a methodology in these matters. This point reemphasizes the Board's opinion that the effects of low-income housing contracts should be analyzed on a case by case basis in light of the specific property at issue, the relevant marketplace, and the evidence available.

In this case, the Board has thoroughly considered the rent restrictions of the LIHTC contract and the value-decreasing impact on the income approach to valuation. The Board was not presented sufficient evidence to attempt to analyze the impact of the tax credits on value as a value-enhancing factor. However, the LITHC contract is not the *only* factor to be considered in the appraisal of subsidized housing. The fundamental principles of the fee simple interest and highest and best use, as well as K.S.A. 79-503a and generally accepted appraisal practice, still apply and must be considered by this Board.

In conclusion, the valuation of real property developed pursuant to I.R.C. Section 42 poses a complex valuation problem for appraisers. The valuation problem becomes more complex when the appraisal is for purposes of *ad valorem* taxation because the appraiser must be cognizant of the law of the specific jurisdiction at issue in order to properly define the interest to be appraised. The Board is not persuaded that *Ottawa Housing*, as applied to the present matter, is properly interpreted to order the use of the income approach with actual income and expenses since the result is a "leased fee interest" appraisal. *Ottawa Housing* was a case of first impression that did not address the underlying concepts of "fee simple interest" valuation of real property at its "highest and best use." The Board finds it necessary to consider these fundamental principles in conjunction with *Ottawa Housing* and K.S.A. 79-503a under the specific facts presented in order to achieve uniform and equal *ad valorem* taxation. Although the County's witness admits his failure to consider *Ottawa Housing* in preparation of his appraisal, the Board finds that this omission is not materially detrimental to the overall opinion rendered as he properly identified the fee simple interest to be appraised. See *In re Amoco Production Co.*, 33 Kan.App.2d 329, 337, 102 P.3d 1176 (2004), *rev. denied* June 9, 2005. The Board believes that it has fully, and exhaustively, considered the effects of the low-income housing contract presented in this case in rendering its opinions of value. Upon reconsideration, the Board concludes that its original opinions of value are sustained.

IT IS, THEREFORE, BY THE BOARD OF TAX APPEALS OF THE STATE OF KANSAS, CONSIDERED AND ORDERED that, for the reasons set forth herein, the original Order certified December 29, 2006 should be, and the same is hereby, sustained.

This order constitutes final agency action. Any party choosing to petition for judicial review of the Board's decision must file the petition with the appropriate court within 30 days from the date of certification of this order. See K.S.A. 77-613(c), and amendments thereto. The Kansas Court of Appeals has jurisdiction over all property appraised and assessed by the director of property valuation, excise, income, or inheritance taxes assessed by the director of taxation, and all tax exemptions. See K.S.A. 74-2426, and amendments thereto. The District Court in the County where the subject property is located has jurisdiction over all tax protests, grievances, and equalizations. See K.S.A. 74-2426, and amendments thereto. Pursuant to K.S.A. 77-529(c), and amendments thereto, any party choosing to petition for judicial review of the Board's decision is hereby notified that the Secretary of the Board of Tax Appeals is to receive service of the petition for judicial review. Please note, however, that the Board would not be a party to any judicial review because the Board does not have the capacity or power to sue or be sued. See K.S.A. 74-2433(f), and amendments thereto.

IT IS SO ORDERED　　　　THE BOARD OF TAX APPEALS