

TAX RULES CLARIFIED FOR SECTION 42 HOUSING

Wisconsin Supreme Court reaffirms subsidized housing valuation methods.

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In a major victory for subsidized housing developers and investors, the Wisconsin Supreme Court has reaffirmed longstanding principles governing the assessment of these properties.

The Dec. 22, 2016 decision in *Regency West Apartments LLC v. City of Racine* confirms that the assessment of a subsidized housing project is a property-specific exercise that must take into account the type of federal program involved, specific restrictions on the property and actual property income and expenses.

The decision also affirms that the value of a subsidized property cannot be determined by comparison to conventional apartment properties that have no restrictions and can charge full market rents.

Historical context

The Wisconsin Supreme Court first upheld these principles in a 1993 case involving a Milwaukee apartment project subject to rental and other restrictions imposed by the U. S. Department of Housing and Urban Development (HUD).

The assessor had valued the property based on market rents at conventional apartments, ignoring the property owner's inability to legally charge market rents. The Supreme Court nullified the assessment, stating that the assessor had illegally assessed the property by "pretend[ing]" that the HUD restrictions did not apply.

The new decision

In the December 2016 decision, the Supreme Court reaffirmed the 1993 decision and announced additional rules governing what assessors cannot do in assessing subsidized housing.

That case involved 72 rental units regulated under Section 42 of the Internal Revenue Code, which provides federal income tax credits for investors in affordable housing. Regulations governing the property restricted both

rent and tenant income levels, and required the owner to enter into a 30-year land use restriction agreement.

For the first of the two tax years in issue, the assessor valued the project under an income approach but failed to consider the owner's actual income and expense projections. Instead, the assessor estimated vacancy and expenses using a mass-appraisal model comprised of market vacancy rates and market expenses for unrestricted properties.

The assessor also used a low 6 percent base capitalization rate, likewise derived from a mass appraisal model consisting of market-rate properties.

For the second year in issue, the assessor used a comparable sales approach based on sales of three properties that the assessor claimed were comparable to the subject property. However, none of those properties was a Section 42 project: Two were rent-subsidized HUD Section 8 properties, and the other was a mixed-use property consisting primarily of market-rate apartments with a few Section 42 units.

The Supreme Court nullified the assessments for both years, concluding that neither approach the assessor used complied with the rule that an assessor cannot value subsidized housing by "pretend[ing]" that the restrictions on the property do not exist.

For the income-based assessment, the Supreme Court found two fatal flaws in the assessor's methodology.

First, the court found that the assessor violated Wisconsin law by using estimated market-based vacancy and expenses instead of the property's projected actual vacancy and expenses. The court reaffirmed that its 1993 decision "unambiguously" requires assessors to use actual income and expenses when valuing subsidized housing under an income approach.

The court further held that by using mass appraisal estimation techniques instead of income and expense information specific to the subject property, the assessor violated the statutory requirement that assessors must use the "best available" information.

Second, the court found that the assessor violated Wisconsin law by deriving a capitalization rate from market-rate properties instead of from the specific market for Section 42 properties. The court explicitly held that Wisconsin assessors valuing federally regulated properties "may not" derive a capitalization rate from market-rate properties.

For the comparable sales-based assessment, the court likewise concluded that the three sales the assessor relied on were not "reasonably com-

parable" to the subject property, as Wisconsin law requires. The court definitively rejected the assessor's claim that Section 42 properties and Section 8 properties have similar restrictions and similar rates of rent and are therefore comparable.

In rejecting the assessor's claim that those two programs have similar restrictions, the court engaged in a lengthy analysis of the fundamental differences between them.

The court emphasized that the two "are vastly different" programs with "different risks for the owners," since Section 42 is an income tax credit program while Section 8 is a rent subsidy program; thus, Section 42 properties are "riskier investment[s]" because the government does not insure against nonpayment of rents.

The court likewise rejected the assessor's claim that the two programs have similar rents, holding that the comparison was invalid because the assessor failed to recognize that Section 8 rents are subsidized by the government while Section 42 rents are not. The Court thus concluded that as a matter of law, Section 8 and Section 42 properties are not reasonably comparable because they do not have the same restrictions.

Key takeaways

The decision is a major victory for subsidized housing developers and investors for several reasons. First, it reaffirmed the 1993 decision that subsidized housing cannot be valued under an income approach based on the income and expenses of conventional apartments. It also provided additional guidance as to what assessors cannot do, including developing a capitalization rate from sales of non-subsidized properties.

Second, the decision addressed for the first time what assessors cannot do in assessing subsidized housing under a comparable sales approach, since the 1993 case only addressed assessment under an income approach.

Finally, and perhaps most significant for investors in these properties, the decision specifically held that different types of subsidized housing programs — Section 42 and HUD Section 8 in particular — are vastly different, and that assessors cannot consider a property under one program to be reasonably comparable to a property in a different program just because they both involve a form of subsidized housing.

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