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February 8, 2007

**Re: City of                      Redevelopment Agency Affordable Housing  
      Silent Second Mortgages**

Dear Mr.            :

This is in response to your December 6, 2006 letter addressed to Ms. Sabina Crocette, Tax Consultant Expert in Board Member Betty Yee's office, which was forwarded to the Board's Legal Department for review. Your letter requests our opinion as to whether the promissory notes and deeds of trust referred to as "silent second mortgages" (silent seconds) are includable in the assessed value of affordable housing units (affordable units) built in the City of (City) by developers under authorization of the City of                      Redevelopment Agency (Agency). As explained in further detail below, under the instant facts, it is our opinion that the value of an affordable unit for property tax purposes may be estimated using the unit's purchase price, which in this case is the sum of any down payment, the face amount of the first mortgage, and the assessor's estimate of the present economic value of the silent second, that is, its face amount discounted to reflect its repayment after 30 years. Nevertheless, the assessor is required to take into consideration the effect of the enforceable government restrictions on value; specifically, to exercise his judgment under Revenue and Taxation Code<sup>1</sup> sections 110 and 402.1, to determine whether the full cash value of the affordable unit is more or less than the purchase price as a result of the impact of the enforceable government restrictions.

**Silent Seconds and Regulatory Agreements in General**

Initially, we caution against the generic use of the term "silent second." Based upon our experience, there is no standard or pro forma "silent second." The specific terms and conditions of a particular "silent second" agreement must be analyzed separately and independently to determine their respective property tax implications. Some silent seconds may only take effect if the purchaser violates the agreement and are forgiven if the agreement is fulfilled. In other words, the silent second operates solely as an enforcement mechanism to encourage compliance

<sup>1</sup> All statutory references are to the Revenue and Taxation Code, unless otherwise specified.

with the enforceable restrictions. In these cases, we generally do not regard the silent second as being part of the purchase price. In other cases, while the silent second may or may not have some enforcement goal, it nevertheless is payable regardless of whether or not the purchaser breaches the enforceable government restrictions. In such cases, where the purchaser has unconditionally committed to pay the silent second under its terms and conditions, the silent second must be given consideration in determination of the purchase price.<sup>2</sup>

As with the specific terms of silent seconds, regulatory agreements for sales of affordable units also vary. Therefore, to determine whether the enforceable government restrictions have an effect on value, the specific restrictions and conditions contained in the agreement must be reviewed.

### **City of**

The Agency, with assistance from the City, increases the supply of affordable housing within its redevelopment area by requiring developers seeking approval to build housing projects to sell a portion of the dwelling units (affordable units) to low or moderate income purchasers (purchasers). In order to acquire the property, the purchaser must obtain a first mortgage from a private lender, the amount of which is tied to the median-area income, the purchaser's income, and current interest rates (first mortgage). It is anticipated that the first mortgage will always be less than the fair market value of similar units with no recorded deed restrictions.

Additionally, prior to closing, each purchaser of an affordable unit must enter into a recorded regulatory agreement (Agreement) with the City that, among other use and sales restrictions on the affordable unit, requires that the purchaser execute a promissory note and second trust deed, referred to as a silent second mortgage.

### ***Terms of the Silent Second***

The terms of the silent second are as follows:

1. The silent second is in favor of the City in an amount equal to the fair market value of the dwelling unit at the date of purchase minus the amount of the first mortgage. (Agreement § 5.7.)
2. The City may, after 30 years, require repayment of the silent second in full, extend the term of the silent second or, at its sole discretion, amortize the silent second. (Agreement §§ 5.7 and 5.8.3(c).)
3. In the event the purchaser sells the affordable unit in an authorized sale, the Agreement requires either repayment of the silent second by the purchaser or the assumption by the new purchaser of a new silent second. (Agreement §§ 5.3.3 and 5.4.)

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<sup>2</sup> This is true even if the silent second promissory note states that it must be paid only in the "sole discretion" of the noteholder. The noteholder always has discretion to accept or decline payment; the key fact is that the payor has unconditionally agreed to pay the note under its terms.

4. In the event that the purchaser breaches the Agreement, including by an unauthorized sale of the affordable unit, the silent second becomes due and the City may pursue any and all other legal remedies available to it. (Agreement §§ 4.1, 5.1.5, 5.3.3, 5.8.3, and 9.)
5. The silent second has priority over any encumbrances the purchaser may place upon the affordable unit, except the first mortgage. (Agreement §§ 4.2 and 5.6.)

### ***Terms of the Regulatory Agreement***

The Agreement provides the following restrictions:

1. The affordable unit must be the purchaser's primary residence during the 10-year term of the Agreement of each purchaser. (Agreement §§ 3.22 & 5.1.1.)
2. The affordable unit may not be leased or rented unless the purchaser establishes that the owner-occupancy requirement would cause a hardship. (Agreement § 5.1.3.)
3. Except in limited circumstances, subsequent sales by the purchaser within the qualified residence period may only be made to another qualified purchaser at an affordable purchase price. (Agreement § 5.1.5.)
4. Any sale of the affordable unit is contingent upon the City's approval. (Agreement § 5.2.3.)
5. Upon sale of the affordable unit, the City shall be entitled to a portion of the equity in the home at the time of sale, roughly in an amount equal to the sale price of the unit multiplied by a percentage which equals the face value of the silent second divided by the fair market value of the unit at the time of initial purchase by the purchaser. (Agreement § 5.8.)
6. In the event that the purchaser violates the Agreement and sells the affordable unit to a non-qualified purchaser, the City may, at its discretion, void the sale (Agreement § 4.1) or pursue any and all legal and equitable remedies available to it including specific performance of the Agreement. (Agreement § 9.)

### **Legal Analysis**

#### ***Purchase Price of the Affordable Unit***

Section 401 requires that every assessor "assess all property subject to general property taxation at its full value." Section 110, subdivision (b) provides that the term "full value" means the "purchase price paid in the transaction unless it is established by a preponderance of the evidence that the real property would not have transferred for that price in an open market transaction." The "purchase price" means "the total consideration provided by the purchaser or

on the purchaser's behalf, valued in money, whether paid in money or otherwise." (Rev. & Tax. Code, § 110, subd. (b).)

In this case, the central fact is that after 30 years, the silent second may – at the City's sole discretion – be required to be paid, even if the purchaser complies with the regulatory agreement. As with the first mortgage, the purchaser has entered into an agreement to unconditionally pay the full face value of the silent second. Thus, the "purchase price" for purposes of section 110, subdivision (b), that is, the total consideration paid for the affordable unit, is any down payment, the face amount of the first mortgage, and the discounted or present economic value of the silent second, reflecting the fact that the City may require repayment of the silent second after 30 years.

We note that, in determining the purchase price in this case, the face amount of the silent second may not be included without adjustment. To simply add the face amount of the silent second to the face amount of the first mortgage would fail to take into consideration the fact that the silent second is not payable, at the promisee's discretion, until after 30 years. Furthermore, since the affordable unit is subject to enforceable government restrictions, discussed below, the assessor, in exercising his judgment as to value, may determine that the value of the affordable units either is more or less than the "purchase price."

### ***Enforceable Government Restrictions***

Subdivision (a) of section 402.1 provides that, "In the assessment of land, the assessor shall consider the effect upon value of any *enforceable restrictions* to which the use of the land may be subjected." (Emphasis added.) This subdivision is made specifically applicable to recorded contracts with governmental agencies by subdivision (a)(2) of section 402.1. And, in assessing land subject to recorded contracts with governmental agencies, subdivision (d) of section 402.1 provides that the assessor "shall not consider sales of otherwise comparable land not similarly restricted as to use as indicative of the value of land under restriction, unless the restrictions have a demonstrably minimal effect upon value."

In this case, the recorded Agreement entered into by the City and the purchaser constitutes an enforceable government restriction under section 402.1. Furthermore, the terms of the Agreement, listed above, significantly restrict the sale or lease of the affordable unit. Thus, the assessor may not use comparable sales of otherwise similar properties, which are not subject to similar enforceable government restrictions, to determine the value of the affordable units. Instead, the assessor may only use comparables from similarly restricted affordable units. In all cases, the assessor must take into consideration the effect upon value that the Agreement has on the affordable units since the restrictions at issue have more than a minimal effect upon value.

To summarize, in the absence of evidence of comparable sales of similarly restricted property, in our view, in the present case, the value of the affordable units for property tax purposes is their purchase price, which in each case may be estimated by adding the sum of the down payment and the face amount of the first mortgage to the assessor's estimate of the present economic value of the silent second. (Rev. & Tax. Code, § 110.) The assessor may, however,

determine that the purchase price does not reflect full cash value due to the effect of the enforceable government restrictions. (Rev. & Tax. Code, § 402.1.)

The views expressed in this letter are only advisory in nature; they represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity.

Sincerely,



Richard S. Moon  
Senior Tax Counsel

RM:pb

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cc: Honorable  
County Assessor

Mr. David Gau	MIC:63
Mr. Dean Kinnee	MIC:64
Mr. Todd Gilman	MIC:70



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State Controller

RAMON J. HIRSIG  
Executive Director

April 10, 2007

Honorable Joel W. Butler  
Yolo County Assessor  
625 Court Street, Room 104  
Woodland, CA 95695-3448

**Re: *City of West Sacramento Redevelopment Agency Affordable Housing  
Silent Second Mortgages***

Dear Mr. Butler:

This is in response to your letter dated November 9, 2006, addressed to Chief Counsel Kristine Cazadd requesting our opinion as to whether the assessed value of affordable housing units (inclusionary units) built in the City of West Sacramento (City) should include the face amount of a Secured Shared Appreciation Promissory Note (silent second).

As explained in further detail below, under the instant facts, it is our opinion that the value of an inclusionary unit for property tax purposes may be estimated using the unit's purchase price, as required under Revenue and Taxation Code<sup>1</sup> section 110, which in this case is the sum of any down payment, the face amount of the first mortgage, and the assessor's estimate of the present economic value of the silent second; that is, its face amount discounted to reflect its terms.<sup>2</sup> After determining the purchase price, the assessor is required to take into consideration the effect of the enforceable government restrictions on value; specifically, to exercise his judgment under section 402.1 to determine whether the full cash value of the inclusionary unit is equal to, or more or less than, the purchase price as a result of the impact of the enforceable government restrictions.

<sup>1</sup> All statutory references are to the Revenue and Taxation Code, unless otherwise specified.

<sup>2</sup> Under section 110, subdivision (b), the purchase price is rebuttably presumed to be the full cash value if the terms of the transaction were negotiated at arms length between a knowledgeable transferor and transferee neither of which could take advantage of the exigencies of the other. This presumption, however, may be overcome if the assessor establishes by a preponderance of the evidence that all or a portion of the value is not reflected in the purchase price. For example, the assessor may consider evidence of comparable sales of similarly restricted property or other evidence establishing that the purchase price does not reflect fair market value due to the enforceable government restrictions.

### **Silent Seconds and Regulatory Agreements in General**

We initially caution against the generic use of the term “silent second.” Based upon our experience, there is no standard or pro forma “silent second.” The specific terms and conditions of a particular silent second must be analyzed separately and independently to determine their respective property tax implications. Some silent seconds may only take effect if the purchaser violates the agreement and otherwise are forgiven if the agreement is fulfilled. Such silent seconds operate solely as an enforcement mechanism to encourage compliance with the enforceable restrictions. In these cases, we generally do not regard the silent second as being part of the purchase price. In other cases, while the silent second may or may not have some enforcement goal, it nevertheless is payable regardless of whether or not the purchaser breaches the enforceable government restrictions. In such cases, where the purchaser has unconditionally committed to pay the silent second under its terms and conditions, the silent second must be given consideration in the determination of the purchase price.

As with the specific terms of silent seconds, regulatory agreements for sales of affordable housing units also vary. Therefore, to determine whether enforceable government restrictions have an effect on value, the specific restrictions and conditions contained in the agreement must be reviewed and analyzed taking into consideration the marketplace for homes subject to similar or identical enforceable restrictions.

### **City of West Sacramento**

The City increases the supply of inclusionary units by providing financial assistance to low- or moderate-income purchasers (purchasers) in the form of a reduced sales price tied to the median area income and the purchaser’s income. It is anticipated that the amount of the down payment plus the first mortgage will be less than the fair market value of similar units with no recorded deed restrictions. In exchange, each purchaser, in addition to obtaining a first mortgage from a private lender, must enter into an Individual Regulatory Agreement (agreement) with the City that, among other use and sales restrictions, requires the purchaser to execute the silent second and a Shared Appreciation Deed of Trust (second deed of trust).

### **Terms of the Secured Shared Appreciation Promissory Note**

In this case, the silent second is an amount equal to the difference between the fair market value of an inclusionary unit if unrestricted and the sum of the down payment and the first mortgage. (Agreement § 2.3.2.) The silent second provides the following relevant provisions and restrictions:

1. The silent second is not amortized but is due and payable in full only upon the sale, conveyance, lease or other transfer of the inclusionary unit. There is no set due date or outside due date. (Silent Second - Introductory Recital.)

2. In the event that the purchaser transfers the inclusionary unit either before the expiration of the inclusionary period of 45 years or thereafter, the silent second requires either repayment by the borrower or the assumption by the new purchaser of a new silent second. If the property is sold within the inclusionary period and the silent second is not assumed, the current principal balance of the silent second is due in full plus contingent deferred interest in accordance with the silent second's terms. (Silent Second §§ 3(A) and 3(B).) Specifically, the "shared appreciation" provisions of the silent second state that upon the sale of the property to an unqualified buyer, the sales proceeds shall be disbursed as follows:
  - a. First, senior mortgage noteholders shall be paid in full.
  - b. Second, the down payment shall be repaid to the purchaser.
  - c. Third, sale expenses shall be reimbursed to the purchaser.
  - d. Fourth, the silent second shall be paid in full.
  - e. Fifth, accrued interest on the down payment shall be paid to the purchaser.
  - f. Sixth, so-called "contingent deferred interest" shall be paid to the silent second noteholder.
  - g. Seventh, balance of the sales proceeds to the purchaser.
3. As indicated herein, if a purchaser subsequently sells an inclusionary unit either voluntarily or involuntarily, with or without authorization, he or she is precluded by the terms of the agreement from realizing the full benefit of any equity appreciation. Borrower's and City's proportional share of equity appreciation is determined at the acquisition date of the inclusionary unit by the formula set forth in the silent second. (Silent Second §§ 1, 3(A) and 3(B).)
4. If a purchaser breaches any obligation contained within the silent second, the second deed of trust, or the agreement, the entire principal sum and contingent deferred interest will at once become due and payable, without notice, at the option of the City. The City may choose to not exercise such option, but failure to do so, does not constitute a waiver of that right. (Silent Second § 6.)

### **Terms of the Individual Regulatory Agreement**

The agreement provides the following relevant provisions and restrictions:

1. The developer upon initial sale, and the purchaser, upon a subsequent sale, covenant and agree, for itself, its successors and assign, that the inclusionary units shall be sold exclusively to qualified purchasers at an affordable purchase price as determined by the agreement. (Agreement §§ 2.1, 3, 3.2 and 3.3.)
2. Covenants contained in the agreement shall be deemed to run with the land and shall remain in effect for 45 years from the date of the recordation. (Agreement § 4.)



3. The inclusionary unit must be the qualified purchaser's primary residence during the 45 year inclusionary period for each purchaser. (Agreement §§ 3, 3.1 and 3.1.1.)
4. The inclusionary unit may not be leased or rented unless the purchaser establishes that the owner-occupancy requirement would cause hardship. (Agreement §§ 3, 3.1 and 3.1.1 (a) – (e).)
5. The silent second remains in effect during the entire inclusionary period of 45 years. (Agreement §§ 3, 3.1 and 3.1.2.)

### Legal Analysis

#### **Purchase Price of the Inclusionary Unit**

Section 401 requires that every assessor “assess all property subject to general property taxation at its full value.” Section 110, subdivision (b) provides that the term “full value” means “the purchase price paid in the transaction unless it is established by a preponderance of the evidence that the real property would not have transferred for that price in an open market transaction.” The “purchase price” means “the total consideration provided by the purchaser or on the purchaser’s behalf, valued in money, whether paid in money or otherwise.” (Rev. & Tax. Code, § 110, subd. (b).)

In this case, unless the silent second is assumed by a buyer under the terms and conditions of the silent second, the purchaser is obligated to pay the silent second upon sale, even if the purchaser has complied with the agreement. As with the first mortgage, the purchaser has entered into an agreement to unconditionally pay the full face value of the silent second, subject only to California’s recourse/nonrecourse liability laws. Thus, the “purchase price” for purposes of section 110, subdivision (b), the total consideration paid for the inclusionary unit, is any down payment, the face amount of the first mortgage, and the discounted or present economic value of the silent second, reflecting the terms and conditions of the silent second, second deed of trust, and agreement.

We note that, in determining the purchase price in this case, the face amount of the silent second may not be included without adjustment. To simply add the face amount of the silent second to the face amount of the first mortgage and down payment would fail to take into consideration that the silent second is not payable except in special circumstances. This is true even after the 45-year term of the agreement. Nevertheless, the method of discounting the silent second falls within the discretion of the county assessor. Furthermore, since the inclusionary unit is subject to enforceable government restrictions, discussed below, the assessor, in exercising his judgment as to value, may determine that the value of the inclusionary unit is equal to, or more or less than, the “purchase price.”

**Enforceable Government Restrictions**

Subdivision (a) of section 402.1 provides that, "In the assessment of land, the assessor shall consider the effect upon value of any enforceable restrictions to which the use of the land may be subjected." This subdivision is made specifically applicable to recorded contracts with governmental agencies by subdivision (a)(2) of section 402.1. And, in assessing land subject to recorded contracts with governmental agencies, subdivision (d) of section 402.1 provides that the assessor "shall not consider sales of otherwise comparable land not similarly restricted as to use as indicative of the value of land under restriction, unless the restrictions have a demonstrably minimal effect upon value."

In this case, the recorded agreement entered into by the City and the borrower constitutes an enforceable government restriction under section 402.1. The terms of the agreement, listed above, significantly restrict the sale or lease of the inclusionary unit. Furthermore, these enforceable restrictions do not have a demonstrably minimal effect upon value. Thus, the assessor may not use comparable sales of otherwise similar properties, which are not subject to similar enforceable government restrictions, to determine the value of the inclusionary units. Instead, the assessor may only use comparables from similarly restricted units. In all cases, the assessor must take into consideration the effect upon value that the agreement has on the inclusionary unit since the restrictions at issue have more than a minimal effect upon value.

To summarize, in the present case, it is our view that the value of the inclusionary units for property tax purposes is their purchase price, which in each case may be estimated by adding the sum of the down payment and the face amount of the first mortgage to the assessor's estimate of the present economic value of the silent second. After determining the purchase price, the assessor is required to take into consideration the effect of the enforceable government restrictions on value.

The views expressed in this correspondence are only advisory in nature; they represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity.

Sincerely,



Travis S. Fullwood  
Legal Analyst



Richard Moon  
Tax Counsel III (Specialist)

TSF:RM:ad

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cc: Honorable Michael V. Strong, President  
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