STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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No. 76/76

April 29, 1976

TO COUNTY ASSESSORS:

ATTORNEY GENERAL OPINION NO. CV 75/267,
SECTION 236 HOUSING

Here is a copy of the Attorney General's April 21, 1976 opinion regarding the valuation of Section 236 housing. The Attorney General concludes that 236 housing projects are subject to enforceable restrictions pursuant to Section 402.1 of the Revenue and Taxation Code, and that interest subsidy payments made by HUD to the lender on behalf of the landlord are properly included within the income stream as future income attributable to the property.

Sincerely,

Jack F. Eisenlauer

Jack F. Eisenlauer, Chief
Assessment Standards Division

JFE:sk
Enclosure

OFFICE OF THE ATTORNEY GENERAL
State of California

EVELLE J. YOUNGER
Attorney General

OPINION	:	
of	:	No. CV 75/267
EVELLE J. YOUNGER Attorney General	:	APRIL 21, 1976
PHILIP M. PLANT Deputy Attorney General	:	

THE HONORABLE W. W. DUNLOP, EXECUTIVE SECRETARY OF THE STATE BOARD OF EQUALIZATION, has requested an opinion on the following questions pertaining to the valuation of partially or totally taxable housing projects constructed and operated pursuant to section 236 of the National Housing Act (12 U.S.C. § 1715z-1):

1. Do the limitations on rental charges and other restrictions contained in the contract executed between the federal government and the owner of a 236 project constitute use restrictions within the meaning of section 402.1 of the Revenue and Taxation Code?

2. When valuing a 236 project under the income approach, does the decision of De Luz Homes, Inc. v. County of San Diego, 45 Cal.2d 546 (1955), require that the anticipated interest-reduction payments made by the government be excluded from the income stream used to calculate the value of the property in question?

The conclusions are:

1. The rental limitations and other restrictions contained in the contract between the federal government and the owner of a 236 project are use restrictions within the meaning of section 402.1 of the Revenue and Taxation Code.

2. The decision of De Luz Homes, Inc. v. County of San Diego, 45 Cal.2d 546 (1955), does not require that the

anticipated interest-reduction payments made by the government with respect to a 236 project be excluded from the income stream used to calculate the value of the subject property under the income approach. In this regard, it is concluded that such payments are properly included within the income stream as future income attributable to the property.

ANALYSIS

The federal government has undertaken several programs designed to give incentive to private enterprise to construct and operate lower income housing. One such program is established by section 236 of the National Housing Act (12 U.S.C. § 1715z-1). The "236 Program," as it is commonly known, is an "assistance program for rental and cooperative housing for low and moderate income families." U.S. Code, Congress. and Ad. News, 90th Congr. 2d session, p. 2893. Under this program, "[t]he development mortgage is insured by the federal government and the developer is given the benefit of low interest on the mortgage." 54 Ops.Cal.Atty. Gen. 168, 169 (1971).

Only nonprofit corporations or associations or limited distribution entities (return limited to six percent of investment) are eligible to participate in 236 Programs. See "Section 236 HUD Program Guide for Sponsors, Builders, Lenders; Rental and Cooperative Housing for Lower Income Families, September 1971," HPMC-FHA G 4442.17 pp. 3-3, 3-4.1/ The federal government subsidizes the owners insofar as the 236 project mortgage is federally insured and insofar as HUD pays the mortgagee all interest on the mortgage loan in excess of one percent per annum. See "Guide," pp. 2-2, 2-4. The owner of the 236 project, in return, executes a regulatory agreement with the federal government which imposes several restrictions upon the owner. Most notably, the regulatory agreement restricts the maximum rental which may be charged to the tenants of the housing project and curtails the owner's power to transfer the project. See generally, "Guide," appendix A, pp. A-24--A-29.

The first question to be addressed herein is whether the restrictions upon rental charges and other limitations imposed upon the owner of a 236 project by virtue of the above-described regulatory agreement constitute use restrictions within the meaning of section 402.1 of the Revenue and Taxation Code.2/ Section 402.1 provides, in relevant part,

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1. Hereinafter referred to as "Guide."

2. All references hereinafter made will be to the Revenue and Taxation Code unless otherwise noted.

as follows:

> "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. Such restrictions shall include, but are not limited to: (a) zoning; (b) recorded contracts with governmental agencies other than those provided for in Section 422; (c) permit authority of, and permits issued by, governmental agencies exercising land use powers concurrently with local governments, including the California coastal commissions, the San Francisco Bay Conservation and Development Commission, and the Tahoe Regional Planning Agency; (d) environmental constraints applied to the use of land pursuant to provisions of statutes." (Emphasis added.)

As we understand that the regulatory agreements between the federal government and the 236 project owner are recorded with the county recorder's office, and as section 422 of the Revenue and Taxation Code does not apply, the language of subdivision (b) would appear to encompass such regulatory agreements and thus the assessor would be required thereunder to consider the effect such restrictions have upon the value of the 236 project.

There is nothing in the overall context of section 402.1 nor in its legislative history which would suggest that the words "any enforceable restrictions to which the use of the land may be subjected" used therein should not be given their natural significance. This being so, it is clear that an enforceable rent limitation would constitute such a restriction upon what would otherwise be a permissible use to which the land may be subjected, to wit: the rental of the property at the maximum rates the open market would allow.

Moreover, the fact that the 236 project owner voluntarily entered into the regulatory agreement with the federal government does not dictate a contrary conclusion. The reference in subdivision (b) to "contracts" with governmental agencies makes it clear that restrictions voluntarily assumed were intended to come within the scope of section 402.1.

In any event, it should be noted that even if the restrictions contained in the regulatory agreements entered into by the federal government and the 236 project owners did not constitute enforceable use restrictions within the meaning of section 402.1, the assessor would nevertheless be required to consider their effect upon the value of the 236 project under the constitutional mandate that property be assessed at a percentage of its fair market value. Cal. Const. Art. XIII, §1; Rev. & Tax. Code §§ 110, 110.5; see 47 Ops.Cal.Atty.Gen. 171, 178-80 (1966).

The second and final question concerns whether or not the rule in the case of De Luz Homes, Inc. v. County of San Diego, 45 Cal.2d 546 (1955), requires the exclusion of the federal interest-reduction subsidy payable to the mortgagees of 236 projects from the net income used to calculate the value of the project under the capitalization of income method of property valuation.

The income capitalization method is one of three basic methods for determining property value. This method was most recently described in Bret Harte Inn, Inc. v. City and County of San Francisco, 16 Cal.3d 14 (1976), as follows:

> "Under the income method the assessor capitalizes the sum of future income attributable to the property, less an allowance for the risk of partial or no receipt of income (see, e.g., De Luz Homes, Inc. v. County of San Diego, supra, 45 Cal.2d 546). The income method rests upon the assumption that in an open market a willing buyer of the property would pay a willing seller an amount approximately equal to the present value of the future income to be derived from the property . . . ." Id. at 24.

It seems apparent at the outset that the federal interest-reduction subsidy payable to mortgagees of 236 projects constitutes a form of income to the project owner in that it reduces the owner's payments on the mortgage loan. The fact that the payment is not made directly to the owner is of no consequence. The federal government could have reached the same result by paying the subsidy to the tenants of 236 projects and permitting the project owner to increase rentals in a like amount. Under those circumstances, it would be clear that the subsidy would result in increased income to the owner. The result should be no different where, as here, the subsidy produces reduced mortgage payments rather than increased rentals.

We have established that the federal subsidy is income to the project owner. However, the income must also be of a type attributable to the property to be includable within the net income to be capitalized. This requirement was stated in the De Luz Homes decision, which discussed at length the operation of the capitalization of income method and set forth the principles underlying its application. As is shown below, it is concluded that the De Luz Homes decision does not require the exclusion of the federal interest-reduction subsidy from the computation of future income attributable to the property.

On the facts of the De Luz Homes case, certain multi-unit housing project operators sought to recover ad valorem taxes levied against their possessory interests in tax exempt lands and improvements leased to them by the United States. 45 Cal.2d 546, 553, 557. These housing projects were constructed pursuant to the National Housing Act, which was designed to alleviate housing shortages on military installations. Id. The federal government leased property on Camp Pendleton to De Luz Homes, Inc., for 75 years at $100.00 per year rental. Id. at 553-54. Under the terms of the lease, De Luz Homes, Inc., was required to build and equip a multi-unit housing project which it would rent to certain designated civilian and military personnel at rentals specified by the Federal Housing Administration and the Department of the Navy. Id. De Luz Homes, Inc. was to pay the taxes. Id. The buildings and other improvements became the property of the United States as they were completed. Id. The lease could not be transferred or assigned without written approval of the government, and the lessee was required to obtain mortgage insurance from the Federal Housing Administration. Id.

The issues before the Court included whether the county assessor correctly valued the possessory interest of De Luz Homes, Inc., under the capitalization of income valuation approach. In discussing this issue, the Court noted the requirement of Revenue and Taxation Code section 401 (as it then read) that taxable property be assessed at its "full cash value," which the Court further defined as "the price that property would bring to its owner if it were offered for sale on an open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other." Id. at 561-62, 563, 566.3/ The Court went on to observe that the valuation of property based upon capitalization of anticipated net earnings peculiar to the present owner of the property would merely reflect a value equal to the present value of that owner's profits--a standard of value very likely to differ from "full cash value." Id. at 566. The Court thus concluded that the net earnings which should be capitalized are the earnings anticipated by a prospective purchaser rather than those earnings peculiar to the present owner of the property. Id. Accordingly, the Court observed that

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3. The term "full cash value" contained in former section 401 has been amended to simply read "full value." However, unless special provision is made, "full value" is equated to "fair market value" in section 110.5, and "fair market value" is equated to "full cash value" and defined in section 110. Thus no substantive change is apparent.

the charges paid by the current lessee for rent and amortization of improvements should not be deducted from the net earnings to be capitalized. Id. at 566-67.

The question posed is whether the principles of the De Luz Homes case described above require the exclusion of the federal interest-reduction subsidy from the net income of 236 projects used to calculate property value under the capitalization of income approach. It is concluded that they do not because the federal interest reduction subsidy does not represent earnings peculiar to the present owner of the property within the meaning of De Luz Homes. On the contrary, such subsidy is an established inducement to operate such 236 projects which as a matter of economic reality will similarly pass to any future owner of the 236 project. In this regard, we are informed that the federal interest-reduction subsidy provided the current owner would go as part and parcel of the mortgage package upon the transfer of any 236 project. Without the federal subsidy in question, no one would invest in a 236 project with the attendant use restrictions discussed in the preceding portion of this opinion. In light of the above, it is clear that the subsidy in question should be regarded as income attributable to the property rather than the particular owner and that therefor it should be included within the net income to be capitalized.

It has been suggested that De Luz Homes requires the exclusion of the federal subsidy in question from the net income to be capitalized because a like result occurred on its facts. Thus, it is agued that the \$100 rental the federal government charged De Luz Homes, Inc., on the facts of that case was so nominal as to really be a federal rent-reduction subsidy similar to the federal interest-reduction subsidy involved here. Despite the foregoing, however, the Court in De Luz failed to include the difference between this \$100.00 figure and the fair rental in the net income to be capitalized. Therefore, the argument goes, De Luz Homes stands for the proposition that federal subsidies are not to be included within net income to be capitalized. The simple response to this argument is that the Court in De Luz Homes did not address itself to the question of the treatment of a possible federal subsidy. The exclusion of such a subsidy from net income apparently resulted from the fact that the Court did not acknowledge the existence of such a subsidy in the first place. Moreover, it should be noted that the characterization of the \$100.00 rent as a federal subsidy becomes much less clear when it is borne in mind that the federal government received certain benefits in return, most notably ownership of all the buildings and improvements as they were completed.

In light of the above, it is concluded that the De Luz Homes case does not require the exclusion of the federal interest subsidy from the 236 project owner's net income to be capitalized. Moreover, because the federal interest subsidy will pass to future owners as discussed above, it follows that the federal interest subsidy is properly includable as a portion of the future income to be derived from the property in question.

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