

**TAX COURT RECOGNIZES
SUBSIDIZED HOUSING AS A DISTINCT HIGHEST AND BEST USE**

by: Richard M. Conley, Esquire and Jeffrey D. Gordon, Esquire

On July 26, 1999, in *Penns Grove Gardens Ltd. v. Penns Grove Borough*, 18 N.J. Tax ___ (Tax 1999), Judge Axelrad of the New Jersey Tax Court recognized subsidized housing as a distinct highest and best use. As a result, she considered the economic benefits of the subsidies in the valuation analysis.

The subject property is a 144 unit garden apartment housing complex. The complex was constructed and continues to operate as a subsidized housing project.

The taxpayer argued that the property must be valued as a conventional apartment complex in order to meet the state's constitutional requirement to value all property under the same standard of value. In essence, the taxpayer argued that consideration of the subsidies is a leased fee analysis that takes into account contractual benefits that are unrelated to real estate. Stated another way, the taxpayer argued that no difference in the "bricks and mortar" exist that warrant treatment different from conventional apartments. To the contrary, the municipality argued that locational and economic differences exist that create a distinct highest and best use for subsidized housing. Judge Axelrad of the Tax Court agreed with the municipality.

The key to the municipality's approach was that its appraiser, Allen Baumholtz, did not value the property based on the existing subsidized housing agreements. Rather, he considered (1) the actual use, (2) relevant locational and economic factors, and (3) ownership incentives that were available on the relevant valuation dates.

As for actual use, the evidence showed that from inception, as of the relevant valuation date and into the foreseeable future, the subject property was, is and will be actually used as a subsidized housing complex.

As for location, the evidence demonstrated that the subject neighborhood contained other subsidized housing properties, including a 120 unit complex adjacent to the subject property and a county-owned, subsidized, high-rise housing unit nearby.

As for economic factors, the evidence demonstrated that a significant amount of the nearby population would qualify for low income housing and that the subject market met the Federal Housing Act's requirement of location in an economically depressed area.

Judge Axelrad also found physical differences that indicated the property was better suited for use as subsidized housing, including the present configuration of the utilities.

As for the ownership incentives that were available on the relevant valuation dates, the evidence demonstrated that the benefits of subsidized housing include the following: budget-driven rental payments that guaranteed a profit after payment of all expenses; government guaranteed non-recourse mortgages; mortgages assignable to a subsequent purchaser with the favorable original terms reset; minimal down payment requirements; significant mortgage interest reduction subsidies; an initial developer's fee from the government that essentially fulfills the owner's equity requirement for the project; reimbursement for an above-market management fee; reimbursement for all repairs and maintenance plus a generous annual deposit into a reserve account of which the owner took full possession at the end of the mortgage term; and, various state and federal tax credits.

Furthermore, both experts agreed that it would not have been financially feasible to construct and continue operating the housing project without the subsidies. Thus, the taxpayer's highest and best use position was weakened by its failure to prove financial feasibility for conventional apartment use.

The municipality also demonstrated that a substantial market for subsidized housing existed that was separate and distinct from the conventional housing market, including the existence of approximately 4,100,000 subsidized housing complexes in the United States and the publication of two separate IREM Manuals, one for conventional apartments and one for subsidized apartments.

The highest and best use determination was the key finding. The remainder of Judge Axelrad's valuation analysis flowed from that determination: "Mortgage interest reduction subsidies, total reimbursement of all operating expenses by HUD and other financing and tax incentives available to the investor in the construction and operation of federally subsidized apartment complexes are benefits which can be taken into consideration when valuing property." *Id.*, slip opinion at 13.

Both experts opined nearly identical income and expense amounts, although this was somewhat coincidental as they arrived at their numbers through wholly different analyses. The major point of contention was the appropriate capitalization rate. The taxpayer's appraiser advocated a capitalization rate consistent with sales of conventional apartments. The municipality's expert used a much lower capitalization rate reflecting his highest and best use conclusion. His mortgage component considered the federal interest rate subsidy that reduced the subject's interest rate to 1%. Although a 3% subsidized interest rate was available on the valuation date, the municipality's expert found 1% to be appropriate because the subject interest rate was assignable with the loan to value ratio reset to 90%. Further, he found that the guaranteed profit and non-recourse mortgage would reduce the equity requirements of a buyer. Thus, he opined a rate similar to an annuity with an upward adjustment for the non-liquidity of the investment.

Judge Axelrad basically agreed with the municipality's expert's capitalization rate. However, she rejected his use of the assignable 1% subject interest rate and used the 3% mortgage rate available to new projects on the valuation dates. As a result of her capitalization rate selection, she found a value in excess of the equalized assessed value.

Based on the evidence presented, Judge Axelrad also found that the use of the actual expenses of subsidized housing was not appropriate if the property was valued as a conventional apartment complex.

Judge Axelrad noted the jurisdictional split on the use of economic rent versus subsidized rent. No dispute existed in the Penns Grove case because the subsidized rent was equal to economic rent. In spite of this, the highest and best use conclusion and the consideration of the subsidies when formulating the capitalization rate suggest that the subsidized rent may be used in future matters.

Finally, it should be noted that Judge Axelrad emphasized the presumption that actual use is the highest and best use. Thus, it appears unlikely that the Tax Court will value subsidized housing as conventional apartments or vice-versa in future matters absent cogent evidence.