Understanding Tax Abatements—including Exemptions and Payments in Lieu of Taxes (PILOTs)

What is a tax abatement?

Properties that have been developed or redeveloped under a state or local economic development program often qualify for some reduction in their real property taxes. This may be in the form of a:

- Tax abatement or exemption – a reduction of or exemption from taxes, granted through a governmental program and implemented by the local taxing authority
- Payment in lieu of taxes (PILOT) – a payment made to compensate a local government for some or all of the real estate tax revenue that is lost due to the waiver of some or all of the real estate tax revenue

The reduction or exemption may be for an infinite or a finite period of time. The terms of the tax abatement are established by the taxing authority or governing body granting the abatement. The abatement may require the owner and/or the property to meet certain criteria. The abatement may be forfeited if the owner and/or property do not comply with the terms of the abatement.

Our tax abatement policies apply to properties being financed through our conventional or Targeted Affordable Housing (TAH) products.

What are the benefits of a tax abatement when underwriting a mortgage purchase?

Due to the reduction in taxes for a specific period with a tax abatement, we may consider using the reduced real estate tax payments for the property in our underwriting after we receive and evaluate information regarding the tax abatement.

How is eligibility of a tax abatement determined?

The tax abatement must be found eligible by Freddie Mac at both the program and property level. A list of approved individual state and local tax abatement programs is available on FreddieMac.com.

If the state or local tax abatement program has not already been approved, a checklist for program level approval is available on FreddieMac.com, detailing the information that must be provided before issuing a commitment or accepting an early rate-lock application.

How does the tax abatement impact the appraisal?

As stated in the Multifamily Seller/Servicer Guide (Section 12.23: Collateral evaluation for tax abatement), the preferred valuation methodology is as follows:

- First, full, stabilized real estate taxes are used to calculate the net operating income (NOI) that is used to determine the property value with full taxes.
- Next, the present value of the tax savings over the term of the tax abatement is determined using a discount rate supported fully by the appraiser.
• The present value of the tax savings is then added to the property value with full taxes to determine the value of the property with the tax abatement.

If local practice is different from this Freddie Mac preferred methodology, the appraiser may use the local methodology provided that any differences in technique are fully discussed in the appraisal. In addition, the appraiser must demonstrate in the appraisal that the tax abatement is likely to continue for its stated term. This can be accomplished by a variety of methods including a review and discussion within the appraisal of the tax abatement agreement and/or documented conversation and confirmation of the tax abatement by the appraiser with the local property tax authority or tax abatement-granting agency.

Evidence of tax abatement

As stated in the Guide (Section 55.2: Requirements for documents contained in the underwriting package), for properties benefiting from tax abatements, the Seller must provide documentation from the taxing authority or the governing body confirming each of the following:

• Evidence that the tax abatement is in effect (i.e., provide a copy of a certificate of eligibility).
• That the property or the Borrower, as applicable, has qualified for the tax abatement.
• The amount of annual tax to be paid, if any.
• The term of the tax abatement.
• Any other requirements of the tax abatement.

Specific guidance is available in the Tax Abatement/Exemption/PILOT Questionnaire, available on FreddieMac.com in the Multifamily Loan Execution Documents – Miscellaneous section. The Questionnaire also accounts for programs that may not have been previously approved by Freddie Mac.

Calculating the Debt Coverage Ratio (DCR)

A property with a tax abatement must be analyzed under one of three scenarios:

1. If the loan has a policy-compliant DCR and LTV with full taxes and passes the standard Refinance Test with full taxes, abated taxes can be used to derive the NOI. If the loan fails the Refinance Test, scenario 3 must be used.

2. If any of the following facts exist, then the abatement is considered “Infinite”: (i) the abatement expires at least 10 years after loan maturity; (ii) the phase-in period, if any, begins at least 10 years after loan maturity; (iii) the abatement runs for 20 years after loan origination; or (iv) the abatement runs for the full term of a fully amortizing loan. If the abatement is considered “Infinite,” abated taxes will be utilized to derive the NOI and to run the Refinance Test.

3. For loans underwritten with a tax abatement that do not fit the criteria in scenarios 1 or 2 above, the underwritten NOI will include the tax expense based on the actual in-place taxes, whether fully or partially abated. A cash flow analysis must be performed to show the effect on NOI of any decrease in the tax abatement for the term of the loan plus 10 years.

For assumptions to be used in this analysis and for DCR requirements over the loan term, please contact your Freddie Mac representative.