# Low Income Housing Tax Credits Strategies for Year 15

## by William S. Hettinger

Low Income Housing Tax Credits (LIHTCs) are the primary source of public funding for affordable rental housing development in the United States. This federal program offers private investors a break on federal income taxes in exchange for investment in affordable housing developments. Since 1987, it has helped to create more than 1.6 million affordable units. To ensure these new units remain affordable, the tax credits come with strict guidelines that keep projects affordable for a 15-year compliance period. But what happens at the end of the compliance period?

The time limits are just beginning to expire on the first LIHTC transactions in New England and throughout United States, and many organizations are wrestling with the new and growing problem of what happens next. In most cases, the investors expect to terminate their participation without adverse tax consequences and possibly with capital gains. Typically, the ownership of the property needs to be restructured. And sometimes, there is pressure to convert to market rate housing. Community development organizations are struggling with tough questions. How can they restructure the ownership of the property? How can they keep the units affordable? How can they pay off the investors?

To better understand how organizations are dealing with this issue, Wyndham Financial Group conducted interviews in the spring of 2005 with several nonprofit and for-profit LIHTC project sponsors, tax credit syndicators, housing finance organizations, and affordable housing organizations. This article summarizes the results of those interviews. It discusses the specific issues faced by project sponsors and describes the strategies that organizations are using to transfer the ownership of LIHTC properties. It also presents lessons learned from those who have gone through the process, and offers a roadmap for organizations that will be facing these questions in the near future.

## **LIHTC Basics**

Enacted by Congress as part of the Tax Reform Act of 1986, LIHTCs finance an estimated 1,300 projects and 90,000 units each year. Like other tax credit programs, LIHTCs are an indirect subsidy. Rather than allocate government dollars directly to affordable housing developments, they engage the private market, ideally enabling affordable housing dollars to be allocated more efficiently.

The tax credits are distributed to each state, based on population. Indexed to inflation, the allocation rate for 2005 was \$1.85 per capita. Massachusetts, with a population of 6.3 million, received an allocation of approximately \$11 million. The states distribute the credits to eligible affordable housing developments. The legislation requires that 10 percent be set aside for nonprofit developers, who tend to keep all units affordable, unlike for-profit developers, who mix market rate and affordable units in the same project. In fact, HUD statistics reveal that more than 30 percent of LIHTC units have been created by nonprofit community development organizations. Developers that receive the credits then sell them to investors, who, in exchange for providing cash now, receive a dollar for dollar reduction in their federal income taxes over the next ten years. Consider a basic tax credit deal. A developer receives a tax credit allocation of \$1 million from the state. This is an annual amount, totaling \$10 million over ten years. An investor purchases the credits at a price equal to the present value of the 15-year stream of tax benefits—the 10year reduction plus minor tax benefits stemming from any operating losses on the property. In this case, the investor would pay between \$6 million and \$8 million for the credits, providing the developer with needed equity for the project.

Often, the process of selling tax credits involves the use of a tax credit syndicator, who matches developers who have tax credits with for-profit investors who are seeking to reduce their taxes. Typically, syndicators pool money from several investors and use the funds to purchase tax credits from different affordable housing developers. The syndicator acts as an underwriter for the investor, assuring that projects meet agreed upon standards and remain in compliance with tax credit regulations. Most syndicators are for-profit with a chief aim of providing a return for their investors. However, there are also a number of socially responsible syndicators who are equally interested in supporting community development and affordable housing initiatives.

Once the tax credits are sold, the investors, syndicator, and developer must agree on the terms of ownership and operation of the property. Typically, a limited partnership is formed. The investors become limited partners, owning 99 percent of the property, while a general partner, typically a special purpose subsidiary of the developer or nonprofit sponsor, owns the remainder. The general partner has responsibility for the day-to-day operation of the property and may be contractually responsible for any operating losses. This ownership structure benefits investors, allowing them to receive the tax advantages of real estate ownership, but frees them from having to play an active role in the operation of the property.

Under the tax code, the partnership must agree to operate the property as affordable housing for 15 years. Forty percent of all units must have rents that are no more than 30 percent of household income for households earning less than 60 percent of the area's median income. Alternatively, 20 percent of the units must have rents that are affordable to households earning less than 50 percent of area median income. Tenant qualification, income verification, financial reporting, and other operating requirements specified in the LIHTC regulations must be followed. In 1989, a Congressional amendment extended the affordability requirement to 30 years, although the limited partners are required to maintain their investment only for the first 15 years.<sup>1</sup>

In its early years, the LIHTC program saw limited use. The program was complicated to learn, the transactions were expensive to structure, and other public funding for affordable housing was available. As a result, only a small number of tax credit projects date from before 1990. However, the program gained favor over time as it became better understood and better funded at a time when other sources of money were drying up. This timing means that the first major wave of LIHTC transactions is just now reaching the end of the 15-year compliance period, and many organizations are asking themselves, "What do we do at the end of year 15?"

The detailed interviews conducted by Wyndham Financial Group in the spring of 2005 focused on just this question. The 15 respondents included affordable housing developers, tax credit syndicators, state housing finance authorities, and representatives from affordable housing organizations. The properties, most within New England, ranged from developments in depressed inner city areas to suburban properties in hot real estate markets. Some properties had the 15-year affordability restriction, while others had 30 or more years of affordability restrictions, but their investors wanted to leave the partnership at year 15. The interviewees were asked a series of questions regarding the specific nature of the issues faced at the end of the compliance period, the strategies used to address these issues, and the lessons they learned through the process. Their responses can help to shed light on this complicated issue and provide guidance for those whose compliance periods have yet to expire.

### The Issues

As the interviews made clear, three primary issues face most organizations at the end of the compliance period:

1. the payment of exit taxes resulting from a large negative capital account,

2. refinancing or restructuring existing debt on the property, and

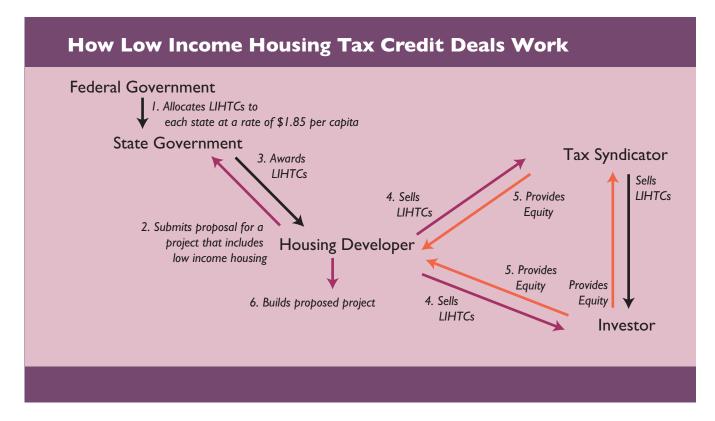
3. funding needed repairs to aging housing units.

The interviews also identified number of secondary issues related to the specific nature of the contract, the original structure of the deal, and the parties involved.

#### I. Exit Taxes

"We were surprised by the size of the negative capital account. We had projected it to be \$20,000 to \$25,000 per unit, but it was much larger because rents did not grow as expected."

At the end of 15 years, many affordable housing developments that were financed using LIHTCs have a negative capital account, resulting from rents that did not grow as expected, higher operating expenses than originally forecast, or high interest rates on primary and secondary debt. Throughout the life of the partnership, these operating losses provided tax benefits to the limited partners, who could write off losses against owed taxes. However, upon dissolution of the partnership, tax law requires that these losses be



recaptured, creating a tax liability for the limited partners. To protect themselves against this common occurrence, syndicators and investors typically include a provision in the original partnership agreement that requires that these tax liabilities be paid either from the assets of the partnership or by the general partner. As a result, the general partner or partnership must pay an "exit tax" to cover these tax liabilities in order to dissolve the partnership. Depending on the magnitude of a property's operating losses, these exit taxes can be considerable.

The interviewed sponsors used a variety of techniques to address exit taxes. Several properties were in hot housing markets, and these proved to be the simplest to resolve. Sponsors were able to sell all or a percentage of the units at current market rates and use the proceeds to pay the exit taxes, as well as any outstanding debt. In most instances, the units were converted to condominiums and sold to individuals. Occasionally, the entire property was sold and converted to market rate rentals.

The conversion to market rate units was not a viable technique for properties under 30-year affordability restrictions or where the economics of the property made its conversion to market rate unlikely. In addition, some organizations' missions precluded converting the units to market rate housing. In these cases, the nonprofit sponsors tried to negotiate a reduced exit tax with the investors and tax credit syndicators. Investors appeared to be more willing to negotiate exit taxes when the property clearly did not have the financial ability to pay the full amount of the taxes or in instances where the syndication fund was nearing the end of its term. Moreover, "socially responsible" syndicators and their investors demonstrated a greater willingness than their forprofit counterparts to negotiate exit taxes and to restructure transactions in ways that preserved affordability. Finally, rather than negotiate, several nonprofits had success in generating income through the forgiveness or significant modification of the partnership's debt. The income reduced the negative capital account and in turn, the exit taxes owed.

#### 2. Restructuring Debt

In addition to the investors' equity, LIHTC projects are also financed through one or more mortgages. Most projects have amortizing first mortgages from banks or state housing finance agencies, and many also have "soft second," or interest-only, deferred-payment, mortgages from housing finance agencies or other state and local government entities. At the end of the compliance period, most of the combined mortgage debt remains outstanding and in some cases, may actually exceed the initial debt. In order to dissolve the limited partnership and transfer ownership of the property, these mortgages must be paid, renegotiated, or forgiven.

For those interviewed, the renegotiation of mortgage debt proved difficult, particularly when public funds had been used to finance part of the LIHTC property. Many state and local government agencies, given their own current budget constraints, were reluctant to forgive debt, particularly on soft second mortgages on which large amounts of interest had accrued. While public lenders were not necessarily looking to be repaid in cash, they were not willing or

# Kowal House: Restructuring an Early Tax Credit Deal

In 1987, West Side Federation for Senior and Supportive Housing, Inc. (WSFSSH) developed Kowal House on the upper west side of Manhattan. The 72-unit housing development was designed to serve elderly adults with a history of homelessness, providing them with not only a permanent shelter, but also needed supportive services. The project was one of the first in the nation to be financed using low income housing tax credits. Development costs for the project were just over \$2.9 million. Of this amount, \$2 million was obtained through loans from private banks and the city, while LIHTCs provided the remaining funds.

Once the project opened, Kowal House befell a fate common to many low income housing projects: operating revenue did not meet initial projections.WSFSSH had counted on Section 8 rental subsidies to cover a sizable portion of tenants' rent, but federal spending on Section 8 did not rise as expected. Rental income fell short and was not enough to cover both operating expenses and loan payments. Choosing to continue operating the complex,WSFSSH allowed the initial construction loan to go unpaid.

By the end of the LIHTC 15-year compliance period in 2002, the situation was serious. The lenders were unhappy that the cash flow from the property was insufficient to make full loan payments and frustrated that their short term construction loan had now been outstanding for almost 15 years. They wanted to be repaid. In addition, the 15-year tax credit compliance period was expiring, and the deal was structured such that the limited partnership would be closed out after 15 years. WSF-SSH needed to restructure the ownership of the property and negotiate with the tax syndicator, National Equity Fund (NEF), over the pay-

able to forgive debt on the properties outright, especially since forgiving a mortgage decreases exit taxes, generating a capital gain for the private investors. However, in many cases, they were willing to renegotiate the terms of the debt in order to facilitate the restructuring of the property and the preservation of affordable units. These public debt renegotiations typically included the imposition of additional affordability restrictions or the extension of existing restrictions.

Debt forgiveness from private lenders and the nonprofit sponsor was a viable alternative for some organizations. In one situation, the nonprofit sponsor controlled a part of the subordinated debt on the property and was willing to forgive this debt, generating enough income to wipe out the negative capital account and the exit taxes. In another case, the sponsor was still owed a part of its developer's fee, had structured the fee as a loan to the partnership, and was in a position to forgive this debt.

#### 3. Repair Funding

As might be expected of 15-year-old residential properties, all of the projects in the study needed a cash injection ment of exit taxes from the project's substantial losses. To complicate the matter, the property needed improvements. Wheelchair accessibility changes, energy conservation measures, and the installation of a commercial kitchen to support a meals program were all required if WSF-SSH wanted to continue to effectively serve its target residents.

To address these issues, WSFSSH began negotiating with its lenders and with NEF. "We had to demonstrate why Kowal House was in trouble and what had to happen to fix it. Then, we had to tie this to our mission and build an argument for solving the problem," says Laura Tavormina, the organization's housing director.

Despite the financial issues, the parties involved valued the services Kowal House was providing to New York's elderly and shared WSFSSH's wish to maintain the mission of the property. "Everyone could see the vision," says Tavormina. "The city was committed to preservation, recognizing that it was cheaper to preserve than to build another building. NEF shared our social mission. They were all willing to work with us, and it gave us an opportunity to restructure and work it out better."

After almost two years of work, in April 2004, WSFSSH had finally negotiated a restructured transaction. A new \$2.5 million loan for the property was obtained from the city's department of housing preservation and development. With a reduced interest rate, the loan was structured around payments that the property could more realistically afford. The money provided sufficient funds to pay off existing lenders and to make the needed improvements to the property. Additionally, WSFSSH was able to negotiate substantially reduced exit taxes with NEF.

for repairs and rehabilitation at the end of the compliance period. Some properties needed only modest repairs, while others required extensive rehabilitation. On average, the typical unit needed between \$6,000 and \$7,000 in repairs. Finding this money was a challenge.

Sponsors had mixed results in obtaining repair and rehabilitation funds from state housing finance agencies. In general, these agencies had limited funds and were perceived to have insufficient focus on the preservation of tax credit units, orienting themselves more toward the production of new units. Moreover, agencies were reluctant to commit additional public money to a property if a portion of the funds was going to be used to pay exit taxes to private investors.

#### "They do not want to refinance it if it puts money in the pocket of the limited partner or others."

Thus, these agencies offered a viable funding source only in limited instances.

On the other hand, nonprofit sponsors had success in finding funds to repair or rehabilitate units, as well as pay exit taxes and pay off debt, from tax-exempt bond issuances and the resyndication of properties with new tax credits. Taxexempt bonds were a popular source of funds for many of the interviewed parties, particularly those who were involved in larger transactions, in the \$3 million to \$4 million range, where the bonds could be issued cost effectively. In some instances, tax-exempt bond financing was combined with new tax credit allocations, and properties were resyndicated into a new limited partnership. Some nonprofit sponsors combined several smaller properties into a larger project to obtain the critical size necessary for the issuance of taxexempt bonds or the resyndication of the properties.

#### **Other Issues**

When LIHTC programs began, there was a general expectation that the partnership would exist for the 15-year compliance period, and then the limited partners would be paid off and the transaction restructured. Likewise, it was also generally understood that the nonprofit sponsor, general partner, or tenants would be the successor owners of the property, continuing to operate it as affordable housing. Unfortunately, in early deals, this understanding was not spelled out clearly in the partnership documents. As a result, there was no mechanism to force the dissolution of the partnership or the restructuring of the property in year 15. This ambiguity negatively affected investors who had planned on exiting in year 15, tax credit syndicators who had operated funds assuming a 15-year horizon, and nonprofit sponsors who wanted to restructure the ownership of the property to fit their affordable housing and community development mission. New details of dissolution had to be negotiated, requiring staff, resources, time, and energy. In the worst cases, an agreement was not reached, and the operation of the property continued under the existing partnership. Fortunately, this issue will subside over time, as partnership documents have become more specific regarding the methods and options for dissolving the partnership at the end of the compliance period. Current deals now contain a tenant or sponsor purchase option or an option for the investor to "put" the property, requiring the general partner, tenants, or others to purchase it.2

Another issue identified among the interviewees was the dissolution of the original sponsoring nonprofit entity. In several instances, the nonprofit sponsor failed in the 15 years between the development of the property and the end of the compliance period. In these cases, another nonprofit had stepped into the role of sponsor and was responsible for restructuring the transaction. However, this successor lacked the historical knowledge of the property and the original transaction, information that was seen as necessary to effectively restructure the project. Thus, the loss of the original sponsor created another level of complexity and confusion.

Finally, restructuring the ownership of the properties at the end of the compliance period was found to be a complicated and time consuming process. Dissolving the partnership and converting the property to new ownership took almost as much time as the original LIHTC transaction. Most of the interviewed organizations began working on the transition 18 to 24 months before the expiration of the compliance period. Many noted that they should have started sooner, finding that 18 months did not give them enough time to complete the transaction. The transition also required a significant commitment of the organization's resources and strained capacity, staff, and budgets. Most organizations relied heavily on the executive director to manage the process, leaving development staff to focus on new work and the finance team to maintain the organization's operations. Many organizations hired the expertise of outside consultants, in addition to the partnership's accountants and attorneys.

#### **Keys to Success**

While the interviews revealed that each LIHTC transaction is unique—in its markets, financial structures, and partnership documents—collectively, their experiences uncovered a number of common steps that any organization can take to improve the success of restructuring an LIHTC property at the end of the 15-year compliance period:

#### 1. Start early.

Restructuring an LIHTC deal takes time and planning. It is not a task that can be left to the last minute. Sponsors with tax credit projects created 10 to 12 years ago should begin to plan for the restructuring now. Sponsors with projects that are only a few years old should monitor the capital account and seek ways to minimize exit taxes in the future.

#### 2. Acquire or hire expertise.

Restructuring an LIHTC transaction is a complicated task that requires expertise, staff resources, and money, and organizations should start to build capacity on all fronts. One way to build internal expertise is to attend a tax credit partnership transition seminar sponsored by the National Equity Fund, LISC, or another affordable housing development umbrella organization. By networking with local housing consultants, attorneys, and accountants, organizations can identify outside expertise that can assist them as they move through the process. Importantly, if an organization is contemplating using external resources, potential sources of funding for these resources should be considered.

#### 3. Understand the deal.

One of the most important steps an organization can take before restructuring an LIHTC transaction is to develop a solid understanding of the original deal. This transaction was completed more than a dozen years ago, and by this time, the original staff may have left, or if still there, may have forgotten the details of the transaction. Refreshing this knowledge involves rereading the legal and loan documents, as well as understanding how the financial conditions of the project and value of the property may have changed.

Legal documents. Dig out the transaction's legal documents and review them to determine what rights and

# The Impact of Year 15 on One Community

Andover, Massachusetts, an affluent suburban community north of Boston, has seen tremendous growth in housing values in the last several decades. Today, houses selling for a half-million dollars are the norm, and the rising prices are increasingly causing concern among housing advocates and local government officials. As such, the town of Andover is committed to ensuring a stock of affordable housing, and currently 11.6 percent of all housing units in the town are affordable.

However, the community is faced with losing many of its 1,331 affordable units as affordability restrictions expire. Of particular concern are two developments, Andover Commons and Riverview Commons, which, by the end of 2006, may lose a total of 222 affordable units. Given the hot housing market, community leaders are concerned that most of the units will be converted to condos or other market rate projects.

The properties are owned by private developers, and the community has no control over the preservation of the affordable units. "There are no hooks in the documents to keep them affordable," says Susan Stott of the Andover Housing Partnership. "We may lose affordable housing units, and there is nothing we can do."

However, the community is working to do what it can. Recently, another development, Brookside Apartments, reached the end of its affordability restrictions and was set to restructure as market rate housing. Mass Housing Partnership became involved in the restructuring and helped to mitigate the loss to only 14 units. The remaining 28 were preserved as affordable units. Mass Housing also helped to structure the transaction so that tenants were not displaced when the 14 units were converted to condos and sold. Without the involvement of this public agency as the lender, all of the affordable units might have been lost.

Unfortunately, Andover may not be so lucky with its other expiring properties. In one case, the affordability restrictions on the property were already extended for five more years during a 2001 restructuring, and it is questionable whether they will be extended again. In the other case, affordable units are already being transformed into market rate condos as the affordability restrictions expire in phases through the end of 2006. The community worries that with the loss of these properties, the town's affordable housing stock will drop below 10 percent, the number at which developers can override local zoning ordinances under the state's affordable housing laws. They are also concerned about displacing long time Andover residents who are struggling to keep up in the increasingly wealthy community. As more and more properties reach their expiration dates, the community must grapple with how it will replenish its supply.

> requirements exist at the end of the compliance period. Are there extended use requirements? Do the investors have the right to "put" the property to the sponsor or general partner? Do the tenants have a purchase option? Does the sponsor or general partner have a purchase option? How are exit taxes calculated? Are the investors entitled to a return of their capital? Can the partnership be continued indefinitely if a restructuring is not worked out?

*Loan documents.* Review the loan documents. Are the loans fully amortizing, or is there a balloon payment due in year 15? In the event the property is transferred from the partnership, are the loans due and payable? Or, can they be transferred to the succeeding entity?

*Financial condition.* Develop a complete financial picture of the property at the end of the compliance period. Compute the current capital account and its projected value through year 15. If it is projected to be negative in year 15, identify any operational changes that can be implemented now to increase income and decrease the size of the negative capital account. Project loan balances for the end of year 15 and the amounts expected to be in the operating and replacement reserves.

*Property value.* Determine the current market value of the property. If the affordability restrictions expire at the end of the compliance period, compute the value of the property both with and without the restrictions. If the restrictions continue, the computation should reflect them. If the property is in a neighborhood where values differ substantially from the surrounding area, make sure the computed value differentiates the property. Knowing the property's value and how it compares with the overall market gives an organization an advantage when negotiating with the limited partners, who generally are familiar only with the larger market.

#### 4. Understand the investors' requirements.

Talk to the tax credit syndicator or the limited partners to determine what their expectations are for the end of the compliance period. Are they interested in a specific internal rate of return? Are they expecting a return of capital? Are exit taxes their primary concern? Are they willing and able to negotiate exit taxes? Do they perceive the property's value to be substantially different from the organization's projections?

#### 5. Understand the lender's requirements.

Talk to each of the lenders. Determine their requirements and expectations regarding the repayment of loans. Are the first mortgage lenders willing to be flexible regarding the assumption of the debt by a successor owner, or are they going to enforce the due-on-sale provisions? Are the subordinate lenders expecting to be repaid in full at the end of the compliance period? Are they willing and able to forgive some or all of the debt? Or, are they willing to negotiate the terms of the debt to preserve the affordable housing units?

#### 6. Create a plan.

To effectively restructure the ownership of an LIHTC property at the end of the compliance period, the nonprofit sponsor must first understand its goals for the property and then determine a plan to meet those goals. The goal setting should occur at the highest level of the organization, including the executive director and the board, and to the extent possible, should reflect the tenants' goals for the property. Once goals are established, an action plan should be created, accounting for all of the tasks and steps that must be pursued to make the transition a success. The plan should be continually monitored and adjusted with mid-course corrections throughout the process.

#### 7. Negotiate from strength.

In following the first six steps—starting early, acquiring expertise, understanding the deal, understanding the investor's requirements, understanding the lender's requirements, and developing a workable implementation plan—an organization has made itself an expert in the transaction. This expertise should be used to the organization's advantage throughout the negotiation process, making certain for example, that all parties fully understand the value and condition of the property.

#### 8. Be proactive.

The sponsoring organization should take the lead in restructuring the transaction rather than waiting for the limited partners or lenders to act. By being proactive, the sponsor will be able to control the pace of the restructuring and will be better able to direct the focus of the other parties on the issues and on finding their solutions.

These steps suggest a roadmap for for-profit and nonprofit community development organizations to follow as they wrestle with the issues associated with the end of the LIHTC compliance period. Above all, as organizations struggle to restructure property ownership and preserve affordable housing, they should remember that a willingness to be creative and explore "outside the box" alternatives is essential to success. <sup>1</sup> Additionally, any time after the end of year 14, owners may seek a "qualified contract" offer from the state agency that originally allocated the tax credits to buy the property. If the agency fails to offer such a contract, which calculates the property price based on a standard formula, the additional 15year restriction is dissolved.

 $^2$  A 1990 Congressional amendment gives nonprofit general partners, tenant organizations, and government agencies the right of first refusal to buy the property at a price equal to the value of the total outstanding secured debt and all taxes generated by the sale, even if this amount is less than fair market value.

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