EXPIRING USE RESTRICTIONS ON LOW INCOME HOUSING TAX CREDIT PROJECTS

Since 1990, low income housing tax credit (LIHTC) properties have been required to have a 30 year low income use restriction. They are permitted to opt out of the use restrictions after 15 years, but only after offering to sell at a fixed price to a qualified buyer. If a tax credit project's restricted rents are significantly below market rents, an opt out will result in displacement of residents and loss of affordable housing. It's difficult to predict how large a problem this is for two primary reasons: 1) large numbers of owners have waived the right to opt out at year 15. 2) For two reasons, a substantial percentage of projects have rents that are already at market levels. The program offers substantial incentives to projects developed in low income areas. In addition, projects qualify for credits with rents as high as 30% of 60% of area median income.

Magnitude of the Issue

The HUD Low Income Housing Tax Credit database is found at: http://www.huduser.org/datasets/lihtc.html. The database probably significantly undercounts tax credit projects. It indicates that nearly 7,000 projects with nearly 424,000 low income units will reach the 15 year mark between 2010 and 2014. Some states, e.g. California, have required owners to waive their opt out rights. Others, like Minnesota, have provided incentives to waive the opt out right in the form of bonus points in allocating the credits. In Minnesota, nevertheless, about 40% of the projects retained opt out rights.

Of the remaining projects, able to opt out, only a portion will have rents significantly below market. A project can qualify for tax credits by setting aside only 40% of the units for households at 60% of area median income. In many markets, rents at 30% of 60% of area median income are higher than market rents. So not all tax credit projects have much value as resources for lower income households. Many, however, do serve households at 30% to 50% of area median income and have rents significantly below market levels. Conversion of these to market rate projects results in loss of valuable resources and displacement of residents.

Potential Effects

There is always a substantial motive for partnerships to sell by the end of the 15 year tax credit compliance period. At this point, tax benefits are exhausted, the partners are typically receiving taxable income from the project, and all potential tax credit recapture has been phased out.

In markets where the credit-allocating agencies have consistently required applicants for credits to waive their opt out rights, and in specific cases in other jurisdictions where owners have voluntarily waived their opt-out rights, a sale should not result in a release of the tax credit constraints. Preservation issues in these cases generally fall into the following categories:

1) Enforcement. After year 15, there are no longer any IRS sanctions available for violation of program constraints on income and rents. Enforcement is strictly up to

the allocating agencies and to residents. All these projects are governed by use restrictions, running with the land, permitting resident and applicant enforcement. One problem with the potential to become widespread is a deliberate default by the owner with the goal of ejection from the tax credit program – see below.

2) Structuring a sale which meets the current owners' minimum financial requirements (generally, payment of exit taxes) and capital improvement needs, while preserving affordable rent levels. These are issues are very project-specific and very similar to those that arise in the preservation of other sorts of subsidized housing through sale to a preservation–oriented buyer.

When the project has retained opt-out rights, there are additional issues related to the opt-out formula: 1) How does the price-setting formula (generally, initial capital contribution increased by inflation plus current debt less cumulative distributions) relate to actual market values and is it being strictly enforced. 2) Are there qualified preservation-oriented buyers available and are the allocating agencies' notification procedures adequate.

The Deliberate Default Issue

Once year 15 has arrived, there are no IRS incentives for continuing to be bound by the program restrictions and no IRS consequences for violating program requirements. The only enforcement mechanism is the use agreement, binding the owner for a second 15 year period and enforceable by the allocating agency, residents, and applicants. Somewhat incredibly, the IRS has issued guidance to the allocating agencies indicating that if an owner violates program guidelines, an acceptable response by the allocating agency is to terminate their participation in the program. Problems with this IRS position:

1) It wholly ignores that this is an invitation to owners to escape the second 15 years of constraints and the opt-out limitations simply by refusing to comply. A similar owner strategy has become an epidemic problem in the Rural Development program, where owners escape pre-payment constraints by deliberately defaulting, causing the agency to accelerate their mortgages, resulting in prepayment without compliance with preservation requirements. This has happened in at least once case in Oregon. If the owner ultimately overcomes legal challenges (plaintiffs lost in state district court and have appealed), expect a rash of how-to-do-it seminars for project owners.

2) It ignores the fact that Section 42(h)(6)(E) of the IRS code restricts termination of the use agreements to two circumstances: foreclosure and the qualified buyer process.

3) The common law of real covenants running with the land doesn't permit one beneficiary of the covenants (the allocating agency) to terminate the covenants without the approval of the other beneficiaries (residents and eligible applicants).