WHAT HAPPENS TO LOW–INCOME HOUSING TAX CREDIT PROPERTIES AT YEAR 15 AND BEYOND?

SUMMARY

U.S. Department of Housing and Urban Development | Office of Policy Development and Research

The Low-Income Housing Tax Credit (LIHTC) Program has been a significant source of new multifamily housing for more than 20 years, providing more than 2.2 million units of affordable rental housing. LIHTC units accounted for roughly one-third of all multifamily rental housing constructed between 1987 and 2006. As the LIHTC matures, however, thousands of properties financed using the program are becoming eligible to end the program's rent and income restrictions, prompting the U.S. Department of Housing and Urban Development's (HUD's) Office of Policy Development and Research (PD&R) to commission this study. In the worst case scenario, more than a million LIHTC units could leave the affordable housing stock by 2020, leading to a potentially serious setback to efforts to provide housing for low-income households.

This study suggests that the worst case scenario is unlikely to be realized. Instead, the answer to the question of whether owners of older LIHTC properties continue to provide affordable housing for low-income renters is a qualified "yes." Most LIHTC properties remain affordable despite having passed the 15-year period of compliance with Internal Revenue Service (IRS) use restrictions, with a limited number of exceptions. These exceptions are closely related to the characteristics of the local housing market, as well as to events that happen at Year 15 and are addressed in this report.

In answering this question and understanding its causes and implications, this study focuses on properties that would have reached Year 15 by 2009—properties placed in service under LIHTC between 1987 and 1994. Over the course of this study, interviews were conducted with industry participants: tax credit syndicators, direct investors, brokers, owners, and Housing Finance Agency (HFA) staff, as well as experts on multifamily finance and the LIHTC program. Quantitative data, including property-level records, HUD databases, and a survey conducted for this study of rents of a sample of former LIHTC properties were analyzed.

The results of the analysis showed remarkably consistent impressions of the outcomes for Year 15 properties:

- The vast majority of LIHTC properties continue to function in much the same way they always have, providing affordable housing at the same quality and rent levels to essentially the same population, without major recapitalization. Some rehabilitation of these properties occurred at or shortly after Year 15, often in connection with a change of ownership or refinancing, but the amount of work done is not extensive enough to be characterized as recapitalization.
- A moderate number of properties are recapitalized as affordable housing funded by a new source of public subsidy, typically a new round of tax credits, either at 4 or 9 percent. These properties underwent a substantial program of capital improvements.
- The smallest group of properties were repositioned as market-rate housing and ceased to operate as affordable. The risk of such repositioning occurring is most likely in strong housing markets.

WHAT HAPPENS AT YEAR 15?

Which of the three outcomes will be realized is linked to events that happen at Year 15, including whether changes occur in the property's use restrictions, whether the property is sold to a new ownership entity, and whether the property became financially or physically distressed before Year 15. The outcome may also be affected by market conditions where a property is located.

CHANGE IN USE RESTRICTIONS

During the first 15 years after a LIHTC property is placed in service, owners must report annually on compliance with LIHTC leasing requirements to both the IRS and the state monitoring agency. After 15 years, the obligation to report to the IRS on compliance issues ends, and investors are no longer at risk for tax credit recapture. Beginning in 1990, however, federal law required tax credit projects to remain affordable for the 15-year initial compliance period plus a subsequent 15-year extended-use period. Properties subject to an extended LIHTC use restriction may seek to have that restriction removed. Using the Qualified Contract (QC) process, owners may request regulatory relief from use requirements any time after Year 15. In essence, the owner requests the state agency to find a buyer for the property, and the state agency then has 1 year to find a buyer who will maintain the property as affordable housing. If the state is unsuccessful, then the owner is entitled to be relieved of LIHTC affordability restrictions, and those restrictions phase out over 3 years.

In practice, each state agency can define its own regulations for implementing a QC, so the process ranges from relatively simple and straightforward to so complex and difficult—perhaps intentionally—that the process is essentially unworkable. Further, a number of states either require or persuade developers seeking tax credits to waive their right to use the QC process in the future. Therefore, QC sales tend to be concentrated in a few states and are not common.

CHANGE IN OWNERSHIP

A change in ownership for a LIHTC property can happen any time. It is most likely to take place around Year 15, because it is in the interest of limited partners (LPs) to end their ownership role quickly after the compliance period ends. They have used up the tax credits by Year 10, and after Year 15 they no longer are at risk of IRS penalties for failure to comply with program rules.

By far the most common pattern of ownership change around Year 15 is for the LPs to sell their interests in the property to the general partner (GP) (or its affiliate or subsidiary) and for the GP to continue to own and operate the property. This is overwhelmingly the case for properties with nonprofit developers but is also true in many cases with for-profit developers. The minority of GPs who end their ownership interest at Year 15 almost always do so by selling the property, almost always to a for-profit buyer. These buyers may be motivated by management fees, economies of scale, or the potential for developer fees.

FINANCIAL DISTRESS AND CAPITAL NEEDS

Although the strong majority of LIHTC projects operate successfully through at least their first 15 years, some properties fall into financial distress. Poor property or asset management practices, a problematic financial structure, poor physical condition of the property, and a soft rental market are the most common reasons for the rare instances of failure.

Despite the fact that LIHTC properties tend to operate on tight margins, the percentage of foreclosures is small, in the range of 1 to 2 percent. Owners are anxious to avoid foreclosure, because it would be considered premature termination of the property's affordability and subject them to recapture of tax credits, with interest, and forfeiture of all future tax credit benefits from the property.

LIHTC properties are usually required to fund replacement reserves annually to pay for capital repairs and renovations. These reserves, however, are usually insufficient after 15 years to cover current needs for renovation and upgrading. The most important determinant of physical condition at Year 15 may be whether the property was newly constructed or rehabilitated when it was placed in service, and, if rehabilitated, the scope of the renovation work that was done then. New construction and extensive rehabs are less likely to need significant upgrades at Year 15 than is a property which received only moderate renovations when placed in service. Market conditions may also affect property conditions over time. Properties in strong markets are more likely to have high occupancy rates and be rented at or near the maximum LIHTC rents and to generate more operating funds that can be used for maintenance and repairs than properties in weaker markets, and thus they enter Year 15 with fewer deferred repair and maintenance needs.

OUTCOMES AFTER YEAR 15

After Year 15, properties take one of three paths: they remain affordable without recapitalization, remain affordable with a major new source of subsidy, or are repositioned as market-rate housing.

REMAIN AFFORDABLE WITHOUT RECAPITALIZATION

All information gathered for this study shows that most LIHTC properties that reached Year 15 through 2009 are still operating as affordable housing, either with LIHTC restrictions in place or with rents that nonetheless are at or below LIHTC maximum levels.

Even in the absence of use restrictions, at least two types of properties will continue to provide affordable housing: those with owners committed to long-term affordability (typically nonprofit owners, but also sometimes for-profit owners) and those located where market rents are no higher than LIHTC rents.

This pattern of properties remaining affordable with their original owners and without major recapitalization by Year 15 is common in strong, weak, and moderate markets alike. Over the longer term, however, developments are likely to fare quite differently, depending on the local market. For example, properties able to achieve high occupancy levels and high rents—even if restricted to below-market levels—can generate significant cash flow and have real market value. These properties are more likely to eventually convert to market rate and less likely to need new sources of subsidy to pay for renovations.

REMAIN AFFORDABLE WITH NEW SOURCES OF SUBSIDY

Some LIHTC properties are recapitalized as affordable housing around Year 15 with a new allocation of tax credits. In addition to receiving new tax credits, the property owner often refinances the mortgage, and acquires new soft debt. These funds typically are used to pay for renovation costs but sometimes also to acquire the property from the original LIHTC owner.

When deciding whether to seek a new allocation of tax credits to recapitalize a property—and accept a new period of use restrictions—owners weigh a variety of factors. At a minimum, the property must have some capital needs (at least $6,000 per unit) to qualify for a new LIHTC allocation. Other factors include whether the property needs to modernize to compete with new affordable housing, whether an infusion of additional equity appears to be the only way to bail out a distressed property, and whether new tax credits and use restrictions affect profitability.

State LIHTC policies also affect the decision to seek a new allocation of tax credits. Some states reserve 9-percent LIHTCs for affordable housing. Analysis of the HUD LIHTC database shows a gradual rise in the second use of tax credits.

REPOSITIONED AS MARKET-RATE HOUSING

By far the least common outcome for LIHTC properties is converting to market-rate housing after use restrictions have expired or after a QC process or financial failure. Foreclosure of the loan on the property is followed by a property disposition by the lender to a new owner who will operate the property as market-rate housing at higher rents if the market will bear them.

The most likely properties to have been repositioned as unaffordable, market-rate housing are those in low-poverty locations. The study found through a survey of the rents of a sample of properties no longer reporting to an HFA, that, even for this group of properties that should be at particularly high risk of becoming unaffordable, nearly one-half had rents below the LIHTC maximum, and another 9 percent had rents only slightly above LIHTC rents (see exhibit below).

AFFORDABILITY OF PROPERTIES IN LOW-POVERTY CENSUS TRACTS AND NO LONGER MONITORED BY HOUSING FINANCE AGENCIES

Property Rents Above 105 Percent of LIHTC Rent	Property Rents Between 100 and 105 Percent of LIHTC Rent	Property Rents Below LIHTC Rent
42%	9%	49%

Source: HUD National LIHTC Database

LIHTC PROPERTIES AT YEAR 30

The properties studied have not yet reached year 30, when the extended use restrictions for most of the properties will expire. After Year 30, the three patterns observed at or somewhat after Year 15 are likely to continue, but with the balance shifting in favor of the third pattern—repositioning and no longer affordable. Several types of properties will almost certainly not be repositioned. These properties include those with a mission-driven owner, a location in a state or city with use restrictions beyond Year 30, and the presence of restrictions associated with financing. Owners of the remaining properties—non-mission driven owners of properties with no use restrictions continuing beyond Year 30—are likely to make a financial calculation about what to do with the property that depends on the housing market. The key consideration is whether the location will support market rents substantially higher than LIHTC rents.

CONCLUSIONS AND RECOMMENDATIONS FOR POLICYMAKERS

Most older LIHTC properties are not at risk of becoming unaffordable, the notable exceptions being properties with for-profit owners in favorable market locations. Maintaining physical asset quality turns out to be a larger policy issue for older LIHTC properties than maintaining affordability. Older LIHTC properties likely will follow one of three distinct paths: (1) some will maintain their physical quality through cash flow and periodic refinancing, in much the same way that conventional multifamily real estate does; (2) others will maintain their physical quality through new allocations of LIHTC or another source of major public subsidy; and (3) some properties will deteriorate over the second 15 years, with growing physical needs that ultimately will affect their marketability and financial health. An increasing number of owners are expected to apply for new tax credit allocations, either at 9-percent or for bond financing and 4-percent credits.

In the coming years, state HFAs will come under increasing pressure as the large stock of LIHTC housing ages. Restricted by finite resources, state policymakers will have to make choices. The study results suggest that HFAs should place the highest priority on the developments that are most likely to be repositioned to higher market-rate rents.

In general, state policymakers should recognize that the majority of older LIHTC properties will, over time, become mid-market rental properties indistinguishable from other mid-market rental housing, and that this is a good result. The report also suggests that policymakers revise Qualified Allocation Plan standards to encourage higher priorities for those properties that need additional use restrictions to keep them from becoming unaffordable and lower priorities for properties in locations where low-income renters have other alternatives.

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EQUAL HOUSING OPPORTUNITY

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