Reviving "Sick" Tax Credit Housing Partnerships

by R. Lee Harris, CRE

The devastation of the real estate industry caused by the Tax Reform Act of 1986 has been well documented. However, if there was any silver lining, it was the creation of the Section 42 Low-Income Housing Tax Credit program effective January 1, 1987. By the time Congress made the tax credit permanent in 1995, after years of annual sunset provisions, the Section 42 program had become the most important resource for creating affordable housing in the United States.[1] Unfortunately, this process has had a downside, with an increasing number of partnerships in distress. By some industry estimates, as many as 25 percent of tax credit properties are under-performing.[2]

There are many reasons why this has occurred. The competition for tax credits has never been greater. Inexperienced developers and operators regularly receive awards more frequently while equity syndicators with substantial pools of capital are under increasing pressure to find projects to fund. This combination of inexperience and excess capital has caused the development of a number of marginal projects. In addition, many markets are becoming saturated with Section 42 developments.

Counselors cannot do much about inexperienced developers and saturated markets, but they can play a role in solving some of the operational and partnership challenges encountered by new and existing developments. The most common problems involve marketing, resident screening, compliance, and funding structures.

AN OVERVIEW OF THE TAX CREDIT PROGRAM

Growing communities need a full spectrum of housing including: affordable single-family dwellings; affluent single-family homes;

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multi-family apartments; assisted living residences; and seniors housing. In an effort to address the affordable housing needs of this country, Congress created a program that adopted Section 42 of the Internal Revenue Code. Section 42 was implemented to provide an incentive for developers to build or acquire rental units with restricted rents and make them available to individuals and families earning a specified percentage of the median income in their area.

For over a decade, the development of affordable multi-family housing using the Section 42 tax credit program has successfully contributed to the overall quality of metropolitan and rural housing. More than one million units have been added to the nation's affordable housing stocks including new construction and the acquisition of existing properties for inclusion in the program.[3] Families occupying tax credit apartments often save their money and eventually purchase a "starter home." Without such affordable rental housing, many citizens would not be able to save for down payments.

Tax credit housing is:

- Housing for working individuals, families, and retirees.
- Generally the newest and nicest apartment community in many smaller markets.
- Housing that requires residents to pay the full amount of rent unless used in tandem with a rent subsidy program such as Section 8.
- A way to help revitalize a neighborhood by restoring a community landmark, such as a vacant elementary school or a former department store.
- A proven method for financing affordable housing that would not otherwise be constructed in many smaller communities.

Tax credit housing is critically important to the economic success of a municipality. Without affordable housing, a growing work force has no place to live. Local industry then finds it harder to recruit employees and cannot expand - a factor that is critical to increasing the local tax base.

Who can live in tax credit apartments? The law permits residency based upon individuals or families who earn 60 percent or less of an area's median income. The median income calculation increases relative to the number of residents who occupy the apartment. Rental rates are determined through a formula based upon 30 percent of the median income figure.

Assume that the median income for a family of four in a particular community is $38,500. Thus to be eligible, this family can earn up to $23,100 per year. The husband works at the area's 450-employee food processing plant that pays $8.50 per hour ($17,680 per year) and the wife earns $4,500 per annum employed as a part-time clerk at a neighborhood grocery store. The family's combined income is $22,180 - below the maximum allowable income under the tax credit program.

THE MECHANICS OF THE TAX CREDIT PROGRAM[4]

Under current law each state receives an annual allocation of tax credits equal to $1.25 per capita. The housing agency for each state administers the tax credit program for the federal government. Private and not-for-profit developers must submit applications demonstrating need for affordable housing in specified locations and compete for an award of tax credits. Typically, most states receive applications for $3.00 to $4.00 for every dollar of tax credits available.[5] Thus, as state housing agencies evaluate the applications, they pay a great deal of attention to market studies; rental rates (are they below maximum allowable rates?); energy efficiency; construction and intermediary costs; project design and quality; and the general support demonstrated by a community.

Once a developer receives an award, he/she must decide the appropriate strategy for utilizing the tax credits. Through passive loss rules, the Internal Revenue Code limits the amount of tax credits that can be used by an individual each year, offset against income tax liabilities. As a result, a large number of tax credits are sold to corporate investors that are not subject to the stringency of these limitations. The tax credits are calculated at nine percent of a project's eligible basis including construction and architectural costs, developer fees, etc. (land is not eligible, nor are certain financing costs). For example, a new apartment community with an eligible basis of $4,000,000 will generate a tax credit of $360,000 (adjusted for the federal Applicable Funds Rate [AFR]) each year for 10 years. In instances where an existing property is acquired, the developer will receive four percent tax credits for the acquisition costs and nine percent tax credits for the renovation costs, however if tax-exempt financing is used on new or acquisition projects, only four percent credits are applicable.

Corporations, insurance companies, and financial institutions with federal taxable income have been

the largest purchasers of tax credits to date.[6] The typical transaction structure has the developer selling 99 percent of the tax credits to the corporate investor on a net present value basis. Currently, industry pricing ranges from $.75 to $.80 per credit dollar.[7] In the example cited in the preceding paragraph, the developer would be offering $3,600,000 in tax credits (we'll ignore AFR adjustments) over 10 years. A corporate investor would pay $2.673 million to $2.88 million for the use of these credits. The developer would form a limited partnership for which he/she would be the general partner and the corporate investor would be the limited partner. The payment from the corporate investor would take the form of equity, and the developer would seek an additional source(s) of funding in the form of debt. In this example, assume that the total project costs – hard and soft – are $4,350,000. If the corporate investor provides $2.75 million in equity at the commencement of the project, the developer must find another $1.6 million in permanent financing.

Once the project has been constructed and each unit occupied (allowing the tax credits to be "placed in service"), the corporate investor is able to reduce its income taxes by $360,000 per annum over 10 years. Meanwhile the developer must adhere to the median income and rental rate restrictions for a minimum of 15 years under the program (some states require an even longer time frame). The IRS and state housing agencies have strict requirements for certifying the income levels of residents and a variety of documents must be filed each year to remain in compliance with the program.

A significant number of developers do not sell their tax credits directly to corporate investors, opting instead to work with a tax credit syndicator. The syndicator establishes relationships with interested corporations and often pools the interests of several companies into a fund that actually becomes the limited partner for the projects in which it invests. The syndicator buys the credits on a wholesale basis and sells them to corporate participants on a retail basis, making a spread on the transaction. Developers are generally required to provide a variety of guarantees to the syndicator (or to the corporation if the investment is direct) including development deficit funding, operating deficit funding, and tax credit compliance.

COMMON PARTNERSHIP AND PROJECT PROBLEMS

The problems that are being encountered in the tax credit industry fall into four primary categories.

Poor Marketing

While the demand for multi-family housing is strong in nearly every corner of the nation, this does not necessarily translate into the immediate lease-up of a Section 42 property. The market for tax credit housing tends to be relatively narrow due to the income restrictions prescribed by the program. In many communities, there is considerable renter interest in a new property, however as many as 75 percent of prospective residents may be overqualified due to their income levels.[8]

For many prospective residents who do meet income qualifications, rental rates at restricted levels may be too high for prospective residents. A 1997 audit conducted by the General Accounting Office (GAO) found that the average tax credit apartment resident earns only 37 percent of the area's median income.[9] The problem with rental rates can be exacerbated when there is significant competition presented by a concentration of tax credit properties located in medium size and large metropolitan areas. Finally, the Department of Housing and Urban Development (HUD) sets the restricted rent levels through an annual market study process in tandem with area median incomes. Income levels in many markets are rising rapidly as a result of the tight labor market. The HUD process does not respond quickly enough to such rising income levels and thus many prospective residents are rejected, who would otherwise be qualified were the market study to have been conducted in a more timely fashion, acknowledging higher income levels accordingly.

A generic marketing effort will often fall short because it is not adequately targeted to the proper audience. The leasing of tax credit apartments generally requires an intensive highly directed marketing program that reaches the small segment of the population that both qualifies for the program from an income standpoint and can afford the rental rates that must be charged. Many developers do not understand this reality and attempt to implement traditional marketing methods without success.

Improper Resident Screening

Slow lease-ups can lead to problems with resident screening. Management may panic and relax rental standards to accelerate the placement of units in service. Just because a prospect is qualified under the Section 42 program does not necessarily mean that a prospect will be an acceptable resident. Slow payment of rent, poor housekeeping,

unruly children, derelict vehicles, and late night disturbances can be the result of failure to contact landlord references, perform credit checks, and conduct in-depth prospect interviews.

Tax Credit Program Non-Compliance

Compliance issues have moved to the forefront in the Section 42 industry during the past few years. The GAO audit may result in tighter regulation by state housing agencies and a commitment by the IRS to audit more tax credit partnerships.[10] This could spell trouble for a struggling property and its investors. Management that is ignorant of the myriad of compliance requirements and the lack of centralized compliance monitoring are the root cause of such problems. The latter is especially critical during the lease-up phase where leasing agents may receive incentives to achieve high levels of occupancy as quickly as possible.

Corporate equity syndicators will do almost anything to avoid a loss for their investors. Were a loss to be incurred, the syndicator would suffer a devastating blow to its ability to raise capital in the future. However, a number of syndicators are slow to deal with problem situations in a timely manner, hoping that the developer/manager will somehow be able to find the "magic" to put a project on solid footing. Eventually action must be taken, usually after the syndicator finds it necessary to modify the partnership agreement and potentially contribute its own funds to deliver promised returns.

Inadequate Funding Structure

According to the U.S. Census Bureau the overall average construction cost of a multi-family dwelling in 1992 was $67,530 per unit. By 1997, this cost had risen to $79,659 per unit.[11] The 1997 GAO audit revealed that the average development cost for a tax credit project over the 10-year period from 1987 through 1996 was $60,000 per unit.[12] Even with the substantial amount of equity invested in most tax credit projects, debt underwriting standards often do not allow a large enough permanent loan to offset the entire development cost when combined with the equity.

Using the 10-year average construction cost of $60,000 per unit, if financed conventionally, a project would require a monthly rental rate of $743 per month.[13] The GAO audit also found that the average rental rate for a tax credit community was $435 per month.[14] The Section 42 program was intended to help fund the difference of more than $300 per month through the use or sale of the tax credit.

The problem is that the cost to build the project had risen to $79,659 by 1997. The rental rate necessary to sustain the project on a conventional basis had also risen to $918 per month. Now the difference between conventional rental rates and tax credit rental rates had become $483 per month. While the higher construction costs generate more tax credits, the sale of those tax credits is at a discount as previously described. Subsequently, the additional equity provided by the larger tax credit amount, does not fully cover the increased cost of development. Increasing the debt financing in response to higher construction costs is not a viable option because the rent levels have not risen enough to support it. As a result, a number of projects suffer from inadequate funding structures from the very beginning. Without some form of additional capital (CDBG funds, HOME money, Federal Home Loan Bank loans, etc.) the funding gap will be underwritten through deferral of part of the developer's fee. The problem is further compounded when initial rental rates are not achieved and the subsequent lowering of rates does not enable the developer to obtain the targeted permanent loan. Development cost overruns, interest rate increases, and operating expenses that are higher than projected will have the same effect. In some cases the funding gaps are so large that the entire budgeted development fee is lost and still a shortfall exists.

SOLUTIONS

Troubled partnership situations can be resolved but require a great deal of planning and precise execution. The replacement of the developer or general partner may be necessary, but can be messy. Another solution is to keep the original developer/general partner and bring in a new managing general partner.

Attracting a replacement or new managing general partner is made easier when there are still development fees remaining to be paid. The new managing general partner should be given the opportunity to earn the remaining fees through the achievement of various performance benchmarks. If no such fees remain, the syndicator may find it necessary to offer new fees to a replacement general partner.

The remainder of this manuscript examines one of the best solutions to reviving "sick" tax credit partnerships — hiring a new managing general partner. The key qualifications of a managing partner are summarized along with some of the most important initial steps they should implement.

QUALIFICATIONS

What qualifications should the new managing general partner possess?

Management Experience

A new managing general partner should have a strong track record with the management of different types of multi-family properties. Certainly Section 42 experience should be a prerequisite. A well-rounded general partner may have managed properties for his/her own account and for third parties as well. Multiple market experience is also helpful, especially if the property in question is located in a different city than where the new general partner normally operates. Development experience may be necessary if the property has not yet been completed. A general partner that is affiliated with an Accredited Management Organization (AMO®) through the Institute of Real Estate Management (IREM) is a good choice. AMO® firms must continuously meet specific requirements and adhere to a strict code of ethics prescribed by IREM.

Understanding the Big Picture

Not only does the new managing general partner need to be successful in the property management realm, but it also should have a clear understanding of the big picture. Does the new general partner have a strategy to improve the cash flow? Increased cash flows can help the equity syndicator recover funds that it may have advanced to preserve returns for corporate investors. Can the general partner help re-structure the financing to improve the overall profit picture? Does the general partner comprehend the critical nature of compliance? Will the general partner provide in-depth reporting that will keep the equity syndicator informed of the progress that is being made to "cure the ills" of the property?

Relationships With State Housing Agencies

A new managing general partner that has a good relationship with the applicable state housing agency is a real asset to the partnership. Such relationships can help mend fences that might have been damaged when the project became troubled. A new general partner may also be able to secure additional tax credits (federal or state) that could create an additional capital infusion for the property.

POSITIVE STEPS TO SUCCESS

What positive steps should a new managing general partner take to breathe new life into a troubled project?

Property Taxes

If a development is struggling there may be a strong case for a reduction in property taxes. A new general partner will recognize this and develop the evidence needed to appeal property valuations for tax purposes. Rental rates may have been lowered; marketing costs may have been increased; and occupancy is probably lagging. All are factors that can be relevant in a tax appeal effort.

Market Study and Analysis

A new general partner will look carefully at the market study that was performed prior to the development or acquisition of the property. If a study was not conducted, the general partner may commission one. The ensuing analysis should produce information regarding capture rates, lease-up velocity, and an accurate identification of market-acceptable rental rates. It may also be determined that the resident profile should be modified. From this information, the general partner can then develop a comprehensive, targeted marketing strategy to lease the property to qualified residents.

Creative Marketing Concepts

Creativity in the marketing of Section 42 properties has not been the standard in the past. It must become a primary focus in the current environment. A simple ad in the local newspaper and a *"Now Leasing"* banner at the property generally will not ensure a successful lease-up. Direct mail; ongoing employer contacts; the support of local charitable groups and events; a sophisticated neighborhood business referral program; contacts with local churches; day care alliances; and many more techniques, must be carefully coordinated by the new general partner/managing agent. Further, an extensive tracking system must be implemented to provide information on where qualified prospects are learning about the property, and to enable management to aggressively follow-up with a prospect until a lease is signed.

Careful Screening

One of the basics and fundamentals of property management is the careful screening of prospective residents. A new general partner will review the rental standards that exist, or establish new standards if there are none to begin with. Must a prospect have held his/her current job for a specified period of time? How many years of landlord references will be checked? Will the on-site manager actually visit the prospect's current home to view its condition? Is drug screening necessary? What about criminal records checks? Once a policy has been

developed, the new general partner must enforce it consistently.

Centralized Compliance Monitoring

Material non-compliance – these words strike fear in the hearts of everyone involved with the Section 42 program. A new general partner should utilize a centralized compliance monitoring process. A well-trained employee of the general partner and/or managing agent should have the responsibility for approving all new applications for lease after reviewing supporting documentation. This individual should not be connected with the property in any sort of on-site capacity. The employee may also provide the same service for other Section 42 properties in the general partner's portfolio. On a periodic basis, the compliance specialist will review all existing files to make certain that documentation is in place and re-certify the residents accordingly. There are currently a number of excellent compliance monitoring/reporting software packages on the market. The new general partner should offer an automated system for compliance purposes.

Additional Funding Sources

There is a myriad of funding programs available for tax credit properties. The good news for troubled partnerships is the fact that there are many more opportunities for generating new sources of funds than is the case for conventional projects. While some sources may not be eligible for a property that has already been placed in service, there are still a number that are. A new general partner will seek to determine the applicability of the HOME program; CDBG funds; state tax credits; state affordable housing credits; low interest state loans; Rural Housing 502, 521, and 538 programs; tax-exempt bond financing; FHA funds; Federal Home Loan Bank loans; HOPE VI funds; soft community loans; tax abatement; tax increment financing; FNMA and Freddie Mac financing; and other state, local, and private sources. The key to success is the layering of a number of different programs until funding shortfalls have been eliminated.

CONCLUSION

There are many complex elements to resolving difficult partnership and property situations for tax credit housing. The replacement or addition of a general partner is a serious event and will more than likely require the participation of attorneys, accountants, lenders, property management professionals, market experts, and others. Extreme care must be taken to select the right party for the role and to re-structure the partnership and the operation of the property in a manner that will lead to a successful investment. Challenging tax credit partnership situations **can** be addressed in a positive and constructive manner through a diligent, patient, and creative effort. Counselors who develop extensive knowledge of the tax credit program and have experience with the development and/or management of apartment communities can be an invaluable resource to the affordable housing industry. REI

NOTES

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