

After Year 15: Challenges to the Preservation of Housing Financed with Low-Income Housing Tax Credits

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Abstract

The Low-Income Housing Tax Credit, the nation's largest subsidy program for low-income rental housing, has financed more than 1.4 million housing units since 1987. Like earlier federal programs that subsidized housing built by private owners, this program does not guarantee indefinite occupancy by low-income households.

This article examines the likelihood that tax credit housing will convert to market-rate occupancy and the challenges confronting the long-term physical viability of the housing if it is to remain affordable. The biggest threat to the long-term viability of tax credit housing as a resource for low-income households stems less from the expiration of income and/or rent restrictions and more from the need for major capital improvements. A relatively small segment of the inventory is likely to convert to market-rate occupancy. Far more of this housing will continue to serve low-income households but will need assistance to pay for essential renovations.

Keywords: Affordability; Low-income housing; Tax policy

Introduction

The Low-Income Housing Tax Credit (LIHTC) is the nation's largest subsidy program for low-income rental housing. Since its inception in 1987, this program has helped finance over 1.4 million housing units, more than the entire remaining stock of public housing (McClure 2007; Schwartz 2006). While the supply of public housing has been declining, the tax credit port-

folio is growing by about 90,000 units a year (McClure and Grube 2007). However, like earlier federal programs that subsidized housing built by private owners, the tax credit program does not guarantee indefinite occupancy by low-income households. The earliest tax credit properties can convert to market-rate occupancy after 15 years unless they are subject to additional affordability restrictions (Collignon 1999). Properties developed after 1989 enjoy more affordability protection, but their long-term sustainability is still by no means guaranteed (Christian 2003; Collignon 1999; Craycroft 2003; Enterprise Community Investment, Inc. 2007).

Now that the tax credit program is more than 20 years old, some of the first buildings it helped finance have already seen their rent and income restrictions expire. Moreover, the continuation of affordability restrictions beyond year 15 does not ensure that the housing will remain viable; resources must still be available to keep it in good condition. The challenge of preserving the continued affordability and viability of tax credit housing has begun (Pitcoff 2003).

In assessing the nature of the challenge, this article discusses the extent to which current and subsequent owners of tax credit developments will have the ability and the incentive to keep their holdings from converting to market-rate occupancy. It also examines the extent to which owners interested in preserving affordability for low-income renters will be able to obtain the resources needed to keep the housing in good physical condition. The analysis is based on a review of program regulations, previous research on how owners have so far responded to the advent of year 15, and interviews with executives from the nation's largest syndicators of tax credit developments (see the appendix). Collectively, as of 2004, the limited partnerships organized by these for-profit and nonprofit syndicators had controlling interests in more than 8,500 tax credit developments with more than 825,000 rental units.

Although tax credit properties put into service after 1989 are subject to additional affordability restrictions beyond the initial 15 years of occupancy, year 15 remains an important issue for the long-term affordability and viability of this housing. First, some properties, for reasons that will be discussed later, can be exempted from these additional restrictions. Second, after year 15, enforcement of the program's affordability requirements and other regulations shifts from the Internal Revenue Service (IRS) to the states, many of which have yet to devise systems to monitor long-term compliance with these requirements or sanctions in the event of violation. Third, the ownership of most tax credit properties is likely to change after year 15, when the original

owners are no longer responsible for maintaining affordability and can sell their interest without being liable for subsequent failure to maintain affordability. Finally, by year 15, many tax credit properties will require major capital improvements.

The chief finding of our research is that the biggest threat to the long-term viability of tax credit housing as a resource for low-income households stems less from the expiration of income and/or rent restrictions and more from the need for major capital improvements. A relatively small segment of the inventory is likely to convert to market-rate occupancy—primarily housing built during the earliest years of the program, housing located in the most expensive housing markets, and housing that is not subject to additional regulatory restrictions. Far more tax credit housing will continue to serve low-income households but will need assistance to pay for essential renovations.

The next section presents a brief summary of the program, including a description of how it helps finance low-income rental housing and an overview of the existing inventory. It also presents basic information on the major syndicators of this housing. The following section examines several major issues dealing with long-term preservation, including the expiration of affordability restrictions, the cost of acquiring tax credit properties from their current owners, and strategies and challenges for financing acquisition and renovation. This section also explores the extent to which these properties have already been sold and have retained low-income affordability. The article concludes with a brief discussion of policy implications.

LIHTC overview

The LIHTC program allows investors to reduce their federal income taxes by \$1 for every dollar of tax credit received. Investors receive the credit for 10 years, and the property must remain occupied by low-income households for at least 15 years. The amount of the credit depends on the cost and location of the development and the proportion of units occupied by low-income households (Schwartz 2006; see also Enterprise Social Investment Corporation [ESIC] 2005). Unlike other tax breaks associated with real estate, the LIHTC is not awarded automatically. Tax credits are assigned to individual housing developments by designated state agencies (usually state housing finance agencies). The total dollar amount of available credit is determined by the state population, as measured by the decennial census. Starting in 2002, per capita tax credit allocations were indexed to inflation. As of 2007, states could allocate \$1.95 per resident in tax credits. At least

10 percent of a state's tax credit allocation must go to housing developed by nonprofit organizations (Schwartz 2006).

The amount of tax credit funding assigned to an individual property depends on its total development cost, excluding land and certain other expenses, and the proportion of units occupied by low-income tenants (ESIC 2005; Schwartz 2006). In practice, the vast majority of LIHTC developments are 100 percent occupied by low-income households; for properties that designate 40 percent or more of their units for low-income occupancy, low income is defined as up to 60 percent of the metropolitan area's median family income. If 20 to 39 percent of the units are slated for low-income renters, low income is defined as up to 50 percent of the median. Properties located in areas with particularly high development costs ("difficult development areas") or in low-income neighborhoods ("qualified census tracts") receive additional credits.

The first step in calculating the credit is to determine the total development cost, less land and certain other costs (the eligible basis).¹ Next, if not all of the units are to be occupied by low-income households, the percentage of low-income units (or the percentage of the total square footage occupied by these households) must be multiplied by the eligible basis to determine the "qualified basis." Finally, if the development is located in either a difficult development area or a qualified census tract, the development receives a basis boost of 30 percent, thus increasing the size of the qualified basis.

The qualified basis is then multiplied by the credit rate to determine the size of the tax credit that can be taken annually for 10 years. For new construction and substantial rehabilitation, the 10-year stream of tax credits is based on 70 percent of the present value of the qualified basis. This amounts to about 9 percent annually, with the exact credit rate calculated each month as the weighted-average cost to the U.S. Treasury of long-term debt with maturities comparable with those for tax credit projects. Developments that cost less than \$3,000 a unit to renovate or developments that receive certain federal subsidies can be considered for a smaller credit based on 30 percent of the present value of the qualified basis, which usually hovers around 4

¹In addition to land, the tax credit does not cover the following: building acquisition and related costs, fees and costs related to any permanent loan financing, fees and costs related to postconstruction operations, syndication costs, project reserves, postconstruction working capital (e.g., marketing expenses included in the development budget), costs covered by federal grants, the residential housing portion of any historic tax credits taken, and the nonresidential portion of project costs (e.g., any commercial space and any community space if its use is not restricted to project tenants) (ESIC 2005).

percent a year. Developments receiving tax-exempt bond financing are automatically eligible for this 4 percent credit.

As noted earlier, investors receive credits annually for 10 years, but the property must remain affordable for an additional 5 years. If the IRS finds that rents have risen above the maximum allowed, or if income standards are violated during the first 15 years of operation, investors are subject to a financial penalty (credit recapture).

Housing developers seldom use the LIHTC program themselves. Instead, they sell the credit to private investors and use the proceeds to help cover construction and other development costs. More precisely, they sell an interest in the development to private investors, who receive the tax credit, other tax benefits (the depreciation allowance), and perhaps some cash flow from operations and a portion of the capital gains if the property is sold. Developers can either sell their interest themselves to private investors or, more commonly, turn to syndicators for this purpose.² Syndicators, which include both for-profit and nonprofit organizations, sell interests in assemblages of tax credit developments to corporations and other investors. They establish limited partnerships in which the investors have no managerial authority over the development. After taking out fees and other transaction costs, syndicators channel the investment proceeds to the developer (see table 1).

Tax law generally limits the LIHTC market to corporate investors; passive loss restrictions prevent most individual investors from using the credit—although individual investors dominated the tax credit market during the first five or so years of the program.³ Syndicators are also responsible for asset management, to preserve if not enhance the value of their portfolios, and also to reduce the risk that developments will violate the program's rent and income restrictions, thereby subjecting investors to a significant financial penalty.

The amount of equity generated by the tax credit depends on two factors: (1) the price investors are willing to pay for the credit and (2) the vari-

²The U.S. Department of Housing and Urban Development sponsored a survey of owners of tax credit developments placed in service from 1992 through 1994. The survey found that 51 percent of the properties had been fully or partially syndicated and that 36 percent involved direct placements. Syndication was most common among properties located in nonmetropolitan areas (66 percent) and least common for properties in central cities (40 percent) (Abravanel and Johnson 1999). The proportion of syndicated tax credit properties has almost certainly increased since then.

³While the two nonprofit syndicators, the National Equity Fund and ESIC, have always focused on institutional investors, for-profit syndicators originally marketed the tax credit to individual investors. According to the interviews, it was not until about 1993 that the major for-profit syndicators shifted to institutional investors.

Table 1. Key Players in the Development, Management, and Preservation of Tax Credit Housing**Syndicators (for profit and nonprofit)**

- Recruit private investors (usually corporations) to invest in tax credit housing.
- Organize limited partnerships in which investors usually receive 99 percent or more of the tax benefits (tax credits, depreciation) and sometimes a portion of the operating cash flow and the residual value of the property (capital gains). Syndicators usually form “investment limited partnerships” that invest in assemblages of tax credit properties. The partnership then acts as the limited partner for each individual property.
- Perform asset management to ensure that properties remain in compliance with program regulations (and protect investors from the financial penalties imposed by the IRS when these regulations are violated) and to see that properties are maintained.
- Receive syndication and asset management fees.

Developers (for profit and nonprofit)

- Usually serve as a general partner in the limited partnership, retaining a 1 percent interest in the property.
- Receive a development fee for constructing or rehabilitating the property and a fee if responsible for property management. Developers may receive operating cash flow as well.
- Are responsible for the day-to-day management of the property.

Private investors (for profit only)

- Originally included individuals as well as corporations, but private investors have consisted mostly of corporations since the mid-1990s.
- In most cases, act as limited partners in the ownership of tax credit properties, receiving tax credits and depreciation and sometimes a share of the operating cash flow and of the residual value. Limited partners have no liability over the performance of the property and no involvement in its management.

State housing finance agencies

- Are responsible for the allocation of tax credits to real estate developers. Credits are allocated according to a plan that gives preference to the state’s priorities (e.g., elderly housing, suburban locations, maximizing the use of private resources).
- See that at least 10 percent of all tax credits are allocated to nonprofit developers each year.
- After 15 years of operation, find buyers interested in purchasing developments put into service after 1989 if developers ask for help. If the agency cannot secure a buyer willing to retain low-income affordability, the original owner can convert the property to market-rate occupancy.

Internal Revenue Service

- Enforces compliance with tax credit regulations.
- If properties are found to violate income, rent, or other restrictions, can impose financial penalties, with interest, on the owners, including limited partners.

State and local governments

- May provide grants or (more commonly) low-interest loans (gap financing) for the development of tax credit housing and for the first mortgage.
- May impose additional income or rent restrictions on the properties they assist.

Banks and other financial institutions

- Provide first mortgages for tax credit properties, usually at market interest rates.
- Motivated in part by the Community Reinvestment Act, frequently invest in tax credit properties.

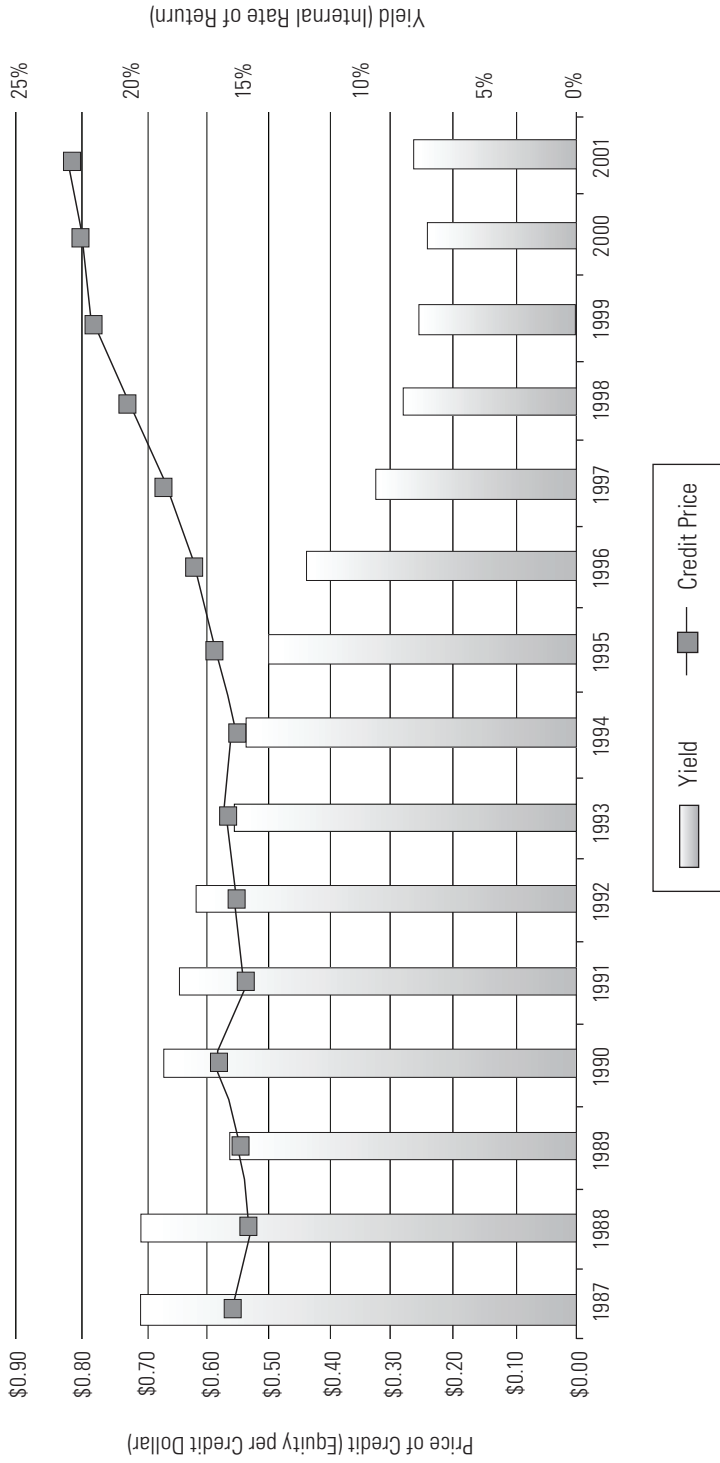
ous transaction costs connected to sale or syndication. Initially, during the years immediately following the establishment of the credit in 1987, investors typically paid less than 50 cents for each tax credit dollar. Transaction costs accounted for 10 or more cents per dollar, leaving only 40 cents or less for the developer (Ernst & Young 2003; Roberts 2001). The price paid by investors has increased over time. As the program became more familiar, and after Congress made the credit permanent in 1993, investors saw less risk in investing in tax credit projects and therefore accepted a lower rate of return. Whereas investors might have required a return of 30 percent per year in the early years of the program, they accepted 7.5 percent or less by 2000 (see figure 1). As discussed later, the higher prices that investors have been willing to pay for tax credits have important positive consequences for preservation. Most important, higher prices generate more equity, enabling developers to take out smaller mortgages, establish larger reserve funds, and produce higher-quality buildings. Higher prices also reduce the likelihood that investors will incur capital gains (exit) taxes when they sell the property after 15 years.

Although tax credit prices vary by geographic region, project type, and other factors, by 2006 investors on average paid 90 cents or more for each tax credit dollar and in some instances paid more than \$1 per credit⁴ (Ernst & Young 2003; “LIHTC Prices, Demand among Issues Weighed” 2006; Roberts 2001; Smith 2002). This increase in the price of credits reflects the lower returns demanded by investors and a decrease in syndication costs. Over time, the LIHTC program has proved itself to be a stable and significantly less risky investment than investors had assumed when the program first appeared as a novel and untested tax incentive. As the perception of risk decreased, investors were willing to accept a lower return. Syndication fees have declined to about 6 percent, down from as much as 27 percent in the earliest years of the program and 10 percent to 14 percent in the mid-1990s (Roberts 2001; U.S. General Accounting Office 1997). These decreases reflect efficiencies gained with experience and probably the shift from individual to corporate investors (E & Y Kenneth Leventhal Real Estate Group 1997).

The amount of equity generated by the sale of tax credits determines the need for additional sources of funding and the minimum rents that can be

⁴Purchasing tax credits for more than \$1 per dollar of credit is analogous to purchasing bonds at a premium. In both cases, investors are willing to accept returns of less than face value. They may do so because of decreased returns from other investments of similar risk and also because of nonfinancial considerations. The market for tax credit properties has become dominated by financial institutions with additional motivation to invest in tax credits besides return on investment (compliance with the Community Reinvestment Act and similar regulations aimed at government-sponsored enterprises such as Fannie Mae and Freddie Mac).

Figure 1. Average Tax Credit Pricing and Yield



Source: Ernst & Young (2003).

charged. As more equity is provided from the sale of tax credits, the developer can take out a smaller mortgage and will have less need for additional sources of equity. A developer that wants to make a tax credit development affordable to households with lower incomes than the maximum allowed—60 percent of the area median—will need to keep market-rate financing to a minimum since rents will have to cover debt servicing costs.

Overview of LIHTC housing stock

Through 2004, the LIHTC program has contributed to the development of more than 1.4 million rental units in more than 25,000 developments. Table 2 presents some of the basic characteristics of this housing, drawing from the U.S. Department of Housing and Urban Development's (HUD's) database on tax credit housing (2007c). Several features stand out.

1. Nonprofit organizations account for more than 20 percent of all tax credit properties and units, more than twice the minimum 10 percent set-aside required in each state.
2. Most tax credit housing consists of new construction, with rehabilitation accounting for less than 40 percent of all projects. (However, new construction makes up less than half of all such housing situated in the central cities.)
3. The 9 percent credit accounts for almost 60 percent of all developments but slightly less than half of all units; 4 percent credits, especially those involving tax-exempt bonds, tend to finance larger developments than 9 percent credits.⁵ The use of tax-exempt bonds has increased markedly since the late 1990s. More than half of all tax credit properties developed with tax-exempt bonds were put into service after 1999.
4. Just under half of all tax credit properties and units are located in central cities. Suburban areas account for about one-quarter of all tax credit developments but over one-third of all units. By contrast, nonmetropolitan areas represent more than one-quarter of all developments but less than one-sixth of all units. On average, suburban tax credit developments are twice as large as their nonmetropolitan counterparts. The

⁵As explained previously, 9 percent credits are based on 70 percent of the present value of the qualified basis, with the exact credit amount determined monthly, while 4 percent credits are based on 30 percent of the present value of the qualified basis. The larger credit pertains to construction or rehabilitation costs that exceed \$3,000 per unit. The smaller credit applies to the acquisition costs of existing structures, construction or rehabilitation costs that are less than \$3,000 per unit, or projects that benefit from tax-exempt bonds or from certain other subsidies (ESIC 2005).

regional distributions of tax credit developments and units are similarly skewed, reflecting the larger average size of developments located in the South and West. Finally, table 2 shows that tax credit developments have become increasingly large over time. Properties put into service after 1999 average 75 units per development and are more than twice as large as those put into service before 1999.

Syndicator overview

Most tax credit developments are syndicated by seven firms; representatives of each were interviewed for this article.⁶ Collectively, as of May 2004, these syndicators had contributed to the development of more than 8,300 tax credit properties containing more than 813,000 rental apartments. They account for over two-thirds of all tax credit units built through 2003. Two of the syndicators, ESIC and the National Equity Fund (NEF) and its affiliates, were founded by Enterprise (formerly known as the Enterprise Foundation) and the Local Initiatives Support Corporation (LISC), national intermediary organizations that support community development corporations. According to the interviews with ESIC and NEF executives, nearly all of the tax credit housing syndicated by these organizations has been developed by community development corporations and other nonprofits.

As indicated by the interviews, the five other major syndicators are for-profit organizations that have focused primarily on tax credit properties involving for-profit developers, although some have also worked with non-profit developers as well (interviews with Boston Capital, MMA Financial, Paramount Financial Group, Related Capital/Charter Mac, and the Richman Group). Table 3 provides a brief overview of the seven major tax credit syndicators, as well as one smaller regional syndicator, the Chicago Equity Fund. The seven national syndicators each control an average of nearly 1,200 tax credit developments and more than 104,000 units. The three largest alone account for 4,700 developments and 566,000 units. The Chicago Equity Fund and its affiliate the Illinois Equity Fund have formed 180 limited partnerships encompassing about 12,000 units. All of the syndicators entered the tax credit market by 1987, soon after the LIHTC program was first established, and have therefore seen their first projects reach year 15. Overall, though the end of 2004, the eight syndicators have sold about 300 developments.

⁶The executives who were interviewed did not wish to have their names attributed to specific statements. Their names and titles, however, are listed in the appendix.

Table 2. Profile of Tax Credit Housing: Projects Put into Service from 1987 to 2004

Selected Characteristics	Percent Distribution of Developments (N=25,950)	Percent Distribution of Units (N=1,415,431)	Mean Size of the Development (Units)
Sponsor type			
Nonprofit	22.0	20.2	53
For profit	78.0	79.8	59
Development type			
New construction	61.6	60.8	45
Acquisition and rehabilitation	36.4	37.3	45
Both new construction and acquisition and rehabilitation	1.1	1.2	64
Existing	0.9	0.7	69
Credit type			
4 percent	33.6	42.9	76
Tax-exempt bond	12.8	31.8	143
9 percent	57.8	49.0	51
Both 4 percent and 9 percent	8.6	8.2	57
Basis boost			
Yes	24.3	28.2	73
No	75.7	71.8	59
Location			
Central city	44.5	49.3	63
Suburbs	29.6	35.7	69
Nonmetropolitan	25.9	15.0	33
Region			
Northeast	17.7	14.2	45
Midwest	30.2	24.3	45
South	35.5	40.8	64
West	16.6	20.7	69
Year put into service			
1987 to 1989	19.4	10.8	31
1990 to 1993	21.5	15.0	39
1994 to 1999	32.6	36.6	63
2000 to 2004	26.4	37.6	79
Total	100	100	56

Source: HUD (2007c).

Note: Totals may not equal 100 percent because of rounding.

The long-term sustainability of tax credit housing hinges on three inter-related issues: affordability restrictions; the cost of acquiring post-year 15 properties from the current owners, which can include payment of the owners' capital gains or exit taxes; and the need for capital improvements and the availability of resources to finance them. The following section examines these three issues, drawing from telephone interviews with syndicators and other tax credit practitioners and from technical reports, handbooks, and other publications.

Table 3. Overview of Tax Credit Syndicators as of 2004

Syndicator	Type	Total Projects	Total Units	Fund Type	Approximate Number of Projects Sold
Related Capital/Charter Mac	For profit	1,000	300,000	Public and corporate	30 to 40 (by May 2004); 180 to 190 (through the end of 2005)
MMA Financial	For profit	1,600	151,000	Public and corporate	86 (through the end of 2004)
Boston Capital	For profit	2,100	115,000	Public and corporate	60 to 70 (through the end of 2004)
Paramount Financial Group	For profit	825	87,000	Public and corporate	About 25 (through the end of 2004)
The Richman Group	For profit	600	55,000	Public and corporate	3 (through May 2004)
ESIC	Nonprofit	1,100	50,335	Corporate	17 (through October 2004); 61 (through the end of 2006)
NEF (and affiliates)	Nonprofit	1,100	55,000	Corporate	27 (through the end of 2004); 58 (through the end of 2005)
Chicago Equity Fund	Nonprofit	180	12,000	Corporate	About 35 (through 2004)
Total		8,505	825,335		About 300 through 2004
Mean		1,063	103,167		
Mean—excluding Chicago Equity Fund		1,189	116,191		
Top Three—Mean		1,567	188,667		

Notes: Data were derived from telephone interviews with each syndicator (see the appendix). Public funds consist of individual investors; corporate funds serve corporations and other institutional investors. Few (if any) public funds have been established since the mid-1980s.

Expiration of affordability restrictions

When the LIHTC program was first created, the federal government required all units funded with tax credits to remain affordable to low-income tenants for a minimum of 15 years—the 10 years in which investors received tax credits and 5 years thereafter. Failure to comply with income and/or rent restrictions during this period subjected investors to financial penalties in the form of credit recapture—repayment of tax credits, plus interest and other penalties. After 15 years of operation, owners were allowed to charge any rent to tenants with any income, unless the property was subject to additional affordability restrictions besides those imposed by the program itself. In fact, many of these properties are subject to additional restrictions. For example, 28 percent of all tax credit properties and units put into service through 1989 also received financing under the Section 515 program through the Federal Farmers Home Administration (later renamed Rural Housing Services), which required 50 years of affordability (Collignon 1999; HUD 2007c). In addition, a substantial number of early tax credit projects carried Section 8 Moderate Rehabilitation subsidies, which also extended affordability restrictions (Smith 2002). Further, local and state governments have imposed additional restrictions that extend beyond year 15 as well (Collignon 1999; Craycroft 2003).

The most recent and comprehensive database of tax credit projects indicates that of the nearly 26,000 properties developed through 2004 (more than 1.4 million units), about 19 percent were put into service before 1990 (HUD 2007c). These developments, however, account for less than 11 percent of all units, reflecting the smaller average size of pre-1990 developments. David Smith, Principal of Recapitalization Advisors, a leading consultant on the preservation of tax credit and other types of subsidized housing, estimates that roughly half of these early projects are not subject to additional affordability restrictions and are at risk of conversion to higher rents (2002).⁷

In 1989 and 1990, Congress passed two measures designed to preserve the affordability of tax credit housing. The Revenue Reconciliation Act of 1989 requires properties completed after that date to maintain their original affordability requirements for an additional 15 years after the expiration of the initial compliance period. However, as will be discussed later, the law does not specify how these additional restrictions should be enforced, and it allows owners to opt out under certain circumstances. The Omnibus Budget Reconciliation Act of 1990 further strengthened the prospects for long-term

⁷His estimates are based on “personal experience and knowledge” offered in the absence of “better data” (Smith 2002, 25).

affordability by granting qualified nonprofit groups, tenant organizations, and public agencies the right of first refusal to acquire tax credit properties at below-market prices—determined by total outstanding debt and any capital gains (exit) taxes due at the time of sale (Collignon 1999; “Year 15 Nonprofit Disposition Strategies” 2004).

These two laws significantly improve the prospects for continued affordability of tax credit housing beyond year 15. In addition to extending the affordability period, they make it easier for properties to be acquired by organizations with an interest in maintaining long-term affordability. However, while these laws make it far more difficult for owners to convert properties to market-rate occupancy, they by no means guarantee long-term affordability or viability. Under some circumstances, the extended compliance period can be waived if the current owner wishes to sell the property and neither the owner nor the state housing finance agency can find a buyer willing to pay the price. Similarly, it may not always be financially possible for nonprofit organizations or government agencies, even with the right of first refusal, to purchase these properties after year 15.⁸ Further, even if current or new owners agree to maintain a property for the full extended compliance period, it is not always clear how these obligations will be monitored or enforced. After the initial 15-year affordability period expires, owners do not have to report tenant income or rents to the IRS and are not subject to any federal penalty for violating extended affordability restrictions. Enforcement is a matter for state housing finance agencies (Collignon 1999; Craycroft 2003).

The 1989 Revenue Reconciliation Act allows for the termination of the extended compliance period under one circumstance. A current owner who wishes to sell a tax credit property can request that the state housing finance agency find a buyer willing to pay the qualified contract price. This price is based on the investor’s initial equity payments, adjusted for inflation (but not to exceed an annual rate of 5 percent), plus the outstanding mortgage debt, less any capital distributions and available distributions. The state housing finance agency has 12 months to find a buyer willing to purchase the property at the qualified contract price. This buyer would then be required to abide by the program’s rent and income restrictions—although, as pointed out earlier, these restrictions would no longer be enforced by the IRS. If no buyer can be found, the property can be sold for any amount and the extended compliance period is waived. Current tenants, however, are protected from eviction and

⁸The right of first refusal gives someone the opportunity to purchase a property before it goes on sale in the open market.

excessive rent increases for a minimum of three years after the property is sold (Collignon 1999; Shellan 2001a, 2001b; Smith 2002).

Qualified contracts pertain mostly to tax credit properties with for-profit general partners. As noted earlier, nonprofit developers generally have the right of first refusal to purchase the property for outstanding debt and exit taxes. A nonprofit with the right of first refusal would presumably exercise its qualified contract option only if it does not desire to maintain ownership. This could happen if the nonprofit cannot secure the resources to purchase the property under the terms of its right of first refusal, if financing necessary capital improvements is not feasible, or perhaps if the sale of the property at the qualified contract price would generate revenue that could be used for new housing development (Collignon 1999; Christensen 2004; Enterprise Community Investment, Inc. 2007, as well as the syndicator interviews).

Although few tax credit properties have as yet become eligible for qualified contracts⁹ and states are still refining applicable regulations and procedures, most experts on tax credit housing do not believe that the opt-out provision will see much action (Bodaken interview; Smith 2002). Perhaps most important, increased competition for tax credits has enabled many if not most state housing finance agencies to discourage developers from exercising their right to seek a qualified contract (Christensen 2004). In evaluating applications for the LIHTC program, some state housing finance agencies give extra weight to proposals that waive the developer's right to return the property to the state for a qualified contract. Others explicitly reject proposals that do not waive this option (Bodaken and Hughes interviews; National Housing Trust 2007). California, for example, requires all developments with 9 percent tax credits to remain affordable for a minimum of 55 years, while developments with 4 percent credits usually have 30-year affordability requirements (California Housing Partnership Coalition 2001). The key exception in this regard consists of projects financed with tax-exempt bonds and 4 percent tax credits. Unlike other projects, these developments are automatically eligible for tax credits and are therefore not subject to the same application and review process.

In addition to having developers relinquish their right to a qualified contract, some state housing finance agencies have adopted regulations and pro-

⁹The first properties to be eligible for qualified contracts would have been allocated tax credits in 1990. To the extent that these properties were also put into service that same year, they would have reached year 15 by December 2004 at the earliest. Most tax credit developments, however, are put into service one to two years after the initial allocation of credits. Therefore, owners are not likely to have requested qualified contracts before 2006.

cedures that will make it administratively onerous and expensive for owners to exercise the option. For example, the North Carolina Housing Finance Agency (2004) requires owners to submit the following documentation as part of their request:

1. First year 8609s (a federal tax form for certification of low-income housing tax credit projects)
2. Annual partnership tax returns for all years of operation since the beginning of the compliance period
3. Annual property financial statements for all years
4. Loan documents for all secured debt during the compliance period
5. Partnership agreements (original, current, and all interim amendments)
6. Physical needs assessment for the entire property
7. Appraisal of the entire property
8. Market study for the entire property
9. Title report
10. Phase I environmental impact study (with a phase II study if necessary)

Requests for qualified contracts will most likely involve a subset of properties that have for-profit general partners and were completed before the mid-1990s—that is, before state housing finance agencies started to give priority to applications that waived the owner’s right to seek a qualified contract. Owners of such properties will be especially motivated to seek a qualified contract when the property is located in a market in which it could command significantly higher rents if the affordability restrictions were removed or when the value under the affordability restrictions is less than the qualified contract price (Christensen 2004). In the first instance, the owners see the potential to realize a sizable capital gain if rent and income restrictions are lifted. In the second, with the qualified contract price greater than the fair market value, it becomes extremely difficult to obtain adequate financing without a substantial subsidy.¹⁰ The second scenario is likely to play out more often than the first.

¹⁰ Lenders usually will not issue mortgages that exceed a specified percentage (loan-to-value ratio) of a rental property’s estimated value, usually 70 to 80 percent. If the value is less than the qualified contract price, financing will be limited to about 80 percent or so of the estimated market value, requiring the buyer to obtain additional funds to cover the difference between the maximum mortgage allowed and the qualified contract price.

Relatively few tax credit developments are situated in the most expensive housing markets, where the financial incentive to convert to market-rate rents would be highest. As shown in table 4, about 38.4 percent of all the developments put into service after 1989, accounting for 47 percent of all units, are located in metropolitan areas with fair market rents (FMRs) in the top quintile of such rents for 2004 (starting at \$816).

However, only 3 percent of these properties, and 2 percent of total units, are located in census tracts where median rents equal or exceed the metropolitan median. The great majority of such properties in the most expensive metropolitan housing markets are situated in neighborhoods with relatively low rents. As the penultimate column in table 5 shows, 68 percent of all tax credit properties in the most expensive metropolitan areas are located in census tracts where median gross rent is less than 90 percent of the metropolitan median and 28.6 percent are in tracts where gross rents vary from 90 to 99.9 percent. Only 3 percent of all properties are in tracts with median rents ranging from 100 to 114.9 percent of the metropolitan median, and no properties are located in tracts with rents above that percentage. Table 5 shows that high-rent census tracts account for a very small share of tax credit properties in all housing markets, with 6 percent of all properties located in tracts with gross rents at or above the metropolitan median.

Acquisition and rehabilitation of tax credit properties

Although affordability restrictions can extend for 30 or more years, this does not mean that housing will remain under the same ownership during this entire period. In many cases, properties will be sold at or around year 15. The costs of acquiring, and if necessary, renovating this housing will play a large part in determining the amount of public and private funding necessary for preservation.

Tax credit housing owned by limited partnerships is especially likely to be sold well before the end of the affordability period. The primary and in some cases only financial benefit investors in these limited partnerships receive is the tax credit. Limited partners receive credits for 10 years. After that, they receive little if any financial benefit, and in some cases, as several syndicators emphasized, the property becomes a nonperforming asset that is a liability to their balance sheet. As a result, investors have little incentive to hold onto properties for more than 15 years. In some cases, investors do not want to wait 5 years to dispose of their interest after the tax credits have expired. In such situations, limited partnerships can sell properties before year 15 if they take out a bond to insure against financial penalties if the

Table 4. Percent Distribution of Tax Credit Developments and Units Put into Service from 1990 through 2002 by FMR Quintile

Metropolitan FMR Quintile (2004)	Developments (N = 10,131)	Units (N = 800,890)
Less than \$513	5.5	3.8
\$514 to \$573	9.2	7.6
\$574 to \$643	18.3	14.3
\$644 to \$815	28.6	27.4
\$816 and Higher	38.4	47.0
Total	100	100

Sources: HUD (2007a, 2007b, 2007c).

Note: Totals may not equal 100 percent because of rounding.

property subsequently violates income and rent restrictions. As noted in the interviews, at least one syndicator will help individual limited partners sell their shares on the secondary market after year 10 or earlier and knows of certain companies that will purchase an interest in limited partnerships.

The interviews revealed that limited partnerships vary in the terms and expectations governing the sale and disposition of tax credit properties. In general, limited partners do not expect to realize capital gains from selling the property. However, most (if not all) syndicators consider it their fiduciary responsibility to sell properties for the highest price the market and tax credit regulations will allow; if a property has residual value by year 15, most syndicators say they need to capture it for their investors.

In some cases, limited partnerships were structured so that the partners would be individually responsible for any capital gains taxes owed when the property is sold. In others, the syndicator or buyer is responsible. In such instances, capital gains or exit taxes can be a major challenge to the preservation of tax credit housing. The higher the tax, the more difficult and costly it may be to acquire the property for continued low-income occupancy. Exit taxes occur when investors in limited partnerships have a negative balance in their capital accounts at the time of sale. In simplified terms, capital accounts represent the total equity that the limited partner invested in the property minus subsequent losses. These losses reflect the difference between net operating income (rent and other income, less maintenance, insurance, and other operating costs) and depreciation, interest, and related expenses. The capital account decreases when depreciation, interest, and related expenses exceed net operating income. No exit taxes are due when capital accounts are positive; they are levied when the account turns negative. In other words, investors must pay exit taxes when their cumulative tax losses exceed the amount of capital invested (“Year 15 Nonprofit Disposition Strategies” 2004).

Table 5. Tax Credit Developments and Units Put into Service from 1990 to 2002 by FMR Quintile in 2004 and Median Gross Rent in Census Tract Relative to the Metropolitan Median (Percent Distribution)

Gross Rent in the Census Tract as a Percentage of the MSA Median (1999)	FMR Quintiles in 2004 (Monthly Rent)					Total
	Less than \$513	\$514 to \$573	\$574 to \$643	\$644 to \$815	\$816 and Higher	
Developments						
Less than 80%	8.1	5.6	1.4	0.3	4.7	3.1
80 to 89.9%	17.5	22.2	30.2	31.9	63.7	42.1
90 to 99.9%	47.2	58.7	62.1	62.9	28.6	48.3
100 to 114.9%	26.2	11.7	6.4	4.5	3.0	6.1
115% and higher	0.9	1.9	0.0	0.3	0.0	0.3
Total	100.0	100.0	100.0	100.0	100.0	100.0
N	553	934	1,850	2,902	3,892	10,131
Units						
Less than 80%	5.2	6.1	1.2	0.4	6.2	3.9
80 to 89.9%	18.4	20.4	32.8	37.4	55.7	43.3
90 to 99.9%	49.8	62.3	59.8	56.4	36.1	47.5
100 to 114.9%	25.7	10.3	6.3	5.6	2.0	5.1
115% and higher	0.9	0.9	0.0	0.3	0.0	0.2
Total	100.0	100.0	100.0	100.0	100.0	100.0
N	30,728	60,377	113,877	241,499	354,409	800,890

Sources: HUD (2007a, 2007b, 2007c) and U.S. Bureau of the Census 2007.

Note: Totals may not equal 100 percent because of rounding.

MSA = metropolitan statistical area.

Tax credit developments put into service before 1990 are subject to fewer restrictions on their sales price than more recent projects. Unless a pre-1990 development is subject to additional affordability restrictions extending beyond year 15, owners are free to seek whatever price the market will bear. However, many pre-1990 limited partnerships with nonprofit general partners—including most partnerships established by ESIC and NEF—allow the general partner to acquire the limited partners' interest for the greater of fair market value or the sum of the outstanding debt and, in most cases, the limited partners' capital gains taxes. Fair market value is calculated by capitalizing the net operating income. If the property is not subject to extended affordability requirements after year 15 and is likely to attract higher-income tenants, it will probably need to be purchased for fair market value.

The Omnibus Budget Reconciliation Act of 1990 gave nonprofit organizations, tenant groups, and public agencies the right of first refusal to acquire tax credit properties with nonprofit general partners for the sum of outstanding debt plus any capital gains (exit) taxes—without having to pay fair market value. While the organization with the right of first refusal may

sometimes be able to assume the outstanding mortgage, it will almost always need financial resources to cover the seller's exit taxes.

Exit taxes can therefore be a key issue in preservation. They are particularly acute for the earliest projects and for those that have nonprofit general partners and are syndicated by ESIC and NEF. These two together accounted for more than 105,000 tax credit units by 2004 (see table 3).

Because investors paid substantially less for tax credits in the early years of the program than later on, the capital accounts of the earliest limited partnerships typically started with smaller initial balances. As a result, it takes less depreciation and other losses to produce a negative balance, and thus exit taxes, by year 15 than would be the case for more recent limited partnerships, as shown in the simplified examples in table 6.

In the first example, with an initial investment of \$600,000 and annual losses of \$75,000, an investor's capital account by year 15 would be negative \$525,000, requiring the investor to pay capital gains taxes on this amount. However, in the second example, the investor would not be liable for any capital gains taxes. With an initial investment of \$1 million (reflecting a higher price per credit) and annual losses of \$60,000 (reflecting lower interest payments because of a smaller mortgage together with improved property management, which can increase net operating income), the investor would have a positive balance of \$100,000 by year 15.

When capital gains taxes are paid on behalf of the limited partners, exit taxes must also cover the additional tax owed by the limited partners because the capital gains tax is paid by a third party. In other words, payment of capital gains taxes by the syndicator or another third party constitutes taxable income for the limited partners (LISC New York City 2003; "Year 15 Nonprofit Disposition Strategies" 2004).

Early nonprofit projects are particularly vulnerable to exit taxes. One reason is that developments sponsored by nonprofits are more likely to be underwritten with deferred-interest loans than for-profit projects. To reduce a project's debt servicing costs, state and local governments and other lenders have provided nonprofit developers with low-cost financing, which in addition to below-market interest rates can allow for the deferral of interest payments. When interest obligations are deferred, they add to the losses on the limited partners' capital accounts, since the deferred interest payments are added to the loan principal and thus increase total interest charges over time.

Nonprofit-sponsored tax credit properties are more likely to require payment of exit taxes for another, less widely appreciated reason. ESIC and NEF have always marketed limited partnerships to corporate investors. By

Table 6. Hypothetical Examples of Two Tax Credit Capital Accounts

	Example 1	Example 2
Equity investment	\$600,000	\$1,000,000
Annual losses	\$75,000	\$60,000
Total losses by year 15	\$1,125,000	\$900,000
Capital account by year 15	(\$525,000)	\$100,000

contrast, the major syndicators of for-profit developments did not target corporate investors until around 1993 (E & Y Kenneth Leventhal Real Estate Group 1997; Smith 2002; syndicator interviews). Before then, their limited partnerships consisted almost entirely of individual investors. The distinction is important. While the Tax Reform Act of 1986 prohibited most individuals from using depreciation and other passive losses to reduce their taxable income, corporations had no such restriction. As reported in the interviews, individual limited partners who are not being allowed to take depreciation are not likely to have negative capital accounts and therefore do not have to pay exit taxes on the sale of the property. In fact, when the property is sold, individual investors can use any negative balances (suspended losses) on their capital accounts to offset capital gains and thereby reduce or eliminate exit taxes.¹¹

The for-profit syndicators interviewed for this article do not anticipate that exit taxes will be a major problem for their investors, a finding consistent with the views of other observers (e.g., Shellan 2001a, 2001b). In most cases, exit taxes were included in the original underwriting of the limited partnerships, although investors may need to be reminded of this. Also, most felt that the amount of the exit taxes that would be required would be quite manageable for their large corporate investors.

*Exit tax mitigation strategies.*¹² Exit taxes are a key concern for many properties developed by nonprofit organizations. ESIC and NEF, along with smaller syndicators of nonprofit-sponsored properties, have devised several strategies to reduce the amount of exit taxes owed by the end of year 15,

¹¹The Tax Reform Act of 1986 severely limited the ability of individual investors to use losses from real estate to reduce their taxable income from other sources (salary, interest, dividends). Real estate-related losses could be used to offset income only from other passive investments (i.e., real estate). Most often, these investors have no other passive income to offset. However, capital gains from the sale of real estate do count as passive income, which can be reduced by the investor's cumulative passive losses (Hyman 1992).

¹²This section is based largely on interviews with the syndicators. See also "Year 15 Non-profit Disposition Strategies" (2004).

when most limited partners will want to dispose of their interest. The syndicators' key objective is for limited partners to have a zero balance in their capital accounts by the end of year 15. If capital accounts have turned negative several years before then, syndicators will look for ways to bring the balance as close to zero as possible.

One way to increase the capital accounts of limited partners is debt reduction. When a lender forgives all or part of a mortgage loan, the capital account is increased by the elimination of accrued interest obligations. Some of the state and local government agencies that provided loans for the development of tax credit projects were not especially interested in receiving timely payments of interest and principal; many would have been willing to provide the funds as grants, but LIHTC program regulations discourage the use of grants. Therefore, some lenders can be convinced later on to forgive all or part of their loans. However, debt forgiveness constitutes taxable income for the borrower. As a result, the benefits of debt forgiveness in reducing exit taxes in the future must be weighed against the prospect of increased tax liability in the short term.

Another mitigation strategy is to reallocate up to one-third of the limited partners' interest to the general partner. This procedure reduces the amount of losses (depreciation, interest) that will accrue on the capital accounts of limited partners. This approach is most appropriate when total losses exceed the amount originally anticipated in the partnership's development pro forma. Federal regulations prohibit the transfer of more than one-third of a limited partner's interest; any additional transfer can subject the owner to financial penalties (credit recapture).

A third strategy is to stagger the sale of properties controlled by the same limited partnership. Instead of transferring each development during the same year, postponing the sale of some properties to the following year can, in some circumstances, allow the capital gains for some properties to be offset by the losses engendered by other properties.

"Bargain sales" constitute yet another way of reducing the exit taxes on a property. If at the end of year 15 the fair market value exceeds the sum of total debt and exit taxes, the donation of this excess fair market value (the sale for debt and exit taxes) counts as a charitable donation that can be used to offset capital gains/exit taxes.

Improved property management can also help lower exit taxes by reducing annual losses. Moreover, improved property management can help increase revenues by reducing the vacancy rate and rent arrears and can decrease operating expenses, thereby increasing net operating income and reducing annual losses.

Syndicator perspectives on exit taxes. Syndicators differ widely in their perspectives on exit taxes. ESIC and NEF, along with the Chicago Equity Fund, see exit taxes as a serious challenge that requires careful planning to preserve tax credit housing. Exit taxes have so far not commanded as much attention from the five for-profit syndicators, in large part because their first tax credit developments were structured as public limited partnerships targeted to individual investors. Few if any of these investors will need to pay capital gains taxes when the properties are sold. Some of the syndicators' corporate funds could be faced with exit taxes, but they were not established until the early 1990s and had yet to reach year 15 by the time this research was completed. Investors in other funds, especially those established since the mid-1990s, may not be subject to any exit taxes at all. As the price commanded by tax credits increased over time, investors in more recent funds started with larger capital accounts, which reduced the likelihood of reaching a negative balance. Even if limited partners do have a negative balance, several syndicators do not believe that their corporate investors will object to the resulting exit taxes because they were incorporated into the original underwriting of the limited partnerships (the taxes were factored into total financial returns) and are not likely to be particularly onerous. Moreover, many of the syndicators' more recent corporate investors are financial institutions whose desire to maximize their financial return is tempered by their objective to support affordable housing (and receive Community Reinvestment Act credit for doing so).¹³

Capital improvements

The preservation challenges for tax credit housing are by no means limited to the expiration of affordability restrictions or the acquisition of properties from limited partners. The most formidable challenge of all, at least for some projects, concerns the financing of necessary physical improvements. After 15 years, virtually any building will need replacement and upgrading of major systems:

Properties older than 10 years will generally have cycled through their appliances' useful lives. By age 15, the property may need

¹³In a report prepared for the National Council of State Housing Finance Agencies, the accounting firm Ernst & Young (2003) estimates that nonfinancial companies comprised only 8 percent of the tax credit market as of 2002. Banks alone constituted 42 percent; Fannie Mae, Freddie Mac, and other government-sponsored enterprises accounted for 30 percent; and insurance companies and other financial services accounted for about 19 percent.

new siding or a new roof. Structural and mechanical systems start to require significant upgrade and replacement by years 20 or 25. (Smith 2002, 22)

Properties financed in the first years of the tax credit program are likely to be in particular need of capital improvements. According to the syndicator interviews, the tax credit generated less equity than later on, so projects tended to involve moderate amounts of renovation as opposed to the new construction and gut rehabilitation that was to characterize most tax credit developments from the mid-1990s onward. As a result, they will typically require more rehabilitation by year 15 than later tax credit projects. Making matters worse, the earliest developments are less likely to have reserve funds available by year 15 to help pay for capital improvements. The earlier projects tended to be underwritten with smaller reserve funds than later projects, and these reserves have often been exhausted well before year 15. According to an official at a large for-profit syndicator, about 25 percent of the tax credit portfolio needs substantial rehabilitation and financial “work-outs” (refinancing, often with public assistance). Most of these properties are located in the inner city and had undergone moderate rehabilitation with tax credit financing.¹⁴

Strategies for financing the acquisition and rehabilitation of tax credit properties

Properties first began reaching year 15 in 2003, when the affordability restrictions on properties put into service in 1987 expired. The national syndicators interviewed for this article reported that they had sold or otherwise transferred about 300 of their properties through the end of 2004 (see table 3) and expect to dispose of a growing number in subsequent years.

The syndicators have almost always sold year 15 properties to the general partner; the primary exception is when the general partner is retiring or is otherwise not interested in assuming control. Depending on the circumstances, properties are transferred to the general partners either by the sale of the property or by the sale of the limited partners' interest. In the first case, the limited partnership is dissolved and the general partner becomes the full owner. In the second, the limited partnership remains in effect, but the general partner owns all of the shares. One advantage of the latter approach is that it allows reserves to remain intact; if the property is sold, reserves may be distributed to the limited partners (LISC New York City 2003).

¹⁴A survey of expiring tax credit properties in Ohio found that 12 percent of them were in fair condition and 1 percent were in poor condition (Dresser and Duffy 2001).

In most cases, the syndicators report that post-year 15 properties have remained affordable to the original target population and have seldom been converted to market-rate occupancy. In the few instances when properties have shifted to a higher-income tenants, the change is usually fairly modest. New residents seldom have incomes much above 80 percent of the area median; conversion to luxury housing is highly unusual.

So far, few post-year 15 properties have been converted from rental housing to condominiums, cooperatives, or other forms of owner-occupancy. Of the seven national syndicators, only ESIC reported a change in tenure. A scattered-site development in Cleveland consisting of multiple small buildings was sold to the general partner, which in turn sold units to individual tenants on a lease-purchase basis. The Chicago Equity Fund, however, has indicated that it converted several buildings into condominiums, using the proceeds to retire the first mortgage on the other rental buildings in the partnership and cover any remaining exit taxes.

In their interviews, the syndicators discussed a wide range of ways to finance the acquisition and renovation of tax credit properties held by limited partnerships. The options depend in large part on the financial and physical condition of the property, the strength of the local housing market, and the availability of additional tax credits and other funding sources.

When properties need physical rehabilitation, it will usually be necessary to recapitalize. To help meet this need, a growing number of states have made the preservation of year 15 properties a priority in their allocation of new tax credits. A survey of state housing finance agencies that was completed in December 2003 identified 15 states that had earmarked a portion of their annual tax credit allocations for the preservation of existing properties or that give extra weight (bonus points) in their assessment of applications to those that will preserve existing developments (National Council of State Housing Finance Agencies 2004). According to the interview with John Hughes, the survey also found that several other states are actively considering similar changes in their future allocations of tax credits. The National Council of State Housing Agencies (2004) reported that in 2003, 32 states provided new tax credits to a total of 222 existing tax-credit developments “at risk of losing their affordability” (64). It should be noted, however, that if the incomes of existing tenants have increased above 60 percent of the area median, the amount of new tax credits will be reduced.¹⁵

¹⁵As explained previously, a property’s qualified basis is determined by the percentage of units occupied by low-income households.

Several syndicators said that the availability of tax credits for preservation of year 15 properties allowed for higher purchase prices than for-profit buyers would offer. In California, for example, one for-profit syndicator reported that nonprofit sponsors with tax credit funding offered over \$1 million more for a year 15 development than for-profit bidders without access to tax credits did.

Besides new tax credits, other public subsidies have been used to finance the acquisition and improvement of year 15 properties. One syndicator, for example, has used tax-exempt bonds (presumably also with automatic 4 percent tax credits) to recapitalize year 15 projects. Others have used grants and loans provided by state and local government agencies and philanthropic organizations.

According to the syndicator interviews and other researchers, the most common way to finance the acquisition of post-year 15 properties is for the general partner to refinance the mortgage and use the proceeds to retire the original debt and pay for capital improvements and any necessary exit taxes (Christensen 2004; Enterprise Community Investment, Inc., 2007; Shellan 2001a, 2001b). Refinancing is especially advantageous when the interest rate on the original mortgage is considerably higher than the prevailing rate. Refinancing, of course, is feasible only when the cash flow can support a larger mortgage. In some instances, cash flow can finance capital improvements incrementally. This is especially true for properties that have retired their mortgages and thus can use the revenue that previously covered debt service for capital improvements.¹⁶

In a handful of cases, a property's remaining reserve funds—if any—can be used to pay for necessary capital improvements. However, the syndicators report that most of the early tax credit properties do not have substantial reserves (if any) left at the project or fund level by year 15, and any such reserves often belong to the limited partners. Unless otherwise specified by the mortgage lender, reserves are the property of the limited partnership and are to be distributed to them at the time of sale. However, if the limited partnership is not dissolved after year 15 and the general partner acquires the limited partners' shares instead, it may be possible to access reserve funds for capital improvements. Otherwise, reserves should be used for capital improvements before year 15 (LISC New York City 2003; Shellan 2001a, 2001b).

¹⁶Early tax credit developments were often financed with mortgages that were coterminous with the 15-year tax credit compliance period. By the early 1990s, most projects were financed with longer-term mortgages (Collignon 1999).

The Chicago Equity Fund, by far the smallest of the syndicators covered in this study, was the only one to report having sold tax credit properties to cover the exit taxes for other tax credit properties within the same limited partnership. Unlike most others, the fund is responsible for paying exit taxes on behalf of its investors upon the disposition of its properties. With multiple-building partnerships, the fund has converted one building to “affordable” (affordable to buyers with incomes of 50 to 100 percent of the median family income) or market-rate condominiums and used the proceeds to pay off the first mortgage on the development and thus greatly reduce, if not eliminate, negative capital accounts and the necessity of paying an exit tax. The fund has also converted expiring tax credit properties to other uses, such as supportive housing and hotels.

The biggest preservation challenges, as seen by virtually all of the major syndicators, are faced by properties located in economically depressed areas with weak housing markets. In many rural areas as well as the old industrial communities of the Northeast and Midwest, maximum feasible rents cannot support mortgages large enough to cover necessary capital improvements. Relatively few properties are located in these areas, however. To estimate the extent to which tax credit properties are located in areas with especially weak rental housing markets, we sorted all of the nation’s counties into eight categories of equal size based on their percentage increase in FMRs from 1988 to 2006. Table 7 presents the distribution of tax credit units and developments across these categories. It shows that counties with the smallest increases in FMR (i.e., the bottom octile) account for 5.3 percent of all units put into service from 1987 through 2004 and that the next-lowest octile accounts for 5.6 percent more. By contrast, counties with the largest relative increases in FMR (the top octile) account for 28.6 percent of all units. The next-highest octile claims 16.6 percent. Projects located in counties with the lowest FMR increases are more likely to be situated in rural or nonmetropolitan areas than developments located in counties with the largest increases. About one-third of all tax credit units in counties with the weakest housing markets are outside metropolitan areas, compared with less than 4 percent of the units in counties with the strongest markets.

In addition to the weakness of local housing markets, another challenge concerns properties with large amounts of deferred debt due as a balloon payment. Many state and local governments provided such loans as part of the original underwriting. If rent rolls are not high enough to refinance these loans and also cover essential capital improvements, the syndicators indicated that these properties will require new some form of subsidy if they are to remain viable.

Table 7. Distribution of Tax Credit Units Put into Service between 1987 and 2004 by Percent Change in County FMR, 1987 to 2006

Percent Change in County FMR, 1987 to 2006	Units and Developments Distribution of LIHTC		Percentage of Units and Developments in Nonmetropolitan Areas	
	Units	Developments	Units	Developments
Less than 35.6%	5.3	11.5	31.3	46.2
35.6 to 43.3%	5.6	11.5	35.2	43.3
43.4 to 50.1%	8.1	14.6	33.0	50.6
50.2 to 55.4%	9.9	12.8	16.1	25.7
55.5 to 61.4%	9.0	13.6	25.1	35.4
61.5 to 70.5%	17.0	12.5	11.7	24.7
70.6 to 80.8%	16.6	9.6	6.4	13.9
More than 80.8%	28.6	13.9	3.6	6.0
Total	100.0	100.0	14.2	25.3

Sources: HUD (2007a, 2007c).

Note: Totals may not equal 100 percent because of rounding.

The syndicators believed that it is less difficult to preserve the affordability of year 15 properties in the most expensive housing markets—largely because political pressure to preserve the housing is highest in these environments and more resources are likely to be available for preservation.¹⁷

Conclusions

The preservation of tax credit housing is not likely to be as formidable a problem as it was for housing funded through previous federal subsidy programs (Achtenberg 2002; Schwartz 2006). The housing most at risk was developed in the first three years of the program, and about half of these developments are subject to additional affordability restrictions that extend beyond 15 years. Housing put into service since 1990 enjoys an additional 15 years of required affordability, although these restrictions may be waived if current owners wish to sell the property and a purchaser who is willing to maintain these standards cannot be found.

¹⁷The year 15 outcomes reported by the syndicators are similar to those found in a recent study of tax credit housing by Ernst & Young (2006). Using a survey of 31 syndicators and other investors, the study examined the financial performance of more than 15,000 tax credit properties, of which 470 had reached year 15. Of these, 142 had been sold or otherwise disposed of. Only 9 percent of the latter had been converted to market rents. More than half had been resyndicated with new tax credits, and one-quarter were refinanced without tax credits for continued low-income affordability. An additional 12 percent were preserved using other strategies (Ernst & Young 2006).

While the expiration of affordability restrictions poses one challenge to the preservation of tax credit housing for low-income renters, it is less daunting than the need to finance the acquisition and physical improvement of tax credit properties after year 15. Affordability protections of even the longest duration will mean little if no resources are available to purchase the property from the original owners and invest in its continued physical viability. Of particular concern are properties whose rent rolls are too small to support a mortgage large enough to finance the cost of acquisition and capital improvements. Most vulnerable are early properties that underwent only moderate rehabilitation and that are located in weak housing markets, as well as properties with large amounts of outstanding debt due as a balloon payment.

Fortunately, most tax credit housing is not in dire straits. Indeed, according to the syndicator interviews and Ernst & Young (2006), most is in decent condition—financially and physically. Over time, as tax credits commanded increasingly high prices, more money was invested in these developments, making more new construction and more substantial rehabilitation as well as larger reserve funds possible. The syndicators feel that most properties will be able to carry a mortgage large enough to finance the cost of acquisition and physical improvements. When acquisition and rehabilitation costs cannot be covered by refinancing, new sources of subsidy are often available. A growing number of state housing finance agencies are providing new tax credits as well as tax-exempt bonds to help preserve tax credit housing.

From a public policy perspective, as Collignon (1999), Craycroft (2004), and others have emphasized, year 15 accentuates the need for state and local governments to balance carefully the goals of preserving and expanding the stock of affordable housing when allocating scarce subsidy dollars. Equally important, states need to establish new and effective ways of enforcing affordability periods that extend beyond year 15. While the IRS can penalize properties that violate income and/or rent restrictions during the first 15 years, the enforcement of subsequent restrictions is completely in the hands of state housing finance agencies. They will need to devise effective ways of monitoring and enforcing long-term affordability requirements, or else extended affordability might be honored only in the breach.

*Appendix*Interviews¹⁸

Syndicators

Boston Capital

Jeff Goldstein, Chief Operating Officer
Katie Alitz, Vice President for Dispositions
Steve Spall, Senior Vice President
Telephone interview, May 3, 2004

Katie Alitz, Telephone interview, May 18, 2004

Chicago Equity Fund

Bill Higgenson
President and CEO
Telephone interview, October 13, 2004

Enterprise Social Investment Corporation (ESIC)

John Brandenburg, Managing Director, Asset Management
Greg Griffin, Senior Asset Manager and Year 15 Coordinator
Telephone interview, May 28, 2004

Greg Griffin, Director, Asset Management
Marian O'Connor, Director and Tax Counsel
Telephone interview, March 18, 2005

MMA Financial

Mike Gladstone, Principal
Ken Mehring, Vice President
Telephone interview, June 8, 2004

National Equity Fund

Judie Schneider, Vice President and Chief Credit Officer
Alice Nicholson, Disposition Manager
Telephone interview, May 25, 2004

¹⁸Affiliations and titles are as of the date of the interviews.

Paramount Financial Group

Michelle Sauer, Chief Financial Officer and Senior Vice President,
Financial Operations
Telephone interview, October 4, 2004

Related Capital/CharterMac

Stephen Rodger
Vice President
Telephone interview, May 24, 2004

The Richman Group

David Saltzman
Executive Vice President
Telephone interview, May 14, 2004

Others**National Council of State Housing Finance Agencies**

John Hughes, Senior Legislative and Policy Associate
Telephone interview, June 15, 2004

National Housing Trust

Michael Bodaken, President
Telephone interview, June 8, 2004

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