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Low-income housing tax credit workouts and bankruptcies: Understanding the basics

Note: This post is the first in a continuing series on the Credit Report Blog on the subject of workouts and bankruptcies involving low-income housing tax credit (LIHTC) projects.

Over the last several years there has been an increase in defaults in loans made to finance affordable housing projects. Many of these projects involve a blend of senior debt financing from a bank lender and investor equity obtained through the sale of low-income housing tax credits (LIHTCs) awarded for the project. When these projects fail, they present unique restructuring and insolvency issues. This blog post is meant to familiarize the reader with the basic concepts of LIHTC financing that must be understood before becoming involved in workouts or bankruptcies involving LIHTC projects.

Our upcoming blog posts will discuss specific issues unique to LIHTC project workouts and bankruptcies.

What is the LIHTC program?

As part of the Tax Reform Act of 1986, Congress established the federal LIHTC program to incentivize the acquisition and development of affordable housing. Under this program, federal tax credits are awarded to a developer in consideration of the developer's commitment to lease a fixed portion of units in a housing project to low-income tenants. Various states have state low income housing tax credit programs that award state tax credits and mirror the federal program in many respects. Both the federal and, where applicable, state programs are administered at the state level by the designated housing finance agency for each state.

When a project is initially approved, tax credits are allocated to the project by the state housing agency. The aggregate amount of tax credits allocated to a project is based on the qualified costs of the project and the amount of units dedicated to low-income tenants. The tax credits are earned in equal installments over a 15-year compliance period, but may be claimed on an accelerated basis over a 10-year tax credit period, beginning when the project is placed in service. When used, the credits reduce the tax liability of the taxpayer on a dollar-for-dollar basis.

A developer may claim the tax credits directly, but most developers do not have an immediate use for the credits and sell them to raise equity capital for the project. The developer can sell the right to receive the credits either directly to an investor or to a syndicator, who assembles a group of investors and acts as their representative. Importantly, however, the credits cannot be sold outright because they are earned by the project on a yearly basis and must be claimed by a party with an interest in the project.

As a result, a "sale" of the credits is structured as a sale of an equity interest in the project and the tax credits are allocated pursuant to the entity organizational documents to the purchaser/equity investor at the end of each year in which credits may be claimed over the 10-year tax credit period. In the event that the project is sold or foreclosed upon, the right to receive any future credits that may be claimed will pass to the new owner of the project, assuming continuing compliance with the applicable conditions/restrictions on the project.

Rent and occupancy restrictions

As a condition to receiving tax credits for a project, the developer must agree to lease a certain portion of units to tenants that meet specified income limitations at a rental rate fixed by the state housing agency. At a minimum, the developer must set aside either 40% of the units for residents that earn no more than 60% of the area's median income or 20% of the units for residents earning 50% or less than the area's median income. Many developers agree to greater restrictions in order to induce the state housing agency to award tax credits for their project.

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The rent and income restrictions on the project initially extend for 15 years from the date that the project is placed in service, but the project must also maintain the rent and income restrictions for an additional 15-year period known as the "extended use" period. The restrictions are evidenced by a Land Use Restriction Agreement (LURA) that is recorded as an encumbrance against the property and is generally binding on a subsequent owner of the property.

One exception to the binding nature of the LURA is that it typically may be foreclosed away by the secured lender on the project. Both the LURA and federal law provide that a foreclosure terminates the LURA, subject to the secured lender's compliance with a "decontrol period." The decontrol period is a 3-year period following a termination of the LURA, during which the secured lender may not (i) evict or terminate the tenancy of any low-income tenant other than for good cause, or (ii) increase the rent for any such tenant above the rent-restricted rate established by the state housing agency.

Typical ownership structure of LIHTC projects

The typical ownership structure for an LIHTC project is a limited partnership in which the tax credit purchaser/investor is a 99%+ limited partner. The general partner is responsible for managing the project and the partnership, while the limited partner is typically limited to a passive investment role. In today's market, investors typically pay anywhere from $.80 to $1.00 per dollar of federal tax credits allocated for a project, depending upon the quality of the project and the reputation of the developer.

If state tax credits are also awarded for the project, they are typically purchased by a different tax credit investor, who retains a small limited partnership interest in the project. State tax credits are considerably less valuable than federal credits because there is a much lower demand for state credits.

LIHTC project development and placement into service

The construction (or rehabilitation) of a project is generally financed by both senior secured debt, in the form of a construction loan, and by the tax credit investor's equity that is received in return for the right to receive the tax credits awarded for the project. Usually, both the senior debt and the investor's equity are advanced in installments as construction progresses. When the project is completed and placed into service, the final installment of the investor's equity is normally due and is used by the partnership to pay-down the senior debt to a "permanent" (long-term) amount, to fund various reserves required under the senior loan and to pay a fee to the project's developer.

Upon the paydown of the senior debt to the permanent loan amount, any guarantees given by the developer or its principals to the senior lender must terminate. This is a unique aspect of the federal tax credit program, which requires senior debt on LIHTC projects to be non-recourse following the placement of a project into service.

Once the project is placed into service, the state housing agency will review the construction and the cost allocations and, assuming the project is compliant, will issue IRS Form 8609 certifying the project and triggering the annual flow of the tax credits.

Tax credit recapture

Because the tax credits are paid out over a 10-year period but earned over a 15-year period, one-third of the tax credits received each year during the first 10 years of a project's life are unearned and subject to recapture in the event that the project fails to comply with the income and rent restrictions or is otherwise not in compliance with LIHTC regulations.

The closer the project approaches its 10-year anniversary, the greater the amount of credits that have been distributed to the investors that have not yet been earned and are subject to recapture. For example, if the project becomes non-compliant at the end of year 10, a full 5 years of credits will be subject to recapture.

Residual interest in the project

At the end of the 15-year compliance period, the tax credit investor will have received all of the tax credits for which it bargained and is no longer at risk of recapture. As a result, the investor typically exits the partnership by selling its interest in the project to the developer.

Check back with the Credit Report Blog to find out more about the issues that crop up when LIHTC projects go into default and bankruptcies and workouts occur.

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Click here to download a pdf of Mark Bossi's complete LIHTC book, which includes all posts in the LIHTC series.

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