

**Abandoning Affordability:  
Factors That Influence a Property Owner's Decision to  
Discontinue the Low-Income Housing Tax Credit Housing Program**

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**Abstract**

*After 22 years, the Low-Income Housing Tax Credit Program (LIHTC) has been responsible for development of approximately 1.7 million affordable rental housing units ("Low-Income", 2009). Developers of LIHTC properties must commit to a minimum 30-year affordability period (15 years of a LIHTC compliance period and a minimum 15 years of an Extended Use Agreement (EUA) period). The Internal Revenue Service monitors only the first 15 years for compliance.*

*Delta Associates reports that the 2009 first quarter Metropolitan Washington, D.C. region vacancy rate for investment grade, stabilized properties was 4.6%, lower than the national rate of 6.6%. Most suburban Virginia LIHTC properties in Metro DC are located in submarkets that will **need and qualify** for rental housing without income restrictions; therefore, property owners have options upon compliance expiration.*

*The first large cycle of LIHTC, developed from 1995 through 1999, possesses compliance periods that will start expiring in 2010. As this approaches, property owners must decide the fate of the property. Previous literature argues that properties most susceptible to market rate conversion are those that received "moderate rehabilitation and that are located in weak housing markets" (Schwartz & Melendez, 2008). This paper examines the likelihood of Virginia LIHTC properties in the healthy, sturdy market of Metro DC abandoning LIHTC at the end of their 15-year compliance period. It*

*reviews the impact of the following factors on the decision to abandon LIHTC: ability to increase rents and property value, initial decision for LIHTC (i.e. social responsibility to provide affordable housing, mandate by local jurisdiction to receive project approval, LIHTC inclusion provided the required return on investment and no social responsibility involved), perception of EUA, type of investment partner (i.e. non-profit), and due date of current financing.*

## **Introduction**

The Low Income Housing Tax Credit Program (LIHTC) was created by the Tax Reform Act of 1986 to provide an incentive for private production of low- to moderate-income housing. It was the first and only production program to replace the Section 8 New Construction / Sub Rehab program terminated in the early 1980s (Colton, 2003). The LIHTC program has been responsible for the approximately 25% of the multifamily construction nationwide (“Low-Income”, 2009).

Currently, the risk of the LIHTC expiration upon affordable housing stock is daunting. Upon the expiration of the compliance period, owners and investors are faced with decisions regarding the future of their properties. The concern of affordable housing advocates is the potential for LIHTC units to convert to market rate units. Properties susceptible for market-rate conversion are those that cannot meet debt payments, in need of significant capital improvements, or market valued more than nonprofits or housing finance agencies are willing/able to pay (McCloud, 2004). As the end of the initial 15-year compliance period approaches, property owners must decide the fate of the property. “Investors are likely to sell after 15 years rather than waiting the full 30 years, because there is no advantage to hanging onto the property once tax

credits are exhausted since few properties turn a profit” (McCloud, 2004). Posed with the thought of operating a property at a deficit without any tax benefit and realizing there is no accountability without the IRS monitoring, owners consider the future of properties – which may be to abandon affordability.

### **Low Income Housing Tax Credit Overview**

The LIHTC Program, which is based on Section 42 of the Internal Revenue Code, was enacted by Congress in 1986, to provide the private market with an incentive to invest in affordable rental housing. By offering a credit against tax liability or a dollar-for-dollar reduction in the amount of liability, LIHTC stimulates the production or rehabilitation of affordable units for low-income families by private developers and investors. LIHTC units provide housing to households with incomes less than 60 percent of the area median income (AMI) (“Low Income,” 2004). Tax credits have become the single most important source of capital subsidy in the development of affordable rental housing (Green & Malpezzi, 2003).

States fund the LIHTC through an annual allocation from the U.S. Treasury that is equal to \$1.95 per capita, with a minimum allocation of \$2 million for small states (“Low Income,” 2004). State housing finance agencies (HFAs) administer the LIHTC program through a Qualified Allocation Plan (QAP). A QAP provides the “framework for building and rehabbing low-income housing...helps to ensure that housing is built within the community context to meet overall community needs in a location that will, among other things, hopefully complement jobs” (Colton, p. 466). HFAs allocate credits through a balance of the state’s housing priorities, as defined in the QAP, and the

developer's housing proposal. "The QAP is developed through a consultative process that also gives advocates at the state level an opportunity to affect housing policy" (Khadduri & Rodda, p. 2). Housing proposal applications are assigned points based upon the project's ability to provide quality, affordable housing and the individual characteristics of the project. Extra points are awarded for longer affordability periods, waiving the right to leave the program at the end of the compliance period, and agreeing to sell to nonprofit organizations to preserve affordability at compliance expiration (Colton, p. 161). LIHTC requires that ten percent of all tax credits go to nonprofit organizations, but often, more credits are allocated to non-profits. Of the 90,000 LIHTC units placed in service annually, approximately twenty percent are developed by nonprofit organizations. The remaining eighty percent are developed by for-profit companies, many of whom partner with a nonprofit sponsor (McCloud, 2004).

Tax credits are awarded to developers of qualified projects. Developers then sell these credits to investors to raise capital (or equity) for their projects, which reduces the debt that the developer would otherwise have to borrow. Because the debt is lower, a tax credit property can then offer lower, more affordable rents. States allocate the credits at either a nine percent or four percent rate. Nine percent rates are given for rehabilitation or new construction projects. Four percent rates are for acquisition projects ("Low Income," 2004).

### **Compliance Period**

Initially, developers committed to a fifteen-year LIHTC compliance period; however, in 1989, Congress extended LIHTC's fifteen-year affordability commitment by an additional fifteen to twenty-five years, depending on the state. This change was in

response to the public's concern for maintaining affordable housing (Colton, 2003).

During the first fifteen years, LIHTC properties are required to provide affordable housing based upon the LIHTC requirements; however year fifteen for properties can be pivotal. The LIHTC program allows investors to sell or transfer a property after fifteen years, provided there are no restrictions on the property. Land Use Restriction Agreements (LURA) are usually in the form of a subsidy program included in the qualification structure of the project, e.g. Project Based Section 8, Farmers Home Administration (FmHA), HOPE VI or Section 236. Another property restriction is the Extended Use Agreement (EUA). An EUA is an agreement between the owner (taxpayer) and the HFA (Faile, 2004). The EUA lengthens the affordability period to a minimum of thirty years and is recorded as a restrictive covenant against the property. Even though the property is required to operate within the LIHTC guidelines, the IRS only monitors the property for compliance within the first fifteen years.

Properties are monitored for LIHTC compliance through December 31 of the 15<sup>th</sup> compliance year. As of 1990, all properties receiving tax credits were required to remain affordable for a minimum of thirty years. "Though the risk of tax credit recapture ceases when the compliance period is fulfilled, projects receiving an allocation after 1989 are required to maintain the percentage of low-income tenants, as defined by Section 42, for at least an additional fifteen years beyond the compliance period" (Faile, 2004).

There are two loop holes that terminate the EUA – foreclosure and the qualified contract. The Internal Revenue Code defines the EUA as terminating if the property is acquired by foreclosure or if the HFA is unable to present a qualified contract (Faile,

2004). A qualified contract is a bona fide offer to acquire the building for a price based upon outstanding debt, equity, capital contribution and exit taxes (“Pricing Qualified,” 2004). (If the property includes non-low income units, those units will be assessed at fair market value for the qualified contract.) Upon the termination of an EUA, the new owners, managers and investors are unencumbered by the once mandated affordability of the property. The end of the compliance period or termination of the EUA frees the property of any LIHTC obligations, monitored or not, and provides the investors, owners and managers with opportunities and decisions, such as elimination of the affordable component.

Technically, there is a third loop hole. It does not terminate the EUA – it just does not exercise it. The owner does not sell, nor refinance, the property, but rather decides to abandon LIHTC and operate it as-is with market driven rents. VHDA cannot cap residents’ income, nor the rents. The property remains affordable and residents are not displaced.

### **Compliance Monitoring**

An area of concern is the 11,800 units with expiring compliance periods between 2010 and 2015 that are not participants of any program subsidy, e.g. Project Based Section 8, Section 236 or FmHA, that would prevent the discontinuation of affordable housing. Therefore, even though the expiring units have an EUA that mandates the property continue as affordable housing, there is no incentive for owners to maintain affordability when the potential to increase their return on investment may be through a conversion to market rate. However, approximately 45% of the total Virginia LIHTC units, waived their right to leave the program upon the expiration of the initial

compliance period. By waiving their right to the qualified contract procedure and potentially leave the program, developers captured additional points in the project application process. Due to the competitive nature of the LIHTC application process, any additional points that can increase developers' chances of being awarded tax credits are critical to the success of LIHTC development. After waiving the right to utilize the qualified contract procedure, the total compliance term is then extended to 30 years with full IRS monitoring and accountability.

Virginia Housing Development Authority (VHDA), the state housing finance agency, regularly monitors the LIHTC units within the study area for compliance. The agency conducts physical inspections of the asset, in addition to financial audits. Additionally, VHDA holds the funding on the majority of the LIHTC units within the state; therefore, they will know of any changes to the affordability of a property.

Owners with properties reaching the end of the initial compliance period should review the following items when determining to abandon LIHTC: 1. Ability to increase rents and property value; 2. Initial decision for LIHTC (i.e. social responsibility to provide affordable housing, mandate by local jurisdiction to receive project approval, or LIHTC inclusion provided the required return on investment without any social responsibility factors); 3. Perception of EUA enforceability; 4. Type of investment partner; and 5. Due date of current financing. Once an owner has decided to abandon affordability, he may submit a request to VHDA within the months of January – March of year 15 to determine the property's eligibility to exit the LIHTC program (QAP) after the end of the initial compliance period. Properties restricted by other programs, FmHA, Project Based Section 8, Section 236 or HOPE VI, must maintain their affordability

(Correspondence with M. Domres, Senior Vice President of Cafritz Interests, LLC (formerly of KETTLER), on May 30, 2009).

### **Sample and Methodology**

The localities of City of Alexandria, Arlington County, Fairfax County, Fairfax City, City of Falls Church, and Loudoun County were selected as the study area due to the market rate and affordable rental properties possessing strong occupancy rates and competitive rents per square foot. LIHTC properties in strong markets are prone to market rate conversion due to the potential to raise rents to market rate, which is \$200/month (average) higher, and thus, increase property value. As of 2008, VHDA reports approximately 63,000 LIHTC non-elderly apartment units within the state of Virginia. VHDA also reports that the study area possesses approximately 11,800 LIHTC non-elderly apartment units. According to the 2008 Census Fact Sheet, there are approximately 861,000 apartment units in Virginia and 187,000 units in the study area. Apartment units are defined as occupied and vacant units in structures with at least five or more units. LIHTC units within represent 6.3% of the total rental apartments available in the study area.

During the months of May - August 2009, the researcher conducted phone interviews with LIHTC experts. These experts included VHDA's Tax Credit Allocation Officer, a former Senior Vice President & Developer at KETTLER (largest holder of LIHTC units in Virginia), a renowned LIHTC attorney at Holland & Knight, and the former Director of Asset Management at KETTLER. This paper focuses on the findings regarding LIHTC compliance period expiration from the interviews and the researcher's personal work experience within the LIHTC industry.

## **Results**

### **Ability to Increase Rents & Property Value**

The ability to increase rents and property value include the factors of: supply, demand, absorption rates, average price/sf, overall market performance, and a property's economic & physical characteristics. Increased property value is best captured through increasing rents. An owner may perceive greater economic gain by abandoning affordability and converting the property to a conventionally-financed, market-rate product. LIHTC rents are often \$200 below the market rate product within the same market; therefore, an owner of a 250 unit property can increase the property value by \$8 million with a \$200 rental increase/unit at a 7.5% capitalization rate (Correspondence with D. Knapp, Senior Vice President of Foulger Pratt (formerly KETTLER), on August 7, 2009). Without incentives to maintain a property as affordable, property owners may experience intense pressure to exit the LIHTC program where low vacancy rates, low interest rates and competitive rents preside within their markets.

### **Initial decision for LIHTC**

When an owner supports with a social responsibility to supply affordable housing, he will identify property financing at year 15 should the property need funding for capital improvements. However, if an owner initially allocated LIHTC units at a project to satisfy proffer requirements or to obtain a more favorable return on investment, he is less likely to maintain the affordability component in a strong market. Furthermore, without a personal commitment to maintain affordable housing, an owner may convert a susceptible property to market rate in an effort to fund capital improvements.

Maintaining a property as affordable within the LIHTC program can be a win-win. After year 10 and before year 15, an owner can recycle the units into a 4% or 9% tax credit deal to infuse capital into the project. An owner can also refinance the property at the expiration of the compliance period. This often yields a substantial savings as many of these properties were financed when interest rates were above 9%. However, a hindrance to preserving affordable housing is finding funds to support the credits. If funds are not available through VHDA, owners can partner with a nonprofit to utilize their access to subsidies and grants. Due to the age of these properties, infusion of capital for renovations is needed. Allocation of new tax credits provides the capital, while preserving the affordability (Correspondence with D. Knapp, Senior Vice President of Foulger Pratt (formerly KETTLER), on August 7, 2009).

### **Perception of EUA Enforceability**

An EUA is recorded on the property deed as a property covenant. An EUA is enforceable and can restrict property sales due to the EUA appearing as a cloud on the title or as a land use violation during the title search (Correspondence with T. Freedman, LIHTC Attorney, on August 12, 2009).

### **Type of Investment Partner**

In a conversation with D. Knapp (Foulger Pratt) on August 7, 2009, he stated “Politics will always trump the economics when dealing with a non-profit”. He was referring to the involvement of non-profits within the community – regardless if a non-profit is an investment partner. Non-profit agencies will always support an entity that provides services, such as affordable housing, to anyone who is less fortunate. However, if a non-profit agency hears of an owner attempting to convert a LIHTC

property, the non-profit will ensure the public knows of the potential displacement of families and children. Therefore, it does not matter the type of investment partners within a property. Non-profits will come to the rescue of a LIHTC property creating public scrutiny.

### **Due Date of Current Financing**

Most LIHTC properties are financed with a balloon payment mortgage that requires a large balance due at loan maturity. Some of the 1995 - 1999 LIHTC property loans will come due within the next five years and most will have a balloon payment due. With a large balloon payment due, most owners will need to refinance the property in order to avoid a large payment. However, financing will be very difficult, if not impossible, due to the EUA recorded on the property covenants (Correspondence with D. Knapp, Senior Vice President of Foulger Pratt (formerly KETTLER), on August 7, 2009).

VHDA has plans to purchase LIHTC properties where the existing owner wants to sell (Correspondence with C. Wallo, Tax Credit Allocation Officer of VHDA, on August 16, 2009). Although, owners may sell to other for-profit companies that may exercise the options listed previously. These options are only legitimately and legally exercised if there are no LURA or EUA prohibiting the change of property use or affordability during the compliance period or extended use period.

### **Conclusion**

A conversion to market rate is typically the product of an extensive rehab to reposition the property. The benefits to converting to an existing LIHTC property to

market rate are: reduction of risk associated with an unknown market; extensive operational history of expenses, income and issues; income stream available for conversion; and properties are still eligible for alternative multifamily financing programs. Even though this option may generate an equitable return, there is still risk associated with market rate conversions. Owners must know their markets. What is the state of the rental housing market? Is there sufficient demand for market rate units? Is there enough differential between market rate rents and affordable rents to justify the conversion/rehabilitation of the property? Many LIHTC properties are located in markets that will never serve a market above the 60% AMI, so conversion to market rate may not be an issue (Correspondence with C. Wallo, Tax Credit Allocation Officer of VHDA, on August 16, 2009).

As LIHTC properties in the study area have utilized all of the available tax credits and have passed year 10, but have not surpassed year 15, none has exercised the qualified contract procedure, nor abandoned affordability (contractually or not). The properties are either (1) refinancing with VHDA or (2) reallocating new tax credits for a new compliance period. Both scenarios provide opportunities to infuse capital into the property for capital improvements while still maintaining affordability through LIHTC (Correspondence with C. Wallo, Tax Credit Allocation Officer of VHDA, on August 16, 2009). Utilizing the first scenario, several companies are purchasing a LIHTC property for the existing debt plus the equity in property from an existing owner and refinancing it through VHDA. Only LIHTC properties that have passed year 10, but not year 15, are eligible for this purchasing/refinancing scenario (Correspondence with D. Knapp, Senior Vice President of Foulger Pratt (formerly KETTLER), on August 7, 2009).

VHDA's continuous monitoring and rigorous property standards have created an environment where Virginia owners can be successful, and thus, Virginia owners have yet to abandon LIHTC affordability. Additionally, VHDA's effective communication with owners and access to training is even more positive reinforcement to maintaining LIHTC upon compliance expiration (Correspondence with C. Wallo, Tax Credit Allocation Officer of VHDA, on August 16, 2009).

In addition to VHDA's monitoring, communication, and training, the economic downturn has influenced owners' decisions. With the current recessionary economy, owners do not want to risk converting properties to market rate when LIHTC properties are experiencing higher, more stabilized occupancy, and increased market rate income. The declining economy has also caused market rate properties to lower their rents to the point where the differential between LIHTC and market rate is very minimal, e.g. less than \$50 at some properties. Converting to market rate is simply not cost effective when the market rate rent return is only \$50. Forecasting eighteen months out when the market returns, VHDA and non-profit entities will not allow a property to violate its EUA and convert to market rate, regardless of how strong the housing market is.

Per my conversation with C. Wallo (Tax Credit Allocation Officer of VHDA, on August 16, 2009, the State of Virginia is atypical regarding how smoothly and effectively LIHTC units are managed. Furthermore, Virginia is maintaining its LIHTC units at the end of the initial compliance period. Other states throughout the nation are experiencing difficulty maintaining their tax credit units at the end of LIHTC year 15.

Without financial consequences, owners are not likely to adhere to the LIHTC guidelines upon the expiration of the initial compliance period. Enforceable sanctions

must be implemented to prompt owners to comply with the EUA. Furthermore, if an owner fails to comply with the LIHTC guidelines on one property, while receiving tax credits on another property, those credits should be revoked until all properties are in compliance with LIHTC guidelines. Also, the approval of future LIHTC housing proposal applications should factor in the status of any existing LIHTC properties owned or managed by the same entity(ies).

The EUA lacks power, in Virginia too, if an owner is not selling the property and affordability will be abandoned with the property operated as-is. If refinancing is needed, private equity financing (which is more speculative) could be utilized and they will be concerned with EUA as much. The tax credit benefits have long been exhausted, which leave no incentive for an owner to comply with the affordability guidelines. “Most observers expect that fewer than 15% of units created under the program will cease to be affordable after the 15-year expiration date” (McCloud, 2004). The concern of accountability with reference to maintaining affordability during the extended use period is paramount. Without incentives or sanctions to promote owner and management company adherence to LIHTC operating guidelines, the supply of affordable housing is at serious risk. Without LIHTC as an affordable option, displacement of lower income renters will occur.

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