Low Income Housing Tax Credit Properties: Non-Profit Disposition Strategies in the Commonwealth

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Submitted to the Department of Urban Studies and Planning in Partial Fulfillment of the Requirements for the Degrees of

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Low Income Housing Tax Credit Deals:
Year Fifteen Restructuring Strategies

by
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Abstract

This thesis examines how non-profit owners in Massachusetts have maintained affordability and ownership of Low-Income Housing Tax Credit (LIHTC) properties after the initial fifteen-year compliance period, at the lowest possible cost. The intent is two-fold: to inform non-profit project sponsors about strategies leading to low-cost outcomes, and to advocate for policies that promote such low-cost outcomes. The impacts of the players in LIHTC deals, Massachusetts state policy, the original capital structure, and legal partnership arrangements on the strategies that non-profit owners can pursue to maintain control of tax credit properties are considered. Specific outcomes described include bargain sale and charitable contribution, debt-plus-taxes or right of first refusal, and transfer of the limited partnership interest. Themes include the tension between for- and non-profit partners, public and private interests, and federal and state policies. Because the LIHTC is administered on a state-by-state basis, the Massachusetts regulatory environment and state housing resources play a central role in shaping disposition outcomes in the Commonwealth. This thesis looks at how the recent lack of recapitalization funding for LIHTC properties has revealed an opportunity for the Commonwealth to improve the existing HUD preservation paradigm. Massachusetts' previous policies and current political environment create an opportunity for the state to promote new model of preservation that breaks from the federal paradigm of prodigal public payments to investors. I recommend that the Commonwealth prevents original, private investors from receiving additional public subsidy at the back end of LIHTC deals by separating the disposition and recapitalization of properties.

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Acronyms

AMI	Area Median Income
CEDAC	Community and Economic Development Assistance Corporation
DHCD	Massachusetts Department of Housing and Community Development
HUD	Department of Housing and Urban Development
IRS	Internal Revenue Service
LIHTC	Low-Income Housing Tax Credit
MHP	Massachusetts Housing Partnership
NIMBY	Not In My Back Yard
NOFA	Notice of Funding Availability
QAP	Qualified Allocation Plan
SHFA	State Housing Finance Agency
TDC	Total Development Costs

INTRODUCTION:
Tax Credit Projects at Year 15

This thesis examines how non-profit owners in Massachusetts have maintained affordability and ownership of Low-Income Housing Tax Credit (LIHTC) properties after the initial fifteen-year compliance period. My intent is two-fold: to identify and share non-profit strategies leading to low-cost outcomes in Massachusetts, and to advocate for state policies that promote such low-cost outcomes. Through literature review, policy and legal document analysis, interviews, and cases of completed property dispositions, I look at the impact of the players in LIHTC deals, of Massachusetts state policy, the original capital structure, and legal partnership arrangements on the strategies that non-profit owners can pursue to maintain control of tax credit properties. I use specific cases of charitable contribution, debt-plus-taxes, and limited partner interest transfer, as well as data from interviews to build on the general recommendations that have been made by a number of community development groups, including the Local Initiatives Support Corporation (LISC) and Enterprise. Most of the existing literature about LIHTC dispositions generalizes outcomes in order to address a national audience. But, I believe that because the LIHTC is administered on a state-by-state basis the Massachusetts regulatory environment and state housing resources play a central role in shaping disposition outcomes in the Commonwealth. By incorporating analysis of the Commonwealth's LIHTC regulating documents and housing-finance policy I am able to place the recapitalization of Low-Income Housing Tax Credit projects in the context of previous affordable housing preservation efforts, and make state-level policy recommendations aimed at preserving the non-profit ownership and affordability of LIHTC units. Massachusetts' previous policies and current political environment create an opportunity for the state to promote new model of preservation that breaks from the federal paradigm of prodigal public payments to investors. I recommend that the Commonwealth prevents original, private investors from receiving additional public subsidy at the back end of LIHTC deals by separating the disposition and recapitalization of properties.

My interest in LIHTC dispositions stems from my work at BRIDGE Housing Corporation, a leading non-profit developer of affordable housing, based in California. In 2003, BRIDGE started work on its first LIHTC disposition, committed to maintaining ownership of the property and keeping low-income tenants in place. Negotiations with a corporate investor who was uninterested in maintaining affordability and wanted to receive an exit payment were long and difficult. Not only was there a mismatch of partners' values, there was no precedent for this type of disposition since the first LIHTC properties had just reached Year 15 – their eligible maturity for sale. At that time, I realized that if LIHTC dispositions were difficult for a sophisticated company like BRIDGE, they would be difficult for almost all non-profits, and that there was a huge pipeline of LIHTC dispositions – hundreds of thousands of units without clear disposition and recapitalization plans.

According to the Department of Housing and Urban Development (HUD), the Low-Income Housing Tax Credit is the "most important resource for creating affordable housing in the United States today" (HUD). Congress established the LIHTC Program in 1986, and since then over two million affordable apartments have been created using LIHTC investments. The first of these projects - placed in service before 1990 - had rent restrictions for fifteen years, which expired at the end of 2001. Subsequently, there has been a required thirty-year rent restriction, with a process to opt-out of the last fifteen years. As a result, "Year 15" remains critical decision point in the life of these projects as the first opportunity for financial restructuring, change in ownership, and conversion to market rate.

The significant loss of affordable, HUD-financed units in the 1980's and 1990's raised awareness about the need for and benefits of preservation. According to the Joint Center for Housing Studies at Harvard University, new production is not keeping up with increasing demand for and losses to the stock of affordable housing ("NHT Issue Brief" 2). Rehabilitation is an efficient use of resources, costing only 25-50% as much as and consuming less new material and energy than new construction ("Window of Opportunity" 4). In addition, preservation projects avoid Massachusetts' lengthy permitting processes and "not in my backyard" (NIMBY) opposition, as well as provide stability for their low-income residents. Overall, preservation is a pragmatic approach to addressing the nation and Massachusetts' need for affordable housing. And non-profit owners are willing partners in

that approach. They own thirty percent (30%) of LIHTC properties and are more likely to have the motivation, but lack the resources, to preserve affordability than their for-profit counterparts.

However, the preservation of LIHTC units has not yet become a focus of the affordable housing industry. When affordable housing experts and advocates refer to "*P*reservation," they are referring to the prepayment of federally-subsidized 221(d)(3) and 236 mortgages and Section 8 contract expirations – HUD programs that have been able to rely on a federal source for recapitalization[1]. Like the LIHTC, these HUD programs were structured to attract private, profit-driven capital to affordable housing development, without fully considering how the investors would exit deals, and what would happen at that time. The program regulations allowed investors to easily convert their buildings to market rate units when the market offered greater profit than federal subsidies, and this is exactly what happened. In the late 1980's and into the 90's, tens of thousands of affordable units were lost. The solution was federal recapitalization, which slowed the flood of conversions by providing a second infusion of public capital to both the investor and the property. HUD essentially replaced the market in providing additional capital to investors; it paid twice for the same building.

The large number of units at risk for conversion to market rate and the unpredicted nature of these HUD crises redefined the once general concept of preservation in the affordable housing industry. Now Preservation refers specifically the second infusion of capital to HUD program properties and investors. Indeed, many in the industry do not consider recapitalization of LIHTC properties to be a preservation issue because there is not yet a crisis. The idea of preventative care, which has become popular in the preservation of people, has not emerged as a standard for affordable housing properties. Instead, short sighted triage has created a view of preservation makes the recapitalization of LIHTC properties – that is the preservation of their physical and financial ability to provide decent, affordable housing - all the more challenging, and the increases the likelihood that LIHTC recapitalization will fall into the established pattern of inefficient, crises-based preservation funding with redundant payments to the investor.

[1] Chapter Two looks at these preservation precedents in greater detail.

LIHTC properties will not, however, be able to rely on HUD for additional infusions of capital. While the HUD and LIHTC programs share the tension created by the involvement of private investment in public benefits, they differ in how they are administered. The consequence of the state-by-state administration of the LIHTC is that there is no federal recapitalization source available to the tax credit projects. LIHTC preservation will rely heavily on state policy, and state resources. The lack of a central recapitalization source has been a challenge for LIHTC projects reaching maturity, but it also presents an opportunity for a more economical preservation paradigm. I conclude the thesis with ideas on how Massachusetts' previous housing finance policies and current political environment create the possibility for a LIHTC preservation approach that breaks from the HUD pattern of recapitalizing investors in the process of recapitalizing properties so that more state resources go directly into maintaining affordable housing.

CHAPTER ONE:
Diving In

Chapter One gives an overview of my research approach, and an introduction to the significant political changes that occurred while I was writing this thesis. Chapter Two includes more information on the affordable housing finance structure in Massachusetts, and Chapter Seven looks again at the recent political changes.

CHANGE IN THE COMMONWEALTH

In January 2007, Duval Patrick took office as the first Democratic governor of Massachusetts in sixteen years. His successful grassroots campaign created a wave of excitement in the Commonwealth, and optimism in the housing industry. He appointed a new Undersecretary of the Department of Housing and Community Development, but retained most of the trusted program staff. Less than six months after taking office, his administration radically changed the preservation funding climate in Massachusetts by lifting the virtual ban on the use of tax-exempt bonds for recapitalizaiton. They have not, however, implemented a new policy in its place and at the time of writing, it is unclear what priorities and policies will be put in place. Hopefully this will be the first step in what many in the housing industry expect will be a greater flow of funds to affordable housing.

Writing about LIHTC dispositions at a time of flux was both challenging and exciting. Much of this thesis (Chapters Four and Six) deals with the situations created by and legacy of previous policy. Chapter Seven and the Conclusion consider how the new administration can take advantage of lessons learned from past policies to create long-term preservation strategies and cost-effective methods of recapitalization.

METHODOLOGY

With a background in affordable housing development, my interest in Low-Income Housing Tax Credit projects and the long-term affordability for these properties is largely practical. I set out to find best practices in the process and outcome of LIHTC dispositions in order to understand how non-profits can optimize their ability to maintain affordability, and how funding regulations and policy can aid that effort. I defined "best" as being low-cost, preservation oriented outcomes and looked for dispositions in which non-profits retained control and affordability at minimal cost, thus allowing them to invest resources in additional housing, programs, and property maintenance.

My initial research focused on establishing a general history of the Low-Income Housing Tax Credit and the context for the preservations of LIHTC units. This research consisted of a review of relevant literature including general information about the use of LIHTC, previous affordable housing preservation efforts by HUD, restructuring advice generated by national community development intermediaries, local advice by community development corporations, and case studies. Existing guides to LIHTC dispositions produced by non-profit syndicators were also vital sources of information, and jumping off points, that I returned to often while researching and writing. Most of these readings are found in industry periodicals and on industry related websites, as LIHTC disposition and recapitalization is still an emerging policy issue.

Much of the existing LIHTC market and data characterization is drawn from the HUD User Database, which includes a database of LIHTC projects. The LIHTC database was originally compiled by Abt in 1996. As of the end of 2006, it was updated with projects placed in service through 2003. Although it is commonly and rightfully criticized for incomplete and missing data, it is, to date, the most comprehensive and widely used national LIHTC statistical source. Massachusetts does not, at this time, maintain its own database of LIHTC projects. The Department of Housing and Community Development (DHCD) is, however, in the process of creating their own database. The database is scheduled to be complete sometime in 2007, but will not be made publicly available. DHCD did provide me

with a list of projects and units that I used to create Figure 1.1, showing when units in the Commonwealth were placed in service and when they will reach Year 15.

After gaining a general understanding of the LIHTC environment, I conducted interviews with housing consultants active in the Massachusetts LIHTC market to identify low cost disposition strategies and specific examples (presented in Chapter Four). The example cases were selected as best practices because their low-cost outcomes allowed the non-profit general partner to maintain affordability without compromising the resources of their other programs or properties and without providing additional, unexpected return to investors.

I then interviewed disposition staff at three of the largest for-profit syndicators, one national bank that has a direct investment portfolio and is returning to direct investment after a period of investment through syndication, and one government sponsored entity that has an early direct investment portfolio that it is disposing of while continuing to invest through syndication. For non-profit sponsors, these for-profit investors represent a greater challenge than non-profit investors in negotiating dispositions because they do not share the mission of providing affordable housing. Their perspective is critical therefore to understanding the challenges in the disposition process, the potential for - or lack of - good will in the absence of policy that preserves affordability, and in revealing how public policy might increase the preservation of affordable housing. Information on Enterprise Community Investment and National Equity Fund (NEF), the two national non-profits, was gathered through written and presentation materials, and second-hand through interviews with general partners and their consultants. Investors bankroll the LIHTC industry, and I felt that understanding their perspective, and their shared and different behaviors, was critical to making policy and non-profit strategy recommendations.

To balance the investor perspective, I interviewed non-profit general partner staff and consultants that managed disposition transactions. Formal interviews with general partners were supplemented by conversations with other housing development professionals knowledgeable about LIHTC, LIHTC dispositions, and the Massachusetts affordable housing finance environment.

Although some interviewees and their companies were comfortable being identified, others preferred anonymity. For consistency, I have chosen to keep all interview material anonymous, with the exception of numerical data and information that has been made public elsewhere. Interviews provided the majority of data necessary to establish and answer case-specific questions, give local and organizational context, compare investor behavior, and suggest general conclusions.

The example cases in Chapter Four examine the restructuring of particular LIHTC developments after their fifteenth year in order to illustrate specific solutions. To the extent possible, cases are informed by and incorporate the experience of the owner, investor, and related consultants. These examples are used to identify opportunities for state and non-profit policy improvement, best practices, and critical timing in the restructuring of LIHTC projects. Data gathered from interviews was combined with analysis of available project documents (primarily limited partnership agreements and multi-party memos) to retrace project milestones and decisions as well as key legal clauses that determine disposition options.

In addition to property-specific documents, I looked at the Department of Housing and Community Development's current Low-Income Housing Tax Credit Qualified Allocation Plan (QAP) and Regulatory Agreement, as well as other financing source terms to analyze their impact on disposition strategies and the current accessibility of recapitalization and preservation funding. Finally, interviews and conversations with and presentations by rental housing staff at DHCD, MassHousing, Massachusetts Housing Partnership (MHP), MassDevelopment and the Massachusetts Association of Community Development Corporations (MACDC,an umbrella organization for community development corporations) expanded my understanding of the financing environment and awareness of post-Year 15 LIHTC projects in Massachusetts.

CHAPTER TWO:
The Low-Income Housing Tax Credit in Context

This chapter is not intended as a comprehensive review of Low-Income Housing Tax Credit (LIHTC) literature. Rather, it is intended to contextualize a subsequent discussion of LIHTC dispositions, focusing on non-profit sponsors and maintaining affordability. First, the definition of and need for affordable, subsidized housing will be established. Then, the LIHTC, a popular subsidy program, will be described. Next, the nature and applicability of previous preservation efforts to LIHTC dispositions will be discussed. Chapter Three follows with a review of the limited literature that anticipated the expiration of the first LIHTC use restrictions in 2002, and an overview of current, practical guides to LIHTC dispositions.

AFFORDABLE HOUSING

What is affordable housing?

All housing is affordable to someone. So, why does "affordable housing" get so much attention – and what does the term really mean? The term "affordable housing" typically refers to housing subsidized by federal, state, and/or local public sources. It is a public benefit and investment, and as such deserves public attention. Affordable housing can be rental or owner-occupied. For rental housing, affordable rent is widely accepted, defined, and enforced, through subsidy regulation, at 30% of household income[2].

Why do we need affordable housing?

The National Low-Income Housing Coalition reports that "there is not a county in the country were a full-time minimum wage worker can afford even a one-bedroom apartment at the FMR (fair market rent)"(Out of Reach, pg 3). There are almost two million minimum wage earners in the US. Taking those individuals alone, ignoring other low and moderate-

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[2] With remaining income spent on food, clothing, child-care, transportation, medical care, etc. Households that spend a greater percentage of their income on housing, must spend less on other needs.

income individuals who are also priced out of the market, the need for subsidized housing becomes clear. When household income is insufficient to procure market rate housing units, public agencies must either provide housing directly – in the form of public housing , or provide the subsidy that is critical to entice property owners to operate or construct housing below market rate. Filling this economic gap between tenant wages and owner-required profit makes previously unaffordable housing accessible to millions of Americans.

What are the benefits of quality housing? Is it worth subsidizing?

In "Housing and Family Well-Being," Rachel Bratt surveys existing studies and finds that connections between "improved housing conditions and less onerous housing cost burdens promote healthier, more productive families" (14). The surveyed studies consider the contributions of the physical quality and safety of housing, availability of housing, affordability, lack of overcrowding, security, length of residency, tenure options, and neighborhood conditions to family well-being. They find that housing exhibiting these characteristics reduced childhood injuries, improved health, improved childhood growth indicators, reduced stress, improved self-image, and improved educational performance.

Over the last twenty years, the Low-Income Housing Tax Credit has become the primary funding source for such quality affordable housing.

THE LOW-INCOME HOUSING TAX CREDIT

How does the Low-Income Tax Credit work?

There are two types of LIHTC. They are commonly called "9% credits" and "4% credits," referring to the percent of qualified tax basis eligible for tax credit. To arrive at the qualified basis, land and other non-depreciable costs like rent reserves and financing costs must be subtracted from the total development cost for a project. Given that the credit is allocated in each of 10 years, the sale of 9% credits by sponsors generally cover 60-70% of total development costs (TDC) in Massachusetts. 4% credits typically cover 30% TDC.

Developers, or "sponsors" submit property applications for individual projects. Sponsors can be for- or non-profit entities with a range of organizational structures, including joint ventures. Properties can serve families or special needs populations, including elderly residents. LIHTC can be used to build or acquire and rehabilitate rental apartments, townhomes, single family homes, and single room occupancy properties.

Massachusetts typically holds two rounds of LIHTC competition each year; one in the late fall and one in the early spring. Notices of Funding Availability (NOFA), which detail application requirements can be found on the DHCD website, http://www.mass.gov/dhcd/. Each year the Commonwealth must update its Qualified Allocation Plan, which outlines the required and desired (competitively scored) characteristics for applying properties.

Tax-exempt non-profit sponsors sell the tax credits they receive to raise equity for properties. The majority of for-profit sponsors also sell their credits, although a small number are able to use the credits themselves. Investors purchase the credits to offset their federal tax liabilities for the ten years after the property is placed in service. The investors also receive tax benefits from losses associated with property operating costs, interest on debt, and depreciation. To meet the IRS test for ownership, the sponsor and investor form a partnership, which takes ownership of the property. Typically the sponsor (developer) is the General Managing Partner (GP) with 1% or less of the ownership of the partnership. The investor acts as a Limited Partner (LP) and owns at least 99% of the partnership. The property must remain affordable though its compliance period. If an owner does not comply with affordability restrictions, tax credits can be revoked and taxes owed. Many properties also have extended use restrictions that require affordability during years 15-30, but cannot endanger the tax credits. The flow of funds and benefits is shown below in Figure 2.1.

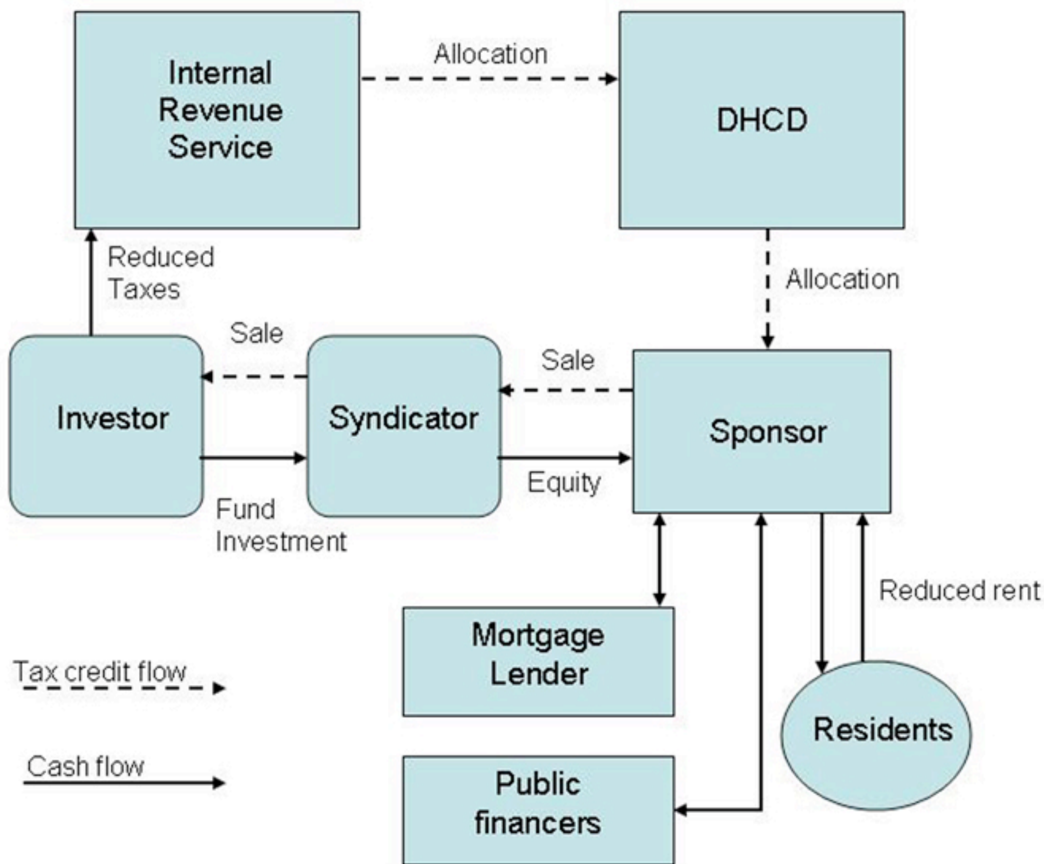

Figure 2.1 Tax Credit Flow of Funds, based on CRS Figure 1

LIHTC investors have changed over time as the program has matured. Early investors tended to be single or partnered corporate entities that could use the tax credits directly, or funds of high wealth individuals. The Chevron Corporation, Bank of America, and Fannie Mae were all early direct investors. Private individuals invested in funds through investment brokers. Funds are set-up and managed by syndicators, organizations that purchase, pool, and syndicate tax credits[3]. Over time, corporate entities moved away from direct investment and replaced private investors in syndicated funds.

[3] Syndicators typically purchase Historic Tax Credits and New Market Tax Credits in addition to Low-Income Housing Tax Credits. Syndicators will be discussed in greater detail in Chapter Three.

How was the Low-Income Housing Tax Credit created?

The Tax Reform Act of 1986 revolutionized the production of affordable housing by eliminating a number of tax shelters on one hand, which had previously provided incentives for wealthy individuals to invest in real estate, and by creating the Low-Income Housing Tax Credit on the other. The tax credit has become the most reliable and the primary federal funding source for the production of affordable rental housing.

The Internal Revenue Service (IRS) allocates Low-Income Housing Tax Credits (LIHTC) annually to state allocating agencies, typically the State Housing Finance Agencies (SHFA) on a per capita basis. In 2007, the Department of Housing and Community Development, the Commonwealth of Massachusetts' LIHTC allocating agency received an allocation of $12,477,549 (Novogradac).

To receive an allocation, states must establish a Qualified Allocation Plan (QAP) that outlines how the credits will be awarded. National policy dictates that properties serving the lowest level income residents and providing longer affordability must be given priority. Beyond that, states may set priorities such as density, large family units, and sustainability, through the competitive scoring process laid out in their QAP. Developers, known as project sponsors (sponsors) apply for credits in annual, typically competitive funding rounds. Nationally, 1 out of 5 applications receives credit (Jackson, 2). In Massachusetts, 1 out of 3 receives credit (DHCD). At the end of the year any unallocated credits must be returned to a national pool. States that have allocated all of their credits may then apply to receive these excess credits[4]. Developers either keep or sell the credits, which are redeemed over ten years. For the owner to realize the full ten-year benefit of the tax credits, the property must comply with affordability restrictions, outlined in a regulatory agreement, throughout the entire fifteen or thirty-year compliance period (depending on the when the credits were allocated).

In 1989, changes to the Internal Revenue Code extended the restricted use (i.e. affordability) period from fifteen to thirty years. (The compliance period remains 15 years.) In 1993, the LIHTC became a permanent part of the Internal Revenue Code. Congress has periodically

[4] Massachusetts regularly receives re-allocated credits, although not in substantial or steady amounts.

changed the per capita credit amount and between 2000 and 2002, it took the unusual action of increasing the LIHTC allocation amount annually. In 2003, the per capita credit was set at $1.75 and indexed to inflation. In 2004, 2005, and 2006 the inflationary increase was $0.05 per capita

To be eligible for LIHTC, a property must pass one of two "income tests," determined by residents' income levels. The "20-50" test is met by providing twenty percent of the property's units at rents affordable to households making less than fifty percent of the Area Median Income (AMI). The "40-60" test, is met by providing forty percent of a property's units at rents affordable to households making less than sixty percent of the AMI. AMIs are established annually by HUD for counties and metropolitan areas, and are adjusted for household size. The typical regulatory definition of "affordable" requires that actual rent plus utilities cannot exceed thirty percent of a household's income.

How many units has the LIHTC produced?

Although there is no database that provides an accurate, up-to-date count of units produced nationally by the LIHTC program, most industry participants agree that the program has produced over 2 million units since 1986. According to DHCD, 32,477 units have been placed in service in Massachusetts by the end of 2006. Nationally, 30% of LIHTC units are sponsored by non-profits. In Massachusetts, 33% of units are sponsored by non-profits.

In 1999 Jean Cummings and Denise DiPasquale collected data on 2,554 LIHTC projects placed in service in the first ten years on the program from four tax credit syndicators. Their analysis of this dataset is an insightful overview of the first ten years of the program, and includes some interesting findings about non-profit sponsors in the early years of the program. Looking broadly at the program economics, they observe that state level administration allows flexibility to meet local needs, and that private participation provides oversight and competition, and leverages funds. However, this flexibility and private involvement also creates tension between the financial viability and policy goals.

Equity returns to investors, as calculated by Cummings and DiPasquale, dropped over the first ten years, indicating a decline in perceived risk. Total development costs (TDC) for

projects by non-profit sponsors were 20.3% higher than for-profits during this period. However, the spread between non-profit and for-profit return requirements disappeared in the first ten years, indicating growing confidence in non-profit developers. The authors also find that costs vary by region and within region, with central city projects having higher overall TDC. They also suggest that central city rehabilitation may be more expensive due to disrepair and under-investment, and that some rehabilitation costs are as high as development costs. Overall, they found the Northeast to be the most expensive region.

Does the LIHTC alone create viable properties?

David Smith of Recapitalization Advisors, Inc. describes the LIHTC program as a "durable" financing source that has been "producing and preserving for over two decades" (The Low-Income Housing Tax Credit Effectiveness and Efficiency). The LIHTC is currently the primary production and rehabilitation source, providing 40-50% of all federal multifamily production subsidies, and involved in 60-75% of all new affordable housing properties (ibid.).

Cummings and DiPasquale find that, nationally, subsidies cover 68% of TDC in LIHTC projects. Tax credits accounted for 66%, with grants and concessionary loans accounting for the remaining subsidy. Subsidies were greater in central city locations. Private lenders rely on these subsidies to reduce risk by lowering the loan to value ratio required through mortgage financing. Nationally, just over two-thirds of all mortgages had below market interest rates. Cummings and DiPasquale found that non-profit developers were more likely to use state and local (non-private) mortgage providers, like MassHousing and Massachusetts Housing Partnership (MHP). In Metro-Boston in 1995, two-thirds of mortgages were provided by the state (285).

Their findings on project operations are worrisome. 22.5% of all projects had negative cash flows and 40% of properties with non-profit general partners had non-positive cash flows in 1995. 56% of properties in Boston had negative cash flows despite low vacancy and relatively high LIHTC rents. Projects that are structured to have little or no cash flow place increased importance on reserves and raise concerns about the difficulty of funding capital improvements.

Cummings and DiPasquale believe that thin capitalization, lack of economies of scale, and lack of liquid resources can increase the predevelopment costs of non-profits developers. Non-profits they interviewed suggested a number of reasons for higher TDC, such as building larger units and additional services. Cummings and DiPasquale control for these suggested reasons, and the results refute these ideas. However, due to inadequate data, they are unable to conclusively test whether more extensive rehabilitation, larger required reserves, higher wage requirements such as Davis Bacon wages, project difficulty, and greater non-special needs service provision contribute to higher non-profit TDC. In their conclusion, Cumming's and Pasquale call for an "increased effort to collect data," and stress the potential for capital shortfalls to be a serious future concern.

Taking Cummings and DiPasquale's findings into consideration, if non-profit sponsor TDC remain high relative to for-profit sponsors, the justification for their participation must come from the long-term economic or public policy implications of their participation, such as the ability to provide community development strategies, properties of better physical quality, or long-term affordability.

In Massachusetts, there is a history of active, successful community development corporations.

THE TAX CREDIT IN MASSACHUSETTS

Massachusetts is lucky to have a wealth of affordable housing expertise and support in both the public and private sectors. The Commonwealth has been an early adopter and innovator of many housing finance mechanisms, and the LIHTC is no exception. Below, Figure 2.2 shows the timing of the 32,000+ LIHTC units produced in Massachusetts.

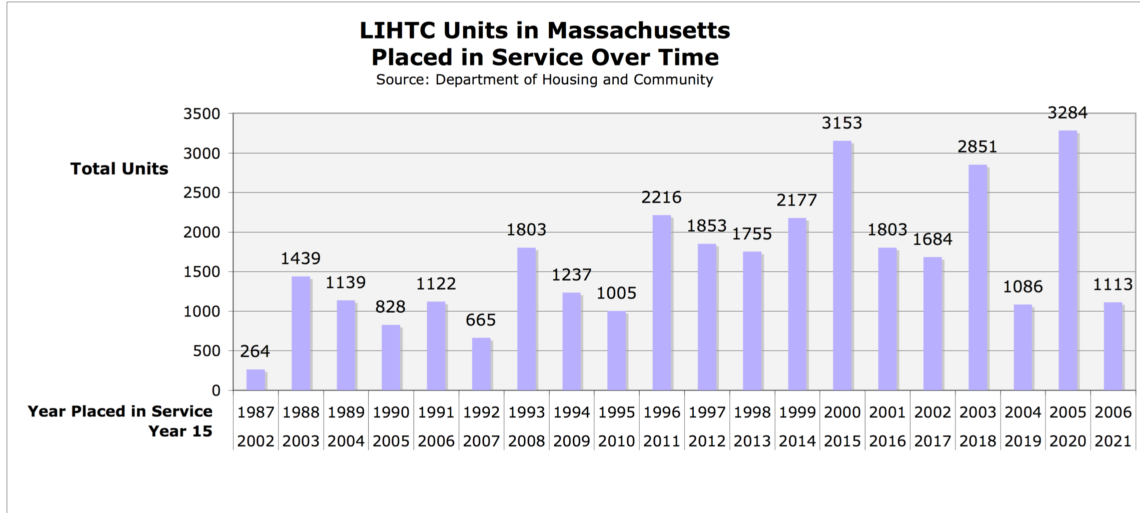

Figure 2.2

Unlike most states, the state housing finance agency, MassHousing, does not allocate tax credits in Massachusetts. The governor has given that duty to the Department of Housing and Community Development (DHCD), the central source for affordable housing funds in the Commonwealth. This allows multiple state and federal funding sources to be accessed at once, through a single application known as the "One-Stop Application." In addition, it keeps the allocation of tax credits under the control of a politically appointed office. DHCD administers the 9% credits directly. MassHousing and MassDevelopment administer 4% credits, a responsibility granted to them by DHCD, and linked to their ability to fund affordable housing projects with tax-exempt bond financing.

In addition to tax-credits, these agencies offer additional affordable housing finance sources. These resources are supplemented by municipal funds, as well as smaller technical assistance and predevelopment loans and grants available from the Community and Economic Development Assistance Corporation (CEDAC) and MassHousing Partnership. Each agency has a slightly different product and timing focus within affordable housing development, indicated in Figure 2.3 below. DHCD retains control of federal and state rental subsidies and the largest housing development subsidies.

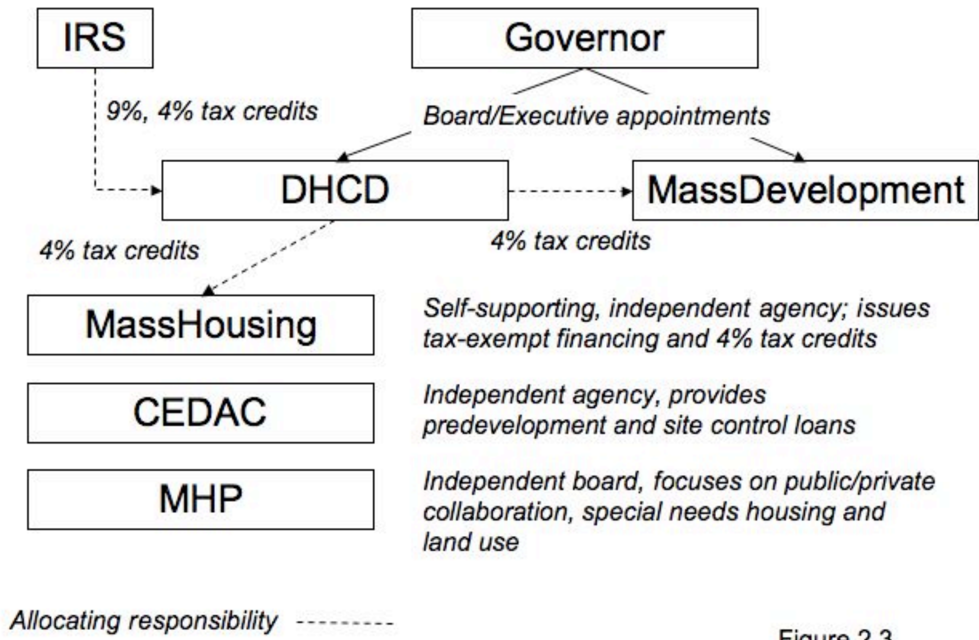

Figure 2.3

The Commonwealth also has a wealth of non-profit developers, community development corporations, and private housing consultants. These experts have guided Massachusetts through the use of previous federal and state housing finance schemes, creating solutions that have become national models. Although HUD mortgage prepayment and Section 8 expiration still dominate the discussion of preservation, some of these entities have been involved in LIHTC dispositions. Undoubtedly this collective housing expertise will be an asset when the state turns its attention to the long-term preservation of LIHTC properties.

As shown in Figure 2.2, Massachusetts has used the LIHTC to produce over 32,000 affordable rental units, nearly 4800 of which have reached Year 15. Although the LIHTC program promotes the production of affordable units, it is not a silver bullet. The tax credit does not provide on-going rental or operating subsidy, or the additional capital infusions that are critical to the long-term health of properties. So, the Commonwealth's LIHTC properties can still be undercapitalized, fall into disrepair, default, or be foreclosed on leaving the long-term affordability of tax credit units uncertain.

PRESERVATION PRECEDENTS

Is there a history of preserving affordable units that the LIHTC program can draw on?

The desire to preserve affordability has both social and economic drivers. Socially, the idea of low-income families being evicted and displaced when their apartments convert to market rate rents is unpalatable to many Massachusetts residents. It could bring added financial stress for elderly residents with fixed incomes, disrupt children's school routines, make employment difficult to maintain, or in the most dire case, result in homelessness. Economically, *preserving* a unit of affordable housing is usually significantly less expensive than *producing* one, and is therefore a more efficient use of public funds.

The need to preserve LIHTC housing upon expiration of the restricted use period should be well anticipated. In addition to clearly established compliance and restricted use periods, there is a history of preservation efforts that the LIHTC program could potentially draw from. The two most recent affordable housing preservation campaigns have resulted in federal responses to two crises caused by prepayment of HUD subsidized mortgages and the expiration of Section 8 contracts. The following overview is largely taken from Emily Achtenberg's "Stemming the Tide: A Handbook on Preserving Subsidized Multifamily Housing" published by LISC in 2002.

How was the HUD mortgage crisis created and resolved?

In the 1960's and 70's, the federal government offered two types of mortgage subsidy to incentivize private lenders and developers to build low and moderate-income rental housing. These incentives were successful in producing 560,000 units (Achtenberg, pg 2). The HUD 221(d)(3) program offered direct loans to developers at below market interest rates (BMIR). The HUD 236 program offered interest reduction payments (IRP) that enabled private lenders to offer one percent loans to developers of low and moderate-income housing. In addition to reduced interest rates, owners received HUD mortgage insurance and tax incentives such as accelerated depreciation. In exchange, owners agreed to limit tenancy to low and moderate-income households at below market rents. BMR rents were established

by the property budget, which provided a limited dividend to the owner. 221(d)(3) and 236 loans typically had 40 year terms, but were predominantly prepayable after 20 years. Upon prepayment of the loan, all use restrictions lapsed.

As real estate markets improved, owners had the opportunity to realize substantial gains by prepaying these loans and converting to market rate rents. This reached a critical point in the early 1980's after the first round of prepayments. In response to a national outcry from tenant and housing preservation and advocacy groups, the Low-Income Housing Preservation Act of 1987 (ELIHPA) and the Low-Income Housing Preservation and Resident Act of 1990 (LIHPRHA) essentially eliminated owners' ability to prepay.

Owners had the option of selling to a local government agency or non-profit, or they could continue to own and operate the property with additional subsidy in the form of Section 8 rental assistance. Non-profits and housing advocates were eventually able to focus these programs on sales to local organizations, what affordable housing expert, Achtenberg terms a "highly successful and cost-effective approach to preservation" (pg 2). Approximately 33,000 units, one third of the total units preserved, were transferred to non-profits.

Owners were, predictably, unhappy with the removal of their contractual right to prepay. In 1996, this right was restored and all federal funding for preservation ended. In place of affordable housing preservation, tenant-displacement prevention programs emerged. Through the Wellstone Notice statute, owners are now required to inform tenants, HUD, and local authorities of their intent to prepay at least 150 days in advance of prepayment. Tenants receive Enhanced Vouchers upon prepayment. These vouchers fill the gap between 30% of the household's income and market rate rents if the tenant chooses to remain in the property.[5] Enhanced Vouchers expire when the tenant moves from the property; the tenant cannot use the voucher at another location, and the unit does not retain the subsidy. As of 2002, the National Housing Trust estimated that 60,000 units have been lost since the elimination of federal preservation programs (Achtenberg 3).

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[5] Note that for Enhanced Vouchers market rate rents can be above the local public housing authority's payment standard, which is used for standard Section 8 vouchers.

How was the Section 8 crisis created and resolved?

The Section 8 program was created in 1974 as a rent subsidy program that would ensure owners received a total rent (tenant portion plus Section 8 subsidy) that would cover the cost of development, operations, and owner profit. Section 8 subsidies are contracted as either "project-based," which directly subsidize a unit, or "tenant-based," which attach subsidy to a household, wherever they choose to live. Tenant-based subsidies are now commonly referred to as "vouchers."

Section 8 subsidies were initially used as a second layer of federal subsidy for 221 and 236 properties to prevent prepayment or foreclosure and deepen affordability. These contracts tended to be short-term, often five year contracts with two extension options. Later, long term (20 year) Section 8 contracts were used to underwrite the development of new affordable units. Congress currently appropriates funding for Section 8 contracts annually.

HUD faced a crisis in the 1990s as short and long-term contracts began to expire at the same time. The renewal cost for such a large number of units was staggering. In addition, HUD had also provided mortgage insurance on over half of the properties receiving project-based Section 8. This meant that defaults and foreclosures triggered by the combination of non-renewed contracts and restricted rents, would result in massive insurance claims against HUD. In her 2003 MIT thesis, Jing An notes that HUD's participation in multiple roles in properties promoted unsound policies that "overrode 'good real estate principles' " (pg 22).

HUD had to find a way to reduce its financial burden while maintaining affordability. The Multifamily Assisted Housing Reform and Affordability Act (MAHRA) was passed by Congress in 1997. It renewed most project-based subsidy, marked contracts that had become above-market due to local rent declines over the life of the contract (above-market contracts) to current market rents, and restructured debt so that HUD would assume the portion of the debt deemed "unsupportable" as a soft second mortgage[6]. Owners

[6] "Soft second" refers to subordinated (second in line for repayment) mortgages that are repaid only when there is sufficient cash flow according to an agreed upon distribution (thus the commitment to repay them is not "hard" and the lender does not expect timely or regular repayment).

participating in this program must renew their Section 8 contract for 30 years and agree to use restrictions even in the event that subsidies were not forthcoming. Adoption of the mark-to-market program has been slow but creative. Some owners opt to take the decrease in rents, without restructuring debt, which allows them to avoid additional oversight and use restrictions.

At the same time, MAHRA provided guidelines to "Mark-Up-to-Market" contracts that were below market. This was initially only possible at the owner's annual option. In the 1990's, however, nearly 40,000 units were lost as high market rents enticed owners to opt out of their Section 8 contracts. In a delayed response, the Congress allowed the Mark-Up-to-Market program to extend renewing contracts to a minimum of five years at comparable market rates. Additional adaptations have provided both for-profit and non-profit owners with rent and cash flow structures that incentivize them to renew contracts or purchase at-risk properties.

What can be learned from the HUD preservation efforts?

Preservation efforts to prevent HUD 221 and 236 mortgage prepayment and Section 8 contract expiration mobilized a federal response that is unlikely to be seen for LIHTC properties. The dispersed administration and varied state policies of the LIHTC program make it difficult for affordable housing advocates to exert national pressure on the program. In addition, the federal government's preservation motivation is reduced since, unlike in the HUD crises in where it provided insurance, it is not financially responsible for foreclosed LIHTC properties. Thus, states will be responsible for crafting LIHTC preservation policies.

There are still, however, important lessons to learn from these efforts. In her 2003 MIT masters thesis, Jing An provides a single, in-depth case study of preservation refinancing using HUD tools. This case study addresses the importance and conflict in the language of affordable housing legal documents, and the challenges of identifying resources and coordinating transactions. The project demonstrates how early preservation deals point out and resolve policy issues. J. An asserts that the Section 8 experience is a paradigm shift to federal policy making through implementation and negotiation. She attributes this

abandonment of the typical top-down policy making to the preservation crisis, the burden of existing subsidy structures (not wanting to add to that burden, as well as wanting to avoid conflicts caused by HUD's multiple roles in the project), and the recognition of the power of the market. This model, in which the first wave of disposition projects establishes policies, is plausible for LIHTC preservation efforts.

The prepayment and expiring use preservations movements were prompted by crisis, each of which resulted in the loss of tens of thousands of affordable units. Pro-active planning for the expiration of LIHTC regulatory agreements could (and should) avoid the pattern of crisis and response that results in superfluous payments to investors. The LIHTC program - like 221, 236 and Section 8 - is structured to advance the involvement of the private sector in low and moderate-income housing creation. This brings with it the conflict between private interests and public benefits, a dynamic that has strained previous preservation efforts and will also shape LIHTC preservation.

Following the elimination of federal preservation programs in 1995, state and local authorities have also responded by using regulations such as rent control, land use restrictions, notification, and rights-of-first-refusal, and financial or tax incentives to preserve affordable housing. To the extent that these methods are applicable to preserving LIHTC properties, they will be discussed in following chapters. Because many LIHTC properties have extended use restrictions, their recapitalization and maintenance will be a more pressing preservation concern. LIHTC have also provided a critical refinancing resource for preserving at-risk HUD-mortgaged affordable units. The long-term affordability of LIHTC units, however, remains uncertain and dependent on the outcomes of their disposition and recapitalization.

CHAPTER THREE:
Disposition – Deals, Players, and the Process

Chapter Three is an overview of the LIHTC disposition process and players. The chapter begins with brief descriptions of the structure of non-profit sponsored LIHTC deals, regulations, and tax concerns. This is followed by an introduction to the disposition process and a look at how the players impact the outcome. The chapter concludes with a review of the literature that anticipated the first dispositions of LIHTC properties at maturity (Year 15) in 2002, and an overview of the existing disposition guides.

DOING THE DEAL

This section gives an overview of the structure of a typical non-profit sponsored LIHTC deal, emphasizing the issues salient to disposition. Figure 3-1 shows the primary parties and their contractual relationships.

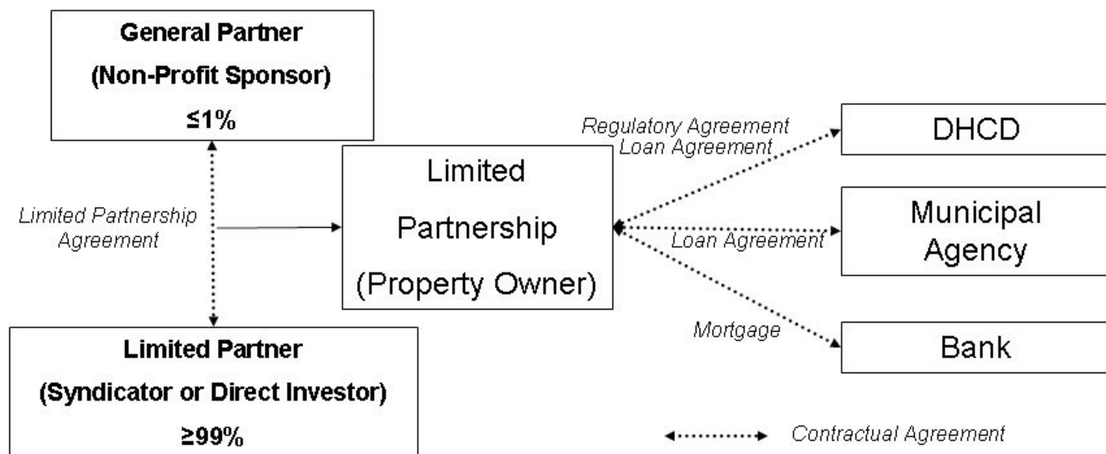

Figure 3.1

What is the structure of the Limited Partnership?

After DHCD allocates tax credits to a sponsor, the sponsor will issue a request for proposals (RFP) or otherwise solicit bids from investors. The non-profit selects an investor as a limited partner based on a number of factors, including tax credit purchase price, timing, and potential adjustors; investor guarantee, reserve, and reporting requirements; and disposition considerations. The Limited Partnership, which will be the property ownership entity, is established in a Limited Partnership Agreement.

The Limited Partnership Agreement governs the relationship between the sponsor/general partner, and the investor/limited partner. Typically the general partner acts as the managing partner and has no greater than 1% ownership interest. The limited partner has at least 99% interest in the partnership in order to capture as much of the tax benefit as possible as it flows through the Partnership. The limited partner must also receive a portion of cash distributions, set in the Limited Partnership Agreement, in order to meet the IRS' ownership test. This is intended to motivate oversight of the development and property by the limited partner – a response to the HUD programs, which required and experienced little investor involvement to the detriment of properties.

The distribution of cash flow, tax losses, and depreciation will effect the investor's capital account (and in turn exit taxes, which are covered below). Distribution of sales proceeds will effect the motivation of each partner to sell – generally the higher the distribution, the greater the incentive to sell at a high price. In considering disposition, one of the key clauses is the sponsor's right-of-first-refusal, which includes a price formula that can be structured with varying specificity. Non-profits also need to structure Limited Partnerships protect their 501c3 status by satisfying the IRS guidance issued as a memo in April, 2006 (Urban). Among other things, this memo requires that non-profits prioritize their charitable purpose over limited partner profit (when there is a conflict), and secure a right-of-first-refusal.

What is the role of the Regulatory Agreement?

The Limited Partnership enters into a Regulatory Agreement with DHCD that establishes the extended use period, and governs the property's compliance with DHCD and IRS requirements that are detailed in the QAP and Regulatory Agreement[7]. Clauses in the Regulatory Agreement that have particular impact on disposition are those addressing qualified contracts and notifications to DHCD. Notification, or required DHCD approval, of changes in ownership would provide DHCD with an opportunity to collect additional data on properties and better manage the preservation of the Massachusetts affordable housing portfolio, as discussed in Chapter Seven. Qualified contracts, which are discussed in greater detail in Chapter Four, are an allowance by the IRS for owners to opt-out of extended use restrictions (years 16-30). By requesting a contract from the allocating agency for a a qualified organization (non-profit, government, or tenant agency) to purchase the property for a formula price of debt-plus-adjusted-equity-repayment and maintain affordability, the owner notifies the allocating agency of their intent to remove the affordability restrictions. If the agency is unable to secure such a contract within a year, the affordability restrictions on the property expire.

What tax concerns arise within the Limited Partnership structure?

The limited partner is primarily motivated by taxes. They invest in the property in exchange for tax credits, which they receive each year for ten years, but they also receive the benefits of tax losses and depreciation, which reduce their capital account in the property (which has an initial balance equal to the equity used to purchase the tax credits). At the time of disposition there are two main tax concerns: exit taxes caused by a negative capital account, and taxes on capital gains. Capital gains taxes, currently at 15%, can be minimized in disposition structures with non-profit general partners, as described in Chapter Four, so are less of a concern than exit taxes. Exit taxes are levied on negative capital accounts at the limited partner's federal tax rate, and are a major concern for all investors. Initial capital account balances are established by equity contributions to the property, and diminished over time by depreciation, losses, and interest accrued that are taken as tax deductions.

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[7] DHCD may also have loan agreements with the Limited Partnership for other gap, or secondary, financing sources.

Under-capitalized properties will create greater exit taxes because investor capital accounts will decrease faster, while properties that have positive cash flow will be less likely to end up with negative capital accounts and exit taxes[8]. Any tax deductions taken in excess of the initial capital account balances must be repaid at disposition. Some syndicators, including NEF and Enterprise, encourage proactive management of the capital account, usually through redistribution of losses, although sometimes through repayment, in order to avoid a negative capital account.

The mismatch of tax sensitivities between for-profit investors and tax-exempt, non-profit sponsors create potential tensions within Limited Partnerships – not unrelated to the larger tensions created by using private industry to provide public benefits. On the other hand, this discrepancy also creates potential benefits in outcomes, like bargain sales and charitable contributions, described in Chapter Four.

THE DISPOSITION PROCESS

When does the disposition process happen?

The IRS requires LIHTC project owners to guarantee affordable use restriction requirements through Year 15, five years beyond the tax credit period, in order to avoid credit repayment. The expiration of Year 15 is determined by adding fifteen years to the date the property was placed in service (PIS) and then extending to the end of that calendar year. For example, a project PIS in February of 1990 would be in the fifteen-year compliance period through December 31, 2006. After a property has reached the end of Year 15, it is indefinitely eligible for disposition.

Early dispositions, before the end of Year 15, are rare, particularly with non-profit general partners, because the IRS requires the owner (Limited Partnership) to post bonds to guarantee continued compliance with the affordability restrictions. Historically bond pricing has been prohibitive for most investors. Recent decreases in bond pricing and hot real estate

[8] To some degree, investors can manage their exit taxes through initial capital contributions and return expectations.

markets have encouraged some early dispositions. Continuation of these trends may increase early dispositions in the future.

What does the disposition process entail?

Because of the fifteen-year IRS compliance period, LIHTC properties are atypical, illiquid real estate holdings. Transactions after Year 15 are the first opportunity to realize financial value beyond the investors' tax credits, and are generally aimed at getting the investor out of the deal. Dispositions can be a sale of the property to a related or third party, or a restructuring of the ownership entity – a simpler transaction. The disposition process and outcome depend on the parties involved, the applicable state and federal regulations, and particulars of the property. The original Limited Partnership Agreement and Regulatory Agreement outline a number of disposition considerations such as cash distributions upon sale, sale approval rights, and prioritized sale options like the qualified contract clause that provides a means for owners to opt-out of the extended use restriction period. Even so, dispositions require extensive negotiations between the partners to reach agreement on when and how and to whom the property will be sold. Transactions involve the partners, their lawyers and finance consultants, as well as accountants, brokers, appraisers, architects, and the involved regulatory agencies. Specific disposition outcomes will be discussed in Chapter Four. Interviews suggest that LIHTC disposition process typically takes about one year, although experiences ranged from ten months to four years (and counting).

THE PLAYERS AT THE TABLE

The following sections look at the roles and impact of the limited partner, Department of Housing and Community Development, and non-profit general partner.

"KNOW YOUR INVESTOR"

Existing disposition guides recommend that non-profit General partners "get to know" their investor. Some suggest understanding the investor's motivation, but none fully explore this issue. This section will look at how the investor's mission, organizational structure, and

fund investors, as well as the fund's pool of properties influence the disposition transaction, and how knowledge about these issues can assist non-profit sponsors.

The investor's mission may influence the tenor, as well as the outcome, of the transaction. General partners may feel less threatened by the mission-driven intermediary-affiliated syndicators[9], National Equity Fund (NEF) and Enterprise. It is, however, important not to indiscriminately lump all profit-driven syndicators and direct investors together. While all of these institutions have fiduciary responsibility to their investors, each organization interprets and satisfies that obligation differently, depending on their internal return calculations, agreements with investors, and differentiation between for and non-profit sponsors.

How do investors' missions influence dispositions?

Like general partners, limited partners can be for or non-profit. NEF and Enterprise are the primary non-profit tax credit investors, although regional syndicators like Massachusetts Housing Investment Corporation are also active. Non-profit syndicators are generally believed to offer more assistance (or "hand-holding") than for-profit sponsors, and underwrite more conservatively, resulting in lower front-end equity contributions. This may be reflective of and caused by their partners, which tend to be non-profits with less capacity. (For-profits and high capacity non-profits are less likely to need additional assistance and/or value the higher equity contribution.) Because their mission is to facilitate affordable housing development, non-profit syndicators are also more willing to take on smaller projects, which do no have economies of scale for transaction costs and may struggle operationally, than for-profits. In dispositions, NEF and Enterprise have often used the desired outcomes covered in Chapter Four, including paying their own exit taxes. This has not been, however, a consistent policy of the non-profit syndicators. It is also difficult to distinguish whether non-profit investors are enacting an assertively pro-sponsor policy or whether the properties in their portfolios necessitate this policy.

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[9]Community development intermediaries are national organizations that raise capital to distribute to community development organizations. NEF is affiliated with the Local Initiatives Support Corporation (LISC), and Enterprise Community Investment is affiliated with Enterprise Community Partners (Enterprise). LISC and Enterprise are the two leading American community development intermediaries that target low-income communities and provided technical assistance as well as access to capital for their community development partners.

The varying motivations of for-profit syndicators and direct investors for original investment will influence their disposition perspective[10]. Fund and direct investors, such as banks, that are significantly motivated by CRA credits may be more likely to promote long-term affordability and support mission driven general partners through favorable disposition terms. Other syndicators are more aggressive, citing the need to maintain their reputation or establish a back-end precedent. Syndicators also differ by the degree to which they distinguish between for and non-profit sponsors. Although the reason is unclear, I observed that syndicators that make a greater distinction typically have differing policies towards for and non-profit sponsors (or affordability-preserving sponsors) that favor preserving affordability.

When properties have more than one direct investor, the majority investor is usually the critical decision maker. For example, when Fannie Mae and Bank of America invested in a property together at 90/10 respectively; Bank of America's position was insufficient to force a sale. This relationship can also be observed between the investors within a syndicated fund. There are two ways to manage this dynamic, somewhat dependent on the relationship between the investors. By getting the majority investor to agree to a disposition strategy, the general partner can pressure minority investors to agree. This strategy is almost guaranteed, since the economics for a minority investor are unlikely to motivate a hold-out. In the example of Fannie Mae and Bank of America, Bank of America's fairly insignificant pro-rata residual would not have been worth fighting for. Alternatively, by getting enough minority investors to agree to a strategy to create a majority, pressure could be applied to the majority, or largest remaining, investor. This second strategy could also be used by syndicators to manage investors in a particular fund.

How does the investor's internal organizational structure impact the disposition process?

[10] A change of investor is also possible. There are two types of investor replacement that I am aware of: 1. a bank acquisition or merger, in which case the investment motivation usually remains unchanged; and 2. The purchase of private individuals' shares in early funds by what one syndicator termed "opportunists and sharks" in the secondary market. According to the same syndicator, this second type of replacement has resulted in class action lawsuit(s) filed against fund syndicator(s) by fund investors who were unsatisfied with disposition values.

The Community Development Division of one of the nation's largest commercial banks, "admires" the commitment of non-profit general partners to providing low-income housing and often supports these partners by donating its interest to them. While it must meet a division-specific budget and revenue quota, it is able to spread any losses across the whole corporation. This arrangement allows the bank to prioritize long-term affordability by suffering some exit taxes in order to maintain ownership by a mission-driven non-profit general partner. Without the internal structure that enables it to off-set losses from one division with gains from another, the bank would be less likely to exit deals in this generous and mission-driven manner.

This example illustrates how an investor's internal structure can affect its flexibility in handling disposition transactions. Most syndicators and banks have set up, or are in the process of setting up, work groups that focus on dispositions. This is a positive development in the front-end focused tax-credit industry. Some of these disposition groups are also tasked with "work-outs," which, by their urgent and unanticipated nature may detract from the group's focus on dispositions. One consultants suggested that this dual workload may sidetrack syndicators and slow disposition transactions.

Given that only 30% of LIHTC properties are held by non-profits, and these are spread between direct investors and the 6 major syndicators, non-profits sponsored properties constitute a small percentage of most syndicator portfolios[11]. Syndicator staff may be less familiar with internal policies towards non-profit sponsors, special non-profit regulations, and the incorporation of additional continued use restrictions into the property valuation, which will take additional time for the limited partner staff to review. As a result, a non-profit sponsored disposition may take longer than a comparable for-profit sponsored disposition.

The limited partner staff that will handle the disposition is typically separate from the asset management staff that general partners have worked with, and often built relationships with,

[11] For example, Boston Capital has disposed of 350 LIHTC properties, no more than 20 of which (less than 6%) had non-profit sponsors. Non-profit sponsors, including those in partnership with for-profit developers, make up 20% of MMA's current volume, but, to date, they have had little disposition experience with non-profit sponsored projects. NEF and Enterprise are exceptions to this trend.

over 15 years of operations. The asset management group will, however, be a primary source of information for the dispositions group. Ideally, a positive relationship between general partner and limited partner management staff will transfer to the disposition transaction staff. This transition between groups can, however, be complicated if there is already a strained relationship, or if the general partner staff has trouble adjusting to the limited partner disposition staff or policy.

How do fund characteristics influence dispositions?

If calculations for the original fund investment returns included a residual, back-end value, as some of CharterMac's early funds did, then there will be greater pressure to realize a disposition value that adds to the fund's return. In this case, investors have paid for an expected return that includes back-end value. If these funds have over-performed, then the syndicator could feel they have already met their fiduciary duty and that they have more leeway in disposing of properties[12]. However, including back-end value in returns is fairly aggressive, and may indicate that the syndicator will aggressively pursue dispositions regardless of fund performance. In contrast, most fund returns were and are calculated on the value of tax credits alone. From the general partners perspective, there should be no expectation of back-end value in these funds. From the syndicator's perspective, they must still fulfill their fiduciary duty to achieve the best return possible for investors. This can cause tension, particularly with non-profit sponsors who often view any disposition distribution to the investor as being made at the cost of affordable housing. Perhaps a best-case scenario for non-profits is one in which a fund realizes sufficient value from for-profit sponsored properties to allow them flexibility in non-profit dispositions.

Most of early funds (1986-1994) are made up of individual, private investors. These investors are not affected by Community Reinvestment Act ratings. There are more investors per fund than in later, corporate investor funds, and they are typically structured as discretionary funds so that syndicators are not required to get every sale approved by each individual investor.

[12] These are earlier funds which had higher expected returns due to lower credit prices ($0.60 - $0.85 per credit) so while they may out-perform later funds, the investors' had higher expectations and the syndicator still has a fiduciary duty to the investors.

Later funds are exclusively corporate investors, with banks, Freddie Mac, and Fannie Mae contributing the vast majority of equity (~85%, varying by syndicator and fund). These funds do not include back-end residuals in their return calculations. Increasing competition for tax credit investment opportunities in the early 1990's eroded the limited partner's back-end split so later fund values are determined by the tax credits and operating cash flows only. In addition, corporate investors are better able to absorb the tax consequences and are more interested in the CRA credit associated with tax credits. With less expectation for back-end value, CRA consideration, and overall portfolios that are larger and more diverse, corporate investors may be more likely to recognize mission-driven sponsors and accept bargain sales and charitable contributions.

A fund's project pool can also have consequences for individual disposition transactions. Funds typically consist of projects placed in service over one to two-and-a-half years. So, dispositions will typically occur over one to three years. Syndicators will be more anxious to close the deals that expire later since, as they move towards closing the fund, fewer and fewer properties carry the cost of administering the fund. This could manifest itself as more pressure to finalize the transaction, or greater willingness to accept proposed solutions, particularly if funds have met or exceeded their return goals. On the other hand, funds that have not yet achieved targeted returns may try to realize more value from dispositions in order to improve returns.

It is worth remembering that syndicators are partners, but not direct investors. General partners will likely never meet fund investors, who are not directly involved in the disposition. But the syndicator will, and must, always be conscious of their investors. Like consultants for direct investors, syndicators' are concerned with their investor relations with an eye toward future business. General partners should consider how negotiations and disposition outcomes can allow the syndicator to look good to the investors while also maintaining affordability.

Do investors have the capacity to manage transactions?

Investors' capacity will depend on the size of their portfolio – whether or not it is large enough to warrant the cost of internal staff. Otherwise, consultants can provide capacity and expertise to investors, as well as distancing them from transactions, which may be politically desirable. Consultants must represent the interests of their client, and gain approval for any final sale. They will also, however, have additional on-going work as well as self-interest in the transaction, in terms of extending the client relationship. Consultants may be less willing to compromise or may require more documentation than investors because they are trying to prove their ability to secure preferable outcomes for their client. They may not want to take certain outcomes to investors for approval until they are extensively documented. The potential of consultants to expedite the process through expertise may therefore be somewhat diminished by their workload and need to gain approval.

As mentioned before, syndicators have established groups to deal with work-outs and dispositions. These groups are typically two to eight people with advanced degrees and significant experience working with tax credits. These groups typically manage heavy workloads and deal with a wide range of partners, including difficult relationships during work-outs. In addition to managing relationships with partners, the disposition groups must manage relationships with fund investors.

How can general partners learn about their investors?

Ideally the disposition outcome – the sale price, purchaser, and future use - for each property would be somehow recorded or collected and made available so that general and limited partners could research each other's track records and back-end precedents. This information could help non-profit sponsors prepare for disposition negotiations, as well as inform the future selection of LIHTC investors. Given that there is currently no such database at either the state or national level, general partners must ask limited partners about the type of investors and position of the property within the fund. Other non-profit sponsors and housing consultants are also word-of-mouth sources for information on specific investors.

Public Finance Agencies

What on-going relationship does DHCD have with LIHTC properties?

This section looks at how the regulatory environment created by the Department of Housing and Community Development impacts LIHTC disposition outcomes. Although the IRS controls the only enforcement tool of consequence - tax credit repayment, state allocating agencies are largely responsible for establishing the LIHTC regulatory environment and monitoring compliance – in essence the gatekeepers to investors' hell. Regulations, established through the Qualified Allocation Plan and Regulatory Agreement, govern tenant income limits, physical property standards, and the compliance monitoring processes, as well as notice or approval requirements for sale of the property.

DHCD has anticipated a number of issues that will arise as an increasing number of LIHTC properties reach the end of the 15-year compliance period. In 2005-2006 the department hired consultants to conduct an audit of properties placed in service since the beginning of the program in order to identify portfolio vulnerabilities. DHCD has not shared this report outside the department, but, through interviews, LIHTC program staff shared the main findings:

- The projects eligible to submit requests for qualified contracts after year 15 will be limited.
- The affordability of some properties is extended through 30-year use restrictions attached to subordinated debt. While this reinforces the affordability, it does not eliminate or solve refinancing challenges.
- Almost all current deals agree to restricted use agreements that extend beyond 30 years, in many cases in perpetuity, and/or have additional subsidy with additional affordability restrictions.

These are discussed further below, and qualified contracts are discussed in greater depth in Chapter Four.

Are extended use restrictions common? Are they helpful?

Sizable concern about qualified contracts' ability to prematurely terminate affordability has been delayed by Massachusetts' adoption of the 30-year use restriction as detailed in Chapter Four. In addition, within the group of projects able to request qualified contracts at Year 15, some, though not many, also have Housing Innovations Funds (HIF) soft second mortgages with 30 year terms that will help preserve affordability.

It is now common for LIHTC applicants to opt-into restricted use agreements that extend beyond 30 years, in many cases for perpetuity. Many projects also have additional long-term use restrictions imposed by other subsidies Other public agencies that provide mortgages or secondary funding may impose additional affordability and reporting restrictions. For example, the City of Boston Department of Neighborhood Development currently requires affordability in perpetuity on properties to which it contributes funds. Extended use restrictions go a long way to ensure affordability, but they do not address refinancing challenges created by operating budgets (deficits) , capital needs, and the use restrictions themselves. These requirements and their effect on refinancing options will be discussed Chapter Six.

The enforceability of affordability after Year 15 is also a challenge, since the IRS does not require compliance monitoring after the initial 15-year period.

Will there be compliance monitoring after Year 15 in Massachusetts?

Interviewed DHCD staff indicated the Department's intent to monitor properties through Year 30. They are currently developing a "Year 16" monitoring policy, which will outline the compliance monitoring requirements for years 16-30. As in years 1-15, DHCD will use an outside contractor to perform this work, and will charge properties an annual monitoring fee. They plan to continue both physical and file inspections, though the level of documentation required may be reduced from year 1-15 requirements. Reporting requirements for projects with HOME funding will not change.

DHCD staff are aware of very few disposition transactions, which is surprising given that they plan to continue compliance monitoring. The Department has been involved in only a handful of dispositions (due to refinancing), even though there are over eighty properties in

Massachusetts beyond Year 15. This highlights the need for better record keeping as a tool to manage the Commonwealth's stock of affordable housing. By requiring notification of all changes in ownership, DHCD could be aware of the majority of disposition outcomes.

NON-PROFIT SPONSORS

Is there a non-profit sponsor profile?

Non-profit sponsors are a diverse group of organizations with no single defining profile. The Massachusetts Association of Community Development Corporations (MACDC), an umbrella organization that describes itself as the "policy and capacity-building arm of the community development movement in Massachusetts," has 60 member organizations. Included in this mix are the non-profit sponsors that own 30% of the LIHTC units in Massachusetts.

Sponsors can range in size from a staff of two, like South Boston Neighborhood Development Corporation, to a sophisticated, multi-departmental organization of over 400 employees, like The Community Builders, Inc. Amongst community development corporations (CDCs), the most typical form non-profit sponsor, foci range from housing development to job training and social services. Some organizations are geographically based, while others are culturally based. They may provide service in one,two, or five languages. Even amongst organizations of similar size, foci may be different so that a staff of five focused on housing development may have the expertise to manage a disposition, while a staff of five in a social services focused organization may not.

Non-profit sponsors typically fall into two categories: capable developers and opportune partners. Capable developers are the sole general partner and oversee the development process directly. These are often organizations whose primary mission is to provide affordable housing so it follows that they have greater capacity to manage transactions and projects. Non-profits with less capacity or other foci frequently partner with for-profit developers. Typically the non-profit acts as the project sponsor and the for-profit develops the project for a fee. The non-profit presence increases the likelihood of public subsidy (including tax credits), can ease permitting, and usually results in a developer fee for the non-

profit. While both of these types of organization are likely to promote long-term affordability, their ability to handle disposition and refinancing transactions are clearly different.

Do non-profit sponsors have the capacity to manage disposition transactions?

In general, staff and consultants that I spoke to on the investor side thought that non-profits lacked capacity to manage dispositions in-house[13]. Positive experiences with capable non-profits, seem to be overshadowed by frustrations with stalled negotiations, and positive experiences working with sponsors' consultants. Despite this, many investors were sympathetic towards their non-profit partners.

What are alternatives to in-house transaction capacity?

Development and finance consultants are common in affordable housing, and dispositions are no exception. Consultants can bring the benefit of multiple disposition experiences and familiarity with resources. Conversely, they add costs to the disposition transaction, which some properties struggle to support in the first place.

ANTICIPATING YEAR 15

Was the LIHTC industry prepared for the first wave of Year 15 dispositions?

The fifteen-year compliance period has been a fundamental part of the Low-Income Housing Tax Credit program since its inception. When the first projects were placed in service in 1987, the clock started ticking. As 2002 approached, "Year 15" became a hot topic among sponsors and investors. Despite extensive backroom speculation, policy and practice guides have been slow to emerge.

I was able to find two reports anticipating the expiration of the first Low-Income Housing Tax Credits. "Expiring Affordability of Low-Income Housing Tax Credit Properties: The

[13] Here again, differentiation by the syndicator between for and non-profits sponsors seemed to be significant in that the one syndicator that felt non-profits had sufficient capacity, also had the most differentiated policies towards for and non-profits.

Next Era in Preservation," was published in 1999 by the Neighborhood Reinvestment Corporation and Joint Center for Housing Studies of Harvard University. It has a national perspective, with some specific examples from Massachusetts. "The Tax Credit Turns Fifteen; Conversion Risk in California's Early Tax Credit Portfolio," was published in November, 2001, by the California Housing Partnership Corporation, and while it focuses on the LIHTC expiration issues in California, it provides useful insight into preparations for LIHTC expiration. These reports, written in anticipation of Year 15, provide a number of predictions and recommendations. This thesis intends to add to the literature based on the actual experiences of the first wave of expirations and recent policy changes.

What does the Joint Center for Housing Studies Paper say?

Writing in 1999, Kate Collignon acknowledges that states were still grappling with the HUD mortgage and Section 8 preservation crisis involving 1.3 million units. As she predicted, the number of LIHTC units have surpassed that number, totaling over 2 million and growing by approximately 63,000 units per year. Collignon's analysis points out that:

- "Devolved authority will place the burden of responsibility for preservation on HFAs." (pg 8)
- States that were early adopters of extended use restrictions will be better prepared and have a less pressing preservation challenge.
- Following the HUD crisis, preservation has wider acceptance as a "legitimate aim of public policy" but may not always be cost effective or financially feasible.
- Division of properties pre and post-1990, referred to as "early" and "later," a classification that seems generally accepted in the industry. Early projects are characterized as projects that do not have 30 year extended use restrictions, received relatively low investment rates (ie 65 cents on the dollar), and have higher income limits (typically 60%). Later projects are characterized by 30 year minimum use restrictions (many state policies encouraged these to be even longer), better equity rates, right of first refusal agreements for non-profit sponsors and increasingly lower-income targets.
- Syndicators' policies will be critical.

Collignon also points out that no data source exists that would allow for the forecasting of tax-credit disposition outcomes. She does, however, provide a thorough list of existing data sources.

Collignon goes on to establish five primary outcome categories:

1. Early projects convert to market rate after 15 years
2. Early project owners voluntarily opt to maintain affordability
3. Later project owners opt out of extended use restrictions and a non-profit or other entity purchases the property through a qualified contract and maintains the affordability
4. Later project owners opt our of extended use restrictions, but no entity can be found to purchase the property under a qualified contract and the property converts to market rate
5. Late project owners do not actively opt out of the extended use restriction period but a lack of compliance monitoring allows them to stop targeting the lowest-income households

In identifying only five outcomes, Collignon does not address some of the most optimal outcomes, particularly for mission driven non-profits:

- Non-profit general partners maintain affordability by purchasing the property through a bargain sale resulting in a charitable contribution by the limited partner
- Affordability is maintained through a purchase of the property by a non-profit for the formulaic "debt-plus-taxes" price
- A sale of the limited partner interest results in the non-profit ownership (100%) and preservation of affordability

It is these outcomes that this thesis is most concerned with and I will focus on the means, methods, and barriers to achieving these outcomes. The following thesis chapters do not provide a statistical analysis of outcomes, but rather look at the ways in which preferable outcomes can and have been achieved.

Collignon, like others before and after her, recommends better data collection. Writing in 1999, she states that "[n]ow is the time for more-organized, systematic learning" (pg.9) and that "[i]t is not too early for states, federal policy-makers and other entities to begin to learn

about and to prepare for the preservation of LIHTC properties." Now, eight years later, there is a chance to examine whether this learning and preparation has happened, and, if so, by whom and how. In addition, she touches on the issues of preservation-price definition, enforcement of extended-compliance periods, and HFA capacity – all which will be discussed later in depth. Two ideas that Collignon offers that will not be picked up in this thesis are the call for preservation entities and a national forum on tax credit expiring-use issues. While these are interesting ideas, they are difficult to implement, potentially duplicative, and have significant barriers to their viability, such as funding.

What can other states learn from CHPC's anticipation of Year 15?

The California Housing Partnership Corporations' approach is more focused and specific. The specificity with which they were able to analyze the California LIHTC portfolio demonstrates the benefits of improved data collection. For example, they knew that 45% of the units expiring between 2002 and 2006 did not have non-LIHTC extended use restrictions in place, because they have data on additional funding sources and *units* (more specific than properties). Data analysis also allowed CHPC to break down units by city to look at potential effects of unit loss and refinancing costs on municipalities and local policy. It is worth noting that California has a mandatory 55-year use restriction for 9% credit projects and 30-year restrictions for 4% projects.

The report walks through disposition outcome options (covered in Chapter 4) and includes a short section on tenant protections. It points out that LIHTC tenants are not eligible for federal tenant subsidies in the way that previous preservation at-risk tenants have been. Further legal analysis revealed that California needed to change its laws to include LIHTC units in notification requirements. Since LIHTC restrictions sunset automatically, sponsors were previously not required to comply with opt-out notification.

Recognizing the impact of investor behavior and policy on disposition outcomes, CHPC analyzed the concentration of units by investor. This analysis will allow them to track investor behavior over time, which could inform future negotiations and sponsors' selection of investors.

CHPC grouped units into risk profiles, based on the likelihood of units converting to market, with five steps between low and high. The risk assessment methodology is a significant contribution of "The Tax Credit Turns 15." It uses the following risk factors to identify projects most at-risk of conversion to market rate:

- Additional affordability covenants – extend affordability periods, though less restrictive agreements may still allow significant rent increases
- General partner – based on CHPC's experience with HUD-assisted at-risk projects, they believe that non-profit GPs are more likely to preserve affordability
- Local housing market – strong markets will incentivize for-profits to convert to market, and will make it more difficult (costly) for non-profit sponsors to purchase properties from partnerships (or on qualified contracts).

This fairly simple methodology allowed CHPC to group the units placed in service between 1987-1989 into low, medium/Low, Medium, medium/high, and high risk of conversion groups.

The report also contributes to the literature by identifying the following factors in a non-profit's ability to buyout their limited partner:

- Purchase option
- Additional affordability covenants
- Comparable market rents
- Mixed income
- Outstanding debt
- Exit taxes
- Recapitalization requirements

CHPC also sets out preservation agendas for various levels of government. At the federal level they recommend focusing on tenant assistance, while at the state level they recommend amending notice provision, publicizing notice provisions, establishing eviction notices, allocating resources to preservation purchases (in particular for non-profit buyouts), and prioritizing existing resources. At the local level, they recommend taking inventory of existing LIHTC stock, researching local use restrictions, maintaining compliance monitoring, contacting owners to ask about disposition intentions, including LIHTC properties in preservation ordinances and allocation resources to preservation. They conclude that the

"expiring tax credit problem – in both its magnitude and its complexity – merits the full and immediate attention of both public and private stakeholders."

LIHTC Disposition Literature Now

Who's talking about dispositions now?

The specialized periodicals, *Multifamily News* and *Affordable Housing Finance* have both run around one feature article a year on LIHTC dispositions over the past few years. Other banking and community development periodicals have also run one-time stories addressing the topic. As would be expected in an article format, these sources offer generalized information on the author's experience. Most of these articles are written by investors or sponsors and provide information similar to that summarized in the disposition guides below. Stephen Rodgers' conclusion in his article on Year 15 dispositions in the June 2006 issue of Affordable Housing Finance exemplifies the tone of many articles: "Everyone's experience with Y-15 has been different, and I can only offer very broad advice and suggestions for surviving the wave." There are, however, a couple of articles that are worth noting for their unique perspective.

In the Nov 2005 issue of Multi-Housing News, Robert Sheppard of Marcus and Millichap, a brokerage firm with expertise in LIHTC properties frequently used by syndicators to establish property values, offered some ideas on preservation strategies. They emphasize that all investors (including syndicators) they have worked with are interested in getting out as soon as feasible after Year 15. Every preservation strategy that they had been involved with as of November 2005 had involved the exit of one of the original parties and the introduction of a new investor. This perspective is unsurprising from a broker, and may not be representative of the full set of transactions, but is ignored in other treatments of Year 15 issues.

In October 2006 Greystone CDE LLC introduced a refinancing product, consisting of a mortgage and a surety bond, that allows the investor to favorably exit a LIHTC deal after year ten and retains the ability for the sponsor to sell and/or refinance again at year 15.

While this product does not seem to be in wide use at the current time, it is indicative of the increasing attention being given to the ability of investors to exit before Year 15.

Are there existing guides to disposition? Are they helpful?

Various players in the industry have created guides to LIHTC dispositions. As a result, these guides provide varying perspectives on disposition transactions. The majority of these were produced in the last two years and are based on actual experience. They are typically formatted as slideshow (Powerpoint) presentations, so their usefulness as stand-alone documents is limited. National intermediaries and local or regional non-profit resources, such as the Federal Home Loan Bank's Boston office, have organized brown-bag lunch and "web-inar" sessions to distribute information amongst sponsors while syndicators have made and attended presentations at industry conferences. An overview of Local Initiatives Support Corporation (LISC), National Equity Fund (NEF), and CharterMac guides follows.

What do the LISC and NEF guides advise?

LISC and NEF have released a total of three guides to disposition transactions that were accessible for review. Without diminishing the service that these guides provide, there are a couple broad concerns that should be pointed out:

- There is potential conflict between LISC, a trusted resource for non-profit community development organizations, and NEF, which, as a syndicator, has fiduciary responsibility to its investors. Yet these two organizations are often perceived as one.
- Sponsors must still think critically about their disposition options and chosen strategy. They should not rely solely on these guides to select a disposition strategy.

NEF provides a seven page guide to "Developing a Year 15 Transition Plan" on its website. The brochure walks through NEF's basic guidelines for the disposition process, focusing on sponsor purchase of the property at the "debt plus exit taxes" price that is typically included in Limited Partnership Agreements with non-profit sponsors. The guide begins by laying out the GP's responsibility for disposition, and NEF's right to approve the disposition. It then lays out the following steps:

- Determine Year 15, based on placed in service date
- Determine whether to buy the property with help from attorneys and accountants

- Determine the viability of the property by evaluating its current operations, market trends, future operating expenses, debt services, and capital needs
- Formulate a purchase proposal that includes the intended future use of the project, a plan for outstanding partnership debt (a worksheet is provided), the proposed purchase price with steps to estimate the debt plus exit tax price (a worksheet is provided to estimate exit taxes), and remaining cash assets of the partnership
- Determine whether to purchase the LP interest or the property

The guide concludes with an outline of the disposition process and a note that, as a non-profit syndictor, NEF is committed to maintaining the affordability of units after Year 15.

In May 2006, LISC hosted an "Experts Online" session entitled "Countdown to Year 15: Are you Ready?" given by Judy Schneider, NEF's Senior Vice President responsible for dispositions; Barb McQuillan, the Executive Director of Twin Cities Housing Development Corporation; and Chuck Wienstock, the Executive Director of Capitol Hill Housing. Nearly 90% of NEF's dispositions have been "rollovers" in which GPs assume existing debt and continue operations, reflective of NEFs community and affordability driven mission. This is reflected in the presentation, which assumes that sponsors want to retain control of the property. The general outline of dispositions provided is similar to the NEF guide. Schneider laid out how to determine Year 15, the sponsor's option to acquire LP interest or the property, and various ways to refinance and special considerations when doing so. She lists some important considerations:

- The new ownership entity must be carefully structured to preserve the acquisition credit.
- The sale of LP interest creates a tax liability, as does the sale of property
- The possibility to restructure partnerships in years 11-15 to reduce the LP interest by 30% to mitigate LP exit taxes

McQuillan focused on negotiations with investors. She laid out a flow of fiduciary duty, which is an important perspective for general partners to remember when negotiating dispositions: the general partner to the partnership and its limited partner, the limited partner to its investors. She also outlines what a Year 15 plan should include, noting the need to examine other debt agreements for terms related to sale, rights to approve transfer of ownership, and use of reserves – which are general partner responsibilities that limited

partners may not immediately consider. She provides some interesting notes on her experience with investors (though it is not clear what non-NEF investors she has negotiated with), specifically that they do not expect to receive equity, are willing to exit with taxes paid if affordability is maintained, expect the contractual split to be the GP profits from a sale, and that they may consider fund performance in negotiating specific deals[14]. She lists some interesting suggestions for managing exit taxes, but does not explain them in writing.

Weinstock covered the decision making process from a Community Development Corporation (CDC) perspective. He thoughtfully includes capacity as a consideration in deciding to buy the property, as well as taking a careful look at the physical property needs. Capitol Hill Housing had been "saving diligently" and did not want to lose these reserves or be forced to spend them, so an LP donation was their favored disposition strategy. While this was acceptable to NEF, it is an unlikely outcome with most syndicators, pointing to the importance of considering the perspective that informs each guide. Finally, the fact that each presentation draws on examples from two states and attempts to make them widely accessible and applicable forces the presenters to avoid specific deal points. As a result, these guides provide a starting point for learning about dispositions, but their generalization limits their instructiveness as transaction guides.

LISC New York City has also produced a manual for New York City based sponsors. Although it contains much of the same information as the previously reviewed presentation, there are some specific features that make it more useful than the guides aimed at national audiences. First, it is formatted as a manual and so delivers sufficient information as a stand-alone document. Second, it includes some of the typical requirements on New York public lenders. It does not, however, including information specific to New York refinancing options. It contains more worksheets than the NEF guide, including one on determining whether to purchase the limited partner interest or the property.

What information does the CharterMac presentation offer?

[14] One slide addresses the need to know the limited partner's philosophy, with a list of motivations but no information on how these impact the transaction. As noted earlier in the chapter, I find this to be an important issue.

In late February 2007, Stephen Rodgers, the head of CharterMac's disposition group, gave a presentation on LIHTC Exit Strategies at a conference held by affordable housing investor group Institute for Responsible Housing Preservation. The focus of this presentation differs from LISC guides in that it is targeted at investors. It outlines the characteristics of first generation expirations and syndicator and investor goals, which will be discussed later. In reviewing sale issues, Rodgers notes that early deal economics favor the limited partner, that general partners may lack economic motivation, that limited partner expectations are high because potential (future) investors are watching, and that these transactions typically take longer and are more difficult than anticipated. The presentation then walks through five Year 15 strategies that represent a for-profit sponsor perspective:

- Operate as-is with sale of limited partner interest or refinancing
- Convert to market rentals
- Convert to condominiums (market rate or below market rate)
- "Recycle" as 4% or 9% tax credit project
- Partner with non-profits to access subsidies

The presentation includes examples of conversion to condos and a case in which a Qualified Contract provision was leveraged to receive a greater appraised sale price from a non-profit, with significant local public subsidy. Rodgers advises starting in Year 13, looking at all possible strategies, and picking the right local partner. His concluding "helpful hints" are:

- "Beware financing or recapitalization that jeopardizes Y15 options – e.g., refi with lockout precludes bonds and 4% credits
- Patience
- Perseverance
- Prozac"

These guides give an understanding of what issues must be considered in disposition transactions, but often don't go beyond identifying the issue. Further research and writing on how these issues impact disposition transactions, and how they can be handled to preserve affordability is needed.

How can further literature on LIHTC dispositions promote long-term affordability?

The existing LIHTC and preservation literature provides a foundation for future work, both in the information it provides, and the topics it has been unable to address. Much of the

responsibility for preserving the affordability of LIHTC units will fall to the states, so it is logical to focus additional research at a state level. In addition, there are significant differences between the mission and resources of for- and non-profit sponsors. Given the mission of most non-profit sponsors, it is reasonable to believe that they are more likely to maintain affordability long-term. This thesis, following on the existing literature, aims to contribute research on current low-cost disposition outcomes and strategies used by non-profit owners of Massachusetts LIHTC projects. Putting these together with information on the various involved parties, previous preservation models, and changes in Massachusetts politics I will suggest how state-level policy changes can efficiently recapitalize LIHTC properties.

CHAPTER FOUR:
Disposition Outcomes

The first section in this chapter identifies possible outcomes for LIHTC dispositions and looks at the applicability of each outcome to non-profit sponsors. The second section then focuses on the possibility of qualified contracts in Massachusetts. While it is unlikely that non-profit sponsors will pursue this outcome strategy, it is important to understand qualified contracts as an element of LIHTC preservation because of their potential to reduce the stock of post-Year 15 affordable units. In the third section, desirable outcomes for non-profit sponsors are described in greater detail with examples drawn from completed dispositions in Massachusetts. I have chosen to address dispositions and recapitalization separately to reflect their mix-and-match nature. While these two events sometimes happen simultaneously and have an incredible impact on each other, there are advantages to conceiving of and structuring them as separate but conditional transactions.

POTENTIAL DISPOSITION OUTCOMES

This section identifies and briefly describes possible disposition outcomes for LIHTC properties. Specific outcome strategies that allow non-profit sponsors to "keep" properties at little or no cost are discussed in greater depth in a later section.

WHAT DISPOSITION OUTCOMES WERE ANTICIPATED?

In anticipation of Year 15, Collignon (1999, 19) identified five potential outcomes:

1. Early projects convert to market rate after 15 years
2. Early project sponsors voluntarily opt to maintain affordability
3. Later project sponsors opt out of extended use restrictions and a non-profit or other entity purchases the property through a qualified contract and maintains the affordability

4. Later project sponsors opt out of extended use restrictions, but no entity can be found to purchase the property under a qualified contract and the property converts to market rate
5. Later project sponsors do not actively opt out of the extended use restriction period but a lack of compliance monitoring allows them to stop targeting the lowest-income households

Early projects convert to market rate after 15 years

Projects that received credit allocations before 1990 have fifteen year long use restrictions. This generation of projects will be the easiest to convert to market rate. Owners will need to comply with fair housing laws regarding evictions, but otherwise face no barriers to convert to market rate apartments or condominiums. Some projects may have longer use restrictions from other subsidies that could delay conversion.

This outcome scenario is likely for for-profit sponsored projects, where both sponsor and investor are interested in realizing value. Amongst non-profit sponsors it is unlikely since it does not maintain affordability, but may be seen if the conversion (or a sale that enables conversion) provides sufficient profit to alleviate the sponsor's financial distress or to provide significantly more affordable housing at an alternate location. Additional affordability restrictions imposed by other funding sources may limit the potential for this outcome.

Early project owners voluntarily opt to maintain affordability

This outcome is more likely with non-profit sponsors. If the sponsor is committed to maintaining affordability, the challenge becomes *how* to maintain affordability and remove the investor. This will still require a disposition transaction and often refinancing which will extend or add affordability requirements.

Even if the sponsor decides to maintain affordability, the rents may still be raised. Subsequent decisions about what level of affordability to maintain will be determined by the regulatory agreement, operating budget, and historic rent raises.

Later project owners opt out of extended use restrictions and a non-profit maintains the affordability through a qualified contract

In 1989, the IRS introduced a clause in the code that allows "qualified contracts." Owners who want to opt out of the extended use restriction and sell a project after Year 15 can request a qualified contract from DHCD. DHCD then has one year to find a qualifying organization – a non-profit, tenant group, or government agency – that will maintain affordability and purchase the property at a prescribed price. The qualified contract price formula is established in the IRS code as repayment of equity invested in low-income units with a cost of living adjustor. Since the investor has already received the full tax credit value, this could result in a near doubling of their expected return.

It is unlikely that non-profit sponsors would utilize this option, given that it puts affordability at risk and is a heavy burden on public funding. There have been some cases in which a non-profit general partner did not wish to retain ownership, and at Year 15, the partnership sold the property to another non-profit. This type of sale is generally privately arranged outside the qualified contract process.

Later project owners opt our of extended use restrictions, but no entity can be found to purchase the property under a qualified contract and the property converts to market rate

If DHCD is unable to secure a qualified contract within a year, the affordability restrictions lapse. DHCD must produce, but not enter into, a purchase contract in order to preserve the affordable use restrictions. The next section elaborates on the conflict and confusion around qualified contracts.

Later project owners do not actively opt out of the extended use restriction period but a lack of compliance monitoring allows them to stop targeting the lowest-income households

This scenario is easy to imagine with an unprincipled or negligent for-profit sponsor. This could occur even with continued compliance monitoring since tax credits recapture is not a threat after Year 15. It is unlikely with a mission-driven non-profit sponsor. There is, however, the possibility that a non-profit sponsor would raise the rents after Year 15 to

cover increased operating costs or additional debt taken on in the course of refinancing. While the property must continue to provide housing for the income levels established in the regulatory agreement, there may be room to increase rents if the property has not kept up with historic rent increases allowed by HUD. This practice of depressing rents below the allowable annual growth rate may be more common at elderly properties, where residents have fixed incomes.

What outcomes for non-profit sponsors have been observed in the first years of dispositions?

After the first few years of disposition eligibility, it has become clear that investors have a fifteen year investment horizon and want to exit partnerships following Year 15, regardless of extended use commitments. A number of factors motivate this desire: fund investment returns are calculated over fifteen year terms, funds may already be in the process of divestment and distribution, the risk of credit repayment disappears after Year 15, capital accounts continue to deplete and drive exit taxes up, and direct investors are anxious to get what they view as under-performing properties off of their balance sheets. From the general partner's perspective, Year 15 is the first opportunity to recapitalize properties and/or gain full ownership.

Collignon's list does not contemplate the mechanics of dispositions or the means by which later projects maintain affordability. Therefore, her listed outcomes ignore some of the most optimal disposition strategies available to mission driven non-profits, by which early and late project owners maintain affordability, and which I identify as:

- Non-profit general partners maintain affordability by purchasing the property through a bargain sale resulting in a charitable contribution by the limited partner
- Affordability is maintained through a purchase of the property by a non-profit for the formulaic "debt-plus-taxes" price
- A sale of the limited partner interest results in the non-profit ownership (100%) and preservation of affordability

These are described briefly below and in greater detail in the third section of the chapter.

Non-profit sponsor purchases the property though a bargain sale after Year 15

A bargain sale is only available only to a non-profit sponsor because it depends on the limited partner's ability to realize tax benefits through a *donation of property*. The property must first be appraised. Then a non-profit, typically an affiliate of the general partner, purchases the property by assuming the existing debt. The investor's tax rate is applied to the remaining value (appraised value less debt), the product of which is considered a charitable contribution. The charitable contribution credit is distributed pro-rata within the original partnership, so the limited partner will typically receive 99.99% of the tax benefit of the contribution. Syndicators then distribute the credit to fund investors. This approach benefits the general partner, but, depending on the distribution of sale proceeds, has less benefit for the limited partner than a market-rate sale[15]. As a result, it may be somewhat difficult to achieve, as will be discussed in the Desired Outcomes section.

Non-profit sponsor purchases the property for "debt plus taxes" after Year 15

The "debt-plus-taxes" price option is a special provision within the Limited Partnership Agreement that provides a non-market purchase price to non-profit sponsors. Essentially it allows the sponsor to purchase the property by assuming the debt and paying the limited partner's exit taxes. It differs from the previous outcome in that the sponsor must pay the limited partner's exit taxes and thus has out of pocket expenses. Negotiations for this purchase option will center on the definition of the "debt-plus-taxes" sale price, which is typically not defined in detail in the Limited Partnership Agreement.

Limited Partner donates their interest in the partnership to the non-profit sponsor

While most dispositions involve a sale of real property, a sale of just the limited partner interest is also an option. This can be thought of as the general partner "buying out" the limited partner. The decision between disposing of the property and disposing of the limited partnership interest has both financial and tax consequences. This outcome is seen less often with for-profit sponsors. The National Equity Fund is one of the syndicators most comfortable with this approach.

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[15] As a simplified example, if a property was appraised at $10,000,000, had $3,000,000 in debt, and the limited partner was entitled to 50% of the sale proceeds, a straightforward sale would result in $3,500,000 cash benefit for the limited partner whereas a bargain sale would result in $2,100,000 of tax benefit ($10,000,000 less $3,000,000 in assumed debt, leaves $7,000,000 multiplied by an assumed federal tax rate of 39%). The Desired Outcomes section of this chapter includes a more detailed example.

Details and examples of these outcomes are given in the Desired Outcome section.

QUALIFIED CONTRACTS

Non-profit sponsors are unlikely to request qualified contracts, which are a tool to opt-out of extended affordability restrictions, and therefore generally in conflict with their purpose. However, it is important to understand the potential for qualified contract requests in Massachusetts as an affordability preservation issue. Qualified contract requests that are successful from the owner's viewpoint will result in a loss of affordable units or an expensive preservation purchase that is an inefficient use of public resources. This section looks at how qualified contract requests have fared thus far, the regulatory environment for qualified contracts, and the probability of contract requests in the Commonwealth.

How does a qualified contract work in theory and in practice?

The qualified contract provision exists in thousands of regulatory agreements. It provides a way for owners to get out of the extended affordability restriction, as well as a one-year window for state allocating agencies to prevent such a move. Thus far, however, it has been largely ineffective in producing sales due to a lack of IRS guidance and states' concerns about loss of affordability and setting national precedence.

The IRS code (§42 (h)(6) (F)) is impractically general with regards to qualified contracts:

> Qualified contract. For purposes of subparagraph (E) , the term "qualified contract" means a bona fide contract to acquire (within a reasonable period after the contract is entered into) the non lowincome portion of the building for fair market value and the lowincome portion of the building for an amount not less than the applicable fraction (specified in the extended low-income housing commitment) of—
>
> (i) the sum of—
>
> (I) the outstanding indebtedness secured by, or with respect to, the building,
> (II) the adjusted investor equity in the building, plus
> (III) other capital contributions not reflected in the amounts described in subclause (I) or (II) , reduced by

> (ii) cash distributions from (or available for distribution from) the project.[16]

The industry has been aware of the need for clarification for years, and the code itself contemplates additional guidance:

> The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this paragraph , including regulations to prevent the manipulation of the amount determined under the preceding sentence.

The IRS has listed qualified contracts on its 2007 guidance agenda, although this does not guarantee that guidance will be issued soon. In the meantime, the lack of guidance has forced states to either establish their own regulations or go without. Discussions with investors indicate that state regulations typically feature extensive documentation requirements (appraisals, property management records, capital needs assessments, etc), a process prolonged by HFA delays to the start of the one-year request period and extensions for additional documentation requests, and owner absorption of the transaction costs. These onerous requirements appear to be discouraging to owners. In interviews, syndicators were somewhat dismissive of qualified contracts as viable disposition strategy, and unaware of any successful sales emerging from the process.

The financial requirements make qualified contracts prohibitively expensive. §42 (h)(6) (F) defines "adjusted investor equity" as

> …the aggregate amount of cash taxpayers invested with respect to the project increased by the amount equal to—
>
> > (I) such amount, multiplied by
> > (II) the cost-of-living adjustment for such calendar year, determined under section 1(f)(3) by substituting the base calendar year for "calendar year 1987".

Essentially the investor is fully reimbursed for her initial equity contribution to low-income units, in addition to having received the tax credits. This reimbursement payment, beyond the expected return, is difficult to justify, particularly for non-profits and public agencies with limited budgets.

[16] See Chapter Three for a typical deal structure.

At this time both allocating agencies and investors seem wary of the process, viewing a request for a qualified contract as a threatening move that may be used to force action on other possible transaction structures. For example, one syndicator used what they call "qualified contract leverage" in Riverside, CA. They notified the city of their intent to file a request for a qualified contract, and were able to subsequently negotiate a market-rate sale of the property to the non-profit sponsor largely funded by the city. The qualified contract price would have been $5.76M, but the appraised value was $6.4M. The refinancing of $10.3M included a market acquisition, the minimum per unit capital expenditures required for tax credit financing, and a $3.1M loan from the city.

Riverside California Disposition Example

SOURCES		USES	
Tax-Exempt Bonds	$3.22M	Acquisition	$6.48M
4% LIHTC	$3.19M	Hard Costs	$1.93M
City Loan	$3.11M	Soft Costs	$625K
HOME Funds	$500K	Reserves	$305K
Deferred Dev. Fee	$300K	Developer Fee	$975K
TOTAL	$10.31M		$10.31M

Figure 4.1

It is important to note that the IRS code requires that a qualified contract be submitted to the allocating agency, not necessarily entered into, in order to satisfy the request. The previous example illustrates allocating agencies' fear of not being able to satisfy a qualified contract request. At the same time, investors fear that the IRS requirements allow agencies to drum up charade responses to qualified contract requests that are never intended to go to sale, in order to preserve affordability.

Recapitalization Advisors, Inc (Recap) a leading affordable housing recapitalization consultant, is critical of states' qualified contract regulations because of the burden they place on owners (investors). Recap's critique highlights the concerns of for-profit owners and investors and urges a "transaction-enabling environment where market mechanisms are used

to sort and prioritize preservation assets" (Web Update 50, 5, 2005). Their analysis results in three possible scenarios:

1. The qualified contract price is below the restricted use value so owners are unlikely to benefit from or request a contract.
2. The qualified contract price is below the unrestricted value (realizable if no contract is submitted) but above the restricted use value, and is therefore a "preservation bargain" that should eligible for typical subsidies.
3. The qualified contract price is greater than the unrestricted value so "owners must use the QC mechanism to access value."

The last scenario is particularly troubling because it presents the allocating agency and potential preservation buyers with a choice between losing affordable units and knowingly over paying to preserve those units. Using the market in this way, may have the unintended consequence of locating all LIHTC preservation projects in areas with lower property values, possibly conflicting with other state and local policies aimed at deconcentrating poverty and creating mixed income communities. Recap's article is, however, a reminder that states must balance their desire to preserve affordability with the necessity to have a process that does not compromise owners' rights, and of the tension that inherently exists in involving the private market in the provision of public benefits. In order to maintain the credibility of the LIHTC program, states and the IRS must avoid revoking investors' rights and re-creating the HUD mortgage pre-payment conflict.

The qualified contract embodies this public-private tension in trying to provide options for both interests without clear intent. Its existence seems to contradict the thirty-year extended use requirement, to the benefit of owners. Yet, its time and process requirements seem to prioritize preservation. To truly serve as a preservation tool that discourages owners from opting-out of extended use agreements and to provide the state an incentive, in the form of a discount, to preserve affordable housing, the qualified contract price would have to be uniformly lower than market. The definition of qualified contract in the IRS code restricts states' ability to shape their policies in this way. The code does, however, give states the ability to enact "more stringent requirements" with respect to when owners can request qualified contracts. The IRS code also limits the states' ability to create a qualified contract policy which functions as a preservation tool.

How likely are requests for qualified contracts in Massachusetts?

In Massachusetts, the projects eligible to submit requests for qualified contracts after Year 15 will be limited to those placed in service in 1990. Revisions to the QAP and regulatory agreement issued in 1991 required a 30-year affordability commitment without the ability to request a qualified contract at Year 15.

Since the qualified contract issue is temporarily limited, DHCD will have the opportunity to learn from other states, like Florida and Washington, which have established qualified contract guidelines and documentation standards. The March 2007 update of the IRS 2006-2007 Priority Guidance Plan listed qualified contracts as one of the issues the IRS plans to issue guidance on. It does not, however, indicate in any way what that guidance will be. Given that there are a limited number of properties in the Commonwealth that will be eligible to submit requests for qualified contracts at present and in the near future, and that the IRS can be expected to issue guidance before post-1991 properties reach eligibility, it is reasonable that DHCD has no imminent plans to create a qualified contract policy.

Interviews indicate that syndicators are not aware of DHCD's qualified contract situation. Without a qualified contract policy, it is possible for syndicators to submit contract requests and attempt to immediately start the one-year clock, disadvantaging DHCD's review. In March, 2007, DHCD received its first Qualified Contract request, submitted on Washington State forms. At time of writing, DHCD had not determined the sufficiency of the request.

It will be important for DHCD to create a policy well ahead of the 2021 Regulatory Agreement expiration for projects placed in service after 1990. With high land values in the Commonwealth and a growing body of LIHTC disposition experience, I expect that owners will be keen to realize value at that point, and therefore eager to submit qualified contract requests. While original investors are likely to have already left deals, there will still be for-profit sponsors and subsequent investors interested in qualified contracts, particularly when the cost of living adjustor provides greater value than the real estate market (Recap's third

scenario). With LIHPRHA as an example, a well-structured and implemented policy could increase the transfer of properties to non-profit ownership[17].

Qualified contracts highlight some the conflicts caused by differences of purpose and lack of clarity between the IRS and state housing agencies, and between private and public goals. Like the HUD programs, the qualified contract provision lacks forethought and clear intent regarding investor exit, creating a situation in which the preservation of affordability requires additional, prodigal payment to the investor.

DESIRABLE OUTCOMES

This section will first touch on the investor perspective. It will then describe three desirable disposition outcome strategies for non-profit sponsors: bargain sale and charitable contribution, debt-plus-taxes, and donation of limited partnership interest. Each description will address:

- When the strategy works
- The strategy's benefits to each partner
- How the strategy works
- Issues to watch out for
- Applicability and likelihood of the strategy to pre and post-1990 projects

For each strategy the sponsor will have to share their post-disposition plans with the investor as a way to reassure them that the property will remain affordable and that they are not being cut out of a profitable refinancing or resale. Unfortunately, investors may not provide the same level of transparency in return.

How do investors view properties at Year 15?

Investors group the properties in their tax credit portfolios into one of three categories of expected value from sale:

[17] See Chapter Two, Preservation Precedents.

- No real value
- Potential but uncertain value
- Clear, realizable value

MMA Financial refers to these as bananas, apples, and plums[18]. Bananas have a short self-life and are browning quickly. Apples are edible but common fruits whose value will hold up fine if left for a while, and plums represent a current market premium because they are juicy, delicious, and eligible for conversion to market rate condominiums. For the most part, investors simply want to get rid of bananas, which can represent up to 15% of their portfolios. Delays in disposing of bananas may be caused by the sponsor as they face the challenge of creating a refinancing plan. Apples take more up-front work to determine the value of the property and devise a disposition strategy. They do not have significant value or risk to the investor, and make up the majority of portfolios. Plums are a small portion of tax credit portfolios (10-15%), but they are what every investor hopes for. Because the following strategies provide less investor benefit than the market sale, they are unlikely to be realized if the investor believes the property is a plum.

BARGAIN SALE AND CHARITABLE CONTRIBUTION

The "bargain sale and charitable contribution" outcome has two parts. The first component, the bargain sale, is essentially a sale to a non-profit, typically the general partner, for the amount of the outstanding debt. The property value above the debt amount is then considered a charitable contribution, the second component, from the original partnership to the new non-profit owner. The charitable contribution results in a tax benefit for the limited partner. This is an approach that was used in affordable housing prior to the LIHTC and has been applied to LIHTC properties by housing experts.

When does the bargain sale and charitable contribution strategy work?

This outcome strategy works when

- There is a non-profit purchaser, *and*
- The appraised value of the property is significantly higher than the outstanding debt, *and*

[18] This nomenclature is attributed to Stephen Rodgers.

- The non-profit purchaser is able to have the existing debt assigned to it, or secure refinancing to take out the existing debt, *and*
- The investors are tax sensitive and able to use any resulting tax benefit.

What is the benefit of this strategy to each partner?

Under a bargain sale and charitable contribution outcome, the general partner bears little to no expense and retains ownership of the property. This outcome also provides the general partner flexible refinancing options post-disposition. The limited partner receives a tax benefit that is a fraction of value of the property. Depending on the Limited Partnership Agreement, this tax benefit could be substantially less than the cash distribution that the limited partner would receive in a market value sale.

How does the bargain sale and charitable contribution outcome work?

1. A 501c3 non-profit purchaser is identified. Typically this is the non-profit sponsor.
2. The property is appraised, with consideration to on-going use, to establish the value. Use restrictions and rental assistance contracts like Section 8 and Massachusetts Rental Vouchers will influence the appraised value. For this strategy a high appraised value is desirable. The IRS requires that appraisals for charitable contributions be done within sixty days of the contribution so the appraisal will probably need to be updated close to sale.
3. The outstanding debt of the property is determined, and acts as the sale price. This should be the total of all property debt, including advances from partners, less the depreciation attributable to the portion of the taxable basis represented by debt.
4. The amount of the charitable contribution is calculated as the appraised value less the debt (sale price). This is the amount that the IRS will consider donated from the original partnership to the non-profit purchaser. This will result in a tax benefit of the investor's tax rate multiplied by the contribution amount. The tax benefit of the contribution will be passed through the partnership to the partners according to tax distributions in the limited partnership agreement. Normally this will mean that the limited partner will receive 99%+ of the tax benefit.
5. The limited partner's tax liability is calculated based on their federal and state tax brackets, the adjusted bargain sale price, and the capital account balance.

6. The overall benefit to the limited partner consists of the charitable contribution tax benefit less their tax liabilities.

Can you give an example?

The South River property, in Lowell, MA, has 267 LIHTC units and was placed in service in 1990. The original partnership consisted of a local non-profit sponsor and two corporate direct investors: a government sponsored entity (GSE) and a national bank that entered the partnership when it acquired the regional bank that was the original investor. The fifteen year compliance period ended in 2005. It was purchased by the non-profit sponsor in partnership with the property tenant group through a bargain sale and charitable contribution. In addition to the standard group of legal and accounting consultants, both the GSE and non-profit hired affordable housing finance specialists. The non-profit's initial and sole proposal was a bargain sale and charitable contribution, which took over a year to finalize.

South River Canal
Bargain Sale - Appraised Value

Sale:	Appraised Value		Bargain Sale
Sales Price	$19,050,000		$11,737,551
Escrows Used to Repay Debt			(1,232,828)
Net Escrow Transfer			(506,487)
Net Sales Price			9,998,236
Accumulated Depreciation	(7,640,227)		(4,009,910) *
*pro rata by net sales price			
Total Gain	11,409,773		5,988,326
Estimated Taxes Due:			
Gain			5,988,326
Federal and State Tax Rate		x	40.27%
			2,411,499
Tax Benefit of Contribution:			
Valuation			19,050,000
Net Sales Price			(9,998,236)
Charitable Contribution			9,051,764
Tax Benefit at Corporate Tax Rate			3,645,145
Total Tax Due			(2,411,499)
Net Tax Benefit			$1,233,647

Figure 4.2

The property was subsequently sold to a new limited partnership (affiliated with the original non-profit), which used tax-exempt bonds and 4% credit resyndication to finance substantial renovations[19]. The structured division of disposition and refinancing had two advantages:

1. The lack of cash proceeds and distribution meant that the partnership did not have to repay secondary lenders. In this case, HUD had a deed restriction that required 90% of sale or refinancing proceeds to flow to HUD.
2. It generated additional tax credit equity for the refinancing because the sponsor was able to sell the property for about $1M more than the $11.7M acquisition (debt) price.

[19] See Chapter Six, Resyndiation for more restrictions on and requirements of resyndication.

What potential issues does this case point out?

In structuring and sequencing the disposition and potential subsequent acquisition, non-profits sponsors should consider:

- Notifications and approvals required by lenders. South River's Section 8 Contract required HUD approval, which was critical and very difficult to obtain.
- Reserves and escrow accounts are considered separate assets from the building and are eligible for distribution at disposition/partnership dissolution. Alternatives that might benefit the property, such as partial debt payment, should be considered and occur before disposition.
- Repayment of subordinate debt. As in this case, paying off debt before the disposition can increases the value of the charitable contribution, thus making it a more feasible strategy. Yet, it also reduced debt also decreases the acquisition basis for resyndication.

What is the likelihood of seeing this structure in pre-1990 and post-1990 deals?

The bargain sale and charitable contribution strategy is not specific to tax credit deals. It is not specifically included as a disposition option in IRS LIHTC requirements, DHCD Regulatory Agreements, or Limited Partnership Agreements. Therefore, it is equally applicable to pre and post-1990 deals. This outcome may be slightly more likely for post-1990 deals because the limited partner typically had smaller back-end distributions than in earlier deals. In early deals, with higher sale distributions to the limited partner, the tax benefit may be too small in comparison to the cash distribution alternative, for the limited partner to agree to this outcome.

DEBT PLUS TAXES OR RIGHT OF FIRST REFUSAL

This section discusses the introduction of the "debt-plus-taxes" option in LIHTC regulations, describes the outcome, and touches on approaches to structuring the option in new tax credit deals.

Debt plus taxes is another name, based on the formulaic sale price, for the right-of-first-refusal included in limited partnership agreements. Changes to the IRS code in 1990 allowed investors to sell at a below market price without additional tax consequences. This right is included primarily in post-1990 Limited Partnership Agreements with non-profit sponsors as a preservation consideration.

The right-of-first refusal is not an option, which the general partner could exercise at its choosing. Technically, it must be exercised in response to another offer, although I found no evidence of this being tested. The LIHTC right-of-first-refusal is atypical in that it has a formulaic price that is not related to the market value or offered price. The cases of debt-assumption-as-purchase that I am aware of are generally poorly operating properties where there is a transfer of limited partnership interest (covered in the next section) and the investor paying their own exit taxes.

When does the debt plus taxes strategy work?

This strategy works when

- The debt-plus-taxes sale price is less than the market sale price, *and*
- The purchaser (general partner) is able to pay for the limited partner's exit taxes, either with organizational funds or through refinancing.

What are the benefits of the debt plus taxes strategy for each partner?

In a right-of-first-refusal outcome, the general partner benefits from a below market price. The right-of-first-refusal also provides a means of preventing a market sale. The limited partner sees no real benefit, but also no harm in that its exit taxes are covered. Aggressive investors who have incorporated sale value into returns, or believe that every disposition should show a net gain, will view this outcome as a loss of potential benefits.

How does this outcome work?

1. The market value should be established as a benchmark sale price.
2. The debt-plus-taxes amount is calculated. This is the most difficult part of this disposition strategy in that the partners must agree on what debt is to be included.

The IRS allows only debt secured by the building and excludes debt incurred within the last five years.

Can you give an example?

Washington Place in Salem, MA is a 62-unit lodging house that was placed in service in 1988 and has struggled through out its history. The limited partner (a syndicator) forcibly replaced the original for-profit general partner with another for-profit entity, at which time a new management company with extensive affordable housing experience entered and purchased the defaulted mortgage with the intent of purchasing the property at Year 15. After that point the property required a series of capital infusions to maintain operations. As Year 15 approached, the management company was no longer interested in ownership and a non-profit purchaser was identified.

Because of its age and original general partner, the Limted Partnership Agreement did not contain a right-of-first refusal. However, eighteen months before the end of Year 15, the non-profit purchaser entered into an option to buy with the Limited Partnership, at an option price of $10, and a purchase price of "all outstanding debts, liabilities and obligations of the Optioner." Before the disposition, the management company paid back one third ($200,000) of the original principal on the city loan, reducing the total debt and resulting taxes. It was clear to all parties that the property did not have sufficient cash flow to pay for the investor's taxes, or support additional debt to pay for the taxes, so the investor paid the taxes.

The new non-profit owner specializes in single room occupancy units and does significant private fundraising to support the operations of its buildings.

Washington Place
Debt-Plus-Taxes (with taxes paid by Limited Partner)

Sale:		Principal Debt Assumption
	Bank Mortgage	$ 1,900,000
	Additional Note	$ 500,000
	Bank Operating Advances	$ 117,783
	MHP Loan	$ 465,000
	Original City Loan	$ 600,000
	City Loan Repayment	$ (200,000)
	Management Advances	$ 285,100
	Sales Price	$ 3,667,883
Estimated Taxes Due:		
	Gain	$ 3,667,883
	Federal Tax Rate	x 39%
		$ 1,430,474

Figure 4.3

What specific considerations are there for the debt-plus-taxes strategy?

- The timing of loan forgiveness should be considered and negotiated with lenders well ahead of the disposition and in light of any future refinancing plans. Debt forgiven before the disposition would push assumed debt down. However, forgiving subordinate debt after the disposition, when the property is fully owned by a non-profit, may be more palatable to lenders.
- In addition to federal taxes, state and local taxes must be considered.
- Even a formula can be flexible. Investors may realize that they need to pay their own taxes in order to get out of some under-performing buildings. In this case, limited partner interest sale/donation is also a viable exit strategy (see next section).

Does the debt plus taxes strategy work for properties places in service pre and post-1990?

In 1991, changes to the tax code allowed below market sales prices without additional tax penalties to investors. As a result, the debt plus taxes strategy is more likely to be in post-

1990 non-profit sponsored limited partnership agreements in Massachusetts, although not mandatory. In post-1990 projects, in which the limited partner typically has the ability to force a sale, the inclusion of this clause is critical for non-profit sponsors to include in their limited partnership agreements. It may be more difficult to get investors to agree to this outcome in pre-1990 projects, where there is no financial incentive or enforcement.

What are considerations for the debt-plus-taxes strategy in future LIHTC deals?

Document standards for non-profit sponsors evolve through the advice and negotiations of their attorneys, who are able to draw on all their deals to benefit each client. The following is a list of recommendations was compiled from interviews with and articles by affordable housing attorneys, on what should be included in the Right of First Refusal Agreement[20].

- Do not assume that the original non-profit general partner will execute the right-of-first-refusal. The general partner could be voluntarily or forcibly replaced. The right-of-first refusal should be exercisable by a range of organizations, including the allocating agency, tenant groups, and other non-profits organizations.
- A longer exercise term for the right-of-first refusal is desirable in that it provides the exercising party sufficient time to identify necessary resources.
- The right-of-first-refusal agreement should also include a market price *option.* This provides the sponsor with a proactive choice and alternative sales price.
- Structure the right-of-first-refusal price to be equal to debt only. This is aggressive and the IRS has not indicated whether or not it would accept this price in a debt-plus-taxes outcome. But, it has a clear benefit to the non-profit sponsor, and happens in practice (as in the above example) when the general partner cannot cover the taxes. Jonathan Klein, a Boston area attorney, advocates this arrangement for his clients. He points out that this forces the investor to incorporate taxes into their return projections so it may result in lower up-front equity but reflects a long-term sponsor view.

[20] The right-of-first-refusal can be negotiated and defined in its own agreement, in addition to the Limited Partnership Agreement.

Limited Partnership Interest Transfer

This section discusses the donation or sale of limited partner interests to the general partner. This strategy is often the disposition outcome for underperforming properties with little market value or for partnerships in which there is a non-profits syndicator is the investor[21], and can be thought of as a buy-out of the limited partner for a nominal price (the proverbial dollar). In some cases it may be more advantageous to have the limited partner sell their partnership interest rather than the property interest, if a property sale will trigger repayment of financing. A limited partner interest transfer is less complicated and in many cases can avoid transfer taxes, and can therefore be less expensive than a property sale. Regulatory Agreements and loan documents should be carefully reviewed to determine whether this will constitute a change in owner that triggers repayment or requires approval. The value of the limited partnership interest is based on the partnership's assets. LIHTC partnerships are typically property specific and limit the rights of limited partner. Therefore the value of the interest will be related to, but significantly less than, the property value.

When does this strategy work?

This strategy works when:

- The investor is a non-profit syndicator *and/or*
- The property has little or no realizable value.

It is often seen when there are limited rehabilitation needs so that operations simply continue after disposition. Refinancing after a limited partnership interest outcome is possible, though the non-profit must be careful to structure around the 10% common owner limitation if it intends to resyndicate[22].

What benefits does this strategy have for each party?

The general partner receives complete ownership and control of the property at no real cost, although it may be asked to cover the limited partner's transaction costs. Because there is no change of owner, the reserves stay with the property, and transaction costs are likely to be lower than in a property sale. There is no financial benefit to the limited partner in this

[21] NEF has disposed of over 60 projects, 87% of which have what they call rollovers in which the general partner assumes the debt and continues operations (LISC presentation).
[22] See Chapter Six, Resyndication for restrictions on ownership entities.

outcome. The limited partner may, however, view getting out of an unattractive property quickly and easily as an advantage.

How does this strategy work?

In most cases, the donation or sale of the limited partnership interest will not trigger lenders' sale approval or distribution requirements because there is no change in owner. There are two main routes to this strategy: a willing investor or financial necessity.

In the case of a viable property with a willing investor, like NEF:

1. The viability of the property, either as an ongoing interest or with refinancing, must be established.
2. The limited partner's exit taxes must be calculated. A positive capital account and a minimal partnership interest value are desirable.
3. How the exit taxes will be paid must be determined.

In the case of an underperforming property where a limited partnership interest sale/donation is the only feasible option:

1. To construct a convincing case for a limited partnership sale, all other options must be considered and rejected as infeasible due to the property and/or non-profit sponsor's inability support the cost of refinancing. The investor will expect to see documentation showing the project's financial status.
2. The value of the partnership interest must be established in order to determine the exit taxes the limited partner will incur. The lower the value of the interest due to restricted uses and limited control over the partnership, the lower the taxes. A positive capital account and a minimal partnership interest value are desirable.
3. How the exit taxes will be paid must be determined. In most cases, the investor will expect to have their taxes paid for. In some cases, however, this will be infeasible.

An example of this second case follows.

Can you give an example?

The Potomac property, in Lowell, MA, has six ground floor commercial units and twelve residential units. Even with Massachusetts Rental Vouchers for nine units, the small

property did not have enough revenue to support additional debt that would have provided the non-profit sponsor with funds to purchase either the property or partnership interest. Yet, the first mortgage had a balloon payment due one year after the end of Year 15, which required a refinancing plan. The value of the property, in relationship to its debt, was insufficient to create tax benefits through a bargain sale. A donation of the limited partnership interest allowed the property to keep its modest reserves, and, under full non-profit ownership, ask the Lowell Development Financial Corporation to forgive its second and third mortgages. A fourth and fifth mortgage were held by the non-profit and an affiliate.

Potomac
Limited Partner Interest Purchase

Limited Partners	Ownership %	Capital Account	Tax Rate	Taxes Due
Bank	29.70%	(293,043)	40.27%	(118,008)
GSE	69.30%	(683,762)	40.27%	(275,351)
Total	**99.00%**	**(976,805)**		**(393,359)**

Figure 4.4

With no sale price, taxes resulted from a negative capital account.

What issues arise in this outcome?

The type of investor is a determining factor in the viability of this outcome. For example, in another state, NEF was willing to donate their interest in a property with commercial income that has considerable growth potential. CharterMac, however, is very future oriented in their property valuation and would be unlikely to give up that potential value.

In the case of a financially distressed property, lenders may be more willing to forgive debt after the limited partner interest is transferred, when the property is wholly owned by a non-profit.

Is this outcome likely for pre and post-1990 properties?

The donation of limited partnership interest is more sensitive to the value of the property and the character of the investor than to the era of the agreements. The lower cash distributions upon sale in later deals may have some impact on the investors' willingness to agree to this strategy.

CHAPTER FIVE:
Strategies for Non-Profit Sponsors

This chapter covers three general recommendations for non-profit sponsors that pertain to any outcome strategy: negotiate on a portfolio level when possible, make your appraisal work for you, and fight like hell. These recommendations are based on observations made through interviews and transaction document reviews of various limited and general partners of successful non-profit negotiations.

PORTFOLIO NEGOTIATIONS

When a non-profit sponsor holds multiple properties that will reach Year 15 around the same time, it may be advantageous for them to negotiate outcomes for these properties at the same time. This requires a strong transaction team that is able to carefully review the documents of all of the properties approaching Year 15 before beginning negotiations with the limited partner.

When does a portfolio strategy work?

This strategy works when

- a general partner owns multiple properties with the same limited partner (the properties can be in different funds with the same syndicator), *and*
- the properties' compliance periods expire in subsequent years.

What is the strategy's benefit?

A portfolio-strategy leverages an advantageous position of one or more properties to benefit a less well positioned property. In the two examples below, the poorly positioned property benefits. The outcomes for the well positioned properties are essentially the same as if it had been singly negotiated. In addition, the non-profit may able to achieve some economies of scale in transaction costs, like consultants' fees, in a portfolio negotiation.

How the does a portfolio-strategy work?

In general, a portfolio strategy relies on one or more properties that can provide tax or financial benefit to the investor or that has a Limited Partnership Agreement that favors the general partner (an example of each given below).

An example of leveraging benefits:

South River, the bargain sale and charitable contribution example in Chapter Four, and Potomac, the limited partnership example, were negotiated together for original syndication as well as disposition. In this case, the tax benefit of one property was leveraged to improve the outcome of the other. Potomac had very little income and few refinancing options. It is also an integral part of the downtown area and a property that the sponsor was committed to keeping. The sponsor's consultants attributed their ability to negotiate a limited partnership sale with the taxes paid by the limited partner in large part to the tax benefit of South River that more than covered the exit taxes of Potomac.

An example of leveraging documents:

Homeless Services Inc (HSI),[23] a Boston area homeless services provider with an extensive portfolio of shelter, transitional, and permanent housing, was able to negotiate a portfolio of five properties and leverage an advantageous general partner position in three of the properties to move the other two properties at the same time, and at a lower cost.

In an early review, the HSI team recognized inconsistencies in the documents of the five projects. In particular, they realized that in three projects, the limited partner was unable to force a sale. This is common in earlier projects, and allows the general partner to effectively hold the limited partner captive in the deal. HSI delayed the disposition of two properties to negotiate the group of five together, and used the three in which they had more power to their advantage, indicating that they would force the partnerships to hold those three indefinitely if they were unable to reach desired outcomes for all of the properties. Their syndicator wanted to get out of the properties, which had a history of negative cash flows owing to the very, very low income residents and rent levels. One property which the fund

[23] Organization and property names have been changed from complete Massachusetts transactions.

investors believed had real estate value required additional time to negotiate and a residual receipt promissory note that requires HSI to pay the investor its partnership share if they sell the property in the subsequent five years. If HSI had negotiated the properties individually, it is likely that they would have had to purchase this property from the investor. Using a portfolio strategy enabled them to reach no cost outcomes for all five properties.

What issues do sponsors need to watch out for when using this strategy?

This strategy requires the capacity – either in-house or through consultants – to evaluate and compare multiple properties in order to identify potential sources of leverage. Sponsors should be conscious of refinancing goals, particularly if one property will have a delayed disposition and/or if they plan to apply to subsidies that are awarded or distributed at specific times. Since it could be perceived as threatening, the presentation of this strategy should be carefully considered with respect to the sponsor's relationship with the investor and transaction team personalities.

What is the applicability and likelihood of the strategy for pre and post-1990 projects?

A portfolio negotiation strategy can work for pre and post-1990 properties, as well as for portfolios of properties from both eras. Homeless Services, Inc. used pre-1990 documents to create better outcomes for post-1990 properties.

APPRAISAL STRATEGIES

There is no standard strategy for appraisals (generally and with regards to LIHTC dispositions). For some outcome strategies, such as a bargain sale and charitable contribution, a higher appraised value will be helpful. Other strategies, like a cash purchase by the general partner, will be improved by a lower appraised value. Appraisers have a number of valuation methods, as well as a number of definitions or types of value, available to them to appraise a property. In addition, they make judgments on how property characteristics like deed and use restrictions, rental subsidies, property tax exemptions, reserves, and other property and use-specific factors impact the property value. With forethought a general partner can manage the timing and magnitude of some of these

characteristics in anticipation of Year 15. Because they are often most familiar with relevant property characteristics, it is important for general partners to be aware of the appraisal's impact and the appraiser's method in establishing value.

FIGHT LIKE HELL

Non-profit sponsors and investors view Year 15 very differently, even down to the vocabulary. Investors see Year 15 transactions as "dispositions," or "sales," while from the non-profit perspective they are "refinancings" or "purchases." While this document has referred to the transactions as dispositions, and attempts to understand the investor perspective, its purpose is to promote affordability by informing non-profits of their counterparts view of the deal. Interviews with investors suggest that non-profits benefit from their stubborn commitment to providing affordable housing at the lowest possible cost.

What are investors' observations of non-profit sponsors' attitude to dispositions?

Syndicators observe that both for and non-profit general partners consider themselves the owner, and expect the limited partner to simply hand over the property. Non-profits are different in that social values, as well as financial resources, fuel their fight for property control. Generally, the investors interviewed felt that non-profits are less willing to negotiate than for-profits.

The head of dispositions at a Boston-based syndicator told me that non-profits believe that investors are "out to screw them," and are more willing to "go to the mat" for money than for-profit partners. A consultant handling dispositions for a GSE investor explained that general partners, particularly non-profits, are more willing to fight for every last dollar than limited partners. He believes that non-profits feel entitled to the right to buy a property for one dollar, even if it means that the limited partner sacrifices significant cash flow from a potential sale. While he believes that this is unreasonable, he acknowledges that, for non-profit sponsors, this is essentially an ideological point.

Is the cause-based fight effective?

Interviews with investors and consultants indicate that while it may prolong the process, the strong-held, value-based perspective of non-profits can result in the low cost outcomes described in Chapter Four. Non-profits investors were described as "unreasonable" and "not willing to negotiate." "Reasonableness" seems to be an important trait for investors and a lack of it was cited as a potential barrier to closing transactions. It is important, however, to remember that the investor and non-profit sponsor may not agree on what is reasonable. An investor may consider the financial arrangements to define reasonable while a non-profit might look at continued affordability and tenancy to define reasonable. In this case, if the non-profit lacks the financial resources to meet the investors needs, it could appear unreasonable.

Certainly a general unwillingness to negotiate, or arbitrary unreasonableness, will delay the disposition process. However, in most cases, lengthy transactions can be attributed to the complexity of the deal and workload of the parties. Some investors are more willing to work with non-profits in order to preserve affordability. If sponsors are able to recognize this, the negotiations and process can move quickly – as was the case in HIS's portfolio negotiation. When negotiating, the sponsor will be better able to anticipate potential concerns and sticking points if they know their investor (see Chapter Three). The ability to recognize cooperative sponsors will save non-profits resources that can be used elsewhere, perhaps to negotiate with less cooperative investors on other projects.

In many cases, non-profits will face tough negotiations to achieve their desired outcomes. In these cases, fighting like hell appears to be worth it. The South River and Homeless Services, Inc. cases are examples of non-profits sponsors' steadfast belief in the unique value they could bring to the property and the success achieved by sticking to that belief. These negotiations were largely successful because, through analysis and documentation, they were able to demonstrate the value or necessity of the desired outcome to their investor. Although not widely discussed in the industry, uniformly true, or easy to distinguish from persuasion, there seems to be some ability to tire investors so that they may eventually accept outcomes that were initially rejected. One syndicator acknowledged that non-profits

sometimes do get better deals because the syndicator eventually just wants them to "go away."

The outcomes sought by non-profit sponsors are often not the highest financial value to the investor, so non-profits must truly believe, and convince their investor that non-profit ownership and long-term affordability is valuable and the best use for the property. Disposition transactions can take a long time, and be mind-bogglingly complex, which can be frustrating, but I believe that non-profits willingness to fight for properties, affordability, and their desired outcomes is largely effective in achieving those goals.

CHAPTER SIX:
Where's the beef?

Focusing on low-cost disposition strategies for non-profits limited the number of refinancing structures I was able to observe since these strategies tried to avoid purchase payments, which can require refinancing. Refinancing examples in Massachusetts are also limited by the lack of refinancing resources available in the Commonwealth. Conversations with DHCD, CEDAC, and MassHousing Partnership staff reveal that these agencies lack significant experience with post-Year 15 LIHTC properties. This lack of experience is also evidence of the refinancing resource deficit (if there were state resources, sponsors would be knocking down agencies' doors).

Although not solely refinancing sources, sponsor and municipal financing sources are worth noting for their pre and post-disposition roles. After brief discussions on these sources, the chapter will conclude with a look at the restrictions on available refinancing sources. Chapter Seven will build on this analysis with policy recommendations.

SPONSOR FINANCING

Most non-profits do not have the capacity to finance projects from organizational funds. Those that do typically loan money from the organization to the property so that when the property produces cash flow, is sold, or refinances the organization can be paid back. It is important to structure advances so that they are treated similarly to other debt rather than simply allowing organizational funds to bleed into the property. Although the non-profit sponsor may be inclined to "donate" money to the property because they have a greater non-financial stake, they should expect financial treatment that is comparable to their partners. In other words, no second-class lenders; these loans should be repaid when a LIHTC property is refinanced so that non-profits can redeploy those funds. If sponsor advances are not repaid through refinancing, they should be rolled over to the new owner as debt to maintain the possibility of repayment.

Although advancing additional capital to a property is usually a last resort for a non-profit sponsor, the Housing Service Inc. case, discussed further in Chapter Five, provides a novel exception. As a non-profit with significant assets and cash flow, HSI was able to access tax-exempt bond financing secured by the organization, rather than by a specific property. They then used this money to perform capital improvements at a number of properties in their portfolio, including minor work at some of their post-disposition properties.

MUNICIPAL FUNDS

Most LIHTC properties require additional sources of funding, including municipal subsidies[24]. These are usually structured as subordinated debt in order to be included in the initial qualified basis calculations for tax credit distributions. The three primary non-profit disposition outcomes described in Chapter Four avoid significant cash flow and distribution, and therefore require that debt be assigned to the new ownership entity or forgiven. In cases where the subordinated debt that will be replaced through refinancing has not yet reached maturity, there may be no compelling reason to forgive it.

Municipalities may be more willing to forgive debt than state agencies since they have less outstanding debt both per property and in aggregate. This in turn may reduce their concern about setting a precedent of forgiveness. Due to proximity, local agencies may also be more politically and socially invested in properties, and therefore more likely to forgive debt. Based on cases supplied by investors, forgiveness is most likely (and necessary) when properties are unable to support existing or additional, needed debt. A number of - but not all - municipalities involved in the deals I reviewed forgave debt, typically in limited partnership interest assignments.

As a comparison, to date, DHCD has not forgiven a soft second loan; many of their loans are structured to "roll over" with refinancing, and they have not received any requests for

[24] This is true of the examples included, as well as of the properties mentioned in research, and is supported by Cummings and DiPasquale (1999), and required by DHCD for most secondary financing.

forgiveness. HIF and HOME loans are both assignable to affiliated owners, a provision intended to facilitate the maintenance of affordability. This makes a sale of the limited partnership interest more attractive since there is no need to gain extensive lender approvals for the sale.

As municipalities recognize the potential for extended use restrictions and secondary funding sources to assist in preserving affordable housing, there is a temptation to stretch the terms of affordability requirements, sometimes even beyond the terms of the financing. For example, the City of Boston's Department of Neighborhood Development now requires affordability in perpetuity on projects it funds[25]. While some developers have no problem with this, others - even some committed to housing the hard-to-house, like HSI - object to this requirement because it limits their traditional financing and future sale options[26].

RESYNDICATION

This section discusses the constrained refinancing resources for LIHTC properties and the regulatory barriers to resyndication as a refinancing mechanism, as of spring 2007[27]. LIHTC properties, like most affordable housing, can be difficult to finance, and to refinance. Their limited cash flow, which must cover existing debt and capital needs, makes them unattractive to commercial, market rate financers, and reliant on the short supplyof subsidized financing. Yet, refinancing is critical to maintain these properties as safe, decent, affordable housing, and timely capital improvements are ultimately cheaper than cycles of severe distress and crisis funding.

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[25] "The affordability and income restriction for rental or cooperative housing development projects shall have an affordability term 'In Perpetuity'". (http://www.cityofboston.gov/dnd/D_7-3_Long-Term_Affordability.asp).

[26] A commitment in perpetuity would eliminate the potential to sell an appreciated property for market-rate use and realize profits that could be used to acquire a larger property and house additional families.

[27] This report was written in the spring of 2007, a time of significant policy change. It tries to capture the effects of previous policies as well as the current, undetermined present environment and most recent decisions.

Where are the LIHTC refinancing resources?

The rise of LIHTC to become the primary financing source for affordable rental housing is more of a reflection on cuts to HUD programs throughout the 1990s than of increases in LIHTC appropriations or efficacy. With the current levels of federal funding and production-focused state policies, properties looking for recapitalization after Year 15 have few options particularly in Massachusetts where regulations discouraged "recycling" (recapitalization).

The growing body of affordable, but difficult-to-refinance properties makes the issue of preservation, and how the Commonwealth and DHCD qualify "preservation" projects, increasingly important. The current QAP, which governs 4% and 9% credits, requires that projects meet the criteria of one of two set aside categories: new production or preservation. LIHTC properties that have reached Year 15 would clearly have to qualify as preservation projects in order to receive another allocation of tax credits. The QAP definition of "preservation" is targeted towards HUD expiring use at-risk Section 8 projects and excludes the majority of LIHTC properties:

> Applications for preservation projects will be considered in this category only if:
>
> The units are located in expiring use restriction projects. An "expiring use restriction project" is defined as a project whose owner is able to prepay an FHA-insured or MHFA- financed loan within nine months of the date of the tax credit application to DHCD. In addition, the project cannot be subject to any other use restriction that would effectively limit the owner's ability to convert the development to non-affordable use. When the use restrictions expire, low- or moderate-income tenants in some locations may face steep rent increases they cannot afford. While not all units in expiring use restriction projects can or should be preserved as affordable housing, many units are too valuable to lose. The replacement cost would far outweigh the cost to the state of helping to preserve the existing stock.
>
> In some cases, valuable Section 8 project-based units are located in projects whose owners have the legal right to terminate the Section 8 contracts, or to "opt-out" of the contracts. An "opt-out" project is defined as a project whose owner is able to prepay and opt-out of a Section 8 project based contract within nine months of the date of the tax credit application to DHCD. In addition, the project cannot be subject to any other use restriction that would effectively limit the owner's ability to convert the development to non-affordable use. When an owner "opts-out" in a strong housing market, he or she may elect to raise the rents significantly, including the rents paid by low or moderate-income tenants. Thus, the "opt-out"

projects represent affordable stock that potentially could be lost from the inventory.

Units are located in distressed or foreclosed properties and area at risk of being lost as affordable housing without an infusion of new capital and/or a new ownership structure. Such distressed and "at-risk" properties will be evaluated based on a capital needs study commissioned by DHCD or a public agency or lender (e.g. MHFA, MHP) that indicates that at least $10,000 per unit of new capital is needed to address immediate repair and replacements needs[28].

Under this definition, pre-1990 properties qualify as expiring use if they have no additional use restrictions. Post-1990 properties, which have 30+ year LIHTC use restrictions, must qualify through physical or financial distress. The $10,000 capital needs requirement is $7000 higher than the IRS' $3000 per unit requirement for acquisition-rehab projects.

Even more onerous was the $35,000 per unit capital requirement for tax-exempt bond financing that was in place until March of 2007 – in effect a restriction against preservation use. This essentially eliminated the use of 4% tax credits, which automatically accompany tax-exempt bonds, from LIHTC preservation. (See Chapter Seven for more on changes to the bond and 4% policy in March 2007.) The state has not issued new tax-credit regulations in light of the removal of these restrictions, so, as it stands, 4% credits remain subject to the current QAP.

DHCD has used the QAP preservation set-aside to "work-out" some distressed, non-LIHTC properties. But, being in need of a work-out is not a situation that project sponsors want to be in, and this is not a formal policy and is, therefore, dependent on the favor of DHCD. In addition, a sponsor with distressed properties risks falling out of good standing, which is critical to the success of future funding applications with all state agencies. On this point DHCD staff stress that they would not automatically consider qualifying for tax credits as a distressed property to constitute poor standing.

[28] Italics mine.

THE SMALL CONUNDRUM

Non-profits that own small properties, units, or capacity face additional challenges. Smaller projects face the additional challenge of paying for bond and tax credit transaction costs with smaller allocations. This was a virtual roadblock and a shared frustration of housing consultants working on properties with sixty or fewer units and no operational subsidies. Single Room Occupancy (SRO) or lodging house properties may struggle to meet the per unit capital requirements because their units are significantly smaller and typically share bath and kitchen facilities. Non-profits without the capacity to manage dispositions and refinancing in-house will have to wrap the cost of consultants into the transaction costs, cutting into any developer fee they might receive. Given these added challenges, tax-exempt bond and 4% LIHTC financing alone may never work for these properties. They, more than other projects, will need operating subsidies, grants, and additional secondary financing.

ALTERNATIVES?

The bias against preservation and recapitalization is not limited to tax credits, but ripples through state resources. There are ten financing sources listed on DHCD's webpage for affordable rental housing developers. One is the LIHTC, two have location qualifications, three are for special needs housing, one provides technical assistance and one is specifically for expiring use projects. This leaves two general sources for recapitalization: HOME and Housing Stabilization Funds (HSF). These sources are typically used as gap financing on LIHTC deals and do not provide sufficient funds for recapitalization on their own. Both programs are capped at the lesser of $50,000 per unit or $750,000 per project, and require a city match for projects in most of the state.[29] According to local housing experts secondary financing like HOME and HSF has, historically, not been made available for recapitalization.

[29] A match of city funds is required in HOME Entitlement and Consortia areas. Non-Entitlement and Consortia areas have a $65,000 per unit or $750,000 total cap.

CHAPTER SEVEN:
What To Do: Policy Recommendations

Chapter Seven picks up on the review of refinancing options in Chapter Six with recommendations on how Massachusetts can increase options for LIHTC Year 15 properties. This discussion focuses on modifying the definition of preservation, and targeting the use of tax-exempt bonds towards preservation. Included in the discussion on tax-exempt bonds are considerations for balancing expanded LIHTC refinancing options with existing preservation and production priorities. I consider how DHCD and non-profits can avoid unnecessary refinancing and encourage desirable outcomes by differentiating between for and non-profit sponsors. The chapter concludes with a note on how better data collection could help improve the state's preservation policy.

The gubernatorial change at the beginning of 2007 was the first political party change in sixteen years and a reminder of the political nature of DHCD. The Patrick administration appointed a new under-secretary to head the department and the housing industry buzzed with optimism about funding and with concern about additional staff changes. The previous administration heavily favored housing production and, consequently, preservation had not received adequate attention despite its cost effectiveness. Encouragingly, the new administration has indicated a greater interest in housing preservation. At the end of March, 2007, the administration, working with the legislature and strongly supported by the housing industry, increased the allocation of private activity, or "volume cap," bonds to affordable housing and removed restrictions on bond financing for preservation projects (Oakman, attachment, 2).

> The Administration is also imposing the following new limitations on the use of volume cap to ensure that the resource is effectively leveraged and used:
>
> - Prior to MassHousing or MassDevelopment allocating volume cap to finance multi-family affordable housing projects, the borrower must first receive approval from the Department of Housing and Community Development for the use of the related federal tax credits….
> - Previous restrictions on the use of volume cap for projects that preserve existing affordable housing have been revoked.

At time of writing, state agencies are convening to discuss how these new measures will be implemented.

RESYNDICATION - PLEASE AND THANK YOU.

How can existing funds be made available for post-Year 15 LIHTC refinancing?

As discussed in Chapter Six, the qualification requirements for a preservation project have been a significant barrier to the use of tax-credits for recapitalization. According to DHCD staff, the definition of preservation projects is determined by the "housing world:" the governor, legislature, and funding agencies (DHCD, MassHousing, MassDevelopment, CEDAC) all have input. The QAP, however, is drafted by DHCD staff and approved by the governor with input from his Development Cabinet. In order to make 4% and 9% LIHTC available as a recapitalization source, the definition of preservation in the QAP should be expanded to consider the Commonwealth's entire portfolio of affordable housing. Specifically:

- FHA or MFHA mortgage pre-payment should be a priority, not a requirement
- Lack of existing use restrictions should also be a priority, not a requirement
- The requirement of distress should be removed and the $10,000 per unit expense requirement should be reconsidered.

These changes would reflect a more holistic approach to preservation that acknowledges that the life cycle of properties includes recapitalization. Buildings are durable, but not indestructible, goods. They require occasional infusions of capital - for systems upgrades, new roofs, to be purchased from current owners, etc. Since almost all affordable housing in Massachusetts receives funding from DHCD, if the Department continues to encourage affordability commitments of fifty years to perpetuity, and to exclude projects that have existing use restrictions, they will eventually be unwilling to invest in the responsible maintenance of most of the affordable housing in the state. Properties that need recapitalization to be maintained as decent affordable housing should not be penalized for existing commitments to affordability.

In addition, the requirement for capital needs must be realistic. It must be high enough to ensure real need and responsible use.[30] But, if it is too high, it will force owners to inflate their per unit cost with unnecessary work, or cease to be a viable option, as demonstrated by the $35,000 requirement. In determining a per unit capital requirement, DHCD should consider

- The IRS' national $3000 per unit requirement
- Construction costs in Massachusetts as a potential argument for a greater per unit requirement
- The availability of other sources to fund capital needs below the required amount and the consequences of deferring typical maintenance that falls below the requirement as potential arguments for a lower per unit requirement

A well-considered per unit capital requirement will ensure that projects that need recapitalization will have access to it, while preventing premature rehabilitation motivated by investors' desire to receive acquisition distributions rather than the property's need. At the same time, the availability of reliable preservation resources will allow non-profit owners to confidently separate Year 15 dispositions and refinancings either strategically to force low-cost disposition outcomes, or naturally because the property requires no immediate funds.

What funds should be targeted to LIHTC refinancing?

Even with current regulations that prevent many refinancing projects from entering the applicant pool, there is stiff competition for affordable housing resources in Massachusetts. Expanding the preservation pool will require balancing this new demand for funds with existing preservation and production priorities. Given the larger capital demands of new construction projects, it is logical to prioritize the use of 9% credits, which are limited to annual allocations and structured to cover 70% of total development costs, for production.

On the other hand, there is no cap on the amount of 4% tax credits each state is able to allocate, and projects financed with tax-exempt bonds automatically qualify for 4% credits. Essentially, state bonds leverage federal tax credits. For this reason, the efficacy of allocating tax-exempt bonds to affordable rental housing is well recognized and the recently increased

[30] The IRS 10% common ownership restriction described in Chapter Three also acts to prevent refinancing for financial gain.

allocation of $225M in bonds to affordable rental housing in 2007 is a sound strategy for growing the states affordable housing resources (Smith and Handelman). The increased bond allocation presents an opportunity to create needed preservation resources without detracting existing production resources.

As reflected in the above suggestions, the state should continue to prioritize the preservation of projects at immediate risk of conversion to market rate. CEDAC maintains a database of expiring use projects that makes this demand pipeline somewhat predictable[31]. If non-profit LIHTC sponsors are able to separate disposition and refinancing transactions, DHCD would have the opportunity to work with them to manage the flow of preservation demand[32].

While this report has focused on recapitalizing post-Year 15 LIHTC properties, the changes to preservation policy suggested above would benefit the entire affordable housing portfolio.

NON-PROFIT DIFFERENTIATION

In 1996, Cummings and DiPasquale (264) find that non-profit sponsors typically have greater total development costs, but do not provide larger units, or serve special needs populations at higher rates. This implies that non-profit developers are less efficient, and that, therefore, distribution to non-profit sponsors is not the most economical use of tax credits. On the other hand, the IRS requires that each state allocate at least 10% of its credits to non-profit sponsored projects, and state and municipal sources routinely award additional points to non-profits in competitive funding. This section looks at the benefit non-profit sponsors provide and how they can leverage differentiation from for-profits to realize better disposition outcomes.

What makes non-profits so special?

[31] See Chapter Two for information on expiring use.
[32] Separating transactions would provide greater flexibility in refinancing timing and therefore the opportunity to apply in a year in which fewer expiring use properties need financing.

As discussed in Chapter Three, a diverse array of non-profit organizations are involved in affordable housing. They do, however, have two things in common: they are mission driven; they are not profit driven. This positions them to provide benefits that for-profits do not. Cummings and DiPasquale test and refute some commonly held beliefs about non-profit developers. Their list, however, is not exhaustive. Below are some of the additional benefits of non-profit developers[33].

- **Greater commitment to long-term affordability.** This widely held view is a logical assumption based on the missions of non-profit organizations active in the housing industry. Unfortunately, in the case of Massachusetts' LIHTC properties, it is impossible to test with the currently available data.
- **Additional resident services for non-special needs residents.** Unfortunately, there is no good data source for the level of service provision at any LIHTC property. Some non-profits provide on-site services, while others employ resource coordinators or facilitate resident participation use of the organization's other services. For example, Boston's Lena Park CDC employs a Resident Resource Specialist to address residents' housing and services needs, identify resident and community needs, and organize community meetings.
- **Lower income residents served.** Lower AMIs result in lower rents, which are unattractive to for-profit developers. Through other social service work or because of their mission, non-profits, like HSI, are more likely to be aware of and serve the housing needs of very low and very, very low-income populations.
- **Community and resident capacity building.** Lowell's Coalition for A Better Acre's (CABC) commitment to resident participation in property ownership structures and low-income board members are examples of general partner capacity building that are not likely to occur with for-profits.
- **More challenging development projects.** Non-profits take on projects that have too many "complications" or too little profit for for-profit developers. As is the case with Boston's Jackson Square, where three non-profit developers are leading development in a socially and economically challenging area.

[33] Testing each of these arguments is beyond the scope of this thesis, so they remain anecdotal.

- **Developer fees support other organizational activities.** Non-profits often invest their developer fee in the property through fee deferral. Fees that they do earn are invested in their other program areas such as home-ownership education and youth development as is the case with Boston-based Asian CDC.

These benefits, particularly the commitment to affordability and capacity building, reflect a comprehensive, long-term investment perspective of affordable housing.

<u>How should non-profits be differentiated from for-profit sponsors?</u>

To promote long-term affordability, non-profit sponsors and DHCD should seize the opportunities they have to differentiate between for and non-profit sponsors. These opportunities exist in funding policies and priorities, as well as in property-specific documents.

DATA COLLECTION: WHO GIVES A STAT?

The above recommendations highlight a number of ways in which better data collection and analysis could help shape state preservation policies:

- Tracking the number of LIHTC units lost
- Confirming or refuting the idea that non-profits are more likely to maintain affordability
- Determining an optimal per unit capital needs requirement
- Managing the preservation pipeline

Without information on disposition outcomes it is impossible to track the number of early LIHTC units converting to market rate. While this is a limited issue in Massachusetts for the time being, requiring disposition reporting has additional benefits, such as providing data that would confirm or refute the belief that non-profits are more likely than for-profits to maintain affordability. Understanding the magnitude of this difference on a state or national level would help to estimate the economic value to non-profit sponsors, and inform policy on sponsor choice. Information on the physical state of the properties at Year 15 could help determine the capital need per unit requirement by indicating an average need. This would also create a record of the number of properties that fall below the requirement and a

starting place to figure out what resources they have been able to access (or if they are falling into a cycle of disrepair and crisis funding). Finally, if dispositions and recapitalizations happen separately, DHCD would be better able to anticipate preservation financing demand if they were aware of dispositions. To facilitate these analysis, disposition reporting would need to, at a minimum, include the planned use of the project, purchasing entity, changes to rent levels, and an appraisal or, preferably, a capital needs assessment.

CONCLUSION:
LIHTC Recapitalization in the Commonwealth: Putting the Money Where it Counts, A New Paradigm of Preservation

The current affordable housing preservation conversation is dominated by Section 8 and mortgage prepayments and by a model of recapitalizing investors in addition to properties. By not anticipating investor exits, these programs created preservation crises, which resulted in the massive loss of affordable units, and a second outlay of capital to investors. At the front end, investors invested in affordable housing for an expected return. The federal government then paid them again to avoid opportunistic conversion to market rate.

This inefficient policy illustrates involvement of private enterprise in the provision of public benefits creates tension between competing motivations. While HUD and DHCD aim to provide affordable housing, investors want to earn a profit. If there's money to be made, if there's arbitrage to be realized, investors will go after it. The experience of HUD and early LIHTC dispositions show that, to investors, it doesn't matter if the money comes from the open market or a government source. They will seek out and come back for second helpings. So, public policy must set the expectations for return at the front and back end.

There is no single federal source of preservation policy or back end funds for LITHC properties. HUD is uninvolved in the program and the IRS, the involved federal agency, is set up to collect, not distribute, money. In the absence of a federal recapitalization source, individual states must create preservation strategies. States' aggressive approach to qualified contract regulations illuminates the IRS code's shortcomings. Like HUD program regulations, the qualified contract clause demonstrates a lack of clear intent and foresight regarding investor exit, as well as a willingness to pay the investor twice. Even though affordability is required for thirty years, qualified contracts allow LIHTC investors to exit after Year 15, having received full return of equity through tax credits, and an additional repayment of equity.

Massachusetts, however, has largely (if unintentionally) avoided this redundant payment model by focusing its housing resources on new construction and severely restricting preservation financing. As the cases in Chapter Four demonstrate, the lack of recapitalization funds available to LIHTC properties has forced non-profit sponsors to seek out low-cost disposition strategies in the Commonwealth. In this environment, non-profit sponsors' ability to provide investors a charitable contribution disposition strategy is an advantage over for-profit sponsors in achieving low cost outcomes. This advantage is, however, quickly lost when the property needs, but cannot access, recapitalization funds. While Massachusetts' lack of preservation funding is itself a shortsighted view, it has revealed the effectiveness of separating dispositions and recapitalizations in avoiding a second payment to LIHTC investors. Even though the properties have depressed market values and their motivation is to get out of the partnership, had recapitalization subsidies been available, investors would have sought additional public funds at disposition.

Now policy is changing in the Commonwealth. The new Patrick administrations seems to realize the value of preservation - of maintaining the existing stock of affordable housing - and seems poised to make tax-exempt bond financing available for recapitalization.

This change presents an opportunity for Massachusetts to break from the current preservation paradigm and establish a new model of recapitalization policy for LIHTC properties. Massachusetts' preservation draught created an opportunity for its current administration by forcing – out of necessity, not policy - the separation of dispositions and recapitalizations, and, as a result, by creating expectations on the part of non-profit sponsors and investors for low or no cost dispositions. If the Commonwealth can maintain this separation and formalize this expectation, they can funnel housing funds where they belong: maintaining properties, not reimbursing investors.

Appendix A

People Consulted: Interviews, Conversations, and Personal Correspondence

Name		Affiliation
Emily	Achtenberg	Consultant
Katie	Alitz	Syndicator
Don	Bianchi	Non-Profit
Laura	Buxbaum	Non-Profit Developer
Sue	Cary	Non-Profit Developer
Wendy	Cohen	Funding Agency
Kevin	Day	Syndicator
Tony	Fracasso	Funding Agency
Terry	Gagne	Non-Profit Developer
Mike	Gladstone	Syndicator
Kathryn	Hanifan	Investor
Jonathan	Klein	Consultant
Peter	Nichol	Syndicator
Tony	Petropulos	Consultant
Anne	Reitmeyer	Non-Profit Developer
David	Robbins	Syndicator
Peter	Roth	Developer
Mathew	Seadale	Funding Agency
Laurie	Tickle	Funding Agency
Kristin	Wang	Non-Profit Developer

Appendix B

America's Largest Tax Credit Syndicators

	Syndicator	2005 Tax Credit Volume in Millions
1.	MMA Financial	$1300
2.	CharterMac Capital	$1100
3.	The Richman Group Affordable Housing Corporation	$910
4.	Enterprise Community Investment	$693
5.	National Equity Fund	$630
6.	Boston Capital Corporation	$600

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