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Worklaw-Alert

Low Income Housing Tax Credit Investment Opportunities

Given today's turbulent market, with the premium on capital at historic highs and investor appetite for risk at historic lows, an investment in Low-Income Housing Tax Credits may provide the best of both worlds: a predictable stream of high returns with relatively low risk. Factor in the Community Reinvestment Act benefits along with the intrinsic benefits of improving the local community and this investment vehicle may be one of corporate America's best kept secrets.

Background of Low Income Housing Tax Credits

The Low Income Housing Tax Credit Program, which is governed by Section 42 of the Internal Revenue Code, was enacted by Congress in 1986 to provide the private market with an incentive to invest in affordable rental housing. Federal and state low income housing tax credits ("LIHTCs") are awarded by state housing agencies to developers of qualified affordable housing projects. Those developers then sell the credits to investors to raise capital for their projects, thereby reducing the project's need for traditional mortgage debt that the developer would otherwise have to borrow. Because of the lower mortgage payments, a tax credit property can in turn offer below-market rents to low-income tenants.

Since its inception, the LIHTC program has been instrumental in the development or rehabilitation of approximately 2 million affordable housing units across the country that otherwise might not have been built.

Benefits of an Investment in LIHTCs

As with traditional equity investments, investors in LIHTC properties expect to receive a rate of return meeting their underwriting and credit criteria. LIHTC investments, however, deliver that return primarily in the form of federal tax credits and, in some instances, state tax credits. These credits are earned and delivered to the investors in a predictable stream over a 10 year period beginning in the year the property is placed in service.

The credits can be used to offset the investor's tax liability on a dollar-for-dollar basis. Because it is a dollar-for-dollar reduction of federal tax liability, the investor's annual credit amount has a positive impact on earnings per share because it reduces tax liability without diluting earnings. In addition to the tax credits, a LIHTC investor will be entitled to tax deductions relating to depreciation and interest expense. While these losses lower tax liability by lowering overall corporate earnings, such losses are typically less significant to the overall investment than the tax credits.

An investment in a LIHTC property differs from a traditional real estate investment in several critical respects. First, a traditional real estate investment is expected to generate taxable income (thereby eroding a portion of the return), while a LIHTC investment generates tax benefits that are not subject to federal or state income tax. Second, a LIHTC investment may be less sensitive to the volatile market risks that may affect a traditional real estate investment. Since the expected return from a LIHTC investment is comprised primarily of tax credits and tax losses (as opposed to cash derived from rental income), market conditions have a much smaller impact on the performance of the LIHTC investment so long as the project as a whole remains economically viable.

Notwithstanding these fundamental differences, the rate of return on a LIHTC investment is typically equal to or higher than a traditional equity investment.

Community Reinvestment Act Benefits for Banks

One of the primary reasons that banks make ideal LIHTC investor candidates is that, in addition to providing relatively high returns and low risk, a LIHTC investment qualifies under the investment test of the Community Reinvestment Act and will be given CRA credit for purposes of determining the bank's CRA rating.

Standard Investment Structure

A LIHTC investment is typically made by acquiring, directly or indirectly through a syndicated fund, a limited partnership interest in a partnership (the "Operating Partnership") that owns the LIHTC project. The developer, either a for-profit or non-profit entity, is typically the general partner of the Operating Partnership. By acquiring the limited partnership interest, the investor will be entitled to the stream of tax benefits (tax credits and tax losses) that serves as the basis for the investor's expected return.

The relationship between the limited partner and the general partner is governed by an operating partnership agreement which is typically a complex document negotiated with the help of experienced tax counsel.

When making a direct investment, the investor is responsible for underwriting the investment, managing the relationship with the developer and performing high-level asset management consistent with the role of limited partner. As such, this approach can be challenging for any investor that wants to make its first entry into the LIHTC arena. Nevertheless, some banks, especially community banks, may have the necessary resources in place as a result of their involvement in financing affordable housing projects.

For those investors lacking the desire or the in-house ability to identify and underwrite potential investments, manage the relationships and perform on-going asset management, an alternative is to invest in a fund sponsored by a tax credit syndicator. A tax credit syndicator has existing relationships with reputable developers and will generally create a diverse portfolio of LIHTC properties on behalf of its investors. For a fee or "load," the syndicator will identify suitable investments and perform on-going asset management functions (including compliance monitoring). Many syndicators offer multi-investor funds, allowing investors to purchase a slice of the fund, thereby offering greater flexibility in determining how much capital to invest. On the other hand, for investors that are interested in maximizing their CRA credit, a proprietary fund may be the best option as the investor will have ultimate control over the geography, acquisition guidelines and pricing of the investment.

Qualifying for LIHTCs

In order to qualify for the LIHTCs, the owner or the property must comply with an onerous and often complicated list of requirements and prohibitions set forth in Section 42 of the Internal Revenue Code and the related Treasury Regulations. Compliance with these affordable housing requirements is necessary for at least 15 years (the "Compliance Period"). A project that fails these restrictions will generally have an ability to cure; however, failure to cure in a timely fashion as well as a failure to satisfy certain mandatory requirements can result in a loss of a major portion of the projected tax credits and some of the previously claimed credits may even be "recaptured." Two examples of how a LIHTC property could lose its tax credits would be the failure to maintain the necessary minimum number of low-income units or to maintain its low-income status throughout the Compliance Period. Expert property management and experienced legal counsel is imperative to ensure that a project will deliver the expected benefits to the investors.

Investment Risks

As noted above, a LIHTC investor's return is primarily comprised of tax credits and tax losses. As such, the principal risk of LIHTC investing is the loss of those tax benefits and any resulting penalties and interest that may be owed to the IRS. The primary causes for loss of expected tax benefits include the owner's failure to comply with the rent and tenant restrictions of Section 42 and foreclosure.

To a large extent, the aforementioned investment risks are reduced by certain guarantees that are typically issued by the developers/general partners of the LIHTC properties. These guarantees often cover (i) 100% of development cost overruns, (ii) 3-5 years of operating deficits, and (iii) 100% of the projected tax benefits during the 10-year tax credit period. Consequently, the credit worthiness of the guarantor(s) is an important consideration when making a LIHTC investment. In addition, the developer/general partner is usually required to establish substantial reserves to cover operating deficits after the guaranty period as well as repairs and replacements. Notwithstanding these risk mitigants, an investor in an affordable housing project should conduct sufficient underwriting so as to be comfortable with projected cash flows, debt service coverage, market advantages and guarantees.

In today's market where capital is at a premium, a successfully structured LIHTC property can be an extremely profitable and safe investment vehicle for investors of all types and sizes, banks in particular, by providing high rates of return, CRA credit and a tremendous benefit to local communities in the form of desperately needed quality affordable housing.

All investors should consult their own tax advisors about the tax treatments and consequences that may apply to their own transactions and should seek tax counsel to negotiate and draft the necessary legal documents.

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