

# LIHTC MONTHLY REPORT

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## Coalition Continues to Pursue Revision to Recapture Bond Requirements

By Fred H. Copeman, Tax Credit Investment Advisory Services Ernst & Young LLP, and Robert Rozen, Washington Council Ernst & Young

Under Section 42 of the Internal Revenue Code, a tax credit is available to owners of multifamily apartment complexes and single-family homes set-aside for qualified low-income households. The credit is claimed annually over a period of 10 years. Qualified residential rental projects must remain as rental property and satisfy a number of other requirements throughout a prescribed compliance period (generally, 15 years from the first taxable year the credit is claimed). An investor wishing to dispose of an interest in a low-income housing tax credit (LIHTC) property during a 15-year compliance period is subject to a recapture of housing credits previously claimed unless a bond from an approved surety or U.S. Treasury securities are posted to the Internal Revenue Service (IRS).

Section 42 provides that the mere transfer of an ownership interest prior to the end of the taxpayer's compliance period will trigger housing tax credit recapture. The recapture tax penalty was included in the original legislation out of a concern that some investors would claim housing tax credits and then avoid their continuing compliance requirements by transferring their interests to a straw party with minimal assets, thus making the recapture provision unenforceable. This concern about potential investor abuse of housing tax credits was based on experience with pre-1986 affordable housing tax incentives that supported an aggressive tax shelter market dominated by individual investors. The statute provides taxpayers with an alternative in the form of recapture surety bonds. The purpose of such a bond is to guarantee to the IRS that it can collect the appropriate recapture amount in the event that a property falls out of compliance without having to locate and assess the appropriate taxpayer(s).

### The Problem

The recapture bond requirement imposes significant unnecessary costs on investors and, according to the IRS, is "administratively difficult" to support. Today, only three surety companies write this type of business and the market for housing credit recapture bonds is very inefficient. Compounding this, in the aftermath of the September 11th terrorist attacks and corporate accounting scandals, the surety market has been in turmoil. Recapture bond premiums, even for highly rated public companies, have increased dramatically over the past two years. At the same time, the incidence of noncompliance with housing credit program rules is exceedingly rare. Indeed, the IRS reported in a September 25, 2003 letter to Reps. Amo Houghton (R-N.Y.) and Nancy Johnson (R-Conn.) that it has never made a claim against an LIHTC recapture surety bond. Yet, the IRS letter states that since 1987 recapture bonds with a nominal value of approximately \$1.8 billion have been posted. That level of bond coverage would require an estimated \$150 million in premium payments during the life of the average bond at current market pricing.

In November 2002, Ernst & Young formed a coalition to create an alternative for investors currently obligated to post surety bonds or Treasury securities in order to avoid housing tax credit recapture when their interest in a LIHTC project is transferred. The objective of the Recapture Bond Coalition is to create a more efficient and appropriate means of ensuring that housing credit properties remain in compliance with the requirements of Section 42 after such an interest is transferred. It is the coalition's position that the cost to insure against an event that has never

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occurred during the program's 16 year life fails to serve a valid public policy purpose. Meanwhile, the additional costs associated with changes in the surety bond market have aggravated the existing lack of liquidity in LIHTC investments, thus reducing equity market demand and undermining the overall efficiency of the program.

## Reasons for Change

The previously held concern that individual investors would abuse the housing credit program is clearly inapplicable to the current operation of the housing credit program. First, virtually all of the equity for housing credit investments comes from widely held corporations investing through housing credit funds that pose no risk of engaging in fraudulent sales to straw parties. Second, the LIHTC was amended in 1989 to require that "extended use agreements" be recorded as restrictive covenants on housing credit properties that require the property to remain in compliance with the targeting rules in addition to the requirement in the tax code. The 1989 changes also imposed new oversight responsibilities on state allocating agencies to ensure continued compliance through site inspections and audits of housing credit property. Finally, even if the original concerns about continuing compliance remained valid today, the recapture bond rule is a poor tool to address the concerns; it is exceedingly narrow in its reach, applying only to the very small minority of properties where there is a transfer of investment interests.

## Proposed Solution

Over the past year, Washington Council Ernst & Young, on behalf of the coalition, which is coordinated through that Ernst & Young legislative affairs group, Washington Council Ernst & Young, and is comprised of approximately 20 members representing major corporate investors, sponsors and other interested parties, has conducted numerous meetings with staff members of the congressional tax-writing committees and Treasury department officials to come up with a more appropriate and viable alternative, Congressional backing of a legislative "fix" to the recapture bond dilemma. In addition to the backing of its members, the Affordable Housing Investors Council recently announced is official support of the coalition's efforts.

Building on the IRS' recent letter, the solution being currently proposed would repeal the recapture bond requirement of IRC Section 46(j)(6) effective on the date of enactment. In place of the recapture bond, a new information reporting regime would be created, effective for LIHTC properties disposed of after the date of enactment. An owner of a building (or partnership interest therein) with remaining compliance period obligations would be required to submit a report to former investors when a recapture event for the building occurs. The IRS would devise a reporting form for this purpose. A copy of all recapture event forms sent to former investors would be required to be filed with the IRS in order to provide the Service with the information necessary to collect recapture liability.

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Under the proposal, the general statute of limitations applicable to taxpayers would be modified so that an investor who disposes of a building (or interest therein) after the effective date of the legislation would remain liable for any potential recapture liability arising from its previous ownership of such building for a period extending through the compliance period for such building. This would provide the IRS with additional time to audit the owner's return to ensure the building's continuing compliance with the credit's requirements. Taxpayers who disposed of a building (or interest therein) prior to the date of enactment would not be required to maintain existing recapture bonds (or any alternative forms of security provided in lieu thereof) if they consent to the extension of the statute of limitation provided for in the legislation.

### Legislative Action

The coalition already has garnered bipartisan sponsorship for the legislation in the House of Representatives from Reps. Houghton, Johnson, Charles Rangel (D-N.Y.) and Richard Neal (D-Mass.), and is currently working on solidifying support in the Senate. The coalition's goal is to have legislation proposed in the House in the coming weeks with a companion bill to follow shortly in the Senate. The bottom line is that this legislative change is expected to be beneficial to all parties - no revenue impact to the government, a reduction in the IRS's administrative burdens while giving it increased oversight capability, lower costs to investors and increased liquidity and capital for affordable housing properties.

For more information regarding the Recapture Bond Coalition, please contact Fred Copeman at (617) 570-8484 or Bobby Rozen at (202) 467-4318. ❖

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