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Despite Pending Expiration, Year 15 Properties Still Hold Potential

By Jane Bowar Zastrow, Editor, Novogradac & Company LLP

They came together to discuss the Year 15 conversion issue and found it to be one of the most timely and one of the most misunderstood matters confronting the low-income housing tax credit (LIHTC) industry today.

Of the 242,097 low-income units nationwide that were allocated tax credits between 1987 and 1989, an estimated 23,000 early stage units reached the end of the compliance period in 2002 and are no longer required to remain affordable. In California, the state's Tax Credit Allocation Committee (TCAC) estimates that about 15,000 units in the state have tax credits that expire between 2002 and 2006 and that of that number about 7,000 units will face some level of risk in the next five years.

It is that risk that concerns many in the affordable housing industry. However, many in the LIHTC field are saying that despite that fact that the initial LIHTC properties have fulfilled their 15-year compliance requirements, they don't see a race to convert these properties to market rate -- for a variety of reasons. The most common, according to one panelist at Novogradac & Company LLP's 10th Annual Affordable Housing Conference in September, can be laid at the feet of government. "Most deals are protected by other subsidies," said Jim Stretz, executive director of the New Mexico Mortgage Finance Authority, noting that as much as 90 percent of New Mexico's LIHTC projects are sheltered by such subsidies.

Many of the investors in the initial LIHTC properties did their transactions in an era when tax credit equity deals were 45 cents on the dollar and everyone thought it was a great deal, said Keeley Kirkendall, executive vice president of the affordable housing division of ARCS Commercial Mortgage. Fifteen years ago, he noted, deals had fewer restrictions, rates on debt were 9 percent to 10 percent, 9 percent deals were fixed and not on what would happen at the end of the 15-year compliance period. Now, many are considering their options.

Almost two decades later investors find a new world; many properties have several layers of complexity that include additional subsidies with longer term affordability requirements, a need for renovations, and have obtained incentives that preserve affordability through the allocation of new tax credits.

According to Kirkendall, today's conversion deals, if done at all, are all over the map. "Rents are way below market, real estate taxes are at risk, rates are at an all-time low, corporate profits are down, underwriting parameters are tighter and there is a huge conflict between the tax credit investor and the lender," he said. "Every deal is very, very different so roll-up your sleeves, read the documents and understand everyone's motivation, they are not the same as when the deal was done."

Conversion to a market rate project is less likely with a post-1989 transaction due to the 30-year extended use period and the right of first refusal, said Faith Bruins, a partner in the San Francisco office of Nixon Peabody. "If mar-

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ket rate conversion is possible, the conversion will depend on local market conditions and the physical condition of the project. Even if the developer elects the 14-year opt-out with the tax credit agency, the project is subject to a three-year transition period."

States are unique in that they are closer to the market than developers and investors assume, but they also have major issues plaguing them, says Stretz. "The issue we're faced with today is that we can't define the issue," he said. "States faced this issue and decided to study it more."

An area that concerns Stretz is how compliance can be supported because in states like California where the budget goes through the Legislature, compliance issues could be swept aside without so much as a backward glance. Then there are the public policy issues and questions as to whether states should create incentives or disincentives to keep properties affordable and whether or not states can continue to meet the ever increasing demand for more tax credits for expiring Year 15 properties.

"Re-syndication is dependent on the availability of tax credits and the application process can take a significant amount of time," said Bruins, noting that tax credit equity may be insufficient to rehabilitate a project if the project fails to qualify for the acquisition credit.

If inclined to withdraw, investors have several exit strategies at their beckon and call. Bruins listed several possible outcomes for projects approaching the expiration of their tax credit compliance period. She warns, however, that it will take some time for any deal to close.

- The project can remain affordable, with restructuring/withdrawal by the investor. In this common exit strategy, refinancing/debt restructuring lowers debt service and may provide funds to pay the withdrawing investor and/or fund capital improvements. Under this scenario, a developer maintains control of the project and continues to receive property management fees.
- The projects convert to market rate, a scenario that is less likely with a post-1989 transaction due to the 30-year extended-use period and the right of first refusal (IRC Section 42(i)(7). If market rate conversion is possible, the conversion will depend on local market conditions and the physical condition of the project. Even if the developer elects the 14-year opt-out with the tax credit agency, the project is subject to a three-year transition period.
- Project re-syndication that provides a new allocation of tax credits. The syndication of new tax credits will preserve affordability and may provide significant capital to pay withdrawing investors to rehabilitate the project. The downside is that re-syndication depends on the availability of tax credits and the application process, which can take a long time. Too, there may not be enough

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tax credit equity to rehabilitate the project if it fails to qualify for the acquisition credit.

- The project becomes available for affordable hone ownership, a path that is being taken by some tax credit agencies to encourage home ownership options for tax credit project.

While only a few of the early projects may have opted to convert to market-rate, the issue of conversion is and will continue to be on the minds of many investors, Stretz may have said it best when he observed, "There are lots of opportunities with Year 15 issues for problem solvers."

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