

Exit taxes strangle preservation efforts

By Stephen H. O'Connor

In today's world, exit taxes are the single largest obstacle to the preservation of affordable housing. This is true whether the housing was developed 30 years ago under the Department of Housing and Urban Development's (HUD) Sec. 8, Sec. 236 or Sec. 221(d)(3) program, or within the past 15 years as part of the low-income housing tax credit (LIHTC) program.

Regardless of the source of the subsidy, it is the accumulating burden of exit taxes that now threatens the nation's inventory of privately built affordable housing. Here's why.

Attracted by all of the tax benefits of real estate, investors in the older assisted HUD properties were also drawn by both the security and guarantee of the federal government. Income supplements from the Sec. 8 program or a below-market interest rate subsidy provided under the Sec. 236 or Sec. 221(d)(3) program secured a revenue stream sufficient to ensure the feasibility of the project.

Depreciation, which was accelerated prior to the 1986 Tax Reform Act, along with mortgage interest deductions combined to offset this income. In fact, the real economic attraction of these investments was generated not by the cash flow of the project, which was usually restricted under each of the subsidy programs, but by the total tax-shielding benefits of the real estate. As a result, these investments typically generated excess tax benefits that were used to offset ordinary income as well. Those were the good old days.

Tax benefits gone, now what?

Today, the investment pendulum has swung full circle and most of these projects sit in a very precarious tax position. Now fully depreciated, many of these older projects have their debt service being applied almost entirely to principal paydowns because most of the interest expense was retired in the earliest years of the mortgage loan.

The combined result now produces a positive cash flow that has become taxable income to the investor, no longer shielded by the now-exhausted tax benefits. This problem is further complicated, however, by the distribution restrictions still imposed under the original subsidy program, which often results in insufficient cash distributions to pay the taxes that are now due. This is the classic "phantom income" situation that currently plagues most of the affordable housing inventory.

In addition to phantom income, many investors are now positioned with negative capital accounts, as years of realizing tax

benefits in excess of their original cash investments have produced another tax liability. Payable when the project or the investment is sold, the recapture taxes on these benefits can often exceed the potential sales proceeds.

Exacerbating this condition are the capital gains taxes that must be paid on any value received above that which satisfies the negative capital account. In total, the liabilities imposed by phantom income, negative capital accounts, and capital gains taxes all combine to motivate the investor to dispose of these assets.

The pressure to relieve the burden of exit taxes runs concurrent to the expiration of original subsidies. No longer bound by the restrictions of affordable rents, many projects now contemplate prepaying the original mortgages in order to "opt out" of the income limits imposed by the various affordable housing programs.

While most of these projects were originally situated in marginal neighborhoods, this is no longer the case for some of them. Particularly within our major metropolitan areas, market rents can completely transform the economics of these properties. With cap rates at historical lows, it is the conversion from affordable to market-rate housing that generates the windfall sufficient to satisfy any exit tax obligation; often with plenty of cash to spare. From a tax perspective, this might prove advantageous to the investor, but it also serves to devastate the lives of the residents who will be displaced.

The newest challenge

Adding to the preservation challenge is the expiration of the affordability restrictions on 1.2 million units of housing created as a result of the LIHTC program. Referred to within the industry as Year 15, this designation coincides with the program's original 15-year compliance period.

Because the first of these projects was placed into service in 1986, the focus of national attention has now shifted to the thousands of LIHTC units vulnerable each year through loss or conversion. Although completely anticipated, no consensus has yet emerged, despite preservation strategies implemented by more than 40 states. In many if not all cases, the resources currently being dedicated are meant to achieve one overarching goal: paying exit taxes.

While the mechanics of the tax credit transaction are unique, the end result is still the same. Sold to investors at a discount to reflect the present value of future benefits, the proceeds

raised are used to provide the initial equity necessary to produce the desired housing. It is, however, in combination with the total losses generated by a project that the credits are used to offset taxes on other corporate or personal income.

Comprised almost entirely of depreciation and mortgage interest deductions, these losses often exceed the amount of original invested capital. The end result produces a negative capital account that in turn produces a tax liability. Once the majority of the tax benefits are exhausted and the end of the initial 15-year compliance period is reached, the investors seek to “exit” the project.

While exit options vary according to when a LIHTC project was placed into service, the liability remains unchanged. In the earliest years of the program, when the price of the credits was low, the exit tax obligation would sometimes fall entirely to the investors. More often, however, the exit price of the project was established at the onset of the venture, incorporating the inevitable exit tax liability into the equation.

For some predetermined value, typically \$1 over the debt plus the exit taxes, the investors were willing to sell the project back to the original developer. Unfortunately, this formula has often yielded a price too high for the developer because most tax credit projects are barely capable of generating the revenue necessary to service their existing debt. As a result of the cost burden imposed by exit taxes, many of these projects are forced to seek additional capital.

Buying time

The most popular solution today is one that simply postpones the inevitable, as many projects return to their state allocating agencies for more tax credits. Using tax credits to pay exit taxes seems like a poor use of the resource because it simply pushes the exit tax problem out for another 15 years. Dedicating scarce resources to pay exit taxes also diminishes the opportunity to undertake necessary repairs, as the capital needs of 15-year-old projects are often substantial. A long-term solution has to be one that finds a way to convert these properties economically into performing real estate investments. Otherwise, capital sources will seek an alternative and better class of performing assets.

Solutions

In response to the exit tax dilemma, the Affordable Housing Preservation Tax Relief Act was introduced in Congress in November 2003. The purpose of this bill is to provide tax relief to investors if they decide to sell their assets to new owners who promise to keep these properties affordable. Although the bill did not progress in this session of Congress, advocates will reintroduce it in the next session. In the meantime, properties continue to be lost to the affordable housing inventory.

A Sec. 1031 exchange represents one possibility for affordable housing preservation. Here, an investor can defer taxes if real estate is exchanged for like-kind property, with a “qualified inter-

mediary” ensuring compliance with Internal Revenue Service (IRS) rules and regulations. The investor (exchanger) cannot receive cash or other benefits without triggering capital gains taxes. As a result, finding suitable exchanges where an investor can both leverage equity and defer taxes is challenging and time-consuming.

Achieving both tax deferral and income is possible, however, through a sale to The Community Development Trust (CDT). As the only real estate investment trust (REIT) in the country dedicated to the preservation of affordable housing, CDT accomplishes its mission by offering to purchase expiring-use properties from owners/investors for either cash, which is a taxable event, or for an equivalent value in the REIT in the form of operating partnership (OP) units, which is a nontaxable event.

When an investor elects to take OP units, they are in essence exchanging their interest in one partnership for another, a transaction that is not treated as a sale by the IRS. It is only when the investor sells the OP units that the deferred tax becomes due and payable, but the timing of that decision is managed entirely by the investor. In addition, CDT is able to structure a transaction with a combination of cash and OP units to meet the specific needs of individual investors.

Given that many original investors in affordable housing are now older, the prospect of tax deferral is appealing, especially as it relates to estate planning. By converting their interests into OP units, this investment can be dedicated to the individual's estate.

Once activated, the entire estate steps up in basis to market value and the capital gains tax is eliminated. In the interim, the OP units can appreciate while paying income through distributions. It is this combination of potential capital appreciation, income and tax deferral that makes the transition from a single nonperforming real estate asset to the diversified holdings of a successful REIT one of the most innovative and compelling exit tax strategies.

Conclusion

To date, many preservation efforts have had to compete with an owner's option of converting affordable properties to market-rate housing. As a result, those who have succeeded have often been forced to overpay, using the variety of remaining and scarce federal, state and local resources to accomplish their mission.

The short time available to put together financing to complete these transactions often precludes making competitive offers, with those that have succeeded often needing to over-leverage their investments. While any preservation is good preservation, as an industry we need better, more innovative ways to compete. Otherwise, we stand to lose a very critical national resource. ■

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