

The Unique Issues Impacting Tax Credit Property Workouts



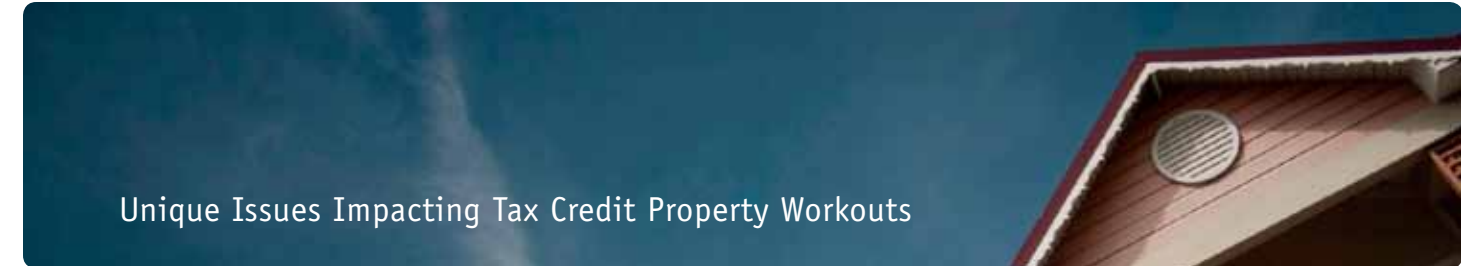
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Unique Issues Impacting Tax Credit Property Workouts

In order to incentivize the development and renovation of affordable housing properties, the government has provided tax benefits to developers and their investors. Tax credit property owner/operators have unique rules governing their actions, and are subject to unique requirements from the various regulatory authorities involved with their respective properties. These rules and regulations must be dealt with adeptly in a workout scenario.

The federal government and housing constituencies discovered decades ago that the private sector was much more adept than the public sector at providing affordable housing to individuals, families and seniors. In order to incentivize the development and renovation of affordable housing properties, over the years, the government has provided tax benefits to developers and their investors.

Since 1986, these tax benefits have come principally from federal tax credits provided pursuant to Section 42 of the tax code. These tax credits provide developers with an economic benefit that has been successfully utilized to attract equity capital to these affordable properties. This equity provides the funds needed to supplement loans and grants, such that debt service can be maintained at a level that allows for affordable rents, as well as provides for a profit component to the developer.

In addition, subsidies are often made available to developers through a variety of sources and in a variety of forms. Taken together, the tax credits and various subsidies have provided the means for the private sector to be successful in fulfilling a necessary public purpose in the provision of affordable housing properties. Nonetheless, it is not uncommon to see that a combination of an overly aggressive financing strategy coupled with an unrealistically low expectation of operating expenses can cause affordable housing properties and their owner/operators to struggle, just as with market-rate properties.

When this occurs, the problems facing the owner/operator can quickly become compounded and impair its ability to see its way through to a successful resolution of its financial

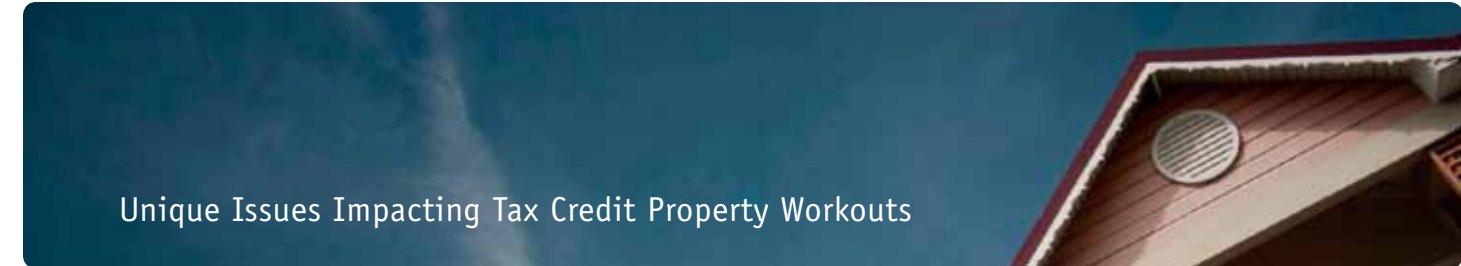
issues due to the restrictions and penalties that come with affordable housing tax credits.

The Fundamentals of Tax Credit Properties

Tax credit properties operate pursuant to Section 42 of the Internal Revenue Service Code. In order to operate as a tax credit property, a developer needs to apply for and receive an allocation of tax credits from the agency within its state responsible for such allocations. Once received, these allocations provide tax credits over a ten-year period in a set amount to the developer, so long as the property is operated in compliance with the provisions of the tax credit program.

These provisions require, in part, that the properties rent their units to qualifying tenants at qualifying rental rates throughout a 15 year period. If units are not appropriately rented, then the developer stands to not receive the tax credits attributable to such units during that year. Additionally, and critically, such failure to qualify units or to have the property fall out of compliance with the provisions of the tax credit program can cause the developer to have to recapture a portion of tax credit already received, along with an interest penalty. This recapture—or repayment of tax credits—can be severe in amount.

In practice, upon receiving an allocation of tax credits, developers are in the position to bring in equity capital through a ready market of investor funds—typically provided directly from corporations or “tax credit funds,” which have been established as vehicles through which corporate investors can pool their funds to invest in multiple properties. The developer will have structured the property ownership interest as a limited partnership in which it, or an affiliated



Unique Issues Impacting Tax Credit Property Workouts

entity, is the general partner owning 1 percent (or less) of the economic and tax benefits associated with the property, with the investors owning the residual 99 percent (or more) share of these benefits.

Therefore, over the 10 year tax credit delivery period, the investors are receiving 99 percent of the tax credits delivered by the property. As part of the transaction to sell the investors the 99 percent interest, and, hence, the tax credits, the developer typically guarantees the investor that the tax credits will be delivered and that any tax recapture will be reimbursed by the developer.

Tax Credit Property Restrictions

In order to receive tax credits, as mentioned above, the developer must rent the property to qualifying tenants at qualifying rental rates throughout a 15 year period. However, these may not be the only restrictions that are imposed on the developer and property.

The tax credit application process in a given state often requires that the developer agree to additional restrictions above and beyond the 15 year restrictions imposed by the Tax Code. In addition, in order to receive subsidies through various federal or local agencies, developers are often required to abide by further restrictions. For example, deed restrictions can be brought into play with such deed restrictions not allowing the conversion of the “affordable property” to a market rate property or restricting to whom the property can be sold to at the point of disposition.

If the property’s ownership entity has been qualified as a non-profit enterprise and is receiving an exemption from the local municipality from the payment of ad valorem taxes, then the property is faced with a self-imposed constraint. Often, such tax exemption is critical in the profitable operation of the property. Therefore, a loss of the tax exemption can be devastating to the economics of the property. Any sale of the property must take this into account. Subsidy programs, whether through the Department of Housing and Urban Development (HUD) or through other entities or enter-

prises, often come with extensive regulatory compliance obligations. These obligations come at an expense and in many forms. Developers with properties that participate in such programs often require personnel to ensure that compliance is taking place and to provide the requisite reporting expertise needed.

When Trouble Arises

Typically, multifamily developments are financed within special purpose entities which have some form of nonrecourse debt associated with the property purchase or development. This is normally the case with tax credit partnerships. However, the tax credit delivery and tax credit recapture guaranties are not non-recourse. Further, the absolute dollar amount of these guaranties can be quite large and it can be questionable as to the guarantor’s ability to make good on its guaranty.

In such cases, the limited partners “take it on the chin,” as they must come out of pocket to reimburse the tax credit recapture (or at the very least have the recapture amount offset against tax credits being received by them from their other tax credit investments). As limited partners invest under the reasonable expectation that they have, by definition, “limited liability,” this requirement to repay recapture amounts can be unexpected and dramatic.

Simply selling the property is problematic. A sale of the property can trigger a full recapture of tax credits, unless the purchaser is willing to indemnify the seller for this exposure. Further, the regulatory agencies, including the tax credit allocation authority, referenced above, will often have restrictions on a sale of the property, making such a disposition significantly more of a problem than with a market rate property. If the owner/operator is a 501(c)(3) entity, the disposition can be even more difficult.

Suffice it to say, when trouble arises with a tax credit property, the tax implications and regulatory restrictions cause the workout to be significantly more involved than that encountered with a market-rate property.

Recent Example: ABC Housing Company

The Chapter 11 Bankruptcy of a Tax Credit Property Owner



The recent case of ABC Housing Co.¹ provides an example of what can go wrong in the case of tax credit properties. ABC Housing Co. was a not-for-profit apartment owner/operator, which amassed interests in a large number of apartment complexes. These properties included properties acquired through the issuance of tax exempt bonds, properties purchased utilizing conventional financing, and properties that had received allocations of low income tax credits under Section 42 of the tax code and had been syndicated with outside investors.

Troubles Facing ABC Housing Company

Due in large part to over-leverage and overly optimistic projections of expenses, serious cash flow problems developed, which eventually resulted in the Company being forced into bankruptcy. The Company struggled in bankruptcy. As in many cases, issues arose between the competing interests and motivations of creditors and management. It struggled with a complicated web of company owned interests in more than 100 special purpose entities (SPEs) that had been established to facilitate the company's ownership of apartment properties and for use as investment vehicles.

It also struggled as senior management departed the company. Further, its apartment properties struggled. Generally speaking, debt financing was non-recourse and was on properties owned within the non-debtor special purpose entities. However, in an effort to keep the "kingdom" afloat in the years leading up to the bankruptcy, cash resources at the ABC Housing Co. were depleted and properties at the SPE levels were, in many case, deprived of needed capital expenditures.

Actions of the Appointed Chapter 11 Trustee


After a lengthy period of time, a Chapter 11 trustee was appointed who brought in experienced bankruptcy counsel and a seasoned financial advisor. In the division of duties, the financial advisor was charged with determining which properties offered value to the estate and then determining how to best realize this value.

For the most part, the analysis and resulting recommendations were straight-forward and consistent with those found in traditional multi-family operations. Non-recourse debt at the special purpose entity (owner) level limited the exposure of the debtor entity. However, the issues involving the syndicated tax credit properties were complicated. Each of the tax credit properties were owned by a limited partnership.² Tax credit funds had acquired the 99 percent limited partnership interest in each case, with ABC Housing Co.—or an ABC Housing Co.—owned LLC, owning the 1 percent general partner interest.

Each of the partnerships had separate partners and a separate partnership agreement dictating the rights and obligations of each party. Additionally, partnership agreements were unique in form, but generally speaking, provided for certain guaran-

¹ The actual name of the not-for-profit housing development has been changed due to privacy issues.

² In some of the partnerships, the limited partners owned in excess of 99 percent and the general partner less than 1 percent.



Recent Example (Cont'd)

ties by the general partners which included, among other provisions, a guaranty to reimburse the tax credit partners for any tax credit recapture incurred.

Further, in most cases, there were separate guarantees executed by the Company wherein it guaranteed the obligations of the general partner. Thus, although ABC Housing Co. was not, in most cases, a general partner, through separate guarantees it assumed the guaranty obligation of the general partner for tax credit recapture.

The limited partners asserted extensive claims in the bankruptcy. A large portion of these were contingent claims emanating from the various guaranties by ABC Housing Co., including those related to the reimbursement of limited partners for tax credit recapture. These claims, if allowed in full, would have significantly diluted the distributions available to other creditors.

The claims were complicated and difficult for the parties that were not experienced with the IRS provisions relating to these low income housing tax credits. The key point was that the bulk of the tax credit investors' claims were contingent-recapture had not yet occurred. The justifiable concern was that the debtor, in realizing that there was little or no value available in its equity interest in the various partnerships, would choose to essentially hand over the keys to limited partners or lenders. This in turn could result in large recapture liabilities to limited partners.

The Resolution

The ultimate resolution with respect to the tax credit properties was a negotiated settlement wherein the limited partners agreed to substantially limit their claims in return for the debtor agreeing to maintain its general partner interest in the respective partnership for a limited period of time in order to provide for an orderly transfer of its partnership interest in a way that minimized the likelihood or impact

of a recapture event. Further, during this period of time the debtor agreed to use its best efforts to cause the general partners to continue to fulfill the regulatory obligations of the respective partnerships.

This resolution provided for a mitigation of the allowed claims in the bankruptcy which was in the best interest of the limited partner-creditors as the distributions on their claims would have been substantially less than the actual damages that they would have incurred from the recapture event. Further, the settlement avoided dilution in the distribution to the other unsecured creditors in the case. The resolution was a somewhat counter-intuitive as it did not provide for an increase in equity for distribution to creditors. Rather, it provided for a decrease in the total claims and an increase in the distribution to remaining creditors.

To be clear, there were and continue to be numerous other issues involved in this bankruptcy. Notwithstanding, an understanding of the tax implications of the plan being imposed and of the regulatory obligations relating to the properties involved in the estate was critical in advancing the plan.

Summary

Tax credit property owner/operators have unique rules governing their actions, and are subject to unique requirements from the various regulatory authorities involved with their respective properties. These rules and regulations must be dealt with adeptly in a workout scenario.

A successful workout of a tax credit property owner/operator, therefore, requires multiple layers of expertise. Guidance should be sought from experts with specific experience in the tax credit property arena. Such a team includes a financial advisor, a real estate broker, and legal counsel—with the financial advisor and real estate professionals having specific expertise in dealing with tax credit properties.

In other industries or subgroups within real estate, using just one of those experts may be sufficient. In this tax credit real estate niche, the experienced team will be critical to unraveling all of the unique aspects of each project's financing, ownership, deed restrictions, ownership restrictions, and countless other variations.

About the Author

Alan L. Weiner, Managing Director with Focus Management Group, brings over 25 years of experience in operations, finance and real estate. Prior to joining Focus, Alan was co-Chief Executive Officer for the country's largest franchisor of independently owned and operated building companies. Previous to this, Alan spent 15 years as an Investment Banker at Raymond James & Associates, where he was a Managing Director providing public and private capital to Real Estate and Consumer focused companies, as well as providing merger and acquisition advisory services.

Alan holds an MBA with a concentration in Finance from the Wharton School at the University of Pennsylvania and received his BS with High Honors in Computer and Information Sciences from the University of Florida.



Contact Information

Focus Management Group is a leading business restructuring firm headquartered in Tampa, with offices in Atlanta, Chicago, Cleveland, Dallas, Los Angeles and Philadelphia. For more information on our experience in tax credit property workouts, contact one of our experienced Managing Directors listed below:

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